Platinum European Fund

Clay Smolinski Portfolio Manager

Disposition of Assets

REGION	SEP 2012	JUN 2012
Germany	42%	40%
France	16%	17%
UK	16%	15%
Italy	4%	3%
Spain	3%	3%
US*	2%	2%
Netherlands	2%	3%
Sweden	2%	2%
Belgium	1%	1%
Russia	1%	0%
Finland	0%	1%
Cash	11%	13%
Shorts	8%	1%

* Pulp stock listed in the US but predominant business is conducted in Europe

Source: Platinum

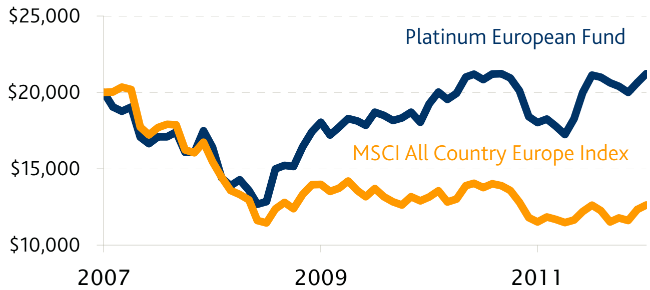
Performance

European markets rallied over the quarter after Mario Draghi, President of the European Central Bank (ECB) made a pledge to provide unlimited funding to the struggling peripheral governments. Large gains were made in all markets, with the Spanish +22%, Italian +18%, German +18% and French +15% markets the frontrunners.

The performance of individual stocks and industries was almost a mirror image of the price action seen from the previous quarter, with sectors harbouring the most fear over a Euro break-up rebounding hard and the defensives being left behind. The best performing sectors were predictably the financials (Soc Gen +22%, ING +22%, Unicredito +21%), the cyclicals (Lanxess +31%, ThyssenKrupp +28%, Michelin +19%, Holcim +17%) and anything with heavy exposure to Italy or Spain.

Value of $20,000 Invested Over Five Years

30 September 2007 to 30 September 2012



Source: Platinum and MSCI. Refer to Note 2, page 40.

On the currency front, the major move over the quarter was the strengthening of the Euro, which rebounded from a low of €1.22 to the US dollar, to finish at €1.30. The reason for the strength was both the funding plan by the ECB, which pushes out the Euro break-up fears in the mid-term, and the renewed commitment of the US Federal Reserve to their Quantitative Easing 3 (QE3) money printing programme.

Measured in Australian dollar terms, over the past three months, the Fund was up 4% versus the MSCI Europe Index which was up 7.2%. Calendar year-to-date the Fund has returned 23.1% versus the Index which is up 10%.

Changes to the Portfolio

Given the strong rally in share prices across the board, much of the activity during the quarter was trimming our holdings in a number of stocks that had performed very well or exiting holdings where our initial reason for holding was no longer valid. In that respect, we trimmed our positions in the French laboratory tester **Eurofins**, drug giant **Sanofi**, African auto and pharmaceutical distributor **CFAO**, and luxury auto maker **BMW**. We completely exited our position in Finnish paper producer **UPM-Kymmene** at a modest profit in favour of deploying the funds in businesses with better long-term prospects.

One sector where we did open new positions during the quarter was in the financials, namely in Italy's **Intesa Sanpaolo** and Russia's **Sberbank**.

The position in Intesa is opportunistic, taking advantage of the sovereign fears that pushed the valuations of the Italian banks to extreme lows. Intesa is similar to Lloyds in the UK, a profitable, reasonably well-capitalised bank and whose business is predominately serving the domestic retail market. In late July, the valuation of Intesa reached lows of 0.3x P/B and 5x P/E, based on fears of future losses on their holdings of mostly Italian sovereign bonds and higher loan losses as the Italian government's budget cuts would force the economy into a harsh recession.

