Platinum Japan Fund

Scott Gilchrist Portfolio Manager

Quarterly Haiku

Pension fund whales flail.

Abe conducts, bonds crack, stocks rise.

FANUC's robots dance.

Disposition of Assets

REGION	MAR 2015	DEC 2014
Japan	88%	81%
Korea	6%	8%
Cash	6%	11%
Shorts	0%	3%

The Fund has a 5% short position in Japanese Government Bonds.

Source: Platinum. Refer to Note 3, page 6.

Portfolio Position

Sector Breakdown

SECTOR	MAR 2015
JAPANESE INTERNATIONAL FOCUS	44%
Electronics (Canon, Panasonic)	25%
Autos (Toyota, Sumitomo Electric)	12%
Industrials (Tokyo Steel, Mitsubishi Heavy Industries)	5%
Resources (Sumitomo Metal Mining)	2%
JAPANESE DOMESTIC FOCUS	44%
Internet (DeNA, NTT, Recruit)	15%
Consumer (Pola Orbis, Asahi)	9%
Health Care (Mitsubishi Tanabe, Daichii Sankyo)	9%
Financials (Mitsubishi UFJ)	9%
Property	2%
KOREA	6%
Electronics (Samsung Electronics)	3%
Financials (KB Financial)	2%
Domestic	1%
GROSS LONG	94%

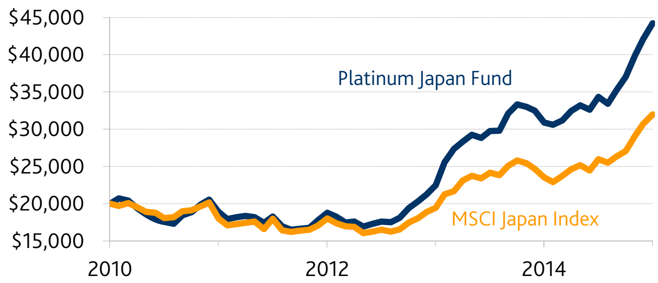
Currency Position

US dollar	46%
Japanese yen	46%
Korean won	6%
Australian dollar	2%

Source: Platinum

Value of $20,000 Invested Over Five Years

31 March 2010 to 31 March 2015



Source: Platinum and MSCI. Refer to Note 2, page 6.

Some of the key themes in the portfolio, in addition to the individual stock ideas around which the portfolio is built:

- Globally competitive exporters – **Toyota**, **Canon**.
- Electronics and components – **Samsung**, **Ibiden**.
- Corporate revitalisation – **Panasonic**, **Mitsubishi Tanabe**, **Mitsubishi Keiretsu**.
- Internet – **NTT**, **DeNA**, **Recruit**.
- Alternative energy – **Rohm**, **Sumitomo Electric**, **Denso**, **Hitachi Chemical**.
- Cheap, neglected cyclical stocks – **Sumitomo Metal Mining**, **Asahi Glass**.
- Domestic consumption – **Pola Orbis**, **Asahi**.

Performance

(compound pa, to 31 March 2015)

	QUARTER	1YR	3YRS	5YRS	SINCE INCEPTION
Platinum Japan Fund	19%	43%	33%	17%	16%
MSCI Japan Index	18%	36%	21%	10%	2%

Source: Platinum and MSCI. Refer to Note 1, page 6.

Portfolio performance for the quarter was positive (+19.5%), assisted by some of the larger positions (**Canon**, **Pola Orbis**, **Asahi Glass**, **Mitsubishi Tanabe**, **Daiichi Sankyo**, **NTT**, **Mitsubishi UFJ Financial Group** and **Toyota Industries**). The Fund's eclectic Internet holdings (**Next**, **En-Japan** and **Recruit**) also contributed to performance. Corporate actions at **DeNA** (+67%, new Nintendo relationship) and **Yamada Denki** (+24%, activist shareholder) were positive. The Fund reduced its small exposure to energy, raw materials and cyclical industries. Some Japanese exporters and heavy industry holdings detracted from performance while the Korean holdings were positive for the Fund. The temporal underweight in Japanese equities was the main headwind to relative performance. The Yen and Won both strengthened against the Australian dollar during the quarter, which significantly benefitted AUD-denominated returns. The Yen was flat against the US dollar for the quarter.

