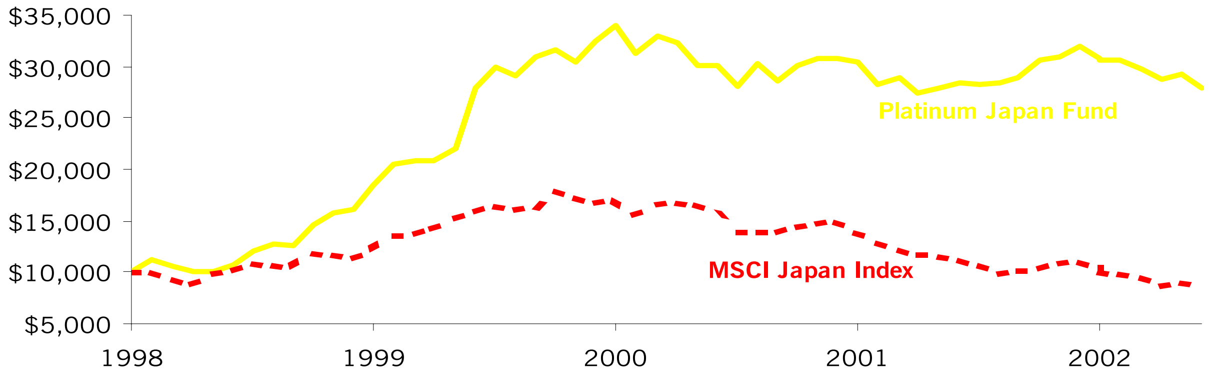
Platinum Japan Fund

Performance

REDEMPTION PRICE: $1.5883

VALUE OF $10,000 INVESTED SINCE INCEPTION (1 JULY 1998 – 31 DECEMBER 2002)



Source: Platinum and MSCI

The Japanese and Korean markets continued to suffer from a deterioration in investor sentiment as a result of sluggish global growth and geopolitical fears. For the quarter, the Topix declined by 8% in local currency terms whilst in Korea the Kospi fell by 3%. Having performed better than global peers last quarter, both markets gave up those relative gains this quarter with a particularly notable turnaround in Japanese banking stocks. The continued failure to arrange a bailout of the banks saw an 8% gain in the previous quarter turn to a disastrous fall of 28% this quarter. At the close of the year Korea was impacted by fears relating to North Korea brinkmanship. Exchange rates generally rose as the US dollar started to decline on fears the US economy would not recover quickly. The yen, won and Australian dollar all rose by 2-3% against the US dollar and this looks set to continue.

The Fund fell by 6.1% over the quarter in A$ terms, somewhat less than the 9% decline in the MSCI Japan index. Stocks that performed well for the Fund included Yamanouchi, Alpine, NTT and Canon but ground was lost on our holdings of consumer finance stocks such as Aiful and Credit Saison. Exchange rates were broadly neutral concerning the performance of the Fund this quarter. For the year to 31 December 2002, the Fund fell 1.2% ahead of the MSCI Japan which declined by 18.4%.

Changes to the Portfolio

DISPOSITION OF ASSETS

Region	Dec 2002	Sep 2002
Japan	75%	65%
Korea	16%	24%
Cash	9%	11%
Net Short Position	-9%	
Net Long Position	11%	13%
Net Derivative Position	3%	
Net Invested Position	94%	

Source: Platinum

There were some quite large changes to the portfolio this quarter.

1) In November we became more bearish on the Korean market and decided to reduce positions. The market had experienced a strong bounce off October lows and with everyone positive, relative to the beaten down Japanese market which was trading at decade lows, it seemed to offer better value. This was especially so when you consider the depth of quality on offer in Japan at very cheap prices. By contrast Samsung Electronics is dominant, not expensive, but extremely well owned.

2) As a result, by the end of the quarter we had switched about 10% of our Korean exposure into Japan. Stocks sold in Korea included Korea Telecom (partial), Kangwon Land, Shinhan Financial and Kepco. In Japan we added some new names including Fanuc, Tokyo Broadcasting, Sony, Sohgo Security (IPO) and Nintendo, and we added to our position in Canon.

3) We dramatically reduced the short positions in the Fund and also rearranged them. We removed all of our stock shorts against Japanese stocks as the market plumbed new lows. However we retained and increased our short against the Kospi index. Toward the end of the quarter we instituted a long Nikkei index future as the market tested 19 year lows.

The end result of these changes is a portfolio more invested than hitherto. This reflects the range of very high quality stocks available in Japan at very cheap prices and that with the market so depressed it is hard to be negative even if the international environment suggests caution. We are also pleased to see that foreigners have sold Japan in an aggressive fashion in the second half of the year.

Commentary

The main point of interest this quarter was our trip to Japan in late November. However let us comment on two topical pieces of interest first.

In the next few months, Prime Minister Koizumi will make the decision on who will replace the retiring Bank of Japan (BOJ) governor Hayami. This is potentially an explosive decision as the government and the BOJ have been locked in debate about monetary policy. The BOJ posture is conservative and requires that the politicians clean-up the banks before there is much change in policy, while the government is asking for greater monetary easing. Blame is being passed around generally as Japan wallows in its political and ideological morass. Going on past experience, the government will stick with the conservative option of the status quo however there is a chance that they will put someone in with a more “like minded” approach. To this end the name of former board member Nakahara has been floated in the press. He is best known for his constantly dissenting opinions on BOJ policy in favour of inflation targeting. We cannot say with any certainty what will happen but if an inflation target is adopted it could have interesting consequences for bonds and especially the yen exchange rate. Watch this space.

