PLATINUM EUROPEAN FUND

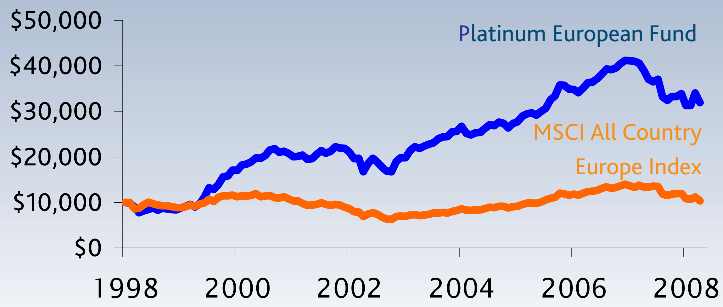
Toby Harrop
Portfolio Manager

PERFORMANCE

In a theoretical model, with informed and rational economic agents, a bank requires little or no capital. In *normal* economic times, a bank requires some capital – enough to give creditors confidence in its ability to manage various normal banking "mismatches" (borrowing short-term versus lending longer term, fixed versus variable interest rates etc), plus a little more for prudence. But in a <u>world without confidence in the banking system</u>, almost no amount of capital is sufficient – in the extreme case until capital alone is funding bank assets.

The weekend of 4/5 October 2008 has witnessed European governments and regulators accept this awkward truth. In Germany the government is providing credit of €50 billion (pretty much A$100 billion) ***to one single bank***! The trouble in (world) banking has two faces: on the asset side many bad loans were made – this is the normal way banks lose money. On the liability side, "wholesale" funding (as opposed to traditional "retail" deposit funding) has become prohibitively expensive. This is a relatively unusual problem caused by a loss of confidence in the funding structure of the banks. In Europe, banks are (or were!) less regulated and more highly geared (ie. had less capital relative to assets) than their US cousins. They are as a consequence imploding even more spectacularly than the high-profile US failures.

VALUE OF $10,000 INVESTED SINCE INCEPTION
1 JULY 1998 TO 30 SEPTEMBER 2008



Source: Platinum and MSCI. Refer to Note 2, page 36.

In the most recent quarter, however, the banks group in Europe did not even make the list of the ten worst performing stock market sectors! That list was dominated by "real economy" industries including machinery, chemicals, energy, steel and mining, (these fell 20-50%). The share prices of the European banks were down a mere 12%. This tells us simply that for all the focus on the banks' woes and the US government intervention to address them, stock markets are discounting the increasing likelihood of a severe global recession. Earnings (relative to the normal share of the economic pie), are (or were) high all around the world and especially in the West, and the growth cycle has been bounteous.

For the quarter the MSCI European index fell 5% measured in A$. Half a dozen stocks rose 20% or more in Europe, while perhaps 125 fell by 20% or more – many by much more. Only the weakness of the A$ (which declined 8% versus the Euro over the period) cushioned the overall (A$) result.

The Platinum European Fund was +2% for the quarter – although the Fund held virtually no bank exposure and enjoyed most of the decline in the A$. As mentioned above there were boundless opportunities to lose money in Europe in recent months…

COMMENTARY

Portfolio analysis and the available landscape

At the risk of fiddling while Rome burns, a consideration of the European company investment opportunities available may help ground the otherwise frenzied panic evident in the markets and in the press. Not that "good value" companies exist in a vacuum; more that a presumption of unending chaos is no more rational than the hitherto widespread conceit that debt could be accumulated without penalty. So we are assuming, broadly, a significant earnings decline and perhaps a couple of years of contraction in economic activity. Can we find compelling investments with these hurdles?

It is true that in the European bear market of 2000-2003, when the German DAX index declined a full 75% from its peak, that pretty much all stocks became "cheap". Significantly, the really strong companies, with the (10-20 year) track records and market positioning to prove it, were very good value by then. We were, for example, heavily invested in the broad-based Linde industrial gases business, in the (German) Merck LCD goldmine (a quasi monopoly in chemicals for liquid crystal displays), and in the uniquely positioned industrial enzymes operation of Novozymes.

Today it seems that there are significant areas of lowly valued, quality companies, but that the "greats", the list of European companies at which we gaze wistfully, are still, generally, expensive. Must they be cheap before the market reaches a base? Not necessarily, but the decision between holding stocks or cash would of course be simpler in such a scenario!

To illustrate: in the shares of Denmark-based Novozymes (the giant of industrial enzymes – biological catalysts – for washing powders, corn-based ethanol and many other applications), we did our best buying below DKK140 in October 2002, and our best selling at nearly DKK690 in July 2007. Today the stock trades at around DKK400, and will make roughly DKK17 of earnings per share, leaving the stock at 24 times PE. This is an improvement on the 30+ times multiple where we finished selling it, but still leaves little room for error. And while the 5-10 year horizon looks very promising for the company, I worry that sanity may prevail in US agricultural policy such that the subsidy to turn food into fuel is reduced. Novozymes can live with a sensible policy on bio-fuels; short-term investors probably cannot!

Elsewhere, Lindt & Spruengli (of chocolate fame), whose share price more than quadrupled over the recent bull market, has seen a one-third retracement and still trades at over 25 times earnings. The progress the company is making in introducing chocolate to America is encouraging, to be sure, but we cannot assume this trend will be unaffected by the coming US consumer recession.

