P L A T I N U M ASSET MANAGEMENT

The Platinum European Fund

Quarterly Report
30 September 1999

Performance – stocks generally struggling as Euroland bond markets undermine valuation

MSCI Europe fell 2.1% for the quarter as measured in local currency, however a weaker Australian dollar (and especially a strong sterling) pushed that return to a positive 2.9% in Australian dollars. The Platinum European Fund struggled to escape the broad market weakness and returned 2.8% for the quarter in A$. Some very significant corporate activity, and rampaging share prices in Greece, had a positive impact on stockmarket performance, but this was more than offset by soft prices in a broad range of shares in the market. In fact it is not inaccurate to summarise that stocks generally fell unless they had a specific reason not to. Why? Interest rates. Over a quarter when the benchmark US bond interest rates were practically unchanged, German interest rates as measured by the 10 year government bond went up from 4.5% to over 5.1%.

In the sense of day-to-day investment flows, European bond markets were weak (ie interest rates rose) because Japanese investors were selling. The most important variable was the surging yen, and as the value of their European assets fell in yen terms, the Japanese sold en masse. The economic sense of rising European rates (with US treasuries flat – despite a runaway economy) is that the market is discounting the possibility of rising inflation in Euroland in the medium term, and/or an official interest rate rise from the European Central bank. One could argue that structural impediments (eg the dysfunctional German labour market) mean that Euroland cannot enjoy US style strong-economy-but-low-inflation-nirvana, and instead that indications of economic recovery in Germany immediately imply inflation risks. This gloomy interpretation is probably intertwined with the policy paradox to which we have alluded in recent years – namely that the removal of individual European country currencies and monetary policies gives rise to the "Eurobubble" phenomena. Ireland, for example, has an economy running white hot, and yet the European Central Bank will not raise interest rates because Germany and Italy do not require it. Such "disequilibria" in a theoretical framework could be a reason for adding risk premium to the bond market.

Major stock / sector movements –gases and trucks, French retailers, and the Deutsche Neuer Markt

Corporate activity, as foreshadowed in our recent reports, remained centre-stage in Europe. The industrial gases industry commenced serious consolidation as the French Air Liquide and US-based Air Products bought BOC of the UK, and Linde (Germany) agreed to take-over the Swedish company AGA, while continuing negotiations to buy the Messer-Gresheim business from Hoechst. While fair trade issues will hold up the completion of these deals for a few months, the general principle of "one-goes–all-go" has been reinforced, and the global mood of industrial consolidation strengthened.

The France based global hyper-market retailer Carrefour and compatriot Promodes (super-market behemoth) announced a merger in late August to form Europe's largest retailer, and in fact a retailer in sales volume second only to WalMart worldwide. We see the same effect as in the gases business – WalMart bought Asda of the UK a few months ago, announcing with great clarity that its two purchases in Germany were just the beginning of its European strategy. This emerging pattern makes our holdings in Rinascente (French parent, Auchan, is in talks with the aggressive Dutch company, Ahold), and Continente (Spanish subsidiary of Promodes) very interesting. Continente's share price increased 20% in the days after the deal announcement, and the Spanish business now looks powerfully positioned. Ahold would be a catalyst for more immediate and public progress at Rinascente (at the moment it suits the privately owned Auchan not to publicise any success in Italy which means as minority shareholders in the subsidiary, we see an improving business but little satisfaction in the share price).

In Sweden, Volvo, having disposed of its car business, bought Scania to form a powerful business in heavy trucks. As a consequence there are now expectations that MAN (Germany), Iveco (FIAT's truck subsidiary) and Renault will react to the new landscape. Late in the quarter Bank of Scotland, a small but highly profitable regional bank in the UK, launched a hostile takeover bid for National Westminster Bank. NatWest is more than twice the size of the aggressive Scots, and in all likelihood other UK or even German or American banks will make higher bids. After Olivetti managed to swallow Telecom Italia, the notion that size is a defence has been rudely shaken; profitability and the rule of the strong receive the full backing of world stock markets.

Despite all the corporate activity, many other areas of the stock markets have struggled. One of the most conspicuous is the German Neuer Markt – the separate section of the German stock market reserved for smaller businesses which need capital and do not wish to pay the high fees of the main board, and in return provide more regular, international-standard financial information to investors. Because it attracted some exciting growth businesses, and because they caught the imagination of the individual German investor, the stocks in the Neuer Markt had reached some highly speculative levels by early July. Perhaps because the business of Mobilcom, one of the leading lights and largest market capitalisations of the Neuer Markt, turned down, or perhaps because a huge number of new issues (more than twenty companies per month by August / September), the Neuer Markt stalled in the middle of July. For the quarter that index is down 23%, and more importantly a lot of the over-enthusiasm of the private speculator has been reigned in. For us, this area of the market could start to offer some interesting businesses at sensible valuations; the danger is that there are many companies listed on the Neuer Markt which have been sold opportunistically to an indiscriminate public.

Holdings

During the quarter we sold Sainsbury (position weakened by WalMart buying Asda), WPP (met price target) Deutsche Bank (stock up over a third since May and still a lot of work to integrate Bankers Trust), Hoechst (a second important "pipeline" drug failed, compromising its metamorphosis into a life-sciences business), and ICI (met price target).

The fund invested in Continente (Spanish hypermarket operator, which we have liked for some time and owned before, whose price had fallen – until its parent merged!), Pro7 (German TV station which will benefit from the advertising cycle improving in Germany), Jil Sander (leading fashion house trading very cheaply and our view confirmed shortly after when Prada bought most of the company), and Baan and SAP (two enterprise resource planning software companies who should see business pick up again once the Y2K spending lull has passed).

Outlook – economic revival vs the valuation debate

The most perplexing issue in the market currently is the weakness in economically-sensitive small (and not only small) stocks at a time when world growth in general, and German growth in particular, looks more promising than it has for many years. It seems that the world is a less dangerous place than this time last year when the threat of deflation and anaemic world growth meant many small business faced meagre volume growth prospects and had minimal pricing power. As we look at our German economy-sensitive holdings, we see businesses with slimmed down cost positions after years of struggle, a very competitive currency (ie cheap euro) and the prospect of volume improvements right now and over the coming quarters. While rising interest rates dictate that very high PE stocks are dangerous, if earnings recover in the broader market, the portfolio should do well.

This week an important event is taking place in Italy where the Olivetti managers are using a series of legal loopholes to try to move valuable parts of the Telecom Italia business (specifically TIM – the largest mobile operator in Europe) away from the minorities in Telecom Italia and up into the holding company structure. This "daylight robbery" is potentially very damaging for the credibility for the Italian capital market. We should be very surprised to see the Olivetti plan proceed, if it does it will damage the valuations of the 6% we hold in Italian stocks.

Breakdown of Portfolio - Fund Size$1.5 million

Categories	**Examples of Stocks**	**Holding**
Technology / Growth	Alcatel, Ericsson, Baan, SAP	32%
Cyclical / Recovery	Linde, Siemens, Schindler	28%
Consumer	Rinascente, Escada, Continente	23%
Interest Sensitive	Toro	3%