# PLATINUM JAPAN FUND

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Portfolio Manager

## PERFORMANCE

Performance continued to be lacklustre in a difficult market environment with the Platinum Japan Fund down by 0.4% in A$ terms over the quarter compared to a rise in the MSCI Japan Index of 1%. Over the past year the Fund is also lagging the Index, falling by 9.9% compared to a 9.1% fall in the Index. Essentially, we have positioned ourselves for a broad recovery in the domestic economy which has not eventuated. As a consequence, the yen has been weak and exporters have prospered. Meanwhile, our financials position has dragged on performance whilst defensive yield plays have soared. Investors should note the continuing high level of influence of the currency markets on returns which we remarked on last quarter. This quarter's extreme volatility in both the Australian dollar/yen cross rate and the Nikkei index have produced a fairly flat Australian dollar unit price for the Fund, which has masked the reality of a very turbulent underlying stock market performance!

## CHANGES TO THE PORTFOLIO

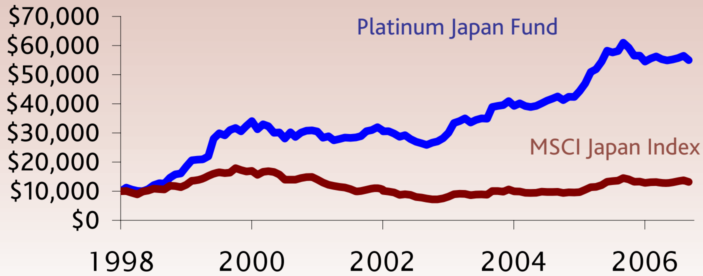
The most significant change to the portfolio this quarter was the reduction in our Korean equity weighting. In our view, Japanese stocks represent significantly better value than Korean equities at this point in their respective economic cycles. Obviously, the weakness of the yen versus the won is a major benefit for Japanese manufactures. More importantly, Japan is much earlier in the domestic asset reflation cycle, with potential for the virtuous cycle of a stronger property market to flow through the economy. This contrasts with Korea where the property cycle seems under increasing threat from determined government and central bank efforts to slow it down.

**DISPOSITION OF ASSETS**

| REGION | MAR 2007 | DEC 2006 |
| --- | --- | --- |
| **JAPAN** | **87%** | **70%** |
| **KOREA** | **6%** | **17%** |
| **CASH** | **7%** | **13%** |
| **NET SHORTS** | **0%** | **8%** |

Source: Platinum

**VALUE OF $10,000 INVESTED SINCE INCEPTION**
1 JULY 1998 TO 31 MARCH 2007




Source: Platinum and MSCI. Refer to Note 2, page 5.

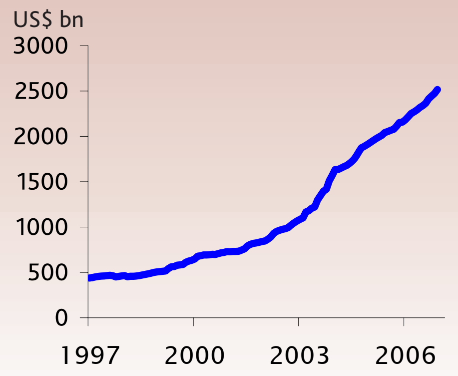
Purchases of Japanese stocks with the funds released from Korea were biased toward property related areas and included Nomura Real Estate and Kajima, as well as related beneficiaries such as Sumitomo Mitsui Bank and Tokyo Gas. We also added to our Sony position and initiated new positions in Rohm and Marubeni. Sony appears to have gained some traction across its business lines and the games business appears far from the disaster that the market had been predicting. The interesting point to note is that notwithstanding the slow take-up of PS3, Sony's overall sales of hardware and software (including PS2 and PSP) have held up surprisingly well despite the success of Nintendo! This is a testimony to the Sony brand and bodes well for PS3 sales when retail sales prices come down later this year and the Nintendo novelty factor wears off.

