investor
REVIEW
AUGUST 2001

PLATINUM ASSET MANAGEMENT

MLC-Platinum Global Fund

QUARTERLY REPORT

Performance (to 31July 2001)

Fund Size: $1.55bn	Last Quarter	Last 12 months	% pa Compound Return over 5 years	% pa Return Since Inception
MLC-Platinum Global Fund	-5.2%	2.5%	22.2%	18.4%
Morgan Stanley Capital International World Index (Accumulation)	-5.1%	-7.7%	18.2%	15.4%

The prospect of improved economic conditions sometime in the second half of 2001 failed to lift markets this quarter. Interestingly, the European exchanges have fared worse than the US and UK, with the composite Euro index having fallen some 11% over the year, versus -5% for the US and -3% for the UK. Japan and Korea were particularly weak, declining by 17% and 25% respectively. The above figures are all expressed in A$ which, on account of its own weakness, tends to understate the inherent weakness abroad. In US$ terms, for example, Wall Street is off 17% over 12 months and Euroland around 22%.

Looking at the global markets, according to official industry classification the weakness has been principally IT and Telecoms – down 48% and 31% respectively in A$ over 12 months, while defensive areas, such as utilities, consumer staples and financials, have risen by 14%, 20% and 8% respectively.

The MLC-Platinum Global Fund returned -5.2% for the quarter and 2.52% for the year versus the MSCI World Index of -5.1% for the quarter and -7.7% for the year.

Changes to the Portfolio

On a geographic basis, the big adjustments over the quarter was the 7% decline in exposure to both the US, 3% in Japan and the 5% rise in Emerging Markets. This represented the introduction of some mainland Chinese shares listed in Hong Kong, the purchase of more Indian shares, a reshuffling and addition to holdings in Korea, and the introduction of gold mining companies.

The Chinese companies purchased are engaged principally in infrastructure such as toll roads and the Beijing airport. These companies are modestly rated on 11-12x earnings and represent a relatively low risk way to participate in that country's burgeoning domestic economy. Starting from a low base, utilisation rates of this infrastructure are rising in the teens which promises some interesting cash flow growth.

India is even more self-contained than China, having a small external sector and receiving only minute foreign direct investment compared to its more business-friendly, north eastern neighbour. The economy, which had been growing at around 6% per year, has slowed recently because of two successive poor agricultural seasons. Fall-out from the IT boom has also had an effect. However, exports are growing strongly and the prospect of a lower oil price has important consequences for both the balance of payments and internal liquidity. One of our purchases, Housing Development Finance Corporation Bank, has a record of 20% profit growth over time and looks well positioned to continue to outstrip its competitors, the somnolent and clumsy State banks.

Within Korea we engaged in switching from both SK Telecom and Samsung Electronics to their respective holding companies which had become abnormally cheap. We also bought Korea Telecom which was depressed ahead of new supply of stock in the form of an ADR issue.

In Japan, the focus of the portfolio moved to smaller companies, that are both cheap and beginning to see the benefits of restructuring; Seino Transport is an example.

There was a fair amount of movement among our US holdings where we reduced our positions in several strong performing tech stocks such as Foundry Networks, Peoplesoft, National Semiconductor and Verisign. We also sold down Diagnostic Products following a trebling in the share price over the last 14 months. We originally purchased this company four years ago. It performed in line with our expectations but at first modest growth was seemingly not enough. Subsequently, it became linked with several sexy themes which, together with accelerating earnings growth, provided an explosive mixture. Subsequent to our sale the share price has pulled back one quarter. Positions have begun to be built in Agere Systems, i2 Technologies, Manpower, Coke, Honeywell and Health Management. With the exception of Health Management, all of these stocks have been suffering downward market evaluations; their longer term prospects now look sensibly priced.

The action of the gold price has drawn our attention. It looks as though it is bottoming out even though deflation now looks as much a risk as inflation. Treating it principally as a commodity, we observe that demand is about 1,000 tons greater than new supply, which is running at about 2,600 tons per annum. That there is above-ground supply of over 30,000 tons is common knowledge but there are several reasons to believe official sales and leasing will be less of a threat in the future. Combine this with unsettled currencies and turbulent markets and we can readily see the price spike by 10% or 20%. In that case, the companies selected could experience improvements in cash flow of 50% or more. The risk/reward trade-off after a 20 year bear market is tantalising.

