PLATINUM ASSET MANAGEMENT

Platinum European Fund

Quarterly Report

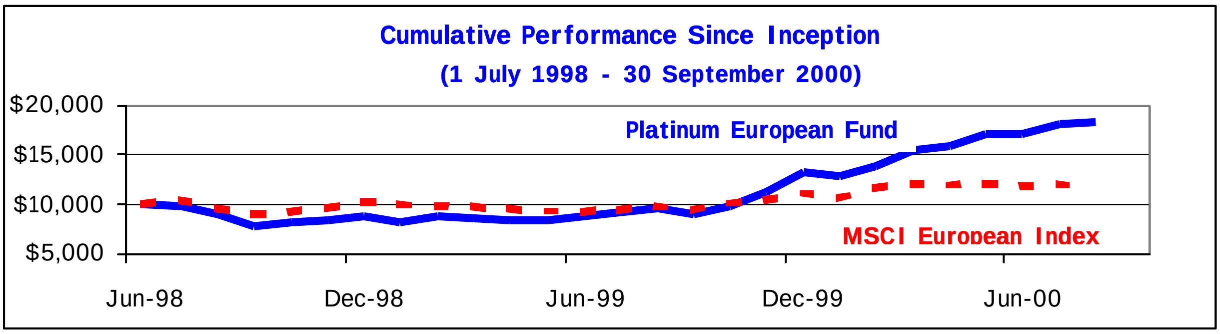
September 2000

Redemption Price: $1.6133 Fund Size: $25 million

Performance – telecom stocks suffer and market struggles with economic outlook

European stock market indices were dull overall for the quarter with the MSCI Europe down 1% in local currencies but up 3% in A$ (as a weak Euro was offset by an even weaker Australian dollar). Sector rotation continued, with the overall European index trapped in a 7% range over the period. Negative influences on the index included steel (-35%), the telecom operators (-16%) and telecom equipment companies (-11%). Strong areas of the market included the computer services sector (+18%) as it bounced back from its Q2 slump, and food retail (+15%), healthcare (+13%) and financials (+10%) as the market sought refuge from technology and telecom weakness.

The Platinum European Fund was up 11% in A$ for the quarter, as solid performances from its holdings in bank, retail, and pharmaceutical stocks were complemented by stability (point to point) in the prices of its main cyclical holdings (including strong performances from transport company Stinnes and paper/forestry company AssiDoman). In addition performance benefited from some successful hedging both in the main European index, and through various short positions in some highly priced stocks. It must be noted that the performance of most of the technology/media stocks the Fund was holding in June made useful contributions before being sold.



Telecom equipment – the customer matters!

At the end of the second quarter the Platinum European Fund report noted the sell-off in telecom operator stocks and identified the third generation mobile operator licence auction outcomes as the catalyst in pricking the valuation bubble. It is worth quoting a concluding paragraph from the June report:

“The other thesis to which the market subscribed was that expensive licence fees meant a rapid deployment of 3G wireless equipment (ie. to start earning a return on the licence fee as soon as possible). This idea meant that even as technology stocks were selling off everywhere, the European telecom equipment stocks remained quite firm.”

This logic held together for a little while but was not sustainable. The capital expenditure potential of the world’s major telecom operators is not difficult to calculate; the fact that almost all of them are quite heavily in debt means that additional spending above internally generated cashflow is awkward. Combine this with the unexpected shock of billions of dollars of 3G licence fees to pay, and an underlying deterioration in cashflow as national long distance and international call profitability collapses, and suddenly the capital expenditure potential is questioned. Telecom equipment stock valuations, by July, were discounting healthy/outlandish capital spending growth, not stagnation.

Another issue was that the gaggle of new, so called “alternative carriers” (themselves presumed to be a nice growth market for the equipment vendors) were losing money as they sought to build their voice and/or data businesses through effectively subsidising new subscribers. This was fine until April/May when the business models were questioned by investors and funding started to dry up.

Clearly all that was required was another catalyst. As it happened there were several: profit warnings from heavyweight Lucent of the US, and from the superstar Nokia over handsets were echoed by ill-defined complaints of “component shortages” from Cisco and more handset problems for Ericsson. From their mid-year peaks, the European stocks were somewhat lower by the end of September: Ericsson –30%, Nokia –29%, Alcatel –25% and Siemens –23%. It is interesting to note that despite their poor run in the second quarter, the actual telecom operators continued to fall: Deutsche Telekom –35% and both British Telecom and France Telecom –17%.

Given that these seven stocks are all among the 25 largest market capitalisations in Europe, it is clear that index-oriented and momentum-based funds would have had a difficult quarter. Platinum European Fund sold its Ericsson and Alcatel holdings at excellent prices during the quarter, sold short the stock of Nokia a few weeks before the profit warning and maintained its small position in Siemens (before adding to the holding early in October).