On the other hand, Inditex (in Spain) is the listed company which owns the Zara chain of clothing stores. It has a track record of growth and profitability which reflects the company's ground-breaking organisational approach (high frequency refreshment of the assortment, and extremely swift replenishment of "hit" items), not to mention their skill in "picking" (or defining?!) the clothing fashion… Today the stock is around half its level of late 2007 and less than 14 times the earnings it will probably make this calendar year. This valuation is getting attractive; for the moment the catch is the large exposure (over a third of sales, and more of profits) to Spain, a market where the consumer is even more deserving of a rest than his US cousins!

How do these sorts of investment candidates compare with the portfolio's current holdings? The table shows the current ten largest positions of the Platinum European Fund, together accounting for 30% of the Fund. Infineon, enjoying the ramp-up of its 3-G mobile phone chipset volumes, but still suffering from its exposure to listed DRAM manufacturer Qimonda, has no earnings or dividend this year. Outdoor advertising giant JC Decaux's track record puts it in the company of the very good or great European listed stocks; while Tomra's "reverse vending" recycling technology is growing in many world markets from a tiny base. So those two have 14-times and 16-times multiples.

Otherwise the bulk of the holdings are rated at 7-11 times earnings, and in each case we have chosen companies who are not reporting unsustainably stretched profitability from the economic boom. That is, adidas is closing the gap (but still well below) Nike's profitability, BMW is less profitable than many mass market producers, and Siemens still has much to do to approach GE's earnings benchmark. Moreover, balance sheets (ie. the level of net indebtedness) of this group of companies range from manageable to strong: we will continue to avoid companies whose indebtedness robs them of choices or worse, threatens their business.

To be frank, this top ten list of companies is more "good" than "great", based on track records and market position, ability to dictate price etc. But their modest prevailing PE ratios means they should prove to be sensible investments over time.

The Euro – a catalyst, or just a barometer of fear?

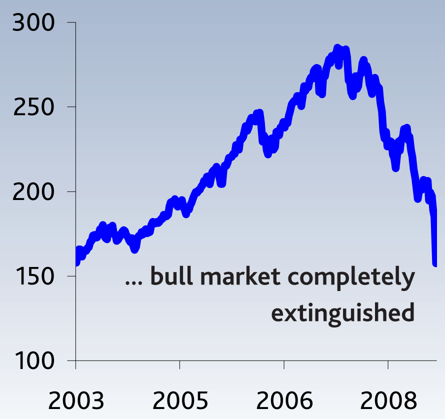
As the chart on page 3 shows, both against the US$ and (importantly) the Yen, finally the exporters of Europe are seeing some relief in the currency markets. Initially, this was a function of too many market participants holding few US$ after years of declines. As money was repatriated by US entities from their international investments, the US$ moved higher, and was chased higher by those caught short. Subsequently, the selling in the Euro reflected concerns that European economies were quickly moving into recession, so that higher Euro-area interest rates would have to decline steeply. Most recently, the continued fall in the Euro has been a

PLATINUM EUROPEAN FUND - TOP 10 STOCKS

COMPANY	INDUSTRY	HOLDING	PE 2008 EST	DIVIDEND YIELD
HORNBACH GROUP	DIY RETAIL	5.2%	7	2%
BMW	AUTO	3.4%	8	5%
LAGARDERE	MEDIA	3.2%	8	5%
ADIDAS	FOOTWEAR	3.1%	11	2%
INFINEON	SEMICONDUCTORS	2.9%	N/A	N/A
GFK	MARKET RESEARCH	2.8%	9	2%
SIEMENS	ELECTRICAL ENGINEERING	2.5%	11	3%
SCHNEIDER	ELECTRICAL ENGINEERING	2.3%	7	7%
JC DECAUX	ADVERTISING	2.4%	14	3%
TOMRA	RECYCLING	2.4%	16	2%

Source: Bloomberg

TOP 500 EUROPEAN STOCKS (over last five yrs)



Source:: Factset

reaction to disunity in the "European" policy response to the ongoing credit chaos.

However, if you are manufacturing in Germany or France and exporting to the US or Asia, the reasons for a weaker Euro are less important than the fact of it. How beneficial a catalyst might this be for BMW, Daimler, EADS (Airbus), Siemens, Schneider etc? So far it appears to have been ignored, but in fact will cushion the fall in earnings we can expect as volumes decline. We have emphasised the importance of the Euro-yen exchange rate, not just that of the Euro-US$, and it is a good sign to have the Euro trading under Y140, rather than at the Y170 level of recent years.

OUTLOOK AND POSITION

We have been too quick to reduce the protection from our short positions in the DAX index, as well as in various UK listed mining stocks, and a large European steel maker. Indeed, all of those have fallen further after our close-outs. As the credit crisis deepens into the chaos evident in early October, hindsight makes any recent optimism appear ludicrous. In the current despair and chaos, though, are presumably the seeds of a more effective response from central banks and governments around the world. The trouble today is that time is not yet a healing force – for that credit markets must again be functioning, and yield curves a more familiar slope (ie. short rates below long).

On various normally reliable measures of ***capitulation*** in markets, the recent days have given strong signals implying at least an intermediate bottom and on that basis, combined with prevailing valuations, we have increased the exposure of the Fund to around 84% net.

In addition, at prices between Eu53-56c we have increased the A$ hedge position in the portfolio to around 40%. Currencies are relative prices, of course, and while the A$ suffers as commodity prices fall and local interest rates are cut, the Euro is feeling some of the problems implicit in its structure: Spain, with its vast current account deficit, still has the same exchange rate with France, Germany etc as it did last week, last month, and last year! And Germany does not want to co-operate in a pan-Europe bank rescue effort, once again emphasising that in a crisis, "Euroland" is fictitious, and national interest is alive and well.