Changes to the Portfolio

It was a busy quarter for the Fund, with many changes to both overall portfolio structure and position sizing. Over the last four months:

- the shorts were closed,
- seven equities were removed from the portfolio,
- nine new equities were purchased, and
- the position size of eight core holdings was adjusted.

The summation of these stock level decisions is a refreshed portfolio consistent with the Fund's long-term historical structure and intellectual framework which has proven successful for the last sixteen years. Since new management took over recently, half of the Fund's top ten positions have changed, which is also reflected in the overall portfolio.

Following the removal of the Nikkei short position last quarter and the subsequent buyback of the Topix Real Estate short position, the net holdings of Japanese equities increased to 88%, a well-timed 12% increase. Cash holdings dropped accordingly after net new investments. Together with the Fund's Korean holdings, the portfolio reached what can be considered a fully invested position during the quarter.

The other change of note was the significant reduction in the Japanese Government Bond (JGB) short position. The key liquid "10 year JGB" futures contract is deliverable and market participants have generally found an optimal arbitrage with their seven year bond holdings. Consequently, the downside to the short position was limited as those instruments trade near or below zero yields. The yield on this bond tripled one day recently, from two basis points to six! For the moment, given the size of the Bank of Japan's (BOJ) ongoing purchases of JGBs, the Japanese bond market appears to be an artificial market with no imminent sign of real stress. Thus, the majority of the Fund's JGB short position was closed due to limited upside potential. Our lack of expertise in what is a highly analysed market contributed to this decision (refer to Commentary below for further discussion). It remains an asymmetric investment.

Commentary

The key events and stories of the quarter seem unrelated, but on deeper inspection, there is a common brush which connects them and which led to the key feature of the quarter: equity market outperformance. Listing some key news items:

- FANUC agreed to engage with the outside world.
- Nintendo will work with DeNA to bring Mario to mobile gaming.
- "Dependable" stocks such as consumer and pharmaceuticals rose to bubble level valuations.

- A range of smaller pension funds announced portfolio changes similar to the Government Pension Investment Fund (GPIF).
- Surging inbound tourists scoured rice cookers from shelves.
- Domestic wages rose for the first time in over a decade at many firms.
- The Japanese stock market hit 14 year highs.

Valuations

While valuations of the overall Japanese stock market remain within historical norms, there are parts of the market which are hard to comprehend from a value investor's framework. For example, Kikkoman, Yamazaki Baking, Ito En and Calbee have price to earnings ratios (P/E) approaching 50. Soy sauce, bread, tea and chips are generally good branded businesses, but these particular ones are expensive relative to both their history and global comparatives. The key reminder from a recent personal meeting with Robert Shiller, Nobel Laureate, was that bubbles exhibit psychological characteristics making timing almost impossible to assess. Such waffly language is difficult to fit into a spread sheet or a back-tested model, thus many modern mavens eschew such real world thinking. This snack food valuation distortion is also reflected in many other Japanese stocks in discrete parts of the market.

Two new market participants seem to be driving this multiple expansion: "smart beta" and pension funds. The GPIF and its many smaller brethren are rapidly shifting their portfolio allocations from bonds to equities and, in the process, are searching the equity markets for companies with duration. This isn't easy as only 2% of listed entities survive 30+ years on the Darwinian savannah. "Smart beta" is not a concept which we find easy to comprehend. It has its background in the same basic criteria that attract the pension funds, but with added emphasis on high dividend yield and low volatility. The underlying principle for both groups is that a P/E of 30, which is equivalent to an earnings yield of 3%, or a P/E of 50, which is an earnings yield of 2%, are far more attractive than a ten year bond yield of 0.4% or negative yields at shorter durations. Life is rarely as straightforward as implied by this analysis. One wide-ranging market strategist has been joking that the logical price for equities in this environment is infinity, perhaps reminiscent of Zimbabwean monetary hyperinflation. While the trajectory of this trend is unclear, the short-term effect is obvious.

