PLATINUM ASSET MANAGEMENT

MLC Platinum Global fund

Quarterly Report
31 October 1998

Performance

Fund Size: $350mn	**1998 Year to date**	**Return Since Inception**
MLC Platinum Global Fund	15.8%	75.6%
Morgan Stanley Capital International World Index (Accumulation)	17.2%	111.3%

The fund's performance for the year to date masks its superior resistance to the precipitous decline that took place leading in to early October. Our view that many stocks are being extravagantly valued has resulted in our carrying protection in the form of cash and a short position against the S&P index. This resulted in the fund's decline being cushioned. However, as the US market has recovered the most, quarter on quarter figures look less impressive. The fund's return for the quarter is down 7.6% versus –6.2% for the MSCI world index.

Top Ten Holdings as at 31 October 1998

Stock	**Country**	**Industry**	**Holding**
Rinascente	Italy	Retail	5.5%
Yamanouchi Pharma.	Japan	Pharmaceutical	3.2%
SIG	Switzerland	Packaging/Engineering	2.9%
Siemens	Germany	Electrical Engineering	2.8%
San Paolo	Italy	Banking	2.8%
Lagardere	French	Media/Defence	2.5%
Suzuken	Japan	Pharmaceutical	2.5%
Hornbach	Germany	Retail	2.4%
Acuson	US	Medical Equipment	2.4%
Deutsche Bank	Germany	Banking	2.4%
Total			**29.4%**

Disposition of Assets

Region	**31 October 1998**	**31 July 1998**
Western Europe	45%	48%
Japan	24%	24%
North America	8%	9%
South America	3%	4%
Other Asia	3%	3%
Australia	2%	2%
Cash	15%	10%

With our North American exposure being offset by the short on the S&P 500 index, our net exposure to stock markets is 74%.

Currency

The fund presently holds some 30% of assets in A$, around 6% in Yen and the fund's European holdings are exposed to their underlying currencies.

Commentary

When we last wrote in July, we cautioned that markets were presuming perfection. As so often happens, the unexpected occurs. In this instance, Russia chose to defer payment on its debt (effectively defaulting) and this started a chain of events. Concerns grew about Brazil and its effect on the rest of Latin America, a continent which takes one fifth of US exports. As the threat of the Asian deflationary contagion moved closer to US shores, so the share and bond markets were seized by a spasm of fear which culminated in a significant hedge fund, Long-Term Capital Management, being bailed out (ironically this saved their bankers the penalty of careless lending in a similar manner to that which protected them from default of their loans to Asia). This is not merely a snide comment because it reflects the inherent instability within the financial markets, caused by excess leverage, and reveals a degree of concern at the highest level where official intervention was seen as the best of two rather unpalatable choices.

In the midst of the crisis, our main concern related to political indecision (affecting both the availability of credit in developed countries and the recycling of loans to the emerging countries, notably Brazil) and the prospect of a sharp drop in the stock market adversely affecting spending in the US. Much to the relief of markets, financial packages have been arranged to supplement the domestic measures introduced in the countries dependent upon foreign capital flows, and the US consumer has barely paused for breath. The average American is presently dipping into past savings to keep the tills ringing thus helping to absorb the surplus capacity emanating from Asia. Further assisting Asia has been the strengthening of the Yen which is believed to improve the competitiveness of Asian exports.

Is that the end of the drama? Probably not. As we have noted in earlier reports, there are significant distortions in many parts of the world. Some of these emanated from the currency turmoils of the 1980s which, when combined with the liberalisation of investment and trade, resulted in an unprecedented boom in the building of factories to produce consumer goods. By way of illustration, today Korea has capacity to produce some 4.5 million cars per year, yet the domestic market will absorb fewer than 1 million. The solution lies in seeking foreign buyers so we find export volumes have risen by 20% and yet overall revenues in US$ terms are no higher.

Other Asian nations including China face the same predicament – vast capacity, too little domestic demand and the necessity to find ever larger export markets. Distortions within the system are throwing up unusual developments, notably the fall of Chinese exports – which seem to relate to tax induced scams. (For more on China perhaps you would like to visit our web site at http://www.platinum.com.au where we outline the problems facing the Middle Kingdom – under investment reports, Platinum Capital, June 1998 annual at http://www.platinum.com.au/reports/pcl_698.pdf).

Rather than suggesting that all is gloom, we are simply highlighting the need to be circumspect about a rapid return to normal conditions in Asia. Indeed some of the economic statistics suggest the worst of the contraction is over, particularly for Korea and Thailand. Interest rates have declined, their currencies have strengthened and most importantly, there are indications that electronic and semi-conductor shipments are accelerating. However, many shares in the region seem to be pricing in an early recovery in profitability which we would doubt on account of our concerns about surplus capacity.

Further stimulatory packages and a bank bail-out initiative have been announced in Japan. The scale of these is truly immense and there is some evidence that the impact of earlier schemes are starting to spread through the economy. The domestic orientated shares we hold in Japan are relatively insensitive to economic conditions on account of their serving necessities such as medicine and soft drinks or services such as mobile communications.

Regarding other markets, we are attracted to the value of stocks we own and can justify buying in Europe. Into the teeth of the October sell-off, several US based companies, which are on our prospective buy list, came within a whisker of activation, only quickly to bounce away. Our judgement is that there will be future opportunities to collect these shares at a more leisurely pace.