## COMMENTARY

### "The yen 'carry trade' – missing the point?"

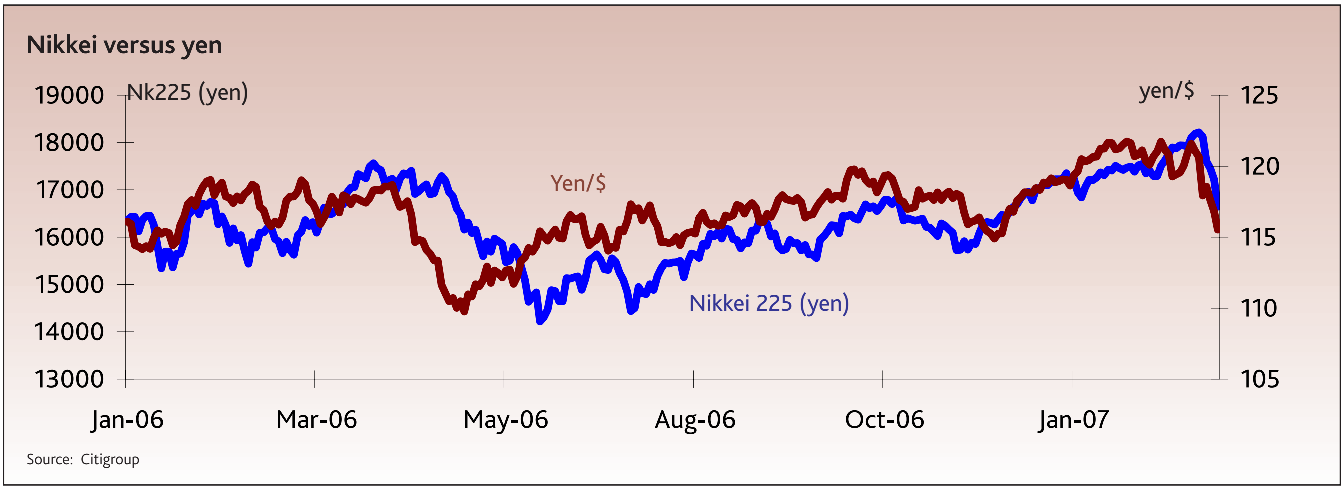
Let's put the yen "carry trade" into some perspective. The "carry trade" is most commonly associated with hedge fund activity with the idea being that large sums of money have been borrowed in yen and used to purchase assets overseas. The overall size of the trade is highly opaque and whilst very few own up to having done so, it is likely to be true that large sums of money have been borrowed and invested in this way. Life is given to the trade by the reality of the huge differentials in interest rates between Japan and other major countries **AND the presumption that the yen will not rise**! This last point is important as it suggests that the yen "carry trade" is merely a symptom of a much bigger problem which is the accumulation of the US dollar by Asian central banks. What must be realised is that the Asian central banks are effectively the single biggest owners of the "carry trade" in the form of their huge foreign reserves. Soaring global equity markets in recent times have disguised the reality that the world has massive imbalances which need to be dealt with. The real question is how and when Asian countries move away from their mercantilist policies and abandon the US dollar peg, and what are the flow-through effects to global growth? A subsidiary question is the vulnerability of places where the "carry trade" assets have been hiding, be it US mortgages or emerging market equities?

**Foreign Exchange Reserves of Major Asian Central Banks (China, Japan, Korea, Taiwan)**




Source: Factset Research Systems

The recent sell-off in global markets gives us some hint of where the funds have been going as it was sparked by concerns over speculation levels in emerging markets such as China. The movement was clearly exacerbated by the reality of the massive global imbalances and the fears in the market place about its unwinding. Hence the sharp movement in the yen being so closely correlated with global market moves suggesting it is the source of a large part of the liquidity driving markets. Perhaps, the most disappointing feature of the moves was that the Japanese market provided no insulation with the Nikkei falling more sharply than most markets. This would seem to reflect a fear of a double whammy; the tightening impact of higher rates (the Bank of Japan recently raised interest rates) and higher currency. Indeed, over the past year, the Nikkei has moved more or less in line with the yen which would indicate to us a total lack of interest in the market which is increasingly seen as dominated by these macro forces.

