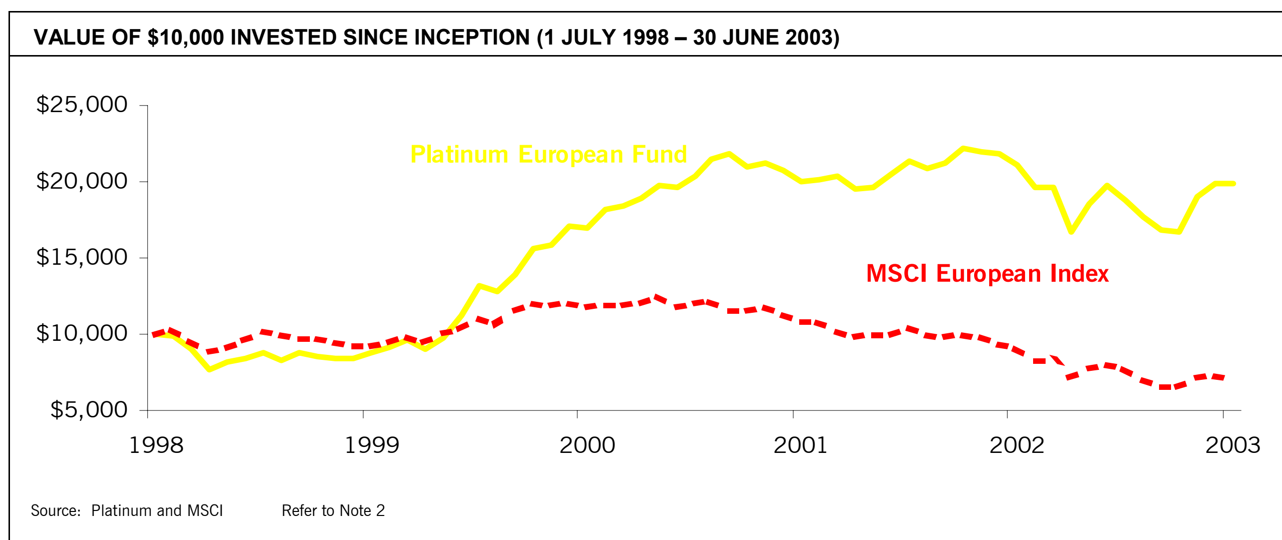
Platinum European Fund

Performance

REDEMPTION PRICE: CUM $1.5195 EX $1.4854

VALUE OF $10,000 INVESTED SINCE INCEPTION (1 JULY 1998 – 30 JUNE 2003)



Source: Platinum and MSCI Refer to Note 2

Stocks rebound, extraordinary moves becoming ordinary!?

European stock markets recovered some ground in the June quarter, increasing 16% in local currency terms. Technology (computer services +40%, software +30%) and financial stocks (insurance +29%, banks +21%) led the gains, while consumer staples (food +2%, beverages flat) reflected a reduced "appetite for safety". "Cyclical" sectors such as paper (+7%) and energy (+7%) showed only modest gains as the strong euro undercut the benefits of hoped-for economic recovery. Germany, after another battering in the early part of 2003, was the strongest individual European market rising one third, while the UK (+12%) had the smallest gain among the main markets.

Among individual stocks, the sharpest upward moves were seen among the deeply distressed insurance companies across the continent (Swiss Life +175%, Royal & Sun Alliance +103% and Allianz +76%), and also in the German banks (Hypovereinsbank +109%, Commerzbank +96%). In fact almost all the big gains in the quarter involved the shares of struggling (in many cases heavily indebted) companies bouncing back from bankruptcy-like lows. Altogether 29 shares among Europe's largest 500 were up by 50% or more in the June quarter; only about 50 companies saw their share prices decline, indicating the breadth of the advance in recent months.

The Australian dollar continued to rise steadily against the European currencies over the quarter, so that the MSCI Europe index returned 10% in A$. The Platinum European Fund increased by 19% over the quarter, as its holdings in Germany performed strongly, and the 55%-60% hedge into A$ afforded some protection from the rising exchange rate.

