imagination one can appreciate new methods of doing business, wonderful opportunities for mass education and the dissemination of information on a scale that was improbable a mere ten years ago. This creates an intriguing paradox in that while the companies involved can grow at an extraordinary speed, they each run enormous risks of being blind-sided by the emergence of a new concept. This happened with the introduction of Java which caught most people off guard and required an immense amount of energy by companies like Microsoft to get back into balance. The paradox lies in the fact that with such uncertainty, one would normally attach a very high risk premium to these businesses and yet this does not happen. Earlier examples of unbridled opportunity were the development of steam engines, steel, railways, automobiles, telephones, plastics and so on, each of which changed the way we do things forever. *So while it is different this time, it is only so in the form of technology rather than technology itself.*

However, the most important aspect of every boom is the misunderstanding of its cause. When we think back to the minor boom in property in Australia in the 1980s, it was only well after the event that people paid any attention to the four-fold increase in bank lending that occurred in the 1980s and inevitably resulted in massive inflation of property assets.

The more tragic example of this misinterpretation occurred with the great inflation in Germany in the early twenties. At that time, all attention was focused on the decreasing external value of the *Reichsmark*, this being influenced by war reparations. The prevailing view was that as a consequence of this loss of reserves, there was too little money in circulation. To counteract this the Reichsbank fed the system with freshly printed notes. It reached its zenith in October 1923, when special paper used for notes was being made by 30 paper mills and the Reichsbank had to resort to 100 private presses in Berlin and the provinces to produce sufficient notes to meet daily demand.

It became so farcical, that on 25 October, the 1,000 printers employed by the bank turned out a record number of new notes of face value 120,000 billion. Sadly on this day that amount was insufficient to meet demand. In response, the Reichsbank announced gravely that it would do its utmost to meet demand and daily production was increased to half a trillion. The complete lack of understanding of the cause of the loss of value here was the self-feeding root of the problem.

For those who believe in their skill to play market sentiment with impunity there is the "greater fool" theory. Here the idea is to take a modest profit on the way up and then pass the package to some other yet more enthusiastic player.

Day traders personified this during the IT boom but after discovering their midas touch, many moved away from the discipline of closing positions daily and instead rode their losses and cut their profits.

Accompanying this mania we have had the customary emergence of financial alchemists, be it stockbroker analysts who were lionised by the media or mutual fund managers who hosted talk shows on CNBC; private investors hung on their every word with the certainty that this would free them permanently from the drudgery of daily gainful employment.

So in the excitement, many lose sight of first principles and also fail to correctly identify the cause of excitement. *The blinding vision of great opportunity draws players away from the cause.* In this boom, we were told that the new opportunity would permanently lift the level of prosperity, where in fact, we were mostly enjoying an asset pricing distortion caused by bountiful liquidity. *The kernel of the wealth generation lay in innovation and yet this paradoxically was the threat.*

Apart from the excitement in the tech end of the market, there was also evidence of over-enthusiasm elsewhere. When examining returns generated by corporate assets over a long period of time, it is clear that returns in the last ten years were approximately twice those of the historic average.

Kerr Neilson
Managing Director
May 2001

For the second year in succession, Platinum Asset Management has been awarded Fund Manager of the Year for International Equities by Money Management and Assirt.

If you have any questions about your investment in the MLC – Platinum Global Fund, please contact
MLC Customer Service on
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from anywhere in Australia or
0800 442 550
from New Zealand

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investor
REVIEW
MAY 2001

PLATINUM
ASSET MANAGEMENT

MLC – Platinum Global Fund

QUARTERLY REPORT

Performance (to 30 April 2001)

Fund Size: $1.46bn	Last Quarter	Last 12 months	% pa Compound Return over 5 years	% pa Return Since Inception
MLC-Platinum Global Fund	-1.5%	12.1%	24.6%	21.9%
Morgan Stanley Capital International World Index (Accumulation)	-1.4%	-4.1%	19.1%	16.9%

Greater uncertainty in world stock markets has diminished investors' appetite for buying the dips. Previous bold forecasts of continued growth of corporate earnings in 2001 have been replaced by the prospect of the first negative year for S&P stocks' earnings in a decade and much reduced expectations for the constituents of other markets. The technology stocks went through purgatory as sales expectations were radically altered and share prices fell accordingly. By April the selling crescendo had abated and buyers fossicked around the wreckage looking for bargains.