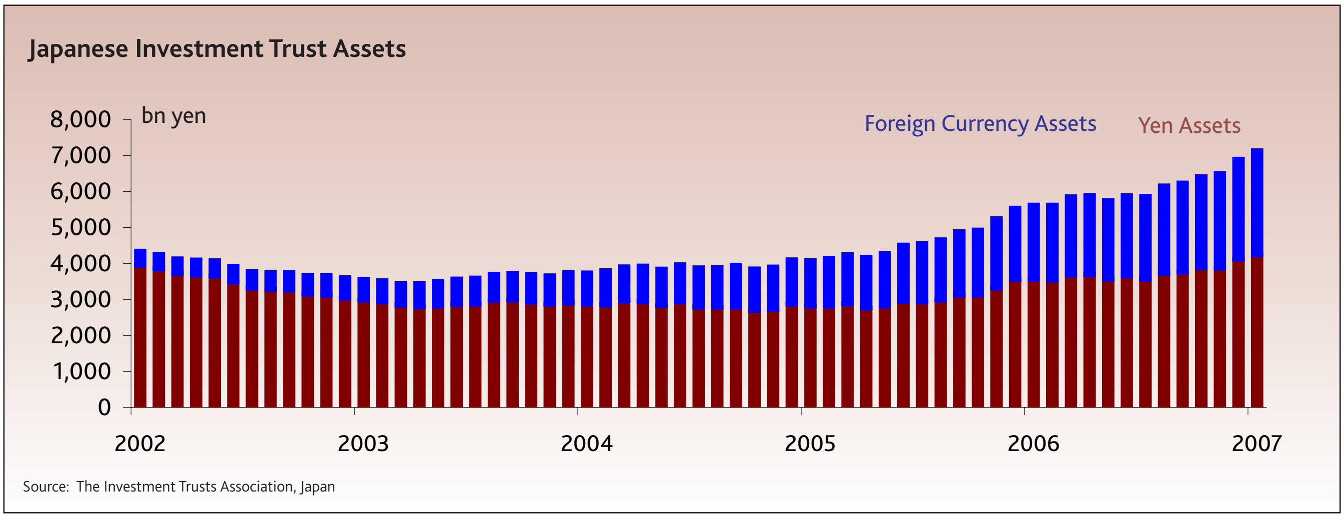



## Where does this discussion lead us?

The issue is not one of just a simple discussion of which hedge funds will be caught short in a move up in the yen, but rather recognising that the imbalances in the global economy have been inexorably building and that this is likely to be destabilising to economic activity at some point. Whilst there has not been intervention by the Ministry of Finance (MOF) recently, its holdings of US dollars continue to accumulate interest. In the meantime, the domestic investor base has taken to the hunt for yield overseas with alacrity underwritten by the MOF position and the belief in a weak currency. What happens if this belief reverses? The current rumblings in markets may be a sign of what is possible if this happens. The missing link in such a reversal is no doubt a stronger domestic story in Japan, driven by consumer spending and leading to rising inflation. Sadly, the recent data gives no cause for optimism on this score, with inflation once again falling back. Indeed, the nightmare for Japan may be both a deflation scare and a strong currency which is likely to shake confidence. For now, it is possible if the yen follows the pattern of 2006 for it to go to about 112 or 110 to the US dollar, at which point, the question of whether Japan would buy more US dollars would arise. Clearly the strength of the economy at that time will be crucial which makes the trend in inflation all the more interesting. It is hard to believe that Japan and Asian countries generally will quickly drop their mercantilist policies in which case the yen may sell-off again as it did in 2006. With the Chinese battling surging inflows and US sub-prime problems suggesting US appetite for more debt is unlikely, surely the day is closer when the Asian currencies are forced higher.