The secret for investment in this environment will be to pick companies that can avoid price destruction and can grow because of the new opportunities that spring from change. Our team has been steadily repositioning the portfolio to take advantage of those areas, which can grow in an environment of low inflation and turbulence. As the table below highlights, the portfolio has very low exposure to companies that have undifferentiated products (so-called commodities) or which are dependent on the economic cycle to achieve a strong boost in profits. The predominant exposure is in companies which have pricing power through brand names, science or market dominance.

Breakdown by Themes

Category	Holding	Examples
Information Technology/ Telecoms	15%	Samsung, Kyocera, Toshiba, DDI, Siemens, Telecom Italia, NTT Mobile, NTT
Pharmaceutical/Medical Equipment	14%	Yamanouchi, Daiichi, Astra, Diagnostic Products, Acuson, Hoescht, Suzuken
Consumer/Stable Growth	14%	Fuji Photo, Wella, SIG, Sony, WPP, King World Productions, Australian Casinos
Retail	12%	Rinascente, Hornbach, Douglas, Continente
Finance/Property	10%	San Paolo, BNP, Deutsche Bank, Unibail
Cyclicals	9%	Pilkington, Scapa, Manpower. Schindler, Great Lakes Chemical
Food and Beverage	8%	Coca Cola bottlers, Pernod Ricard
Traded Goods/Other	3%	Tata Engine, Lagardere
Cash	15%	

Outlook

Most of the leading economic indicators suggest world industrial activity is slowing. In response one can expect short term interest rates to drop, perhaps led by the Federal Reserve Board. (Bear in mind that short term interest rates, though low in nominal terms at 4-5%, are indeed not so low in real terms in the industrial nations with inflation at 1-2%). However, lower rates may be less supportive for share prices than some would hope because of the pressure on corporate profits. For example earnings for the companies that make up the S&P index have been flat over the last 12 months and yet surveys suggest analysts are expecting growth in the mid-teens in 1999. Given the high valuations, failure to meet these expectations would be unhelpful.

Conclusion

It is not clear that the aggregate indices will be appreciably higher over the next six months and the main focus should be on finding individual shares that can convert a tricky environment to their own advantage. An example of this may be found in the Suzuken stock story which follows.

Stock Story - Suzuken (Japan)

The well publicised contraction of the Japanese economy is bringing about a fundamental reappraisal of traditional Keiretsu business ties as suppliers of credit assess their relationships. Weaker companies are being shut down in record numbers as banks curtail lending and the traditional support of corporate relationships are no longer seen as sustainable. Whilst this is destabilising for corporate Japan, the flip side is that the strong are getting stronger. Suzuken is clearly such a company.

It is the leading wholesaler of pharmaceutical products with a market share of 13%. In many ways the changes going on in its industry are a microcosm of the structural adjustments occurring in the wider economy. The top four wholesalers in Japan only control 35% of the market whereas in the US where a process of consolidation is largely complete, the top four have 70% of the market. We see no reason why in time the Japanese market cannot move much closer to that which prevails in the US and indeed most other markets. The forces likely to promote this process are:

- The wholesaling business is essentially a fixed cost business with the primary costs being those of warehousing, physical distribution and sales and marketing. Because of this, profitability is determined largely by the volume the wholesaler can push through its network. Suzuken has operating margins that are more than 2x the industry average as a result of its scale. Hence it is in a vastly superior position to offer either a better price or a superior service to its customers and must therefore take market share over time.

This advantage comes to the fore when the economy turns down as the weaker wholesalers often go into losses and questions are raised over their financial viability.

- The local drug manufacturers seem to be following global trends in gradually consolidating around a powerful R&D effort and working to remove costs in the sales and marketing channels. This is in response to both greater efforts by the government to cut the public health bill and the rising influence of foreign drug companies that now hold 27% of the market. The foreign companies prefer using the large nationwide wholesalers because of their reach. At the same time, they are imposing more rigorous discipline on the payment terms and rebates paid to the wholesalers.

Wholesaling is becoming much more of a value added service business than merely being distribution functionaries of the major drug manufacturers. This is caused by the pressures on the public hospital system where the typical hospital is in deficit yet still supports up to 10 wholesalers each with their attendant costs. Increasingly the better wholesalers are able to provide systems such as on-line ordering or actually go into the hospital and become responsible for aspects of the administration. Also the trend away from hospital dispensing to pharmacies plays to the strength of the larger wholesalers.

It is our view that the smaller, regional wholesalers have a limited life span: they will either have to merge or close. This will clearly benefit Suzuken in that its sales base will rise as it takes market share or merge with another company. In addition, its margins should benefit in two ways. First it is able to leverage its already existing distribution into higher volumes and secondly it can take a better bargaining position with its suppliers and customers as the number of competitors is reduced. The process has already begun with wholesaler numbers having fallen from 418 to 260 in the past 10 years. Suzuken, for its part, recently merged with a large regional wholesaler in Hokkaido which expanded its sales by 17%, and added to its regional coverage.

When we look at the valuation, the company possesses a large amount of cash which either can be paid out to shareholders or used to purchase competitors. If the PE is adjusted for this, the stock sells on 11 times current earnings or 23 times earnings on an unadjusted basis. However, current operating margins at 1.3% compare with typical margins earned by overseas wholesalers at 1.6% to 2.5% and are well below Suzuken's own recent margin highs of 2.5%. So with gains in market share and the expected lift in margins, profit growth looks well set for the next few years.

Kerr Neilson
Platinum Asset Management