investor
REVIEW
FEBRUARY 2001

MLC - Platinum Global Fund

QUARTERLY REPORT

Performance (to 31 January 2001)

Fund Size: $1.35bn	Last Quarter	Last 12 months	% pa Compound Return over 5 years	Return Since Inception
MLC-Platinum Global Fund	5.2%	19.0%	24.5%	21.7%
Morgan Stanley Capital International World Index (Accumulation)	-8.2%	9.1%	19.2%	17.8%

It has been a gruelling quarter for investors. Initially some thought the market was simply accommodating a convergence of valuations between the highly valued tech stocks and the rest. Subsequently, the massive erosion of Nasdaq (down 36% for the quarter) and the other *Neuer Markts* of the world had a knock-on effect as concerns emerged about the broader implications of such value destruction. These included margin calls, credit delinquencies and other factors associated with a slowing world economy. Investors are now starting to come to terms with the reality that shares are not a non-stop express to wealth creation. The Fund has been relatively well positioned for this change in sentiment. Apart from allowing cash to rise we have continued to run a short position against the S&P500 index.

The consequence of this activity is that the Fund has managed to rise by 19% for the year, after a fourth quarter advance of 4%. By way of contrast the MSCI returned 9% for the year, having had a miserable last three months when it declined by 8%.
Long term supporters will be pleased to note how the gap has widened against the MSCI - a 7% per year differential over five years. An investment of $10,000 five years ago would now be worth $29,800, whereas a similar investment in a representative sample of world stockmarkets ie. the MSCI World Index would now be worth $24,200. These returns place the Fund in the top three performers of international funds available in Australia over a 1, 2, 3 and 5 year period (Source: Mercers).

Changes to the Portfolio

Apart from sound stock picking, our relatively strong performances can be attributed to the changes in emphasis of the portfolio throughout the year. By March we had exited most of the over-priced tech and telecom stocks and began to move to low priced "old economy" companies which were very out of favour. This also happened to lead to greater exposure in Europe where we reasoned companies would be least affected by a retrenchment by the consumer in the USA. These simultaneous movements built-up our holdings in Europe and reduced them significantly in Japan. The table overleaf quantifies these changes.

Note that companies with cyclical earnings patterns, together with those companies sensitive to interest rates, now constitute 31% of the portfolio versus 18% a year ago. Technology, telecoms, and software are still well represented at 29% but down from 35% last year. Moreover, within this category the valuations of our holdings are a fraction of those typically found in Nasdaq – specifically an average PE of 16.7x 2000 earnings versus an estimate of 115x for the NDQ 100 index.

Currency

Over the quarters we have written about the effect of the US economy growing faster than the rest of the world, as well as M&A and investment demand causing an over-valuation of the US currency. We believe this tendency reversed decisively in the fourth quarter as the US economy slowed and inward flows diminished.

Platinum Global Fund C

Disposition of Assets

Region	31 January 2001	31 January 2000
Western Europe	33.5%	23.0%
North America	18.4%	14.3%
Japan	17.5%	37.7%
Emerging Markets	4.7%	10.9%
Australia	0.0%	0.3%
Cash	25.9%	14.1%

The fund has a short position against the S&P500 index of 10%.

This greatly helped the hedging position we had taken (albeit far too early) as we saw the Euro climb 7% versus the US$ and 13% versus the Yen. Presently 44% of assets are held in A$; 42% in the Euro, Pound and Swiss Franc; 4% in Yen; 4% in Won and the balance, 6%, in US$.

Commentary

To counter the problem of myopia - caused by doing daily battle with markets – it is helpful to review the key points that were made about the US in our last three quarterly reports. Starting in March, we referred to Mr Soros' concept of reflexivity and how once the tide changed the trend becomes mutually reinforcing. In June we alluded to the risk of deteriorating consumer confidence in the face of falling stock market values. By September we were pointing to the Euro and oil price as damaging the "priced-for-perfection" mentality and introduced the prospect of a soft landing. Intertwined throughout were references to the over-leveraging of US consumers and companies, the poor pricing environment facing companies, the distortions within the system (tracking stocks, excessive option grants, deteriorating credit) and other evidence of a mania which was most starkly revealed by eccentric valuations of tech stocks relative to the so-called "old economy companies".