June 2003 marks five years since the commencement of the Platinum European Fund. Over the five years the Fund has compounded at 14.7% pa, while MSCI Europe has lost 6.3% pa. Alternatively, $10,000 invested in the Fund in June 1998, with income reinvested, has become $19,860 today, while the market has reduced June 1998's $10,000 to $7,215.

Commentary

Economic "recovery", plentiful credit, and oversold markets

The dreadful circularity of the insurers' behaviour (as stocks fell, they needed to sell to maintain statutory ratios thus causing stocks to fall further, etc) was described in the last quarterly report, and it coincided with worries about the "war" in Iraq, pessimism about economic prospects, and bond markets whose strength led the momentum investors (most institutions) to switch from stocks to bonds. The exaggerated downward moves resulting from these factors meant that stock markets had to rebound, which is just what happened in April and May.

The commentators (stockbrokers, newspapers, etc) generally fit the words to the music, and never more so than when economic prospects are as confusing as they have been in the last 6-12 months. Thus when the stock market was suffering in the months up to March, it was clear that "deflation" was virtually certain, that Germany was to be the "next Japan", and that the incompetence of the European Central Bank meant European stocks should trade at structurally lower valuations than, say, those in the US. By contrast, the headlines today insist that the US economy is recovering, that the rest of the world will follow, and that monetary policy "works", and thus it is not surprising that "the bear market is over". It is hard to say which of these conclusions is more exaggerated!

With the rise and rise of what may be thought of as marketing-driven funds management, it seems that the "institutional perversion" in the stock markets is greater than ever - and this is, in the context of general economic confusion, the best explanation of the volatility in share prices.

Marketing-based fund managers attempt to produce a return – positive or negative – that is close to the index return; they then rely on their marketing department to attract/retain investors. The behaviour of such managers exacerbates trends in the stock market because they run fully invested portfolios, and as their investors panic in and out in response to market movements (ie. almost always after the fact) the manager sells low and buys high.

The key point is that there are proportionately more direct participants in the stock market making decisions primarily based on share price momentum (and thus not enough fundamental investors to take the "other side"). Thus while little has changed in the knowable macroeconomics of Europe in the first half of calendar 2003, and the stock market is flat, the volatility of markets over the six months has been remarkable.

Thus while an argument could be run explaining in economic and political terms the sell-off and rebound, the main point is that the self-reinforcing trends in stock prices are becoming more entrenched. It is for this reason that we must (and do) take account of market positioning realities as well as fundamental factors.

April/May company visits

As to fundamentals, we visited 31 companies, mostly in Germany, Denmark, France and the UK in April/May. The companies included some the Fund already has investments in, potential new candidates, and competitors etc of existing/possible investments. The general message was that that economic conditions were not worsening, but nor were they improving – people seemed to have adjusted to a dull level of activity. Managements were generally concerned about the slide of the US$ against the euro, and concerns were raised, as usual, that labour market reforms in Germany were progressing too slowly.

One of the most interesting companies we visited was a German business called Medion. As we mentioned in a previous quarterly, we have been trying to find a way to play the so called "Aldi phenomenon" – ie. the strategy, on a large scale, of taking some of the very huge profits made in the production and distribution of food and household goods. For perspective, who would have imagined 50 years ago, amidst shortages and rationing in Western Europe, that in the coming half century undreamt of fortunes would be made in distributing consumer staples? Despite incredible developments in technology etc, a review of the list of global billionaires reveals that in practically all western countries, some of the very largest fortunes have been made in supermarket retailing – the Walton (WalMart) family in the US, the Sainsburys in the UK, the Auchan and Carrefour owners in France, the Albrechts (Aldi) in Germany, etc. This super-profitable industry must of course attract competition – and it has and will continue to come from many angles. Aldi itself is a private company, and while we consider the high-quality discount format portion of French retailer Casino to be very interesting, it is still only a small part of that company. Suppliers to Aldi (and its imitators) tend to be the multinational food companies (making a pragmatic decision that it's better to do a private brand for a big buyer than to miss out on supplying it at all), so again the phenomenon is diluted in Nestle, Danone, etc.

