Platinum Unhedged Fund

Clay Smolinski Portfolio Manager

Disposition of Assets

REGION	DEC 2016	SEP 2016	DEC 2015
Asia	30%	27%	29%
North America	25%	29%	28%
Europe	24%	22%	25%
Japan	8%	9%	9%
Russia	3%	3%	2%
Cash	10%	10%	7%

Source: Platinum. Refer to note 3, page 5.

Top 10 Holdings

STOCK	COUNTRY	INDUSTRY	WEIGHT
Raiffeisen Bank International	Austria	Financials	3.8%
Applus Services SA	Spain	Industrials	3.5%
Level 3 Communications	USA	Telecom	3.4%
Lixil Group Corporation	Japan	Industrials	3.3%
PICC Property & Casualty Co	China Ex PRC	Financials	3.2%
IHS Markit Ltd	USA	Industrials	3.2%
Alphabet Inc C Class	USA	IT	3.1%
Cisco Systems Inc	USA	IT	3.0%
Jiangsu Yanghe Brewery	China	Consumer Stap	3.0%
Erste Group Bank Ltd	Austria	Financials	2.9%

Source: Platinum. Refer to note 4, page 5.

For further details of the Fund's invested positions, including country and industry breakdowns as well as currency exposures, updated monthly, please visit https://www.platinum.com.au/fund-updates/#MonthlyUpdatesForThePlatinumTrustFunds.

Performance

(compound pa, to 31 December 2016)

	QUARTER	1YR	3YRS	5YRS	SINCE INCEPTION
Platinum Unhedged Fund	7%	6%	9%	16%	11%
MSCI AC World Index	7%	8%	11%	17%	6%

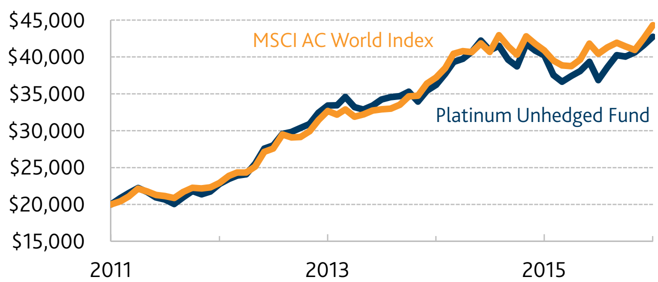
Source: Platinum and MSCI. Refer to note 1, page 5.

2016 has been a year where investor sentiment around macro and political issues has driven huge swings in global markets, with media headlines filled with concerns over a collapse in China, Brexit, a Trump presidency and the Italian referendum.

It is worth pointing out that the common thread to these events is that when the perceived 'bad outcome' did occur (as was the case with Brexit, Trump and Italy), the subsequent stock market reaction was considerably more positive. European banks quickly recovered from the Brexit sell-off, and, contrary to expectations, US and Italian stocks rose immediately after the two countries' respective election and referendum results! This is yet another reminder that market obsession with 'the macro' creates opportunities.

Value of $20,000 Invested Over Five Years

31 December 2011 to 31 December 2016



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

Underneath the headlines there has been a meaningful shift in price leadership among asset classes, in particular, favouring more cyclical businesses at the expense of the 'safe' defensives and bond proxies. This has been sparked by a realisation that global growth has been better than people had expected, governments are increasingly turning towards more fiscal stimulus, and that the combination should produce some inflation.

In response, there have been big price moves in both commodities and interest rates. Spot prices of thermal coal are up +69%, iron ore +60% and copper +20%, while government bond yields have risen considerably across developed markets.[1]

This has driven a huge rally in Materials (Antofagasta +28%, Rio Tinto 23%), Energy and Industrials (Inpex +28%, Suncor +22%, Baker Hughes +28%) and Banks (JP Morgan +30%, Mediobanca +38%, Intesa +23%). In contrast, the previously favoured 'safety' stocks like Consumer Staples (Colgate -11%, Nestle -10%) and Real Estate (Simon Property Group -14%, Macerich -14%) were weak.

The other major move over the quarter was the continued strength of the US dollar, rising 15% relative to the Yen, and 6.5% relative to the Euro and the Australian dollar.

Over the past year the return of the Fund has been 6.2%, compared to 8.4% for the MSCI AC World Net Index ($A).