As we enter the new year, the tone of the market has changed considerably. There is consternation about the speed of the slowing in the US economy as witnessed by the recent decision by the Fed to cut the discount rate by 1% in a month. Discussion about interest rates and tax cuts can be expected to receive plenty of coverage.

At this stage we are largely agnostic about the degree of softening that the US economy may experience. From our work on credit we get no comfort.

As you know, our underlying fear in the US has been the growth in debt and the impact of stock market weakness on consumer confidence. In the last five years the debt/equity ratio of US corporations has risen from 74% to 82.6% despite an extraordinary rise in company profitability. This is reflected by the decline in labour's share of the cake when expressed as labour costs to companies revenues; towards the base of the normal band of 62-68%. By contrast, earnings per share has accelerated from the normal trend of 7% pa to around 12% pa since 1995. As some share prices collapse, the wisdom of buy-backs will come under scrutiny. More importantly though, the concerns about the burden of debt – which was in earlier years expressed in terms of optimising a firms balance sheet – is being reflected in a significant blow-out in lending spreads. BAA companies, the average of the S&P500 index, must now pay 2.6% more than US treasuries (versus 1.2% in January 2000) and even top AAA's credits are required to pay 1.8% over treasuries. (The treasuries themselves have continued to strengthen – perhaps warning of a more difficult environment as well as the fact that the budget surplus is curtailing supply of government bonds).

The banks are already experiencing a rise in non-performing loans (NPLs) but in very specific areas where it became fashionable to borrow against supposedly secure income streams – notably funeral homes, cinema chains and at the extreme, competitive local exchanges (CLXs).

There is not much evidence yet of rising consumer delinquencies.

We remain highly vigilant because of the still large balance of outstanding share margin accounts at $219 billion in November. Further, we believe that households applied some of the benefits of mortgage refinancing to play the market. Lurking in our subconscious is the belief that the credit induced mania just witnessed must have cultivated some extraordinary expectations, the folly of which will only be revealed gradually, if starkly.

One should not, however, paint too gloomy a picture for the US. As noted earlier, the government's finances are in the best position for years – which will allow for massive tax cuts. Further, the Fed can drop rates significantly to prop-up confidence. We believe the inflation implications are very low even with the US$ weakening, principally against the Euro, because of the deflationary bias around the world. However, these steps will only partially ameliorate the likelihood of labour's share reverting to the mean. By way of example, Microsoft has already indicated that it will bolster wages in the face of the loss of value of its staff option schemes.

We are somewhat more sanguine about Europe. While the EU is also slowing, there are several factors that should provide a growth buffer. Firstly, the big economies of Europe have been lagging behind North America and consequently they are at a different phase of the cycle. Europe has only recently began to issue stock options and the public's ownership of shares is relatively small. Further, European predilection towards shares is notoriously lower than in the Anglo Saxon countries so the adverse affect on consumer sentiment will be correspondingly lower. After five years of belt-tightening by governments, 2001 will be the first year of fiscal expansion, led by Germany, with tax cuts equivalent to 1.2% of GNP. France and Italy have smaller cuts but the move to tax reform is well established.

Japan and Korea give us little room for comfort at the macro-economic level. The leadership under the LDP will go down in history as some of the most inadequate in modern Japan. Fortunately, companies are very aware of the threats and opportunities of globalisation and our investment faith resides in the calibre of the people, their education and commitment to leading-edge technologies. Our recent visit highlighted the breadth of know-how in the digital world and optics (the backbone of modern telephony). Our investments in North East Asia are highly selective and tend to have a technology bias. Built in to our stock selection is the view that both Japan and Korea will lose growth impetus as a consequence of a slowdown in the US.

