PLATINUM ASSET MANAGEMENT

The Platinum European Fund

Quarterly Report
31 December 1999

Performance – stock indices surge despite further losses in bond markets

MSCI Europe rose 24% for the quarter as measured in local currency, although a stronger Australian dollar versus the Euro cut the index return to 18% measured in A$. As in the US, a weak bond market (German 10 year government bond interest rates increased from 5.08% to 5.36% over the quarter) was no match for investor enthusiasm for the "new industries" stocks. The top performing European industry segments were telecommunications equipment (which more than doubled in the three months), computer hardware and software (up nearly 80%), computer services, media and telecommunications services (all three up over 60%). Some of the more economically sensitive cyclical segments gained on conviction that the economic revival is sustainable this time (industrial products and machinery both up 43%), and the only really dull areas of note were consumer products and food, and some of the water utilities (especially in the UK).

Only about 60 of the largest 500 stocks in Europe fell by over 10%, while more than 60 increased by over 50%, of which about 20 doubled (or more) in the quarter. Almost all of these 20 fall into the five categories mentioned above, and Ericsson (+115%) and Nokia (+114%) were the clear leaders among the very large market capitalisation stocks.

The Platinum European Fund benefited from good performances from the technology, telecom, and media related stocks in the portfolio. Ericsson, Alcatel and Siemens, all of which we have highlighted in recent quarters, were important contributors. In addition several new stocks were introduced (and some in fact subsequently sold during the quarter as price targets were met). For the period the Fund returned 47% in A$, 29% above the index.

Market focus – subscribers – mobile, pay TV, internet

Technology, telecom and related stocks took off in late October all around the world, and recorded a stunning fourth quarter as mentioned above. Our explanation is that the market was paying up for subscribers to services in the new economy – principally of course with the internet in mind. In Europe the main difference to the patterns in the US can be best described as a function of platforms. On one level America is very PC-centric. This is partly because there are more PC households in the USA than in Europe or Japan. But it is also because the principal alternatives (under-development in mobile phones, and very old cable networks for TV based interaction) are relatively inappropriate compared to Europe and Japan. Thus in Europe the fascination for the internet is being expressed in the value of mobile phone operators and TV companies just as much as it is in ISPs and actual web businesses themselves.

WAP, or wireless application protocol, the important agreement on a standard for mobile data to which we alluded in our second quarter report, was very much the buzzword in Europe in Q4. Mobile data sent the valuation of mobile phone operators and equipment vendors soaring, and it also resulted in great excitement in the peripheral businesses such as the so-called web agencies. These hybrid ad agency/IT consultants design front end interactive web sites and integrate them with the central database of the client companies – and those with WAP expertise were some of the most exciting in the quarter.

And the internet as a theme was played in the TV companies – BSkyB in the UK and Canal + in France were, among others, all beneficiaries of the idea that pay TV customers are just as valuable (for internet services) as ISP or mobile subscribers. Broadcasters generally – but also magazine publishers and other media producers - were also strong as the market realised that with all these wonderful delivery systems the content itself was also valuable!

Corporate action has been a theme for our last several reports, and as European industries continue to consolidate, such activity will continue. In the final quarter of 1999 the major deals took place right in the "subscribers" sector under discussion. The most spectacular (and over-analysed!) deal has been the Vodafone-Mannesman-Orange one. In October, the German company Mannesman bid for the number four UK mobile company, Orange. Mannesman, ten years ago a modest engineering concern, was awarded the second German mobile licence in the early 1990s. Since then it has built a fantastic position in Europe with its German operations, majority control of Omnitel (the second player in Italy) and a loose alliance with Vodafone of the UK in various other markets. The problem with a bid for Orange was that it pitted Mannesman directly against its erstwhile partner - in Vodafone's home market! Vodafone's reaction, in mid-November, was thus not really surprising – a hostile, Eu104 billion plus bid for the whole of Mannesman.

Since then the politics (to what extent will the German government and business establishment allow a foreigner to make a hostile takeover?) and economics (are the benefits of scale – in purchasing from Ericsson/Nokia, of rolling out billing systems, of roaming etc – so great as to justify a price tag of over US$100bn?) of the deal have been debated and there is still no resolution. What is clear is that operating companies as well as financial speculators are enamoured of businesses "controlling" subscribers to the new industries.

Elsewhere, but in a similar vein, the Microsoft/France Telecom – backed cable company NTL (of the UK) bought the cable assets of Cable & Wireless Communications in the UK, and it bought the cable business called Cablecom in Switzerland. Again a purchase of connected and potential subscribers, and the physical capacity to deliver voice/data communications services, as well as internet and other media content. BSkyB (Murdoch) bought a stake in the Kirch pay-TV business in Germany – and the analysts were immediately gloating about the "per subscriber" price paid (somewhere over US$3,000) and applying that number to other pay TV operators, ISPs etc.