As we show in our commentary, we felt the fear around Italy and hence Intesa had been over-played, and in any case the concerns were more than discounted in the price. Longer-term we doubt the Italian banking market will show much growth and therefore Intesa is not a buy and hold investment, but with the stock price rebounding nicely since our initial purchase, it has been a profitable trade.

In contrast, **Sberbank** which controls 55% of the Russian deposit base has considerable long-term potential. Russia is a major beneficiary of the high oil price, and after years of running massive current account and budget surpluses, the government is now allowing the oil wealth to flow down to the wider economy via increased budget spending and higher wages. In addition, foreign direct investment is growing as multinationals are increasingly building out their businesses within Russian borders, a trend which will be helped by the country's recent admission into the World Trade Organisation.

When considering an investment in Russia there is always a concern about the rule of law and governance, and Russia rightly trades at a discount. However, with Sberbank trading on a P/E of 6x versus banks in other emerging markets like Turkey, Hungary and South Africa trading on 10-11x, it is clear investors are already tarring it with a fairly heavy brush. The size of the discount is interesting to us as the big picture for Sberbank and the Russian banking market looks great[1] and the Putin government has put forward a policy of reform aimed at reducing corruption, improving the legal system and trying to transform the economy from a mere commodities exporter to one with a significant technological and science-driven manufacturing base.

We have often seen these 'risk discounts' placed on emerging markets fade over time (think India, Indonesia etc) and with Sberbank's business and earnings currently growing at 20% pa, we feel Sberbank will be a solid investment if the status quo is maintained and a spectacular investment should reform in Russia really take hold.

[1] In our favour, we have an economy with the tailwind of high energy prices, an almost debt free government, a private sector that needs to invest in infra-structure and an educated population who are experiencing rising wages and have little existing borrowings.

Commentary

Over the past two years the European stock markets have danced along to a recurring pattern. The steps have been: 1. the market sells down on the latest evolution of the European sovereign crisis, 2. investor panic intensifies as European policy makers publicly disagree on an appropriate solution, and 3. eventually a substantial policy response is agreed upon and the stock market goes on a massive relief rally. Having seen this sequence play out in February 2010, August 2011 and most recently in May 2012, investors are pondering whether the latest funding plan by the ECB signals a turning point that will break this pattern of crisis escalation.

The ECB's offer is essentially this – they will provide unlimited low cost funding to a country in need, IF that country makes a written agreement to execute a deficit reduction plan supervised by the International Monetary Fund (IMF). This is a very powerful tool, as it completely removes the doubt over long-term financing. With financing taken care of, the key issue that will determine the future of the Euro is whether the peripheral governments can balance their budgets without disenchanting their public to the point they vote to exit.

Readers have probably noted the financial press is fairly poor in communicating any real detail of what the governments have actually achieved in reducing their budget deficits; instead we generally just get lots of emotive articles about the lack of spending cuts etc. Therefore, in order to make a judgment on what the path to fiscal redemption will look like, it is worthy to lay out the basic facts around the government's current budget positions, what action they have taken, and what further they need to do. For this exercise we will concentrate on Greece, Italy and Spain.

Greece

Greece makes an interesting case study; as the first country to be engulfed by the crisis it has been working on its fiscal adjustment programme for the longest.

The first thing you will notice here is the oft repeated view that the Greek government has 'done nothing' to fix its budget is a **myth**. Points to note:

1. The government has not been able to increase its overall revenue take in the face of a rapidly shrinking economy. The government has raised taxes and improved tax collection (note how revenue has grown as a percentage of GDP) but this has been offset by a lower income base to tax.

