# Platinum Japan Fund

**Scott Gilchrist** Portfolio Manager

## Quarterly Haiku

Arrows miss Target

Quiver reloads, Election

Nikkei forebodes ill

## Portfolio Position

### Sector Breakdown

| SECTOR | SEP 2015 |
|---|---|
| JAPANESE INTERNATIONAL FOCUS | 29% |
| Electronics (Canon, Panasonic) | 19% |
| Autos (Toyota, Nissan, Sumitomo Electric) | 6% |
| Industrials (JSR) | 4% |
| JAPANESE DOMESTIC FOCUS | 32% |
| Internet (DeNA, NTT, Recruit) | 11% |
| Consumer (Asahi) | 5% |
| Health Care (Mitsubishi Tanabe, Daichii Sankyo) | 5% |
| Financials (Mitsubishi UFJ) | 9% |
| Property | 2% |
| KOREA | 5% |
| Electronics (Samsung Electronics) | 3% |
| Financials (KB Financial) | 2% |
| GROSS LONG | 66% |

## Disposition of Assets

| REGION | SEP 2015 | JUN 2015 |
|---|---|---|
| Japan | 61% | *87% |
| Korea | 5% | 6% |
| Cash | 34% | 7% |
| Shorts | -6% | 0% |

* The Fund had a 4% short position in Japanese Government Bonds as at 30 June 2015.

Source: Platinum. Refer to Note 3, page 9.

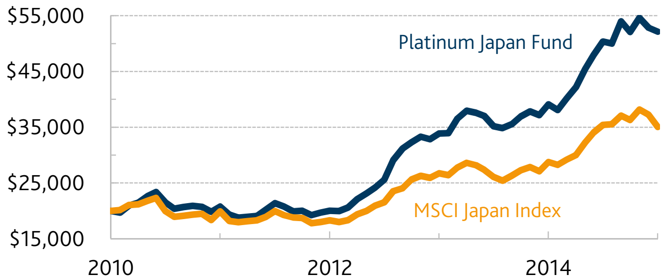
### Currency Position

| | |
|---|---|
| Japanese yen | 89% |
| Korean won | 5% |
| US dollar | 4% |
| Australian dollar | 2% |

Source: Platinum

### Value of $20,000 Invested Over Five Years

*30 September 2010 to 30 September 2015*




Source: Platinum and MSCI. Refer to Note 2, page 9.

**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, Nissan, JSR**.
- Electronics and components – **Samsung**, **Ibiden**.
- Corporate revitalisation – **Panasonic**, **Mitsubishi Tanabe**, **Mitsubishi Group**.
- Internet – **NTT**, **DeNA**, **Recruit**.
- Alternative energy – **Rohm**, **Sumitomo Electric**, **Denso**, **Hitachi Chemical**.
- Domestic consumption – **Asahi**.

## Performance

**(compound pa, to 30 September 2015)**

| | QUARTER | 1YR | 3YRS | 5YRS | SINCE INCEPTION |
|---|---|---|---|---|---|
| Platinum Japan Fund | 0% | 33% | 38% | 21% | 15% |
| MSCI Japan Index | -3% | 22% | 24% | 12% | 2% |

Source: Platinum and MSCI. Refer to Note 1, page 9.

Portfolio performance for the quarter was positive (+0.1%) despite equity market weakness. The strength of some larger holdings (Shiseido, Next, Mitsubishi Tanabe, Asahi, NTT, Recruit) offset drops in export focused companies. The combination of AUD weakness and Yen strength partially offset the widespread weakness across the Japanese equity market. Cash holdings and short positions (Nikkei, Tokyo Steel, Daikin) protected the portfolio. Won weakness and USD currency hedging were slight detractors.

## Changes to the Portfolio

The changes to the portfolio during the quarter, in combination with the changes reported in the last three quarters, have shifted the disposition of the Fund's assets and risks. Listing the changes in the most recent quarter: (1) the last of the Japanese Government Bond (JGB) short position was removed, (2) the short Yen and long Won currency positions were removed, (3) holdings in exporters were reduced, (4) holdings which were approaching full value were sold, (5) short positions were initiated, and (6) residual exposure to resources was removed. There are three major consequences of the cumulative changes made since late last year: (1) cash levels have increased to around 30%, (2) overall portfolio exposure has been reduced, and (3) the Fund is predominantly exposed to the Yen.