Conclusion

While global headlines may initially carry a prognosis about interest rate and tax cuts, and budgetary stimulus, the key will be the performance of company profits. When we examine the underlying arithmetic of global markets we find that earnings in the last five years have risen about 10% pa which together with rising PE's (multiple expansion) from around mid-teens to 26x has lifted share returns to above twice the historic average which is around 9%. While bond rates are likely to remain subdued, which helps valuations, the higher risks associated with slower growth and poor pricing power is likely to cause some multiple contraction – thereby reducing returns. We therefore see further mileage in the theme of the convergence of valuations. At the same time, companies producing volume sensitive items (mostly commodities) are in many instances investing at less than their depreciation rates. This theme of capital starvation, which should logically lead to a period of higher profitability, may throw up some good opportunities, particularly when it is reinforced by plant closures and mergers.

Our third theme relates to productivity take-off. Just as the US experienced a productivity surge from the mid-90s, we believe companies in continental Europe and Japan can experience the same benefits attributable to changes in information technology and ways of doing business. Now that the Europeans have bedded down their "systems" in a single market of 350 million consumers, it is quite plausible to expect the growth in labour productivity to outstrip that of real labour costs. Japanese companies will have less help from their domestic economy, which we expect to remain flacid, but the indications to date have exceeded our expectations.

The Digital Revolution

Not so long ago, a mobile phone felt like a brick, music was recorded on black vinyl records, VCRs were guaranteed to rip the cassette tapes to shreds, and a leading personal computer ran at 133Mhz. This year's Christmas shopping lists would alert one to how much things have changed. Not only are mobile phones smaller, they also have longer battery life and include features such as radios and computer games. One can compile and down load one's favourite music into MP3 players with just a few clicks of a button. DVD offers amazing audio and visual quality, TV screens have refresh rates of 100Mhz and a powerful PC can now process millions of instructions in a second. And yet, we are still merely at the dawn of the digital age. From here on, nearly all communications will be first converted from the physical world of analog; that of sight and sound, into the digital world of zeros and ones, transmitted at the speed of light via optic fibre cable or wireless and then converted back into the analog world on the other side.

This has enormous implications for us as investors. We cannot vaguely refer to these developments as new fangled ideas but must understand their workings intimately to maximise the opportunity available. Let's start with the semiconductor chip. These rectangular shaped objects, which are normally housed in protective black plastic casings, are typically less than half a millimetre thick and usually two to ten millimetres in length and width. In its purest form, a semiconductor chip is a collection of transistors. A transistor functions as an electronic switch which allows current to flow or prevents it from flowing. Strange as it may sound, a collection of these simple ON and OFF switches/transistors allows all instructions and data to be converted into a binary language of ones and zeros. The Pentium III logic chip, which may be at the heart of one's PC for example, is made up of 28 million microscopic transistors. Yet, it is only 106mm^2 in size (smaller than a finger nail). The process of computing involves the pulsing of electrons through the chip at very high frequency (over a billion pulses per second) which regulates like a metronome the reading of codes, the fetching of data, the processing thereof and the final storage of the result.

To achieve this level of speed and compactness, chip makers, together with their equipment suppliers, have devised some extraordinarily complex manufacturing processes. An integrated circuit, better known as a semiconductor chip, is comprised of 6-8 layers of material in total. The base is a thin sliver of silicon crystal, hence wafer, upon which sequential layers are systematically deposited. Circuits are imprinted by shining a fiercely bright light through a stencil (mask) onto the photo-sensitive treated wafer. That part of the surface which is struck by light is softened while that which is in the shadow remains hard, thus in the subsequent washing and etching process the exposed part is removed thereby creating maze-like patterns. The process then proceeds to the next layering and so on. A typical wafer takes two to three months to manufacture having been through several hundred steps. There follows the dicing of the wafer into discreet chips (possibly three hundred). This is followed by the mounting of the chip on a leadframe, the spider like leads that allow the minute circuits of the chip to communicate with the printer circuit board (PCB) upon which it is mounted. Once attached to the leadframe, the chip is encased in a protective casing (that black cube), though new mounting techniques are evolving.