Greek Government Finances (Euro bns)

	2009	2010	2011	2012	Change 2009 to 2012
Total Revenue	**85**	**83**	**81**	**79**	**Down 6bn, -7%**
GDP	224	213	198	188	Down 36bn, -16%
Revenue as a % of GDP	38%	39%	41%	42%	
Expenditure					
Wages	31	27	26	24	Down 6bn, -20%
Welfare Payments	49	47	46	43	Down 6bn, -12%
Goods, Services and Other	20.5	17.3	14.5	13.1	Down 7bn, -34%
Net Capital Expenditure	9	4	4	2.4	Down 6.5bn
Interest on Outstanding Debt	12	13	15	13	
Total Expenses	**121.5**	**108.3**	**105.5**	**95.5**	**Down 26bn, -21%**
Total Expenses ex Interest	**109.5**	**95.3**	**90.5**	**82.5**	**Down 27bn, -25%**
Total Deficit	**-36.5**	**-25.3**	**-24.5**	**-16.5**	
Primary Deficit (ex interest payments)	**-24.5**	**-12.3**	**-9.5**	**-3.5**	

Source: Greek Ministry of Finance and IMF

2. They have been able to implement large cuts to spending, and this has not just been limited to the less politically sensitive areas like the purchase of third party goods and capital expenditure. The public sector wage bill and welfare payments are down -20% and -12% respectively since 2009.

3. Since 2009, Greece has seen its economy shrink by -16%, its government cut spending by -25% and its unemployment rate increase to 23%. While the election was close, despite this environment the citizens have voted to remain in the Euro.

All up the Greek government is close to achieving a primary balance (revenue minus all non-interest expenditure); however, if we include their interest bill they still need to find another €16 billion to balance their books. To do this without growth in revenue would mean the government needs to cut its non-interest spending by another -20%, which is simply unrealistic. You can see why there is more serious discussion at the European level around a stimulus plan to restart economic growth in Greece, and we would not be surprised to see Greece seek further forgiveness of interest at some stage.

Italy

It is clear the position of the Italian government is far better than the news headlines suggest. They are on track to record a €44 billion *primary surplus* by the end of this year.

Points to note:

1. The majority of the adjustment by the Italian government to date has been via increased taxes. They have successfully pushed through tax increases to the tune of €51 billion, while the economy in nominal terms has grown slightly.

2. The government has done little in the way of reducing expenses. They have made cuts to the usual 'easy' areas of capital expenditure and other sundry expenses. Welfare costs have increased by €24 billion, whilst the wage bill and purchases of third party goods and services are flat. Total non-interest expenses have fallen by only -€5 billion since 2009, a reduction of less than 1%.

Italian Government Finances (Euro bns)

	2009	2010	2011	2012	Change 2009 to 2012
Total Revenue	**705**	**713**	**726**	**756**	**Up 51bn, +7%**
GDP	1,533	1,550	1,578	1,575	
Revenue as a % of GDP	46%	46%	46%	48%	
Expenses					
Staff Wages	171	172	170	169	Flat
Welfare Payments	336	344	352	360	Up 24bn, +7%
Use of Goods and Services	89	90	89	88	Flat
Net Capital Expenditure	38	32	32	30	Down 8bn, -21%
Other Expenses	83	76	68	65	Down 18bn, -21%
Interest	70	70	78	87	Up 17bn, +24%
Total Expenses	**787**	**784**	**789**	**799**	**Up 12bn, +1.5%**
Total Primary Expenses ex Interest	**717**	**714**	**711**	**712**	**Down 5bn**
Total Deficit	**-82**	**-71**	**-63**	**-43**	
Primary Deficit/Surplus (ex interest payments)	**-12**	**-1**	**15**	**44**	

Source: Italian Ministry of Finance and IMF

All up, the Italian government is in a fairly strong position. They need an adjustment of €43 billion to show a fully balanced budget, and even if the whole €43 billion was achieved via spending cuts, this would only account for a -6% reduction to total non-interest spending. Historical precedents tell you this is far from an unrealistic goal, and if the Italians have modest success executing on the new deficit reduction plans issued by the current Monti government, it is highly likely that they will have balanced budget by 2014.

On this basis the fear around Italy looks over-played.

Spain

The position of the Spanish government is far weaker than their Italian compatriots. Despite some success in increasing taxation revenue and having already cut non-interest spending by €45 billion to date, they still need to find another €75 billion to be able to deliver a balanced budget.

