Platinum European Fund

Clay Smolinski Portfolio Manager

Disposition of Assets

REGION	SEP 2011	JUN 2011
Australia	0%	1%
Belgium	1%	3%
Finland	1%	1%
France	17%	17%
Germany	46%	46%
Italy	4%	4%
Netherlands	2%	2%
Spain	2%	1%
Sweden	2%	2%
Switzerland	1%	1%
UK	12%	11%
US	2%	2%
Cash	10%	9%
Shorts	6%	2%

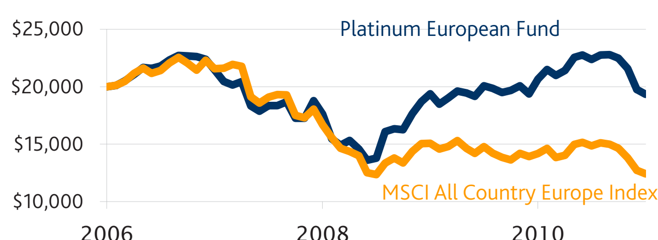
Source: Platinum

Performance

The debt crisis in Europe took on a new dynamic in July as the yield on the 10 year Italian government bond rose from 4.8% to close to 6% in the space of 18 days (compared to the yield on the German 10 year bund which now sits at 2%).

This move signaled the credit markets have now lost confidence in Italy and Spain. Restoring true confidence in the creditworthiness of the Spanish and Italian government can only be done through changes to taxation, expenditure and regulation that will take many years to implement and play out. The markets will continue to put upward pressure on the price of borrowing for Italy and Spain until a formal policy response is announced that will allow both nations to fund themselves outside of debt markets for at least the next few years. Undoubtedly the equity markets in Europe will remain volatile until this policy response is announced and it is likely the ultimate funding will be provided by the European Central Bank (ECB).

Value of $20,000 Invested Over Five Years
30 September 2006 to 30 September 2011



Source: Platinum and MSCI. Refer to Note 2, page 5.

The pace of the markets collapse in Europe mimicked the swiftness in the loss of confidence in Italy. Within a two week period the indicies of the German DAX and the French CAC had both fallen 25%, with the Italian MIB (-28%), Spanish IBEX (-19%) and the British FTSE (-13%) fairing little better.

In terms of specific stocks, there were few areas of resilience. Of the 550 stocks in Europe with a market cap above $3 billion, 479 fell over the quarter with 77 falling by over 30%. There were a mere ten stocks within the group that managed to gain more than 10%.

The European banks were at the epicenter of the collapse, with the major French (Soc Gen -48%, BNP Paribas -42%) and Italian banks (Unicredito -45%, Intesa Sanpaolo -34%) all crushed due to fears around their holdings of European sovereign debt. The cyclical sectors received the same treatment as expectations Europe would lead the globe back into recession grew, with autos (Daimler -32%), industrials (Alstom -39%, Siemens -25%), building materials (Lafarge -40%) and chemicals (BASF -30%) all leading the market down.

Measured in A$, over the past three months the MSCI All Country Europe Index was down -15.2%, with the Fund returning-14% over the same period. Measured over the past twelve months, the Fund has returned -6.4% versus the Index which is down -12.5%.

Changes to the Portfolio

Over the quarter we made a significant change to our currency exposure, where we reduced our holdings in both the Euro and the A$. As we discuss later in the report, the solution to Europe's debt problem will likely include the combination of some money printing by the ECB, a prolonged period of low rates and cuts to government spending dampening economic growth; not a recipe for a strong currency in the medium term. In regards to the A$, while the A$ has a number of fundamental strengths (high interest carry, little government debt) it remains highly susceptible to changes to expectations around Asian growth and with the A$ still at record highs against the major crosses, we are reluctant to hold much A$ here. The currency exposure of the Fund is now 26% Euro, 26% US dollar, 23% Norwegian krone, 13% British pound and 10% Australian dollar.

In terms of stocks, we exited some of our more 'defensive' holdings that have held-up well, namely Belgian pharmaceutical player **UCB** and UK mobile giant **Vodafone**, using the proceeds to top-up our positions in **Infineon, Lloyds Bank, Daimler, Deutsche Börse and Amadeus**. In terms of new holdings to the Fund, we have been patiently building a position in two fine services companies, both of which, given their cyclical exposure, have been thrashed back to their GFC lows.

