Platinum Unhedged Fund

Clay Smolinski Portfolio Manager

Disposition of Assets

REGION	JUN 2016	MAR 2016
North America	29%	30%
Asia	28%	28%
Europe	24%	25%
Japan	8%	7%
Russia	3%	2%
Cash	8%	8%

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

Performance

(compound pa, to 30 June 2016)

	QUARTER	1YR	3YRS	5YRS	SINCE INCEPTION
Platinum Unhedged Fund	-2%	-10%	10%	11%	10%
MSCI AC World Index	4%	-1%	14%	13%	6%

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

International stock markets have been weak over the past six months, and this was exacerbated by the panic that ensued from the UK vote to exit the European Union (EU).

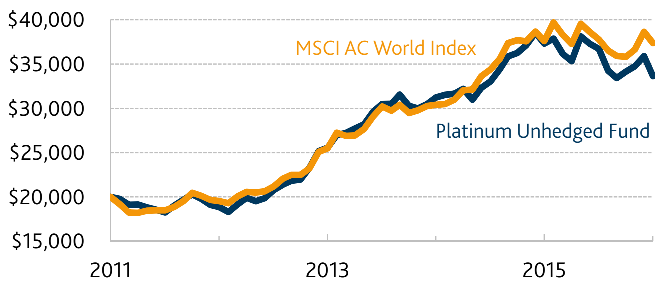
Expressed in Australian dollar terms, of the major markets in the calendar year to date Europe (-7%), the UK (-5%), Japan (-8%) and China (-7%) are all in negative territory. The exception is the North American market, which continues to defy the others and is up 1%.

The calendar year-to-date return of the Fund is -8%, versus -1% for the MSCI AC World Net Index.

This performance is disappointing and we devote this report to walking through the major contributors to this outcome.

Value of $20,000 Invested Over Five Years

30 June 2011 to 30 June 2016



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

Commentary and Changes to the Portfolio

European Banks

The UK vote to exit was not an outcome that we thought was likely. In holding this view, we put weight on the negative economic consequences from leaving, the fact that people tend to be risk averse and the skew of the betting market for remain (which typically tends to be less biased than polls). In hindsight, the emotional nature of the immigration issue and the startling rise of Trump in the US hinted that the anti-establishment vote could surprise.

The worst performing sectors following the referendum were the cyclicals, namely, banks, construction, retail and travel. The Fund's main exposure to these sectors is the banks.

Over the past six months the Fund has had 15% of its assets invested in banking stocks. This aggregate 15% was split between three markets, with 5% in each of Western Europe (Lloyds and Intesa), Eastern Europe (Erste and Raiffeisen) and Asia (ICICI of India and KB Financial in Korea).

Of the 8% fall in the value of the Fund in the calendar year to date, 3.5% is attributable to our bank holdings. The vast majority of this relates to the Europeans, which following the UK exit vote saw their share prices fall by 30-40%.

The simplified rationale for owning our European banks was centred on the following considerations:

1) After surviving five years of recession the banks were now considerably safer. In many cases the banks had written off 10% of their loan books in defaults and doubled the amount of capital they held as a risk buffer.
2) The European economy is steadily recovering. This can be seen in the charts below of EU economic output and unemployment, which started to improve since 2013. Overall, the EU recovery was happening on a three year time lag to the US.
3) As employment increased and the economy grew, the costs of customer defaulting on loans would fall away, and modest demand for credit would return. This would increase profits and leave the banks trading on single digit P/E multiples.

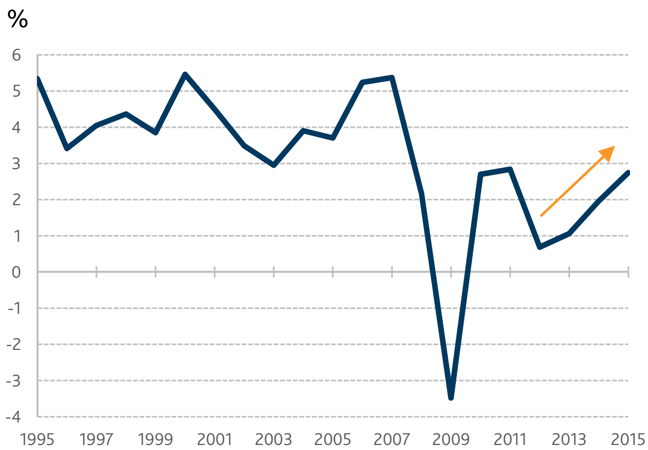
While all of these considerations still hold true, in the last six months the banks have been negatively affected by two extrinsic factors:

1) The European Central Bank (ECB) pushed its experimentation with negative rates further and cut the deposit rate to -0.4%. This instantly reduces the net interest income of the banks.
2) The panic after the UK voted to leave the EU – in the subsequent two trading days the EU bank index fell 30%.