Our willingness to take a different path from the crowd with our stock picking approach and to take out insurance measures has paid off handsomely. Compared to a decline of 4.1% by the benchmark MSCI index, the Fund rose by 12.1% over the last 12 months. Interestingly the average return of global managers in the Micropal survey was -8% highlighting the tendency for most managers to hug the index. We are tediously emphasising this point so that you understand that from time to time when others are doing well, we may look shabby by comparison.

Changes to the Portfolio

There has been little change in the geographic disposition of the Fund's assets as new flows were largely directed to topping-up existing positions some of which had sold off fiercely with the market. Earlier in the quarter we took profits on several of our tech names, such as DuPont Photomask, Lam Research and Teradyne, which had been bought during the initial October sell-down. Towards the end of the quarter we were enticed into initial positions in enterprise software vendors such as i2 Technologies, Commerce One and Verisign. The latter is involved in issuing digital certificates used to secure a wide range of internet and e-commerce applications. We also bought IC chipmakers like Foundry Networks, Agere Systems (the optical components spin-out from Lucent Technologies) and Agilent Technologies (the electronic testing and chip making company that was formerly part of HP). This latter purchase takes the place of Anritsu which proved a highly successful investment.

Disposition of Assets

Region	30 Apr 2001	31 Jan 2001
Western Europe	37.5%	35.7%
North America	23.9%	25.3%
Japan	18.2%	19.2%
Emerging Markets	6.9%	5.8%
Australia	1.0%	0.6%
Cash	12.5%	13.4%

The fund has a short position against the S&P500 index of 7.3%.

Currency

The so-called commodity currencies, which includes the Australian and Canadian dollar, have suffered as the view about global growth deteriorated. Interestingly, the Canadian dollar has softened notwithstanding much improved terms of trade resulting from the rise in oil and gas prices. Investors focused on liquidity and safe havens and the US dollar fitted the bill. However, we believe market sentiment has begun to change and this reinforces our positive stance on the A$.

The one event we believe to be significant, the decision by the Bank of Japan to target money reserves, vindicates our strategy to remain mostly hedged out of the Japanese Yen. At quarter end the Fund was hedged 47% into A$. Other currency exposure included 41% Euro/Europeans, 3% US$ and related currencies, 3% Yen and 5% Korean Won.

Commentary

The sell-off of stock markets from their peaks by anything from 20-35% has provided something of a resting place from which to observe the unfolding economic scene. The devaluation to date reflects an initial adjustment for changed earnings expectations combined with a reappraisal of risk. The difficult problem now is to read the cross-currents that are apparent in the leading economies. On the one hand we are seeing short term interest rates being lowered, with even the European Central Bank making a concession recently to weak economic statistics coming out of Germany. This can have the affect of inducing a greater willingness by the consumer to borrow and spend and also reduces the cost of borrowing by risk takers. Against this is the continuing evidence of jobs being lost as corporations move swiftly to align their capacity with lower demand and as they attempt to compensate for the recent extravagant levels of investments.

To highlight the impetus generated from lower short term rates, Bernstein Research calculates that the annual pre-tax gross savings from mortgage refinancings in the US at the current 6.9% rate is worth about US$23 billion or 0.3% of spending. Of course there is an offsetting loss to *rentiers* but they are generally not the big marginal spenders. Also aiding the US consumer is the promised help by the Congress which is proposing a tax cut or tax rebate before year end.

A new bull market?