## Commentary

During the quarter, we spent two weeks in Tokyo and Kyoto visiting companies in the portfolio and new opportunities. In total, we met almost 90 companies. As usual, it was a mix, with a smattering of world class competitors plus some laggards and the full range in between.

### Inbound Tourism

Inbound tourism continues to be a major theme with 1.5 million tourists arriving in Japan every month, up more than 100% over the year. The weak Yen has made Japan an attractive destination for the mainland Chinese who now account for almost one third of arrivals into Japan and are the biggest spenders. Colloquially, their behaviour is *bakugai* or "explosive shopping". Buying empty suitcases at the main strip in Ginza, the Chinese tourists go home with everything from staples to discretionary items. Queues form in Matsumoto KiYoshi drug stores around Tokyo where purchases over JPY5,000 (A$53) of consumables are tax free. Kao face masks, Shiseido sunscreens and Unicharm nappies are just some examples of the high quality daily products the Chinese have been taking back home, although recent anecdotes of lower spending levels seem to have coincided with the launch and rapid growth of direct online sales from Japan into China. The experience from Korea's inbound tourism boom reminds us that these trends are cyclical within an overall growth phase. Unforeseen events will lead to significant setbacks.

Busloads of tourists buy inexpensive fast fashion at Fast Retailing Co's Uniqlo and discounted lifestyle goods at Don Quijote. Do be prepared for a unique experience at DonQi while they monitor store profitability by the minute, and do search for the roller-coaster atop their store in the centre of town. Laox, owned by Suning, the Chinese retailer, seems to specialise in something called "hostage shopping", although recently some customers have refused to leave the bus as they can see on their smartphone that prices are much cheaper just down the road. In the department stores, tourists wait to be advised by Chinese speaking beauty consultants so they can be shown the best in skincare and the latest in this season's colour palette. Demand has been so great that whole floors are being remodelled to suit the different cultural norms while maintaining the shopping experience expected by long-term local customers. Japanese branded, 'Made in Japan' cosmetics such as Shiseido's high-end Clé de Peau Beauté and Pola Orbis' Bio Active skincare and cosmetics are some examples of popular brands on the shopping list. Duty free makes up more than 30% of sales at some major department stores in popular tourist destinations such as Ginza's Isetan Mitsukoshi.

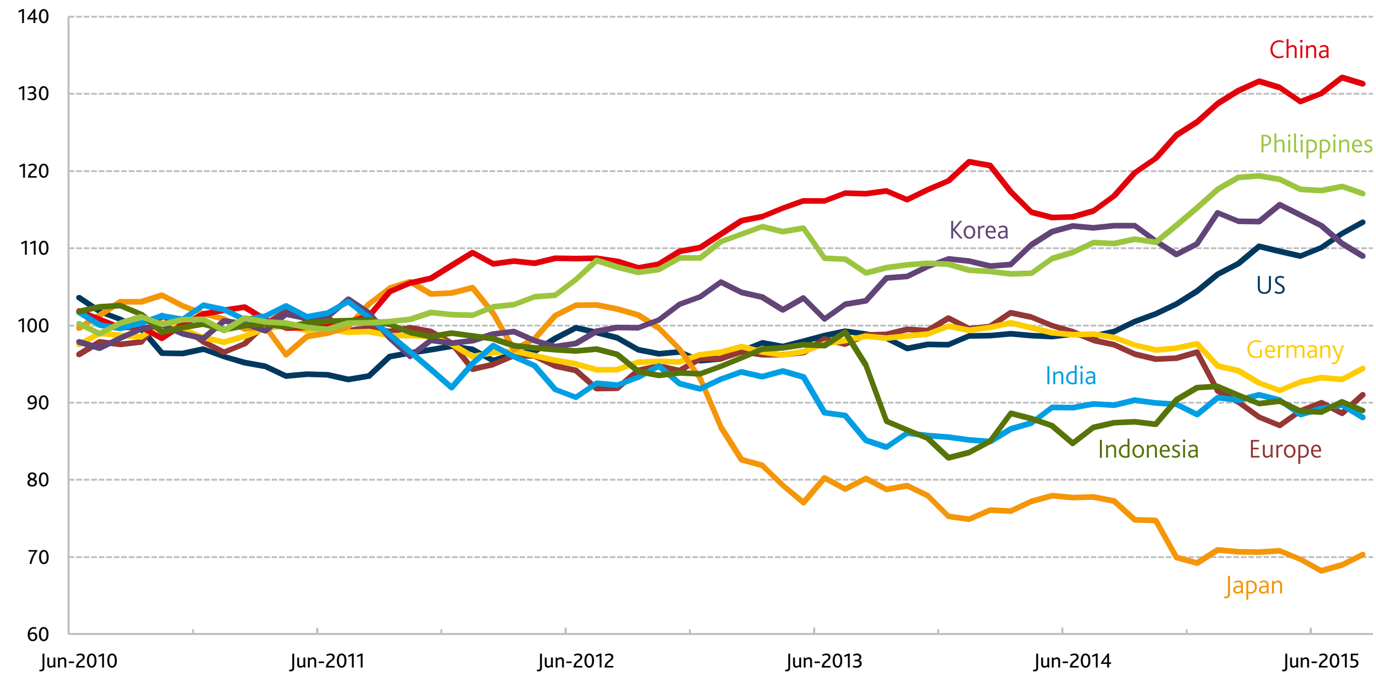
In electronics, Zojirushi rice cookers and Toto electronic toilets are in high demand. Laox, Bic Camera and Yamada Denki all offer tax free sales in their central urban stores. And it's not only Tokyo; tourists pack the heritage town of Kyoto, where hotels are often fully booked. While the kimono dressed ladies enjoy cuddling foreign babies, they seem tired of the endless requests for photos by pushy foreigners.