The opposite of the above heats are the neglected sectors of resources, banks, trading houses, industrials and autos. In this group, single digit P/E multiples abound as the herd rightly eschews businesses with any, even tenuous, connection to China's property, infrastructure and equipment sectors. Negotiating the highwire described above is undoubtedly tricky, but also presents attractive rewards.

Some of the Fund's more recent acquisitions have been in the neglected areas of the market. Three smaller companies have been purchased which have cash and investments roughly equivalent to their market cap in addition to solid operating businesses. It appears that FANUC's decision to adjust their stance towards investors was made as part of a completed circle, including the highest levels of political power, domestic funds, external advisers and foreign investors. This increasing focus on return on equity (RoE) is seen throughout the market with share buybacks at high levels and overseas acquisitions continuing to be a focus. Japanese corporate margins are at record highs and the key detractor from overall returns is balance sheet structure. Outside the small delights described above, it is not uncommon to find large companies with outsized opportunities to become more financially efficient and it seems that this process is accelerating with broad acceptance of the new paradigm. Somewhat surprisingly, after many years of resistance, quite a lot of the shareholder activism prevalent in the West has recently found traction in Japan where Institutional Shareholder Services Inc. (ISS), a shareholder advisory group, is increasingly working to implement changes in corporate governance. Recent meetings with senior global strategists highlighted that Japanese monetary conditions are properly accommodative for the first time since the "bubble years of the late 1990s". If this fluid environment continues, then it would not be hard for Japanese equity markets to continue to perform strongly through the business cycle over the years ahead. In terms of market sentiment, a recent survey places Japan as one of the top three overweight Asian equity markets as well as a top three underweight market – lots of both love and hate. Current valuations do not reflect the focus on improving returns. Our broker community is certainly verbally bullish, but if you scratch the surface a bit, they are very reluctant to believe in the sustainability of the market. Japan remains an under-serviced market. As the bull market matures, it should be expected that the breadth will extend to more neglected parts of the market.

Monetary Policy

The monetary situation in Japan, as described through the lens of the JGB market, can likely be seen as a template for Western economies over the next decades. After two and a half decades post "the Bubble", the current sole primary outcome of the BOJ's recent balance sheet expansion has been cited as lower interest rates. They manufacture new digital money, buy JGBs at a high price from the secondary market, then give the cash to the vendor who then deposits it with the BOJ either directly or through intermediaries. The loan-to-deposit ratio across the system, excluding cash on deposit at the BOJ, is still below 80%. So there is more than enough balance sheet capacity for increased lending, absent a major reallocation of system assets which may finally be happening if recent investment fund flow data continues to surprise. For the first time in a few years, it appears as though Japanese loan growth is rising faster than deposit growth (5% versus 4%), so it seems almost impossible for interest rates to rise based solely on the supply and demand for cash in the system. Of course, it's not a completely fungible market across regions and products, so there might be a few areas of increased yields, but for the moment, yields keep drifting down. The increased loan books offset the falling net interest margin at many regional banks, leading to flat to slightly rising profits. The Fund holds positions in the mega banks which have limited profit exposure to domestic net interest margins and would benefit from higher rates.

As the BOJ continues to expand its balance sheet at a rapid rate, it has wide-ranging financial market effects. The key discussion in the bond market has been the coming lack of liquidity as the "easy-to-pry-loose" JGB supply becomes exhausted and the remaining pension fund, insurance and banking holdings cannot be sold to the BOJ for a range of regulatory, duration matching and asset liquidity reasons. It is not clear when this hard limit will be reached as various key commentators say that it should have already passed. This event has the potential to lead to further bond price rises as the BOJ has purchase volume requirements and is not price sensitive. It is possible that the market will see negative yields across the full curve if this occurs. In contrast to this extraordinary potential outcome, the current process appears seamless as the BOJ is merely acquiring assets from large entities who are reallocating assets from bonds to equities, similar to an off-market trade.