Within Europe, we selectively added to existing holdings and participated in the IPO of the Deutsche Stock Exchange and Frankfurt Airport. We seldom participate in IPO's believing that the market tends to over-pay in the face of accompanying promotional hype. These issues came without the normal exuberance of the bull market – with the DAX down 27% since its peak in March 2001, the pricing was accordingly more modest. Further, we believe that because these are relatively new market sectors they are not thoroughly covered by analysts and investors do not fully appreciate their growth and operating characteristics.

Disposition of Assets

Region	31 Jul 2001	30 Apr 2001
Western Europe	39.4%	37.5%
North America	17.0%	23.9%
Japan	15.4%	18.2%
Emerging Markets	12.7%	6.9%
Australia	1.3%	1.0%
Cash	14.2%	12.5%

The fund has a short position against the S&P500 index of 8%.

Currency

There has been virtually no change in our currency stance. Investment flows continue to favour the US$ as Europeans buy US based companies and, increasingly, US corporate paper. Movement in the Euro/dollar exchange rate is accentuated by money managers trying to second guess the next move by the European Central Bank. We believe the Euro is now at the bottom of its trading range versus the dollar. We continue to regard the Yen as the safety valve for the Japanese economy and expect further weakness. The Korean Won is unlikely to be much stronger than the Yen. Our principal positions are long the Euro and A$, and short the Yen, Won and US$.

Commentary

We have not moved to any great extent from the views expressed in the last few quarterly reports. Breadth on the New York Stock Exchange is encouraging as those shares that are rising significantly outnumber those declining. This process has been evident since November but at the same time the Dow index has shown deteriorating breadth and both the Dow and S&P index have declined. The commonly held view is that the steepening yield curve (following the Fed's six interest rate cuts since January 2001) has historically presaged a recovery in the economy and stock market.

What is troubling is that the rest of the world is slowing more quickly and to a greater extent than was generally expected as little as three months ago. Further, it seems as though the lessons of the tech bubble are not being applied to other areas of the economy. In particular, investment banking, housing and retail space are each being deluged with capital as individual firms continue to expand aggressively without thought to the consequences of their combined actions ie. creating over-supply and thereby removing surplus returns.

The traditional pattern of an economic slowdown being brought on by a tightening of liquidity has somewhat distorted this cycle. The second half of last year was significantly influenced by both the spiking of the oil price and the fallout from the tech bubble. Lay this on top of the deflationary pulses being emitted principally from Asia and so-called globalisation, and one has a pattern quite different from the cycles common since the 1960s. Regular readers will be bored to be reminded of our concerns about debt. Not satisfied that the average US consumer surrenders 14% of his monthly income to service debt payments, Mr Greenspan is trying to induce a higher level of gluttony for fear that the consumer may start to consider his weight. Worse still, the US corporate sector is similarly loaded with debt with management preferring, for dubious reasons, stock repurchases to debt reduction.

Notwithstanding the recent battering of Nasdaq, 18 years of happiness, engendered by a trending fall in short term interest rates combined with the corporate sector winning a greater share of the economic cake, at the expense of labour's share, has been deeply etched into investors' minds. In their eagerness to deploy their assets at better rates than those available in the money markets, investors have moved into defensive sectors or those which will be early beneficiaries of a growth recovery. This has resulted in the unusual phenomena of valuations being driven to the very top of their range even before a recession has been declared or a recovery has been registered.

Such is the general optimism that a trailing earnings yield of 3.7% for the S&P 500 index is being accepted by investors. In all likelihood this will only be 3% once this year's lower earnings are posted. Is the market essentially saying that with inflation tamed, the investment scene is less risky and/or that come the next upturn, the share of the cake won by the corporate sector will expand further? We cannot imagine this, although were it not for the fact that we recognised the craziness of the recent bubble, we might show greater humility and acquiesce to the superior wisdom of the crowd. As it is, we cannot help suspecting that even dropping the cost of money by 2.75% in six months may prove no more than a short lived, though potent, elixir for the market.

Over the coming months one can expect the US economy to receive rapt attention. For all the benefits of lower tax rates and tax rebates, there are the important offsets of high debt, minuscule personal savings, the fall out from an extraordinary capital expenditure boom that has left extreme over-capacity in some parts of the economy with the associated drag on company profitability. Capping this is the high US$ and weak or deteriorating conditions among the other large consuming nations. Corporate profits are high by historic standards and seem unlikely to expand further short term. Much is likely to be said about the profit drought in the months ahead.