Changes to the Portfolio

The major new addition to the Fund's portfolio over the quarter was **ENN Energy**, a last mile 'city gas' pipeline operator in China. ENN's business is very similar to that of China Resources Gas, which we detailed at length in the September 2016 Quarterly Report. As the main risk to these businesses are price changes set by local regulators, it made sense to diversify that risk across two companies, each operating in different regions.

In terms of selling, we fully exited from two of our oil exposed holdings **Suncor** and **Baker Hughes**. Baker had risen 45% from its August level after announcing that they would merge their business with General Electric's oil and gas product division. A generous assessment of the value of the combined business indicated a US$65 stock price which is where we sold out. Similarly, after a 30% move up to US$44, Suncor's price was factoring in an oil price of US$75-80 per barrel, which no longer allowed for much further upside.

Outside of this we trimmed our positions in **Level 3 Communications, PayPal, Carnival, Kweichow Moutai** and **AstraZeneca** after strong moves in their respective stock prices.

Commentary

When the Fund takes a substantial new holding in a company, we always try to include a detailed write-up in the Quarterly Report outlining the thinking behind the investment. It is a worthy exercise to go back from time to time and look at how those cases actually played out.

To ensure that we are focusing on investments that have had enough time to progress, we will look at some major holdings presented in the September 2014 and March 2015 Quarterly Reports, namely Applus Services and Kweichow Moutai.

Applus Services – In share price terms, the thesis has not played out as expected.

Applus is involved in testing and inspection, and is effectively an industry auditor for the oil, infrastructure and automotive industries. 60% of their business relates to the oil industry where they provide testing, certification and quality control services for oil pipelines, storage and petrochemical facilities.

We started buying Applus in December 2014 after its share price had fallen from €16 to €8, based on the collapse in the oil price down to US$45 a barrel. At the time we were looking for oil related companies that were cheap and would survive even if the recovery in the oil price took much longer than expected.

The initial case was built around the following considerations:

- Half of Applus' oil exposed revenue was mandated testing of infrastructure already in place, which would be stable in spite of the oil price fluctuations.
- The 40% of their business relating to autos and infrastructure (power lines, utilities) was growing nicely at mid-single digits and would continue to produce healthy profits throughout the oil downturn.
- At 10-11x earnings, the company was considerably cheaper than oil service peers (that had 100% exposure to the downturn) and other testing peers like Intertek and Bureau Veritas which traded on 17x.

1 The US 10-Year Treasury yield from 1.6% to 2.5%, the UK 10-Year Gilt yield from 0.6% to 1.25%, and the Italian 10-Year Government Bond yield from 1.1% to 1.8%.

How the case has progressed

Applus's non-energy related businesses have performed according to expectations, with revenue and profits in these divisions up 14% and 10% respectively since the end of 2014. The stand-out has been their automotive testing division IDIADA, which has benefited from the ongoing research and development of automated safety and autonomous driving features in the latest generation of cars.

Where our assessment and predictions faltered was how hard Applus' oil related revenue would be hit, in particular, the more recurring mandated audit work. While demand for the recurring audits held up, the problem was ***pricing***. Our view was that audit fees (a small expense in the scheme of things) would not be the first place that oil companies would look to for cost savings. However, given the intensity of the downturn, it seems all suppliers needed to make concessions and Applus was forced to offer 10-15% style discounts to maintain the work.

Overall, to management's credit, they have done an excellent job in managing costs through the protracted downturn, to the point where net profit this year is only 10% below the peak.

As I write, Applus is trading at €9.30 versus our average purchase price of €8.40. The 10% return has been very dull, especially when compared to the large moves we have seen elsewhere in the energy related stocks. However, we are still enthusiastic about the returns we can make from here. Activity in the energy industry is arguably at a trough and, with oil and gas capex set to pick up in 2017 and a number of pipelines nearing approval in the US, in our view, Applus should enjoy a steady recovery over the next three years.

Kweichow Moutai – This case has played out well.

Moutai is China's national premium brand of *baijiu* (white liquor), with a fabled history that included being Mao's choice of liquor to serve visiting heads of state. We acquired the bulk of our Moutai position between July and December 2014.

The main concern around the business at the time was the fall in demand and price driven by China's corruption crack-down. During the boom years, demand from the government sector accounted for a full 60% of Moutai's sales, and given it takes five years to produce new stock, supply shortages drove the retail price up to RMB1,800 a bottle (A$360). The advent of the corruption crack-down put an end to this, with demand from the government sector falling by 70% and the retail price halving to RMB900 (A$180) a bottle.