It seems we are only at the early stages of the inbound growth trajectory. Prime Minister Shinzo Abe set a goal of 20 million visitors per annum by 2020, which is likely to be reached as early as this year at the current pace of growth. Last year only 2% of mainland Chinese outbound tourists chose Japan as their destination, but this year it could surpass 5%. Abe sees tourism as a key driver of economic growth, calling for faster immigration and customs procedures and encouraging tourism in regional areas too. Moreover, the Japanese Government has introduced visa waivers for ASEAN countries despite previous bad experiences with such, and has eased multiple entry visa requirements for Chinese visitors. To overcome infrastructure bottlenecks, the Japanese Government is looking to increase landing slots at Tokyo's two major airports, Narita and Haneda, before the 2020 Tokyo Olympics. New hotels are also under development in the Tokyo area. Yokoso Japan!

**Currency**

It is arguable that the only significant outcome of Abenomics was a weak currency. And what a success! Please glance at the accompanying chart. The Yen has been the weakest real currency over the last few years, both relative to its Asian peers and globally. There are many obvious and subtle effects of this. Locals have rediscovered their interest in domestic holidays with overall Shinkansen passenger numbers growing at 4% per annum. Foreign tourist arrivals are clearly growing exponentially. Domestic competitiveness has assisted the recent conclusion of the Trans-Pacific Partnership, likely lowering tariffs and modifying interaction between the 12 partners comprising 40% of global GDP and a third of global exports. However, there are also some unexpected outcomes of a weak Yen. Auto exports are not yet growing and, in fact, are still falling despite spare capacity in many factories which are perhaps only capable of producing uncompetitive models.

**Bank for International Settlements (BIS) Real Effective Exchange Rates**




Source: BIS

Overall, exports are not growing anywhere near the pace expected given the magnitude of the depreciation. Retail analysts talk of a domestic recession which is papered over by inbound tourist spending. The weak Yen has driven up import prices for key consumables, thereby reducing the spending power of the majority of the population, reinforcing thrift and causing problems for Abe at the polls, just when he was pushing military measures through the National Diet and looking towards the next election. Noisy protests ensued.

The key influence of the weak currency for the Fund has been on corporate profitability, as illustrated by the attached table. In cyclical industries, it is often a mistake to pay low multiples of peak earnings. The current market valuation is summarised below. Most financial metrics and valuation multiples are at decade highs.