Some will possibly argue that the recent rally is the beginning of the new bull market. As evidence, they may point to the breadth of the advance (the number of prices advancing versus a smaller number declining); the prospect of low and falling interest rates – further steepening of the yield curve – and the likelihood of earnings turning positive in 2002. Counter-arguments about high valuations impeding further share price advances may be met by the logic of low discount rates and the poor prospects from alternatives such as bonds and property.

We are ambivalent about the investment outlook. We have been impressed by the way a broad range of companies have experienced gradually rising stock prices since December and share the belief that cheap money is highly seductive. However, valuations are at levels that would not normally signal the beginning of a new bull market and we cannot believe that the recent excesses have left the system unscarred.

A little more inflation!

What could be happening is that we are seeing the initial affects of surplus liquidity beginning to affect the general price level. As regular readers will recall, we have had the view for several years that the prospects for inflation were benign. This view was supported by our observation of the deflationary affects of the opening of massive new labour markets in the developing world and the rapid transfer of technology and financial resources. However, we are now moving to the view that perhaps there can be some price inflation emanating from the services sector, notably in the Anglo Saxon countries and perhaps in due course, as these trends are established, there will be lesser willingness on behalf of investors to hold these currencies. This could exacerbate an emerging inflationary trend. In the first instance this could be beneficial to segments of the stock market as companies that hitherto had suffered from weak pricing power experience a somewhat more favourable environment for raising their prices to re-establish their historic profit margins. This may also explain the behaviour of the share prices of smaller companies and lower growth companies versus typically fast growing companies. In other words, the differentials between growth and slow growth companies will narrow as inflation increases a little. Having raised the prospect of slightly higher inflation we do not at this stage see it accelerating at anything like that experienced in the seventies. We see a continuing over-supply of many traded goods which will impede sharp increases in general prices. This factor has been accentuated by the Bank of Japan's recently announced measures to target the money base. It is our view that this will have the effect of debasing the external purchasing power of the Yen which will mean the relative price of Japanese exports will be highly attractive and put downward pressure on the producers of these goods elsewhere. Further, while a steepening yield curve is normal for a cyclical recovery, it is consumer confidence which is the ultimate driver of stronger growth. Though the retail sales figures have picked up in the US, with savings so low, **stagflation** may be more likely to be the headline banner than growth.

The distortion of easy credit conditions is still working its way through the system. There is no better example of the distorting of the cost of debt than in the US production of manufactured homes. This industry experienced during the 1990s the entry of aggressive new lenders who were not limited by the traditional banking reliance on deposits. Asset-backed securitisations rose from approximately $1 billion in 1990 to over $14 billion pa in 1999. This facilitated a sharp rise and persistent sale of manufactured homes at levels of around 350,000 from the mid-nineties onwards.

These aggressive lenders continuously cut credit standards in their rivalry to gain market share. They extended the duration of loans from 15 to 30 years, presumably the useful life of manufactured homes, as well as accepting applicants with dubious credit histories. Subsequent failure to meet monthly payments has crammed the lots with repossessed homes. Further, the major lender, Conseco, is repossessing at an annual rate of 25,000. Competition from repossessed homes and supposedly tighter credit standards has greatly reduced demand for new homes. The current projection for new sales for 2001 is put at 170,000. The manufacturers stare at share prices as low as one tenth of their peak.

Conclusion

The quarters ahead remain challenging for investors as they try to anticipate the ebb and flow of consumer confidence and rotation within the market. It is encouraging though that the bottom 250 companies in the S&P500 index account for a mere 9% of market weight and are on valuations that are justifiable by their long term returns. This compares with the top 150 companies by capitalisation which constitute 81% of the index but which are highly valued. Likewise in Europe and North East Asia, the smaller companies are not expensive by historic criteria.

Notwithstanding our longer term concerns, increased liquidity is starting to help to resuscitate activity around the globe. This will help markets and give rise to new opportunities. We have added further to companies that will benefit from stronger growth as well as taking an initial position in gold miners. The US dollar and gold are at the top of our watch list.

Financial Manias

On the anniversary of the peak of Nasdaq and subsequent 70% collapse we thought it might be profitable to examine the common characteristics of financial manias.