## A narrow stock market

With so little to excite the stock market recently, it is important to note the continued narrowing of the market's rise around dividend yield plays. To us this is merely an extension of the search for yield that has been going on in foreign currency bonds and the local property market, and which is now making its way into the local equity market at the edges. Flows into dividend yield funds in Japan have been good and yields on listed Real Estate Investment Trusts (REITs) have been pushed down remarkably to the 2% level! This has then spilled over into traditional yield plays such as power companies and even the low PE steel stocks which in some cases have risen by 80% in three months! The bullish hope would be that yields on the so-called yield stocks now merely equate with that of ordinary industrial companies which have much greater scope to increase payout ratios. If these companies decided to be more proactive after witnessing the upward movement in other stocks based on yield, we could get a broadening of the market. This would complete the missing link in the Japanese equity




market which has been the lack of recycling of corporate cash flows through to the investor base and the economy.

As for the Japanese property market, we appear to have seen the peak in the price appreciation of central locations with a gradual spreading to regional locations likely. However, it would appear to us that there is considerable scope for a large rise in transaction volumes of everything from housing (including second hand) to old office buildings and industrial plants as investors from as far afield as Australia arrive in droves. In this liquidity driven environment, the beneficiaries should be the remaining large owners of latent landholdings who can sell into the general enthusiasm. We would generally not be buying REITs although apartment REITs strike us as being interesting. Holders of land include railway, utility and warehouse companies. It is also likely that Japanese property remains a safe haven if deflation rears its head again and a stronger currency shouldn't diminish the story either.

## OUTLOOK

We remain positive on the companies we own in Japan, but concede that the risk of macro disruption and liquidity withdrawal have risen, which could undo the good potential we see in them. The re-emergence of the deflation word in Japan is also likely to do the rounds, adding to the pressures on both the authorities and market participants. We think the yen remains mildly undervalued at these levels and remain weighted toward domestic positions with an emphasis on property related and financial sectors, with smaller positions in retail and industrial plays. Clear under weights are technology, telecom and commodity related plays. For now, the market remains hostage to the movements of the yen and perhaps it is likely to remain so until the imbalances are addressed.

# NOTES

1. The investment returns are calculated using the Fund's unit price and represent the combined income and capital return for the specific period. They are net of fees and costs (excluding the buy-sell spread and any investment performance fee payable), are pre-tax and assume the reinvestment of distributions. The investment returns shown are historical and no warranty can be given for future performance. You should be aware that past performance is not a reliable indicator of future performance. Due to the volatility of underlying assets of the Funds and other risk factors associated with investing, investment returns can be negative (particularly in the short-term).

2. The investment returns depicted in the graphs are cumulative on A$10,000 invested in the relevant Fund since inception relative to their Index (in A$) as per below:

Platinum International Fund:
Inception 1 May 1995, MSCI All Country World Net Index

Platinum Unhedged Fund:
Inception 31 January 2005, MSCI All Country World Net Index

Platinum Asia Fund:
Inception 3 March 2003, MSCI All Country Asia ex Japan Net Index

Platinum European Fund:
Inception 1 July 1998, MSCI All Country Europe Net Index

Platinum Japan Fund:
Inception 1 July 1998, MSCI Japan Net Index

Platinum International Brands Fund:
Inception 18 May 2000, MSCI All Country World Net Index

Platinum International Health Care Fund:
Inception 10 November 2003, MSCI All Country World Health Care Net Index

Platinum International Technology Fund:
Inception 18 May 2000, MSCI All Country World Information Technology Index

(nb. the gross MSCI Index was used prior to 31 December 1998 as the net MSCI Index did not exist).

The investment returns are calculated using the Fund's unit price. They are net of fees and costs (excluding the buy-sell spread and any investment performance fee payable), pre-tax and assume the reinvestment of distributions. It should be noted that Platinum does not invest by reference to the weightings of the Index. Underlying assets are chosen through Platinum's individual stock selection process and as a result holdings will vary considerably to the make-up of the Index. The Index is provided as a reference only.

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Before making any investment decision you need to consider (with your financial adviser) your particular investment needs, objectives and financial circumstances. You should consider the PDS in deciding whether to acquire, or continue to hold, units in the Funds.

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