**Current Market Valuations**

| P/E | P/B | P/S | EV/Sales | Dividend Yield | Net Margin | RoE |
|---|---|---|---|---|---|---|
| 17 | 1.6 | 0.9 | 1.2 | 1.6% | 5% | 9% |

Source: Bloomberg

**Nikkei EPS and Currency**

| | 2008 | 2009 | 2010 | 2011 | 2012 |
|---|---|---|---|---|---|
| EPS | 361 | 226 | 627 | 500 | 588 |
| USD:Yen | 100 | 90 | 85 | 80 | 80 |
| | 2013 | 2014 | 2015E | 2016E | 2017E |
| EPS | 963 | 1149 | 1298E | 1437E | 1552E |
| USD:Yen | 95 | 100 | 120E | 120E | 120E |

Source: Factset

**A New Quiver**

Reform continues across the whole country, both facilitated by the government and acted out in everyday business by free market participants. The obstinacy of Japanese companies that continue to defend weak market positions, rather than allowing consolidation, leads to a hyper competitive environment in many industries. This is exacerbated by spare capacity across most sectors, including retail, transport, drinks, housing, telephony, etc. There are also hidden inefficiencies such as heavily manned container ports, over serviced restaurants, large contingents at corporate receptions, and masses of retail assistants. It is well known that the Yakuza carry business cards and have pension plans. We ate a lovely, cheap sushi dinner at a well-regarded restaurant with 12 seats, attended by six employees. Australian ports are now human-free zones, while Japanese unions impede innovation, resulting in manning levels in Japanese ports remaining as they have been for decades. We visited a company which is in the process of tripling their production capacity with six people managing robots and complex automation relative to the 200 able bodies in the existing factory. Unfortunately, the slow pace of change in many parts of the economy has worked against the interest of the nation as what seemed like thoughtful and considerate decisions led to backward thinking and a retreat from reality. The results are now being seen in companies like Toshiba and Fujitsu. It is rather surprising that many companies, even some of the better ones, are only now waking up to the wider world outside their own archipelago. They will be surprised to find that the world has moved on and left them behind in many areas. "Why do you own a golf equipment business as it doesn't seem to fit with your core activities?" "We play a lot of golf and we like to test the products." In a similarly discordant version of the world, coins and banknotes will apparently play an increasing role in society despite the seemingly inexorable trend towards digital payments and e-money. Japan remains a net exporter of cement; domestic demand for their "high quality" product has fallen 50% from the peak.

JR Central has initiated construction of their US$100+ billion project to build a new train line between Osaka and Tokyo. Recent trials of the magnetic levitation train set have reached speeds of 600 km/h following four decades of research and development. The route is direct, thereby negating the tsunami risk on the current circuitous route along the seaside. The existing Nozomi Shinkansen takes about 2.5 hours to travel the Tokyo-Osaka route while the new train will take 67 minutes… in 2047! The first section to Nagoya will be opened in 2028, after more than 200 kilometres of tunnels are bored. JR Central is using cashflow from their existing Shinkansen routes, borrowings from the major Japanese banks plus construction contractor vendor financing to avoid government assistance. When interest rates approach zero, the value of long-dated projects doesn't require the intricate calculations of a discounted cashflow, merely a summation of a future century of cash generation. Most global markets are not yet well acquainted with this simple maths.

Towards the end of the quarter, Abe and Kuroda declared that Abenomics had been successful and announced three new arrows: (1) raise nominal GDP by 20% by 2020 to JPY600 trillion, (2) raise the national fertility rate from 1.4 to 1.8, and (3) enhanced social security focused on the elderly. The original three arrows were fiscal stimulus, monetary easing and structural reforms. It's almost certain that the original key target of 2% inflation won't be achieved. The Bank of Japan's (BOJ) balance sheet remains large as a percentage of GDP at well over US$3 trillion in total assets, up 32% in the last 12 months. This implies that the BOJ has a gearing level of more than 100 to one, but standard financial metrics are almost certainly not applicable in this situation. As a reminder, the Japanese Government has JPY1,209 trillion of outstanding debt which is equivalent to 242% of GDP, including JPY783 trillion of JGBs, JPY152 trillion of T-bills and JPY161 trillion of other loans. The BOJ's holdings of JPY309 trillion of JGBs are offset by cash deposits from the broad banking system of roughly US$2 trillion, thus the newly minted digital currency has not actually entered the financial system. Recent machinery orders have been negative for the last three months, the first time this has occurred since early 2009. At the current and likely rate of purchase, the BOJ will own all available JGBs within a few years. The rest of the world also faces its own debt dilemma; the problems that led to the 2007 Financial Crisis have not been properly dealt with. It is somewhat surprising that global debt levels and overall gearing, including derivatives, are currently above previous peaks. While house prices in deleveraging economies have been coming down, this has not occurred in many regions, especially those where domestic credit remained expansionary. Emerging market domestic bank credit to GDP is now higher than G4 levels in late 2008, according to the BIS.