While the BOJ and other government entities appear to dominate the bond market, there are still many bond market participants who are driven by the aim of making a profit. This group of natural buyers seem unwilling to own JGBs at these historically low yields. Based on historical economic analogues, Japanese interest rates should be rising cyclically and the yield curve should be flattening in contrast to the current stagnation. There is a lot of debate about the yield which would entice natural buyers back. The current calm is dependent on policy and legislative continuity. If the intention of monetary policy is low - but rising - inflation, it would seem critical that interest rates be controlled.

One second order effect of the BOJ's activity has been to weaken the currency, thereby remaining deep in the peloton, and consequently assist a wide range of Japanese companies, including the autos and a myriad of exporters and inbound tourism companies. The share price of Zojirushi, a famous maker of rice cookers, has doubled in the last three months. Their appliance plays a song when the subsidised domestic rice is cooked to perfection, though it also seemingly plays a stirring rendition of Xi Jinping's wife, Peng Liyuan's, favourite songs, as the Chinese tourists to Japan are keen buyers.

The great puzzle is how the BOJ deals with its more than 100x geared balance sheet. Default or inflation? Does the Japanese government have zero debt or a lot? Perhaps there exists a solution where an agreement is made to write off the BOJ's and other government entities' holdings of JGBs and print cash for the private sector in return. It is currently beyond our capacity to unravel this situation to our satisfaction.

It is arguable that the overall financial system problem is a lack of Yen revenue relative to the substantial and growing asset base. The recent monetary strategy is clearly an attempt to incentivise activity through higher asset prices as there certainly isn't any shortage of cash in the system, whether it's households, corporates or banks. Despite more than two decades of deflation, there still aren't enough good domestic projects to utilise the available investment capacity. Japanese foreign manufacturing investment continues apace while domestic re-shoring is mainly in the newspapers. Meanwhile the domestic economy continues to move along at a slow, but steady, pace.

By contrast to the above discussion of low interest rates, a recent study of inflation by the Bank for International Settlements predicts that the natural CPI, given Japan's demographic and economic structure, is 2-3%. This would be a complete surprise to almost all market participants.

Asian Infrastructure Investment Bank

The Japanese have recently been bidding for long-term energy supplies that do not traverse the South China Sea or the Straits of Malacca. This is in reaction to announcements by China relating to the Silk Road Fund and the "One Belt and One Road" strategy alluding to historical trade routes. China recently launched the development of the Chinese-led Asian Infrastructure Investment Bank with greater than expected size. It was launched from the Boao Forum in Hainan, a well-known holiday destination. China is now the world's largest physical economy and these recent moves highlight its increasing influence on both Asia and the wider world to the detriment of Japan and the USA. Cuba has emerged from decades of repression with a surge of entrepreneurism and even Iran seems now desirous for constructive dialogue with the Western world (perhaps keeping a cap on oil prices). Hopefully China can steer through its environmental problems and rigid internal control to return to its historical position in the world without causing significant disruption throughout Asia. China's millennia of history were rarely straightforward. The idea of 100 million members of the Chinese Communist Party directing global discourse is rather unsettling to many. China's internal issues are not a new phenomenon, as evidenced by the migration of the country's wealthy to Vancouver's property market since the mid-1990s, a movement which has accelerated in recent years. We were reminded of the problems recently in Hong Kong where the air was acrid and seriously deleterious to our health. Locals there continue to resist Beijing's efforts to dictate their activities, yet lament the loss of mainland tourists to cheaper prices in Japan.