However one other strategy that Aldi uses (especially to bring new customers in to the outlets) is to hold promotions of non-supermarket items – eg. a laptop PC. So for example, they might advertise that in each of the hundreds of Aldi stores in southern Germany, on the 20th July, 200 laptops with specific features

will be available for say E1,199. The product will be state-of-the-art in configuration, and will be at a price well below that of a comparable mainstream laptop computer brand in an electronics shop. Because of this, these promotions themselves have become something of an event – usually there are queues outside the shop from say 6am for the 8.30am opening, and the products will be all gone by 9am. By which time, of course, 200 customers, who may not otherwise have entered the Aldi store, have come through and seen the price that tomato sauce can sell for if you try a bit harder!

But Aldi does not make cutting edge configuration (or any other!) laptops, and nor would Dell, Toshiba, etc be too keen to supply them at such a price, nor on a promotional basis when they are sitting in every electronics shop, department store, and computer specialist shop in town. More to the point, Aldi does not want to have to deal with inquiries about how to set up the computer etc. Medion is the very unusual company that provides, on a project basis, specific products that companies such as Aldi would not usually stock. Medion is not a manufacturer, but it designs the products in the sense of determining the configuration of the PC, and its real skill is in bringing together all the different component suppliers, and then overseeing assembly on schedule. They have no branding expense, nor do they carry any stock, yet the defined project nature of their orders makes them a desirable customer to all the electronics component suppliers. Medion has telephone operators who handle all after-sale problems, inquiries, etc (and the issues arising from this customer contact are fed directly back into the design/configuration decisions for the next project). The company has sales of E3bn, profits after tax of over E100mn, trades at 16 times this year's expected earnings, and is growing quickly at the moment.

Is Medion too Aldi-dependent? That is certainly the key customer, but there are many others, and in the "mature" Medion market Germany, the products are now available in the mainstream electronics chains (effectively on an in-stock basis – ie. all the time – but from Medion's perspective still on a project, ie. no inventory-risk, basis). That the maverick, unbranded product now sits beside the global brands suggests that Medion is no longer a marginal player. The company is growing quickly in Europe, and has been doing test projects for Best Buy and Cost Co, etc – big retailers in the US for the last couple of years. The investment is interesting without assuming success in the US, and the low-risk, slow, careful approach they are taking in that giant consumption market means the US is a very interesting potential aspect for the company.

Market concerns about consumption in Germany, and the general slump in stock markets a few months ago gave us an entry opportunity (30% below the current price) so that the Fund now has a 3% position in Medion.

In Denmark we spent several hours with the board member responsible for production at Novozymes. The stock has been the largest holding in the Fund for most of the last year, and the company's production competence is one of the core aspects of the story. Enzymes are almost always more effective at carrying out a given process, but usually the chemical alternative is cheaper. Thus the requirement is not only to come up with an enzyme based biological catalysis process (eg. for making laundry powder effective on stains), but to be able to produce it efficiently enough that it is cheaper than the traditional chemical process it aims to supplant.

We were taken through the fermentation and purification plants – a huge site one hour's drive west of Copenhagen – and concluded that potential new entrants to the industry faced ghastly hurdles (unsurprisingly, there have been no new entrants for years). More important is the point that despite the continual growth in enzyme output from the production site, no new fermentation capacity has been installed in the last 15 years. Instead, the yield achieved from the fermentation process has increased, perhaps *ten-fold*. This increase represents the core biological and manufacturing know-how of this company, and it is the implicit cost reduction that allows more enzymes to be competitive with chemicals, while simultaneously allowing Novozymes to increase its research & development expenditure and increase the earnings of the company.

Reform in Germany starts to look promising, but early days

The need for labour market reform is one of the broken records of any economic discussion about Germany. Hourly labour costs in manufacturing are around E27 (US$31 or A$46) – double that of Spain and 20% or more above the EU (excluding Germany) average. The "successful" six year union campaign in the 1980s which resulted in a 35 hour work week in Germany exacerbates the problem, as do the large number of vacation days meaning that German workers put in 16-18% fewer hours per year than their Japanese and US counterparts.

High manufacturing costs have traditionally been acceptable in Germany as corporate strategy usually revolves around world-leading products which support premium prices (to the Asian or American alternatives). However as manufacturing shifted

from engineering predominance to electronics predominance, Germany's competitive advantages have been less able to compensate for wage differentials. This coming winter, it is forecast, unemployment in Germany will exceed five million. Hence the need for labour market reform – which really means easing hiring and firing rules, allowing more flexible enterprise based bargaining, etc.