A notable characteristic of both bull or bear markets is that they can endure for a surprising length of time. Operating in a crowd, these extremes become all the more accentuated as we share in the delight or sadness of the prevailing mood. The longer a boom continues, the more the actions of the participants themselves extend the cycle. Having spent some time studying the history and behaviour of markets, I have come across a list of characteristics that generally accompany a really glorious mania. Without exception, the creation of excessive liquidity and/or credit, ie. the plentiful supply of money or the facility to use money at very low cost, is a core ingredient.

Liquidity creation in the mid to late nineties stemmed from several sources. In order to re-finance the impaired balance sheets of the Japanese banking system, the authorities effectively created Yen and drove down the cost of money close to zero. The effect of this was felt in the international arena via the growth of international monetary reserves which effectively contributed to lowering international borrowing costs. Simultaneously the European Central Banks sharply lowered the cost of borrowing to offset the contractionary effect on their economies caused by several governments' reducing their deficits in order to meet the convergence criteria for monetary union. Later in the decade, the Fed generously added to liquidity at the time of the bail-out of LTCM.

Historically, it has been the creation of credit that has fuelled the great bubbles, viz:

- Tulip mania in the 1630s
- John Law and the Banque Royale in 1716 and the South Sea Company in 1720
- The infrastructure and banking booms in North America in the mid-1800s
- Hyper-inflation in Germany in the 1920s
- The Wall Street boom in the 1920s
- US MBO's and junk bonds in the 1980s
- The internet/IT boom of 1999/00

This is nowhere better illustrated than the great manias surrounding the Chartered companies of France and Britain in the early 1700s. Here the liquidity was built on the exchange of company shares for outstanding government stock which had a chain letter type of effect on liquidity.

As in other great booms, it is astonishing how large segments of the population become obsessed with the pursuit of wealth. *The excitement of the moment seems to obliterate their critical faculties.* At the height of the rush, it is very hard for the individual to stand aside with self-confidence and repudiate the prevailing argument partly because the case invariably has elements which are undeniably correct.

Moreover, early sceptics are initially proved to be wrong as the momentum of the mania builds and some switch sides to participate before it's too late. Another reason for the deadened critical faculty is people's comfort in numbers. When matters are written up in newspapers and magazines calling on the authority of so-called experts, and when most people seem to be saying the same things, it is often difficult to disagree. This is particularly so when the crowd is actually making money and enjoying itself. *We are surely most vulnerable when enjoying ourselves.* Of course, adding to our conviction is the fact that we favour and select commentators who support our optimism. So, to summarise, the key characteristics of a mania tend to be:

- A romance with technology or distant lands.
- The willingness to extrapolate.
- The "things are different this time" syndrome.
- The greater fool theory.
- The emergence of new financial alchemists.
- An incorrect assessment of the driving force.

During the South Sea bubble, Isaac Newton was an early participant and saw his investment of £7,000 double. However, the baying of the crowd encouraged him to go back in which eventually resulted in his losing £20,000. Subsequently he declared that "he could calculate the motion of the heavenly bodies, but not the madness of the people". *It is this intuitive realisation that the game must end – but without knowing when – which drives the madness on.*

The most recent and exciting idea in the US market was the internet and the IT revolution. New companies were being listed daily and no self-respecting promoter would introduce his company without appending to its names some reference to information, technology or software.

Apart from the wonderful performance achieved by these companies in that year, perhaps you will share my wonder at their valuations to revenue ie. sales, which of course makes them frantically expensive in relation to asset value or earnings. By way of reference, the average price to sales ratio on Wall Street at the time was around 1.5, itself higher than its historic average. These valuations could always be rationally explained so long as every man, woman and child plus family pet got linked to the internet. The whole emphasis was on participating and not missing out, rather than protecting the downside.

Adding to this uncertainty is the mirage that it may be different this time. The flowering of the information age has undoubtedly opened up immense opportunities. With little