Korea

In recent meetings with a range of Korean companies, valuations were the key attraction, but we are hesitant about increasing our investments in the country despite the market being one of the cheapest in Asia. Firstly, Korea benefitted hugely from China's industrialisation with exports of equipment, ships and a wide variety of manufactures to support the multi-decade growth pulse. However, it appears that the current Chinese adjustment is being felt throughout Korea with empty shipyards, factories and ports which has flowed down through the economy via many ancillary suppliers. Secondly, it appears that Korea is transitioning through a tricky period in terms of corporate governance. The "chaebols" which led the post-war industrialisation are now handing over to the third generation with much lower ownership levels. This is complicated by societal structures carrying over from their not-so-distant feudal, warring past. For example, the many feuds positioning for control and power in the Hyundai Group are compounded by the varying genetic mixtures across the entities. While the Samsung Group may have avoided such obvious complications as Mrs Lee was strong enough to keep the mistresses' children off the main household register and in the "little house", much of the wider family are involved as suppliers to the main entities. These complicated structures are prevalent throughout Asia, with the Korean word for "little house" phonetically the same in Thai. While outwardly many Korean companies seem to operate on Western standards, it seems that their fate is not obviously in their own hands despite large foreign shareholdings. With the health of Samsung's Chairman a topic of much discussion, it appears as though only a core clique of eight know the future structure of that empire. Against this background, the interaction between politicians, the National Pension Service and the grandchildren is in a major state of flux. This puts Korea in an awkward position as China rapidly moves up the manufacturing chain and no large new growth areas or products are visible.

Outlook

Japanese equity indices have risen to multi-year highs. The external backdrop is not particularly supportive, but the domestic monetary situation, asset allocation shifts and balance sheet restructuring in addition to the domestic economy are all positive. We can still find attractive assets on very reasonable valuations and the distortion in relative valuations also presents significant opportunities.

A Historical Note from *Sakamoto, the Man and the Myth*

Born Jan. 3, 1836, Sakamoto was a key figure in Japan's modernization and contributed to overthrowing the Tokugawa Shogunate. Spending his youth in what is now modern-day Kochi Prefecture, Sakamoto demonstrated exceptional talent as a swordsman, but he also had a flare for business.

He is known to have founded Kaientai, an entity that became one of the first modern Japanese trading companies but which also served as his private navy.

Sakamoto was a pro-Emperor, anti-Tokugawa activist who had a vision of ending feudal reign and swiftly modernizing a country that had isolated itself from the rest of the world. He played an important role in uniting what were then Japan's two most powerful local governments: the Satsuma and the Choshu. The union eventually became the driving force that ended more than 260 years of Tokugawa reign.

Sakamoto was assassinated together with his close friend Nakaoka Shintaro in 1867 during their stay at an inn in Kyoto. Pro-Tokugawa assailants were believed behind the assassination, but the true killer remains a mystery to this day.

Sakamoto is among those enshrined at Yasukuni Shrine in Tokyo.

-- by Jun Hongo, The Japan Times

Notes

1. The investment returns are calculated using the relevant 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 historical 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).

   The inception dates for each Fund are as follows:
   Platinum International Fund: 30 April 1995
   Platinum Unhedged Fund: 28 January 2005
   Platinum Asia Fund: 4 March 2003
   Platinum European Fund: 30 June 1998
   Platinum Japan Fund: 30 June 1998
   Platinum International Brands Fund: 18 May 2000
   Platinum International Health Care Fund: 10 November 2003
   Platinum International Technology Fund: 18 May 2000

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

2. The investment returns depicted in this graph are cumulative on A$20,000 invested in the relevant Fund over five years from 31 March 2010 to 31 March 2015 relative to its benchmark index (in A$) as per below:

   Platinum International Fund - MSCI All Country World Net Index
   Platinum Unhedged Fund - MSCI All Country World Net Index
   Platinum Asia Fund - MSCI All Country Asia ex Japan Net Index
   Platinum European Fund - MSCI All Country Europe Net Index
   Platinum Japan Fund - MSCI Japan Net Index
   Platinum International Brands Fund - MSCI All Country World Net Index
   Platinum International Health Care Fund - MSCI All Country World Health Care Net Index
   Platinum International Technology Fund - MSCI All Country World Information Technology Net Index

   The investment returns are calculated using the relevant 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 benchmark 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.

3. Invested position represents the exposure of physical holdings and long stock derivatives.

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