The political stalemate existing in the German parliaments, and the power of the large unions has meant that progress has been slow on reform and that when ("socialist") Chancellor Schroeder proposes change the unions underpinning his party complain bitterly. Thus the events in Eastern Germany in recent weeks should be seen as interesting developments. The great "gift" Helmut Kohl bestowed upon east German workers after reunification was wage equalisation with the west over the 1990s. In fact this consigned the east German labour force to the unemployment lists because their low productivity/training/skills were unsaleable at west German labour prices. Thus in many ways June's strike action by IG Metall (among the world's strongest industrial trade unions) to reduce East Germany to a 35 hour week as well, was strategically foolish. After a few weeks bringing auto factories etc to a standstill, the employees went back to work and told IG Metall they would not support it. This has been seen as an unprecedented setback for the union, and a public statement by real people about what they want; both sides of politics see this as a chance to get the reform agenda on track. We see this development as promising while being in its very early days; however the reliable thing about Germany is that once a decision to take a certain direction is made, the progress is relentless.

BREAKDOWN BY INDUSTRY

Categories	Examples of Stocks	Jun 2003	Mar 2003
Pharmaceutical/Biotechnology	Novozymes, Novartis, Serono	16%	17%
Miscellaneous Services	Hagemeyer, SGS Surveillance	14%	14%
Capital Goods	Océ, Schindler, Siemens	12%	11%
Tech/Media	Ericsson, Infineon Tech	10%	6%
Consumer	Adidas, Henkel, Michelin	9%	11%
Retail	Hornbach, Douglas	7%	13%
Chemicals/Materials	Linde, Merck KGaA	7%	10%
Financials	Alleanza, Allianz, Assicurazioni Generali	5%	4%

Source: Platinum

Outlook

Some investors expressed surprise at the Fund's nearly 40% position in German stocks in the dark days of March. But the position made sense to us given the companies available at very modest (in many cases fire sale) prices. While the position was subsequently vindicated by the strong rebound in German share prices, the main point is that if the Fund did not have its largest position when the consensus was becoming hysterical about Germany generally, then we would be surprised.

Equally, notwithstanding the indications of change mentioned above, the German economy is quite clearly struggling, so as hope, and even some enthusiasm, was priced into stocks in June, we steadily scaled back the exposure (around 34% in early July).

We are reluctantly proceeding (given the apparent appeal of today's modestly priced cyclicals/exporters) on the assumption that the US$, after this brief rally, will continue to slide against the euro, and this

assumption makes us wary of becoming too enthusiastic about European companies with big Asian or US competitors. The Platinum European Fund is currently 83% long, 17% cash, and 3% short for a net exposure of 80% in European equities. 54% of the Fund is hedged into A$, the remainder exposed to euro and other European currencies.

Toby Harrop
Portfolio Manager

Notes

1. The returns represent the combined income and capital return for the specified period. They have been calculated using withdrawal prices, after taking into account management fees (excluding any performance fees), pre-tax, and assuming reinvestment of distributions. The returns shown represent past returns of the Fund only. Past performance is not a reliable indicator of future performance. Due to the volatility of underlying assets of the Funds and other risk factors associated with investing, returns can be negative (particularly in the short-term).

2. The investment returns depicted in the graphs are cumulative on A$10,000 invested in the Funds since inception and relative to their Index (in A$) as per below:

   Platinum International Fund:
   Inception 1 May 1995, MSCI World Accumulation Net Return Index in A$

   Platinum Asia Fund:
   Inception 3 March 2003, MSCI Asia Free ex Japan Net Return Index in A$

   Platinum European Fund:
   Inception 1 July 1998, MSCI Europe Accumulation Net Return Index in A$

   Platinum Japan Fund:
   Inception 1 July 1998, MSCI Japan Accumulation Net Return Index in A$

   Platinum International Brands Fund:
   Inception 18 May 2000, MSCI World Accumulation Net Return Index in A$

   Platinum International Technology Fund:
   Inception 18 May 2000, MSCI Global Technology index in A$

   The investment return in the Funds is calculated using withdrawal prices, after taking into account management fees (excluding performance fees), pre-tax and assuming 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.