Our case around Moutai focused on the following key factors:

- The company was much better positioned to deal with the political climate than its peers as it had not pushed up wholesale price to distributors during the boom. Effectively it was the distributors who had made out like bandits when retail prices sky-rocketed, and they took the hit when prices collapsed.
- The fall in prices made Moutai more accessible to the middle class. There was evidence that public sector consumption was being replaced by the retail buyer.
- Moutai's valuation was already factoring in a pretty dire outcome. The stock traded on 11x earnings while it had US$5 billion of excess cash on its balance sheet – a huge discount to Western liquor makers who traded on 20x P/E and carried a lot of debt on their balance sheets.

How the story has progressed

The key development was Moutai's success in diversifying its business away from government officials, with this channel now representing less than 10% of sales. This was aided by two factors:

- There were many distributors who could not get access to supply in boom years. Once stock became available, they were eager to carry it, helping Moutai expand their retail reach.
- The supply shortage allowed many of Moutai's weaker competitors to gain market share with their own high end *baijiu* brands. Moutai's superior brand position allowed the company to reclaim that share once supply was no longer an issue.

With retail purchases picking up the slack, demand has now risen to a level where prices are rising again, from a low of RMB900 per bottle to recently trending at RMB1,200 for Chinese New Year. This is a very healthy sign for Moutai and gives them room to start modestly bumping up their wholesale price.

The market, seeing the business begin to grow again, has re-rated Moutai significantly, with the stock having more than doubled from our RMB150 (A$30) average entry price. While Moutai still has good potential for future growth, with the stock trading closer to a 20x P/E multiple (and no longer at a major discount to Western peers), we have been trimming our position.

Outlook

At this time of the year it is common to be asked about our view on where we should be invested in 2017 and beyond. When building the portfolio our main focus is around the specifics of each individual business, however, there are some broader factors that provide a signpost to what areas should be promising going forward.

So what factors can we observe today?

1. Past performance – This can be useful when identifying extremes, and arguably the US market is now falling into this category, having massively outperformed the alternatives in every time period over the past 10 years. Consistent with the adage 'trees don't grow to the sky', the simple observation here is that markets that have outperformed for a decade tend not to repeat the feat, with the last 50 years showing a pattern of mean reversion after long periods of outperformance/ underperformance.

2. Valuation – On a P/E basis, Europe, Japan and Asia are trading in-line with their historical averages, while the US is trading at a 30% premium to both its long-term average and the other markets.

3. Sentiment and positioning – Across the spectrum of extremes, investor sentiment is still clearly negative around the Emerging Markets, cautious-to-neutral in Europe and Japan, and quite positive around the US post the Trump election win.

MSCI Index Market Performance to 31 December 2016 (in AUD — Non-Annualised)

	1 YR	3 YRS	5 YRS	10 YRS	P/E2017E	CAPE10YR*
North America	12%	53%	160%	96%	18x	27x
Japan	3%	33%	110%	15%	15x	24x
AC Europe	1%	11%	88%	10%	14x	15x
AC Asia ex Japan	6%	24%	79%	57%	12x	14x
Emerging Markets	12%	14%	51%	31%	12x	11x

* CAPE is the cyclically adjusted P/E. Current price divided by average earnings over the last 10 years adjusted for inflation.

Source: MSCI, StarCapital, Factset, JP Morgan.

It is important to point out that factors like starting valuations are not useful for predicting short-term returns. For example, the US market has been at lofty valuations for two years now and it continued to outperform. But starting valuations are fairly reliable in predicting long-term returns and, importantly, as an indicator of the amount of risk in markets.

In keeping with the goal of looking for the best risk-adjusted return, the desired combination of low valuations and low expectations would point to better prospects in Asia and the Emerging Markets and, to a lesser extent, Europe and Japan. This is broadly consistent with where we are finding interesting investments on a stock by stock basis today.

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$20,000 invested in the relevant Fund over the specified five year period relative to the relevant benchmark index (in A$) 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. Regional exposures (i.e. the positions listed other than "cash" and "shorts") represent any and all physical holdings, long derivatives (stock and index), and fixed income securities as a percentage of net asset value.

4. The table shows the relevant Fund's top ten long stock positions as a percentage of net asset value as at 31 December 2016. Long derivative exposures are included. However, short derivative exposures are not.

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