There have been other transactions in the older industries, and many of these will have highly beneficial impacts on profitability in those areas. We have been very interested to see the Linde-AGA deal (ie. Linde of Germany buying the industrial gas business AGA) completed which will allow Linde to negotiate some important asset swaps with Air Liquide and other industry players in the coming months. Bayer bought the polyurethane feedstock business of Lyondell (quite a contrast to the market fantasy of Bayer doing a deal in pharmaceuticals!), and heavy engineering firm ABB has continued to focus its portfolio of activities with the sale of its nuclear business at the end of December. While the stock market at large has paid scant heed to these deals compared to its fixation with telecom deals, they are nonetheless important and suggest that some of these "old industries" offer good opportunities.

Germany – tax reform

Recent government proposals on this topic in Germany are significant and highlight the general rule of German politics this last year or so – namely that soothing left-leaning rhetoric from the "socialist" government is being accompanied by policy that is more pro-capital than that of the previous conservative government. Although the government does not currently control the upper house, commentators reckon the legislation will be passed largely intact because the opposition parties all claim to be pro tax reform as well.

There are two interesting implications from the government proposals (important parts of which were released in the days before Christmas). The first is that at around Eu36 billion, the tax reform being implemented over the period to 2002 is equivalent to nearly 2% of GDP – an important supply side shock that should underwrite an already improving economy. The reforms are both to corporate rates (profits taxed at 25% instead of 30-40%, with some offsetting reductions in depreciation allowances) and to personal income tax rates which are coming down at all levels of income. A further important tax reduction is on capital gains on sales of stakes by one domestic company in another, and that is the second important aspect. With large stakes in many of the medium and large industrial companies, Germany's banks have "lazy" balance sheets and also effectively make large swathes of German industry take-

over proof. German banks have been lobbying for this tax reform for several years so that they can sell the assets. Thus the implications of the capital gains tax reduction are that the banks will have capital to consolidate their own fragmented industry, and that poorly performing German industrial companies are no longer protected.

The other aspect of the tax reforms policy is that it marks a definitive departure from many years of tight fiscal policy in Euroland. The area has suffered as EMU-related policies have harmed economic growth, and the German government is now sending a clear message that the budget deficit will be repaired by economic growth, not by further fiscal stringency.

Holdings

Through the quarter we have sold out of our position in *SAP* (we added to its competitor *Baan* and introduced the Swedish ERP company *Intentia* instead), we sold Spanish retailer *Continente* (this sort of defensive position is inappropriate at the moment) and we exited advertising company *Havas Advertising* after a very strong run. In December we sold out of *Alcatel* (at a big price given the challenges ahead for the company), so that *Siemens* and *Ericsson* carry our telecom equipment hopes on their own now. We bought and sold during the quarter *Canal +* (French pay-TV company), *Optosof* (one of the several Swedish web agencies), and *Tiscali* (Italian internet service provider) - all three of these investments served the fund extremely well.

Several major new holdings were introduced during the quarter. *Epcos* is a passive components maker and world leader in filters, resonators etc for mobile phone handsets and base stations, which was listed by its parents *Siemens* and *Matsushita*. *Stinnes* is the owner of *Schencker*, the largest land transport business in Europe which is set to benefit from the pick up in the Euroland economy. And *Hachette Filipacchi*, publisher of Elle among many other titles, is a media content play based in France. We also bought *Bayer*, and *Merck* (of Germany) which is a pharmaceutical and chemical conglomerate in the throes of rationalising its activities. In addition we added to Dutch paint/pharmaceutical/chemical conglomerate *Akzo Nobel*, *Hornbach, Linde, Metso* (new name for the pulp/paper machinery businesses of *Valmet* and *Rauma*), *Schindler* and *Elexis* in Germany which generally raised the exposure to economically-sensitive companies.

Outlook – “new economy” stocks dangerous, “old industries” offer potential as economy improves

As we have trimmed or sold some of the hotter telecom and technology related positions from the portfolio, we have been conscious that we may see higher prices – and in a few cases that has happened. However we have been happy to put the money to work in some of the other areas of the European economy, as mentioned above. Macroeconomic indicators (especially some of the purchasing manager, investment intention and capacity utilisation surveys) point clearly to economic resurgence in Germany – the largest and, with Italy, the recent laggard economy of Europe. Our recent meetings with German companies have confirmed these broader indicators – enthusiastic feedback on domestic activity was a contrast with the circumspect answers we have received in previous years.

The prices of many of the economically sensitive stocks are modest relative to their own histories, and very low compared to the overall markets. It will take a few quarters with better volume and pricing to show the profit improvements made possible by years of cost cutting through tough times; we expect the stock market to anticipate this in the coming months by starting to switch money into these sorts of companies. Our holdings such as Akzo, Bayer, Linde, Hornbach, Metso, Elexis, Stinnes etc should be well placed for such an eventuality.

Whether the higher interest rates will severely erode the valuations of the technology and telecom stocks is unclear in the short term, though reason would suggest a correction is inevitable. With holdings such as Ericsson, Epcos, and TIM (Telecom Italia Mobile) for example, we retain some of these strongly growing (if highly priced) companies in the portfolio. However we have far less exposure to them than we had during the fourth quarter, and if a correction occurs in the prices of other strongly positioned businesses then we have some cash available in the fund to re-enter such stocks.

The fund size is currently $4.5 million