During the heavy falls ensuing from the exit vote we have been adding to our EU bank holdings. After such a large shock, you may be wondering **if it makes sense to own these banks now**.

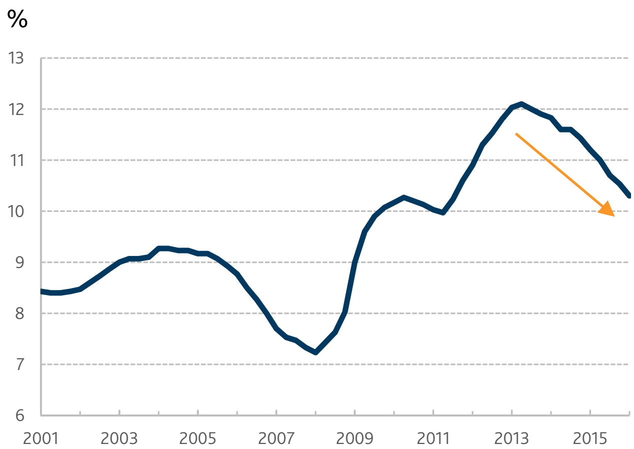
To answer that question, we would first point to valuation. In the week after the referendum several of our banks were trading at 0.6-0.7x book value, 6-8x earnings, with dividend yields of 8-10%. Valuation levels this low imply that the banks are going to suffer large permanent falls in their earnings power. We do not think this is likely.

EU Nominal GDP Year-on-Year Growth



Source: European Central Bank

EU Unemployment Rate



Source: European Central Bank

Walking through the sources of fear, the first is the economic impact of Brexit. The post-Brexit slowdown will be driven by a hit to confidence, as businesses and consumers defer purchase decisions. A recession of this type is more benign (and can snap back faster) than one with a specific catalyst such as the sovereign crisis seen in Europe several years ago where multiple governments were slashing spending and laying off workers. Hence, the impending slowdown represents a short-term hit to bank earnings, not a threat to their capital bases.

A second concern is whether the ECB will cut interest rates even further into negative territory. While this can't be completely ruled out, we can take some comfort that the ECB has been fairly clear that there are limits to negative rates, and since the second cut the emphasis has been on using other tools at their disposal (such as buying corporate bonds) to boost growth. As for how long negative rates will persist, we still believe negative rates should be viewed as an experiment, and not the new status quo going forward.

Finally, the banks' share prices are factoring in fear of further political risk, namely, a full break-up of the European Union. The impact of **recency bias** plays a big role here. As we have just seen a large country making a shock exit, suddenly the probability of further exits feels significantly heightened. But we need to take into account that the European governments will react and concessions will be made. Readers will remember the constant rhetoric during the sovereign crisis around how Germany would never let the ECB buy government bonds. However, when bond purchases became necessary to save the Union, permission was given and the debate moved on.

One concession may be the approach to fiscal spending. Since 2012, EU governments have been practising fiscal 'austerity', and have successfully reduced their deficits. However, with unemployment still relatively high, this stance is becoming increasingly unpopular with voters and is fuelling the popularity of the more radical Euro-sceptic/anti-austerity parties (who are the parties most likely to call another exit referendum). As governments can now borrow at rates close to 0%, their interest costs are set to collapse as they refinance existing debt at almost no cost. This leaves them considerable leeway to increase spending, which will simultaneously address concerns on growth and employment while taking a key campaign thrust away from the 'new radicals'.

In summary, the 30-40% share price falls in the banks have not been matched by a similar deterioration in their operating fundamentals. Their share prices already imply that many of the risks will come to fruition, and any good news would likely be enthusiastically received by the market. The European banks in the Fund's portfolio are well capitalised,[1] have worked through the worst of their bad debts and are now paying large dividends. On starting earnings yields of 12-14%, we feel these banks are very attractive investments.