The market volatility allowed us to be fairly nimble with our shorts, with our position over the quarter ranging from 2-14% to 6% at the time of writing. Our initial shorts were targeted at a collection of European banks, heavily indebted utilities and Real Estate Investment Trusts (REITS), all of which would feel the knock-on effects of the sovereign debt crisis, whether through fear of losses on bond haircuts, windfall taxes or difficulty accessing funding. Post the heavy fall in markets, we have closed a number of these short positions and have now rotated our focus towards some of the high flying growth stocks that are valued on lofty multiples of earnings. These shorts are unlikely to hurt us much if we get a bounce in markets but can suffer a decent multiple de-rating should the growth element of these stories start to come under question.

Commentary

With Europe attracting so much media coverage and the proposal of many seemingly ineffective 'bail-out' solutions, it is worth providing a simplistic outline of Europe's problem and the evolution of the response to date.

- With the backdrop of a weak economy, credit markets became worried about the long-term sustainability of European sovereigns who had a large stock of outstanding debt and were running high (-10% GDP) budget deficits. The funding costs of these nations quickly spiked to unsustainable levels.
- In response, **all European Union (EU) governments** have implemented plans to reduce their budget deficits (i.e. Italy has enacted a 'zero deficit law' with the goal of having a balanced budget by 2014).
- The synchronous cuts to government spending are slowing the EU economy directly in the sense of loss of jobs and cuts to pay but also indirectly as the uncertainty kills confidence in the private sector. The subsequent fall in GDP we have seen in countries like Greece have tended to offset progress made by those governments on reducing expenditure and fears of an eventual default increase.
- This situation is weakening the banking system, and confidence is being lost in the euro zone banks. The banks are attacked from two angles. Firstly, the weakening economy hits them through higher loan defaults and falling collateral values. Secondly, many of the EU banks have large holdings of sovereign bonds; if there were to be a sovereign default it would wipe out a significant amount of euro zone bank capital.
- The final problem is the risk that the weak position of the banks is transmitted through the real economy as they curtail lending. The first reaction of a bank who is having difficulty sourcing funding is to start pulling back on lending, and it is usually the small/medium sized businesses and consumers who find it the most difficult to borrow.

The initial bailout packages provided to Greece and later Portugal and Ireland, reflect the hopes and expectations of how the debt situation would play out at that time. The first €110 billion package was a short-term measure which would provide funding for 1-2 years in the hope that an economic rebound would ease market pressure. The announcement of the extended powers of the European Financial Stability Fund (EFSF) in July of this year goes much further in providing a holistic solution:

- The firepower of the fund was increased to €440 billion and can be accessed at low rates – this would comfortably meet all the deficit financing needs and bond rolls of Greece, Ireland and Portugal for the next five years.
- The fund could buy bonds on both the primary and secondary market, and could conduct precautionary buying (i.e. they can act before markets completely shut).
- The EFSF funds can be used to recapitalise banks.
- The announcement of the fund came with a proposal for a selective default on Greek government bonds. In essence, holders of Greek debt could swap their bonds for new 30 year bonds guaranteed by the EU, in exchange for taking a 20% haircut on the principle (quite a generous offer in our view given the pricing of Greek bonds).

The EFSF provides the tools to tackle the majority of the issues. Governments who are both willing and realistically able to reduce their budget deficits are given plenty of time to make the adjustments, while those where the initial debt burden is too great can default with the fund recapitalising the effected banks where needed. As we have seen in the UK, any recapitalisation of the banks will also likely come with some mechanism to force the banks to 'keep lending'.

Problem solved? Unfortunately no. The funding capability of the EFSF was built to fight the last war. It is simply too small to fund Italy and Spain for any meaningful period of time (Italy and Spain will need close to a €1 trillion to fund deficits and bond rolls over the next few years). The mechanics of the EFSF also prevent the funds being used by either Italy or Spain[1]. In short, a new funding solution must be found.

1 The money raised by the EFSF is implicitly guaranteed by each EU member, with the size of the guarantee in proportion to their ownership of ECB capital. The guarantee proportions are 28% Germany, 20% France, 18% Italy, 12% Spain, 5% Netherlands etc. Of course to receive funds, Italy and Spain would need to 'step out' of their guarantee, further reducing the size of the EFSF.

The ECB or Eurobonds?

There has been much press discussion around the possible implementation of a Eurobond as a solution to the crisis. The realities around implementing a Eurobond system (framework design around ceding control of national tax bases to a central body, overcoming massive populous opposition etc) mean that it is simply not a realistic solution in the medium term.