## Outlook

The news flow from around the globe is certainly not encouraging: Caterpillar is implementing another major restructuring, a Chinese coal mine fired 100,000 staff, copper demand is weak, deflation is spreading, Chinese manufacturers are ramping their global ambitions, global sovereign bond defaults are at record levels, bond spreads are rising, corporate profits are weakening, margin debt is falling, and emerging markets are described in terms akin to a crisis. While each specific item might be a new revelation, they are generally consistent with the direction of the last year, albeit accelerating recently. In totality, they represent a severe short- and medium-term headwind for equity markets. The market had been clinging to the hope that the trend would stabilise and reverse, but that now seems forlorn. Market participants are hardly unaware of this outlook, as seen by large short positions in major markets. It appears as though trust in the ability of Central Bankers across the globe is being lost. Sentiment has dropped to very low levels. Despite the very attractive Japanese internal corporate and asset allocation dynamics, it's inconceivable that the deteriorating external environment won't be felt across the nation. Against this backdrop, the Fund's 30%+ cash position allows for opportunistic purchases amid likely volatility. In the event of a more benign outcome, the cost of this insurance would be a period of relative underperformance.

**L0-Series (L-Zero) Trial Linear Shinkansen**

Source: PIXTA

## A Historical Note from *Inside Hosoo, the 327-Year-Old Textiles Mill Supplying Chanel and Dior*

**This story will have been seen by some, but it is worth repeating as a reminder of the longer timeframes and family ownership structures found in Japan.**

*The Nishijin textile district in the north of Kyoto was established over 1200 years ago. Today, the relatively compact area covers only a few blocks just northwest of the city's busy Imadegawa-Horikawa intersection. Located down a nondescript side road stands one of the oldest enterprises in the city: Hosoo, a textiles mill that has been passed down through twelve generations of its founding family. Today, the mill is run by director Masataka Hosoo, 37, who is accompanied to work most days by his 86-year-old grandmother. In the showroom, a framed photograph of her receiving a hug from Pharrell Williams hangs next to an image of her and Caroline Kennedy. Such is Hosoo's cultural significance to Kyoto that touring celebrities, politicians and ambassadors are often brought to visit.*

*The mill was founded in 1688, when it was kept busy weaving traditional kimonos for Shogun warriors and samurai from the elite Tokugawa clan. Nowadays, the kimono business still exists, but it is nothing compared to what it once was, says Masataka Hosoo. "The market for traditional kimonos has diminished by 90 percent," he says frankly.*

**Fabrics made by Hosoo Mill**

Source: Business of Fashion

**Fabrics made by Hosoo Mill**

Source: Business of Fashion

*"We work directly with our clients, no distributors," says Masataka, acknowledging that the pair's straightforward business approach is unusual for most Japanese mills, but incredibly attractive for overseas clients seeking easy communication. Many of these clients are global luxury brands, who purchase high-end fabrics for their store interiors, a lucrative business for Hosoo. Indeed, the mill has woven speciality textiles for the likes of* ***Louis Vuitton****,* ***Christian Dior****, and* ***Chanel****. "We have probably worked on 40 to 50 Chanel stores and, for Dior, we have made fabrics for 19 interiors," explains Masataka. The mill provides textiles directly to fashion designers as well. Their fabrics appeared on the runway at Paris Fashion week in Japanese designer Mihara Yasuhiro's A/W12 and A/W13 menswear collections. The Italian designer Luisa Cevese also featured Hosoo's work in her creations, when she inventively repurposed their cast-off selvedge edges.*

*Hosoo's textile production is a time consuming process, with many stages. "There are maybe twenty process leading up to the finished fabric," explains Benito Cachinero, "which means there will be twenty master craftsmen involved along the way."*

-- by Tilly Macalister-Smith
Extracted from Business of Fashion

## 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$20,000 invested in the relevant Fund over five years from 30 September 2010 to 30 September 2015 relative to its benchmark index (in A$) 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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