Japanese Holdings

The second area of detraction was our Japanese positions, which cost the Fund roughly 2% in the calendar year to date. The largest detractors were **Lixil**, **Panasonic** and **Rohm**.

Lixil is a manufacturer of branded residential home fixtures (such as tapware, toilets and kitchens) and controls brands like Inax, Grohe and American Standard. The company is an unusual example of a Japanese corporate consolidating its domestic competitors where it has shut overlapping manufacturing sites, cut costs and improved profitability. We initiated our original position when the stock fell 20%, paying a low teens earnings multiple, after problems arose in two of its international acquisitions. Subsequently, the then CEO (Fujimori) was fired due to the acquisition missteps and has been replaced by a very interesting candidate, Kinya Seto. Seto built Monotaro (a distributor of maintenance, repair and operating supplies) from scratch into a US$4 billion business in the space of 10 years.

Seto's initial strategy tweaks have been promising, and he has aligned himself with shareholders by taking his first year's pay in Lixil stock (again, very rare in Japan). However, like many new CEOs, he has been very conservative and 'kitchen-sinked' his guidance for the company's performance this year, causing the market to sell down the stock by a further 25%. Once the restructuring expenses are factored in, we estimate Lixil to be trading on a sub 10x P/E whilst peers like Toto, Masco, Geberit and Fortune Brands trade on 18-20x. We have been adding to our position.

Panasonic and **Rohm** are similar in that they both had a large exposure to Japanese audio/visual consumer electronics, a market that was shrinking. Both have successfully restructured their businesses and have built interesting positions supplying electronic automotive components and semiconductors (the highest profile one being Panasonic's battery supply deal with Tesla), hence are set to benefit from

1 Readers may have noticed the headlines around an Italian state capital injection into the banking system. These funds are largely earmarked for Banca Monte dei Paschi di Siena and a tail of listed and unlisted credit unions. Our holdings, Intesa and Mediobanca, do not need these funds.

the shift towards electric vehicles. The stocks have been hit by the strengthening Yen, which is hurting the translation of their export revenue, and the start-up costs for expanding their auto businesses. Similar to Lixil, the valuations are very attractive, with Panasonic trading on 12x earnings and Rohm's market capitalisation being roughly equivalent to the cash it has on its balance sheet.

Outlook

There are two major risks in stock market investing:

- paying too high a price for a business, and
- the future earnings power of a business comes in lower than you expect.

The fundamental guide to our investment method is to seek investments where the company faces some uncertainty, but the reasons for that uncertainty are *transient*. The presence of uncertainty generally results in the business trading on a low price and investors having low expectations of its future earnings power. This combination lowers risk. As the problems causing that uncertainty are solved in time, earnings typically will rise and investors will become more confident with paying a higher multiple for those earnings, thus resulting in a higher stock price.

In recent times our approach of taking on uncertainty has not paid. Over the last 12 months, the average return of the markets that carry some uncertainty (Japan, EU, China and Emerging Markets) was -11%. Over the same period, the 'safe' market, North America, was up 5%.

So why persist with our method? Why not move into 'safety' now? The answer again lies in valuation and expectations.

First, we can look at it on a high level. The valuation of the US market today is 17x earnings, and expectations around earnings growth are high. In contrast, the Euro zone and Japan are on 12-13x P/E and there is a lot of pessimism around future earnings. Whilst the US might presently feel good, on the basis of price and expectations it in fact carries higher risk than one might realise.

Second, we can turn to the specific stocks in our portfolio. The selection of attractively priced stocks on offer has not been this good for some time. Large portions of the portfolio are trading on earnings multiples between 8x and 13x, and those companies have the ability to grow. In a zero interest rate world, that is fairly attractive. While we can't guarantee prices will be higher in the next six months, on a two-year outlook, purchases at these levels should reward investors handsomely.

Notes

1. The investment returns are calculated using the relevant Fund's unit price and represent the combined income and capital return for the specified 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 in the 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$20,000 invested in the relevant Fund over five years from 30 June 2011 to 30 June 2016 relative to the relevant benchmark index (in A$) as per below (the "Index"):
   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 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.