The obvious source of funding is the ECB. The ECB is currently buying Italian and Spanish bonds in small quantities and while there is internal squealing about their discomfort in doing this, the key is to remain focused on their actions rather than the rhetoric. The reluctance of the ECB to engage in wild US style money printing stems both from the lessons learnt from Germany's hyperinflation in the 1920s, and the desire to maintain pressure on the governments to fix their budget problems. The ECB will act as the lender of last resort but only if Italy and Spain are keeping their part of the bargain.

There are a number of guises under which the ECB can safeguard both the banks and the sovereigns. For instance, a plan recently proposed by George Soros calls for the ECB to provide a guarantee and recapitalisation of the major banks, whom in return would agree to follow ECB instructions to keep lending. With the ECB standing behind (and providing funding to) the banks, they would then instruct sovereigns like Italy to raise the funding they need via short-term (one year) debt at a low interest rate (1%) which would be bought by the banks using ECB funds. Over time, as the governments show they are making progress reducing their debt, the ECB can wind down the short-term funding mechanism and the governments can go back to funding themselves on the long-term debt markets.

Of course the eventual plan may include all or none of these methods but the illustration is a reminder that despite the dramatisation in the press, there are a number of realistic solutions to prevent the nuclear collapse scenario and the policy makers are getting closer to a holistic solution.

Outlook

As discussed, our central case is that European policy makers keep funding the troubled European nations and will ensure the banking system remains functioning. In exchange for this support, European governments will reduce spending and increase taxation and this is going to restrain economic growth across the region. Combined with recent falls in activity measures in the real economy (airfreight cargo, temporary employment) increasingly pointing to another recession, it is difficult to be enthusiastic about the 'macro outlook'.

When we return our gaze back to the valuations of the companies on offer, our enthusiasm level is a lot higher. Outside of the depths of the GFC in March 2009, the selection of attractively priced investments has not been as good for some time. Stocks which operate in more heavily cyclical industries can be picked up for 5-6 times earnings (Daimler/BMW), while at the less cyclical end there are many solid companies with sensible balance sheets and strong industry positions trading at ten times or below. Although it must be said that many of Europe's truly exquisite businesses have yet to be priced down to levels that would make them great investments.

Over the next six months what should you expect to see from European markets? Given the despair around the sovereign situation, any comprehensive policy response from the ECB would certainly set the markets up for a big rally but in the face of deteriorating economy and pressure on corporate earnings this will likely prove to be a trading rally at best. Their can be no guarantees that markets will not continue to fall over the next 6-12 months, however, on a three year view we are confident that purchases at these levels will reward investors handsomely.

Notes

1. The investment returns are calculated using the Fund's unit price and represent the combined income and capital return for the specific period. They are net of fees and costs (excluding the buy-sell spread and any investment performance fee payable), are pre-tax, and assume the reinvestment of distributions. The investment returns shown are historical and no warranty can be given for future performance. You should be aware that historical 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, investment returns can be negative (particularly in the short-term).

   The inception dates for each Fund are as follows:
   Platinum International Fund: 30 April 1995
   Platinum Unhedged Fund: 31 January 2005
   Platinum Asia Fund: 4 March 2003
   Platinum European Fund: 30 June 1998
   Platinum Japan Fund: 30 June 1998
   Platinum International Brands Fund: 18 May 2000
   Platinum International Health Care Fund: 10 November 2003
   Platinum International Technology Fund: 18 May 2000

2. The investment returns depicted in this graph are cumulative on A$20,000 invested in the relevant Fund over five years from 30 September 2006 to 30 September 2011 relative to their Index (in A$) as per below:
   Platinum International Fund - MSCI All Country World Net Index
   Platinum Unhedged Fund - MSCI All Country World Net Index
   Platinum Asia Fund - MSCI All Country Asia ex Japan Net Index
   Platinum European Fund - MSCI All Country Europe Net Index
   Platinum Japan Fund - MSCI Japan Net Index
   Platinum International Brands Fund - MSCI All Country World Net Index
   Platinum International Health Care Fund - MSCI All Country World Health Care Net Index
   Platinum International Technology Fund - MSCI All Country World Information Technology Net Index
   (nb. the gross MSCI Index was used prior to 31 December 1998 as the net MSCI Index did not exist).

   The investment returns are calculated using the Fund's unit price. They are net of fees and costs (excluding the buy-sell spread and any investment performance fee payable), pre-tax and assume the 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.

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