Strong sectors – only by default?

The healthcare and food retail strength reflects their traditional safe haven status; the counter-intuitive strength in the UK computer services stocks reflects a strong quarter worldwide for software companies such as Oracle, SAP and Peoplesoft as the “post-Y2K software expenditure strike” seemed to be ending. The banks and financial services sector was up 10%, though many financials were a lot stronger with continental insurance stocks following the lead of the US businesses where it seems the insurance cycle has turned upward.

It is difficult to get too excited about the fundamental position of the food retail or the pharmaceutical stocks in an industry-wide sense. The food retailers are facing domestic market saturation and very competitive conditions when they try to expand into new territories. Heavyweight Carrefour, itself working through the merger process with Promodes, noted recently that they are surprised that there has not been more consolidation in the sector in Europe; certainly those Europeans hoping to grow in the US are faced with the daunting task of addressing WalMart on its home ground. For the pharmaceutical companies, the US presidential election period is a dangerous time to the extent that proposals for reform of the dysfunctional (and hugely profitable) US drug market are made. Very few of the reform models are positive for pharmaceutical company profits, and the Europe-based firms are happily feeding at the US trough.

Euro weakness, Danish referendum, the ECB and monetary policy

We were distressed and surprised to see the European Central Bank raise interest rates another 25 basis points this week (early in October). While the direct impact of such a rate rise is probably limited, the signal it sends is a strong one. European interest rates had already gone up several times and by 200 points (ie. 2%) over the last 12 months. Worldwide, and especially in Europe, economic releases have indicated slowing growth in the major economies. This is probably due to the oil price “tax”, to the mounting US trade deficit, to the reduction in confidence caused by the slumping Euro, to the cessation of Y2K-related spending, to the string of rate rises already imposed etc. Most central banks have not raised rates when last given the chance (including the Federal Reserve, the Bank of England, the Reserve Bank of Australia and the Swiss National Bank). Most of them trust, to varying degrees, in the technology-led productivity cushion which characterises the late 1990s global economy (versus its 1970s predecessor). With the globalisation-related threat of deflation only ever a recession away, the powers that be err on the side of loose monetary policy.

Except in Euroland. The troubling message that this latest, unexpected, rate rise sends is that even if growth is slowing, the ECB mistrusts the Euroland market mechanism (especially the labour market) to cope with the hopefully transient events of $30 oil and a weak Euro. And of course the nature of economic behaviour is that this becomes a self-fulfilling prophecy: after five years of wage restraint, the powerful German labour unions have threatened wage demands in response to this week's rate rise. And the Euro weakened in response – as most currencies will when the market regards a policy move as inappropriate to the economic reality.

A week after giving a "No" response in their national referendum as to whether they would like to join the Euro, the people of Denmark could be excused for breathing a sigh of relief that the ECB will not (directly at least) be managing Danish monetary policy. More generally our view would be that the "success" or otherwise of Euroland will be determined in the real performance of the major economies involved rather than whether Denmark, Sweden or indeed the UK desire to join. The Danish "No" quite correctly, therefore, had little impact.

Finally, while all the focus is on the weak Euro (even as the problem a few years ago was seen as the "strong yen" rather than the weak US$), it must be noted that the strength of the US$ is rapidly becoming a serious problem itself – witness the recent doubling of the US trade deficit. Currencies are by definition pairs, and the over-stretched US economy itself will probably be the best friend of the Euro in the coming years.

Holdings – stock specific and still not in the telecoms!

The Fund is holding a significant position in European consumer stocks – drinks companies, general retailers, Wella and Adidas. Additionally there are several economically sensitive companies, though these are specific stories rather than reflecting a view that the price-takers generally are interesting at the moment. We are holding three different banks having sold SanPaolo-IMI (Italy) in favour of Lloyds-TSB, UBS, and more Nordic Baltic Holdings (Sweden-Finland). A small number of technology positions and virtually nothing in the telecom operators guarantee that the portfolio is still quite different from the European index.

Over the quarter we added Adidas, Bic, (both attractive valuations and business reorganisations starting to yield results) and the banks mentioned above. We sold the last of the Ericsson, SanPaolo-IMI as mentioned, Spanish media group Prisa, and Alcatel. All these stocks had exceeded the prices we expected of them. We have tended to hold more of the Fund assets in cash, especially in September.

The outlook is always tricky in October; we would be getting quite positive given the very negative calls coming in the from the stockbroking community in recent weeks (plenty of capitulation downgrades of the telecom operators after the horses have bolted, for example), though as suggested above the ECB is not making things any easier. Valuations in Europe are generally more reasonable than they have been for the last 10-12 months, though the economic uncertainty now prevailing counteracts this somewhat. Overall we imagine that stock markets will have trouble making much progress and that careful stock picking will be important in the coming months.