The Platinum European Fund

Quarterly Report

31 December 2000

Redemption Price: $1.7352   Fund Size: $31 Million

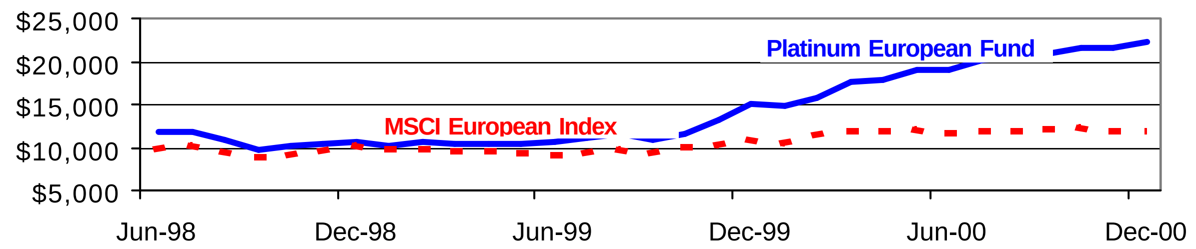
Performance

Earnings downgrades and NASDAQ destroy Technology, Media and Telecom (TMT) stocks

Once again benign index outcomes have masked enormous moves within the European stock markets. For the quarter, MSCI Europe was –6% in local currencies and –1% in Australian dollars. So-called “cyclical” sectors were the highlight, with the steel, paper and chemical indices each up 20 to 30%. On the other hand the computer services index and the computer hardware & software index each lost more than one third of their value. More problematically, there were few good places to take refuge as only 54 of the top 500 stocks were up over 20% for the quarter, compared with 89 stocks down more than 20% (29 of these were down more than 40%).

The Platinum European Fund returned 8%, as it benefited from good returns from chemical, paper, beverages and banking stocks.

CUMULATIVE PERFORMANCE SINCE INCEPTION (1 JULY 1998 – 31 DECEMBER 2000)



Commentary

Markets – the bubble bursts, the “old world” resumes as the “real world”

Most of the calendar year 2000 for European stock markets has in fact been a story of the consequences of the November 1999 – March 2000 technology bubble. This phenomenon pervaded stock markets the world over and, as we have noted several times, manifested itself in Europe in a relatively narrow range of stocks, many of which were more hope than reality. We wrote in the second quarter 2000 report of the *Neuer Markt*, which we labelled “the supercharged NASDAQ of Europe”. This market segment, which rose eight-fold from its inception in 1996 to its peak in March 2000, has, in the last nine months, lost over 70% of its value. To understand the scale of the bubble to March, it must be noted that this 70% decline brings the market back only to the levels where it traded for most of 1999.

As with any mania, there have been stories of excess and deception that characterise all collective lapses of reason. The erstwhile largest capitalised stock, EM.TV, a company intending to merchandise characters from films etc, has had to concede that perhaps the accounts were not quite correct and of course various members of management have left the company. EM.TV is an elegant representation of the loss of reason in the market; more generally of course there are many legitimate business listed on the *Neuer Markt* which we can now begin to consider.

One of the signs of the peak in the tech/telecom mania was the curious labelling of companies and industries as "old world " – this went so far as to include entire countries, eg. Australia! As a thoughtful cynic noted several months ago, few of the dot coms or concept tech stocks possess anything like as much technology as the average chemical, auto, or aerospace company. As the dot disappeared from dot com, the attractions of earnings, earnings visibility, market position, cash generation and sensible valuation, were remembered. Thus in the last few quarters and especially in the last few months, good share price performance has been seen in these apparently "old world" sectors. In some cases this has probably gone too far – today the valuation of the classic "defensive" stocks in Europe is unattractive.

European economy – the US, the euro, domestic growth and the oil price

The US economy has began to slow quite sharply from its very brisk growth of recent quarters. This is not helpful to the extent that European growth has been propelled by exports to the US (fuelled by the weak euro). However as we have mentioned over the last few quarters, the European economies are starting to show an improved domestic performance. France, for example, has seen a higher rate of employment growth in each of the last three years than that of the heroic US economy. And in Germany the unemployment rate has declined persistently for quarter after quarter. It is interesting that tax receipts in both Germany and Italy have been increasing in recent months despite the dull growth – presumably people/businesses are not increasing their tax payments just for fun!