The international press is full of comment about North Korea and its nuclear program. This is a serious development for North East Asia but should be seen in the context of a North Korea that over the years has made a name for itself in the art of brinkmanship. Having observed Korea for some time we note that it has paid to ignore such events from a market point of view. This is exactly what the market seems to be doing despite some wobbly action of late, which can also be traced to pre-election enthusiasm. A further significant decline below the 600 level would probably be a buying opportunity. This is not to say that we treat the event lightly but rather we would prefer to believe in the effectiveness of a nuclear deterrent on all parties concerned.

Japan Trip Impressions

In our latest round of company visits we talked with 18 companies. The immediate observation is that current business conditions are quite tough however the deeper and more lasting insight is that there is a confidence in the people we talk to about the underlying strengths of their companies. What we mean here is that the fundamental building blocks of any company such as long term commitments to people/knowledge, processes, products and innovation have never been stronger. This is too often mistaken in the press as Japanese resistance to change but we think that fails to give weight to the long term view of corporate entities. When we look objectively at the list of Japanese manufacturing companies that dominate their industries or indeed have increased their lead, it remains very impressive for a supposedly dysfunctional country that the press presents. The likes of Toyota, Sony, Canon, Fanuc, Fuji Photo and Murata are getting stronger versus their competitors despite ten years of poor economic growth. Whilst we were in Japan another huge US$8 billion monthly trade surplus was announced. It is easy to dismiss this as due to insufficient consumption by the cosseted domestic consumer in a dysfunctional economy however we believe it demonstrates real strength. It is dull that commentators rarely focus on this aspect of Japan, eager to play up the ineffectiveness of the banks, which are mere intermediaries in the economy and whether they are owned by the public or government it does not really matter. Rather the commentators hold out the US model as the only alternative but fail to see that many US companies have foregone their longer term competitive essence in their head-long rush for short term gain.

Another observation that contrasts heavily with accepted wisdom is that a lot has actually changed at the corporate level in Japan. Five years ago when we visited there was much talk about the need to reform company management structures to reduce top heaviness and speed decision making. The need to reform pay structures to reward results was also seen as essential. This time around there is not much talk about these issues but this is because they have already been adopted in a very quiet and understated way! The latest round of profit results would seem to bear this out with profits rising markedly on very little sales growth and we would expect this to become a trend in the future. Against this argument commentators hold up China as the big problem for Japan in that it will hollow out the country's manufacturing base. We say that China is the best change agent Japan could have! When we talk to the companies about China it is clear they are now quickly embracing the country although with some continuing reservations about local business partners and the need to tread cautiously with distribution channels and business terms. The unique feature of China is the extraordinary level of competence of local suppliers. Quality is still a problem but once reliable sources have been identified, their ability to scale-up production and meet ambitious production schedules is better than any other developing country they have operated in before. Hence companies are shifting production very quickly now (Yokogawa Electric just announced it would close all 12 Japanese based plants and shift to China) and are seeing great benefits in terms of costs.

On our trip we saw Olympus which has shifted digital camera production to a new China plant and is now making good margins in this area after years of losses. Also we note with interest that Daikin derives its highest operating margins in air conditioners from its China business. This challenges the often heard comment that no-one can make money out of China. The arbitrage of costs in China is allowing the companies to break open the labour situation in Japan. Of course, most of this "China advantage" may be competed away but the benefit resides in those high value-added Japanese manufacturers being able to trim their cost base. Further, their product and process superiority protects them against local competitors as they roll out distribution to the Chinese consumer.

One interesting company we spent time with under the shadow of Mount Fuji was Fanuc. This company is the world's largest maker of Computer Numerical Controllers (CNC's) for machine tools (50% share) and one of the world's largest producers of industrial robots (15% share). In its original form, it served as the machine tool arm of Fujitsu. The core strengths of Fanuc are:

- Single product area focus.
- Dominant position in high value added machine tool operating systems (the brains).
- Internal manufacturing of key components including CNC, Servo motors (arms and legs) and sensors.

These strengths have enabled Fanuc to record an average operating profit margin of 28% over the past 15 years, well above comparable company returns anywhere. This has given it the base from which to drive expansion into newer areas and also significant cash reserves on the balance sheet. We see growth coming from rising market shares in industrial robots and new applications such as injection moulding machines and "intelligent robots". The latter exhibit much improved sensory capabilities enabling the range of manufacturing tasks performed by robots to expand. China will be a particular area of growth for the company although this will partly be through lower end machines (fewer axes of movement). The company has an advantage over its competition in the shift of manufacturing power to China with many of its competitors in financially stretched conditions. Whilst the stock is not very cheap based on PE ratios, it has enormous cash holdings equal to 38% of its market capitalisation. It recently conducted a share buy back from Fujitsu which holds 37% of the stock and we expect this to continue as Fujitsu desperately needs the cash. Fanuc is the sort of stock that we favour in an environment where outstanding management should be priced at a premium on account of industry change and a testing environment.

Outlook

The global environment will continue to remain tough as the world continues to wean itself off US led growth - a process that could take some time. However, Japanese stocks remain particularly depressed and take little account of the world that has gone on quietly but steadily to enhance the competitiveness of these businesses. If China develops as we expect into a leading economic force, we are optimistic that quality Japanese manufacturers are among the best placed to both benefit from lower costs and the expanded sales opportunity. Korea should also benefit from the shifting of economic power to North East Asia.

Jim Simpson
Portfolio Manager