One positive is that the Spanish government has a relatively low tax take as a % of GDP which would point to further leeway to increase taxes. The negative is that Spain has already aggressively cut capex and spending on third party goods – further progress requires them to go after the difficult areas of wages and public welfare.

The Spanish cannot be accused of ignoring the need for action and in response, the Rajoy government has released an enormous budget reduction plan. On the revenue side, VAT increases, higher taxes on fuel, alcohol and tobacco and removal of corporate tax breaks are expected to net €20 billion. Another €20 billion of expenses will be cut in the form of reducing government subsidies for prescription drugs and surgical procedures, teaching hours and classroom sizes will be increased in education, and 500 overlapping government departments are scheduled to be closed.

More importantly for the long-term health of the economy, these cuts are being accompanied by deep reform of the Spanish labour market. The power of industry-wide collective bargaining agreements are being removed, the conditions for fair dismissal of employees has been significantly broadened and once the fair dismissal conditions have been met, employers have far more flexibility to alter working hours and pay as a first option rather than automatically firing staff. In addition, if lay offs must occur, the maximum redundancy payments have been reduced. All of this will help the Spanish labour force improve competitiveness versus its European peers.

Spanish Government Finances (Euro bns)

	2009	2010	2011	2012	Change 2009 to 2012
Total Revenue	**366**	**380**	**377**	**379**	**Up 13bn, +4%**
GDP	1,046	1,056	1,077	1,083	
Revenue as a % of GDP	35%	36%	35%	35%	
Expenditure					
Employee Wages	125	124	124	120	Down 5bn, -4%
Welfare Payments	184	193	193	203	Up 19bn, +11%
Purchase of Goods and Services	61	58	62	48	Down 12bn, -20%
Net Capital Expenditure	48	42	29	18	Down 30bn, -62%
Subsidies and Other	46	41	38	30	Down 16bn, -34%
Interest Bill	19	20	26	35	Up 16bn
Total Expenditure	**483**	**478**	**472**	**454**	**Down 29bn, -6%**
Total Expenditure ex Interest	**464**	**458**	**446**	**419**	**Down 45bn, -10%**
Total Deficit	**-117**	**-98**	**-95**	**-75**	
Primary Deficit (ex interest payments)	**-98**	**-78**	**-69**	**-40**	

Source: Spanish Ministry of Finance and IMF

Overall, despite some good work the reality is the sheer size of the adjustment needed means Spain will remain the focal point of the crisis for some time to come. €75 billion represents close to 20% of current non-interest spending. As a benchmark, if most of this is achieved via spending cuts, this would mean Spain would have cut its total non-interest spending by -30% since 2009. Greece has shown reducing spending by this level is not impossible, but with a starting climate of 25% unemployment the path to doing this is guaranteed not to be smooth.

So returning to our initial question, is the ECB funding plan the turning point towards the resolution of the European sovereign crisis? The ECB funding plan in a basic sense is another extension of the bailouts we have already seen for Greece, Portugal and Ireland; funding is provided on the condition that the government balances its budget. The difference this time is that the funding is coming from a politically independent body and given the ECB's ability to print money, the size and duration of the bailout is credible.

The success the Spanish government will have in adjusting its budget and the political will of its voters remains to be seen. However, we see both parties taking a pragmatic approach. No doubt the Spanish will fall short of their initial targets, but as long as some progress is being made the ECB will continue to provide funding, and allow the adjustment to be made over a longer timeframe to soften the blow on the overall economy. If we get evidence the Spanish are making headway with their budget, it will be fair to say this ECB plan is indeed a turning point towards a final resolution of the crisis.

Outlook

After a 20% rally in stock markets, it is usually right to be cautious of a pull back, however, the fears that had led to many investors labelling Europe as 'un-investable' are only just starting to be unwound. Overall, valuations are still cheap, with many European companies trading at 20-30% discounts to their peers in the US. Given this starting point, we are still confident in making good returns for the Fund.

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$20,000 invested in the relevant Fund over five years from 30 September 2007 to 30 September 2012 relative to their Index (in A$) 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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