European structural reform continues to be the key underpinning (and requirement) for solid economic conditions in the coming five years. To a considerable extent the desperation of the mid-1990s was the catalyst for change. At that time manufacturing costs per hour in Germany were 70% higher than in the US and well over double those of the UK. Today labour in Germany costs 10% more than the US and only 40% more than in the UK (adjusting this advantage for poor UK management and product quality explains the seemingly perverse disappearance of the UK manufacturing sector). Interestingly, the cost of labour in France is below that of Britain for the first time in two decades. All this thanks largely to the euro. As the euro stabilises (and in fact probably strengthens more than most imagine in coming years), continued structural reform (of tax regimes, labour markets etc) will be crucial to maintaining growth and competitiveness in Europe. As we have mentioned before, the fiscal position of European governments will protect/promote growth in the coming year or two – in fact for the first time since 1993 most or all of Europe will enjoy expansionary fiscal policy in 2001.

These impulses should be complemented in the short term by the decline in the oil price (now one third below its September peak and more than that measured in euros), the steadily improving level of capital investment in Europe (encouraged by a strengthening euro) and, hopefully, a cut in interest rates early in 2001 (to reverse October's unnecessary hike). Considering all these factors, we are encouraged that growth in Europe, though clearly slower than early in 2000, will be maintained at a reasonable level in the coming quarters. More importantly, we do not observe in Europe the severe distortions that characterise the US economy (business and consumer debt, trade deficit etc) and thus cloud the medium term picture.

Industry consolidation – auto components, specialty chemicals, paper

European industry consolidation continues apace. The demise of a few strangely priced telecom stocks has had little impact on the imperative for scale and reach in the real economy. In the midst of concerns over the slowing US auto market (and the attendant misery for DaimlerChrysler), European auto components companies are scaling up. One of the consequences of Vodafone's take-over of Mannesman early this year was that the industrial businesses of the German conglomerate were put up for sale. The purchase of Mannesman's very large auto components business was hotly contested; in the end a Siemens-Bosch combination triumphed over the hapless steel conglomerate Thyssen-Krupp. And then in October the Peugeot family, via the long-suffering listed company that bears their name, bought the French parts supplier Sommer-Allibert. Perhaps more interesting still is that the benchmark European component company, Valeo, is understood to be willing to merge with a large (American?) partner.

These deals are a continuation of a process of concentration – in the case of auto suppliers the pace is probably driven by the pace of consolidation of their customers – the auto assemblers. Although there has not been the raft of mergers that analysts predicted Daimler buying Chrysler would precipitate, the consolidation has been steady (if stealthy) nevertheless. With partial acquisitions (eg. Renault buying part of Nissan, Daimler pressing on by buying a stake of Mitsubishi etc), and "alliances" (on marketing, parts sourcing etc) becoming more common, the suppliers have seen the inevitable and are teaming up as well. We are looking at some suppliers because their position in the industry will structurally improve, but the auto cycle has been a strong one worldwide so we are wary of getting involved too early.

Specialty chemicals is an industry which has continued its deal making – December's long awaited take-over of the UK's Laporte by Degussa-Huels (Germany) is among the last remaining British-owned specialty chemical businesses to fall into continental hands. The industry is far from homogenous - and in a lot of ways based on profitability, market shares and technical lock, some of the business of the so-called bulk chemical maker Bayer are more "special" than the pure plays. However in general it is another low growth but cash-generative industry where valuations and consolidation mean that there are some interesting opportunities for investment.

An area of special interest for the Fund has been the paper and forest products area where the industry has for once displayed capital discipline even though pricing and demand are solid. Thus the cycle looks like being extended rather than suffering the usual spectacular boom-bust. The Fund has invested in three Scandinavian paper companies – world leader UPM, newsprint focused Norske Skog, and also AssiDoman, which owns six million acres of Sweden – in forest! The interesting thing for these Scandinavian producers is that their plant is sufficiently efficient and their market positions sufficiently large that even if the euro returned to parity with the dollar, these companies would still be the world's lowest cost producers by quite some distance