THE DIGITAL REVOLUTION PROVIDES A STRONG GROWTH OPPORTUNITY ALBEIT CYCLICAL

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000F	CAGR*
Sales(US $bn)	55.0	60.0	77.3	101.9	144.4	132.0	137.2	125.6	149.0	209.0	14%

*Compound Annual Growth Rate

A modern chip factory, so called fab, costs US$2-3 billion. The expense lies principally in the ultra clean conditions required and the intricate equipment. Do remember, these chips comprise circuits of 0.18*u*m in width, which is around 1/600th the width of a strand of human hair. Putting it another way, it is equivalent to the amount one's hair may grow in a single minute. A good example of the sophistication of the tools employed is that of the stepper. This is the photolithography device that allows the pattern to be laid down on the chip. It comprises a laser, which was first envisaged in the US Department of Defence Star War project, and a platform (stage) that moves the wafer imperceptively under the gaze of the light source. Such a tool can cost over US$10 million even though its footprint is only 6.5m^2. The multiple faceted lens alone takes nine months to produce.

As one might imagine from the above, the semiconductor industry has spawned a multitude of disciplines and industries that barely existed 20 years ago. This is fertile ground for us to look for opportunities for investment in a similar way to that which existed during the glory days of machine tools. The beauty of this industry is that unit demand is still growing very strongly which not even an economic slowdown will damage. A good example of this is the car industry. Additional functions such as air bags, ABS braking, global positioning systems all entail greater electronic content within a car: 60 – 70 chips are used in the current BMW 7 series and this is expected to double in the soon to be released model. Mobile phones and personal digital assistants (PDAs) are new areas that will require more and more semiconductor chips: mobile handset shipments quadrupled in a little under four years, from 108 million units in 1997 to approximately 420 million units this year. More importantly, semiconductor content per mobile phone is expected to rise as we move to the next generation wireless protocol.

There also have been tremendous strides in fixed line communication. The backbone of the system is now largely comprised of optic fibre and with ingenious engineering a single strand of fibre can carry 64 channels by using multiple light wavelengths. This adds impetus to the semiconductor industry in that the analog signals (electrical pulses) must be first converted into light pulses, amplified and shot down the optic fibre. At the other end, the reverse has to take place. In this case, there are a host of semiconductors used to translate electrical pulses into light for amplification and for transmission.

Despite the favourable long term trend to worldwide semiconductor consumption, one cannot lose sight of the fact that it is a cyclical growth industry. Like many industries that benefit from economies of scale, incremental additions to capacity tend to be chunky and often come on stream just after demand has peaked. Further, this industry has been characterised by broadening geographical participation with the Taiwanese and Koreans playing catch-up and challenging the likes of Japan and America. One factor that may smooth the amplitude of the cycle is the development of the super fab companies who take in works from the design specialists. This is also an important development for the equipment suppliers who face a greater concentration of buyers. The outcome of this may be more mergers and acquisitions amongst the equipment suppliers who in any case see benefits from consolidating R&D budgets. Furthermore, over the next three years, the equipment suppliers will find themselves better insulated from the vagaries of the cycle as their customers, the semiconductor makers, are at the start of two major technology upgrades. For all that, the industry stands out for its persistent profitability: even at the bottom of the cycle the quality companies remain profitable.

We believe the recent sell off in the Nasdaq, where some share prices have collapsed to a third of their peaks, establishes an interesting environment for investors with sensible time horizons.

Kerr Neilson
Managing Director

If you have any questions about your investment in the MLC – Platinum Global Fund, please contact MLC Customer Service on
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