In Asia, we see sluggish growth in most regions with perhaps China being an exception and India to a lesser extent. Japan continues to wallow in gradual restructuring but, ironically, confidence is holding up well on account of the life-time employment structure – which, of course, also acts to retard change. There is hope for good deeds from the new Prime Minister and some support for the view that his election represents a changing of the guard within the LDP.

Korea has made good progress to reduce debt at the national and corporate level. This has come from surging net exports and a more measured approach to capital expenditure by companies. Though capex is still high by world standards, at around 28% of GNP, it is a full 10% points lower than was common in the early nineties. The consequent improvement in the trade balance, puts the economy on a sound footing although it remains highly dependent on world trade.

Europe continues to struggle from the one-size-fits-all management policies of the ECB. However, at the individual country level, there are far fewer distortions and fundamental problems than the weak Euro might suggest. Tax levels are coming down, government finances are sound, corporate capex and balance sheets are largely harmonious and the consumer has savings and carries little debt.

Conclusion

Trying to read the ebb and flow of economic news over the next few months will cause more heartache than benefit we suspect. Our attention will be directed at companies with clear growth prospects. We remain reluctant to simply buy cyclicals on the basis of some impending broad-based recovery.

The New World of Electricity

The additional burden placed on the environment as China and India industrialise their economies highlights the need for alternative clean energy sources. Throughout the world, numerous chores formerly done by hand have been ceded to machines which are powered by stored energy from the sun in the form of petrol, coal and natural gas. Fortunately, technology is at hand to remedy or alleviate the dangers of environmental degradation. In the short term, heavy duty natural gas turbines are the preferred solution while hydropower's deficiencies are currently being starkly exposed in California and Brazil. Wind power and the emerging technologies such as fuel cells, microturbines, solar panels and flywheels will eventually become an integral part of the upgraded electrical generation system. None of these technologies are particularly recent but thanks to significant developments in materials technology and microelectronics, humankind is close to economically harnessing the enormous renewable resources of the globe.

The leading force in industrial gas turbines is presently General Electric (GE) thanks to their development work on aircraft jet engines, new materials and cooling processes. An intriguing example of new technology is the use of steam at a temperature of 900 degrees celsius which is forced through minute passages in the turbine blades to keep them "cool". In a machine where an additional 1% efficiency reduces the operating cost by $200,000 per year, every small advance becomes vital. Siemens and Alstom have not been able to achieve the same thermal efficiency and recently Alstom incurred over a billion dollars of abnormal expense due to warranty claims and development work resulting from faults in their turbines.

The beauty of these new machines is not only the high primary efficiency of the turbines but also the recovery of energy from the exhaust gases which makes a combined cycle unit the most energy efficient way to generate electricity – with a 59% thermal conversion ratio. These benefits have not been lost on utilities and merchant power producers and at present GE has a backlog of "F" Class turbine orders which is equivalent to one third of the USA's existing electrical power generation capacity of some 800 gigawatts. GE has responded to this market demand by increasing capacity by 300% over the last two years. Gas demand has soared as the turbines come on line resulting in temporary gas shortages which have been well documented in the press, especially the debacle in California.

The Europeans have been the most proactive with renewable energy. The EU has set a target of 22% by the year 2020 while the UK has set a target of 10%. Subsidies will be required to achieve these ambitious targets. In the USA, the Production Tax Credit for wind generated power is set at 1.5 cents per kWh compared with the cost of residential power of 6-8 cents per kWh.

The world leading wind technology companies are located in Denmark and Germany. We well remember visiting Plambeck's wind farm on the gale swept coast of north west Germany – and agreeing with the technicians that building wind mills was much more fun than planting sugar beet. The size of the wind farms is large because the turbines must be spaced twice their diameter apart for reasons of turbulence. One hundred of these turbines would be equivalent to a small power station but without the consistency of output. The construction cost for a modern wind farm is around $1,000 per MW, which is over twice the cost of a combined cycle gas turbine unit. Low operating costs reduce the overall cost differential however, and the sale of carbon trading credits further improves the economics. To give you some sense of the scale of these machines, the top of the range 2.5 megawatt wind turbine has blades with a diameter of over 80 metres and ideally they require persistent high wind speeds over 10 m/s which are commonly found in coastal areas. The economics of wind generation improve greatly as wind speeds increase due to the cubic relationship between wind speed and the available energy. Longer term, it is likely that 5 MW turbines will be developed and these machines will be prime candidates to be put into offshore wind farms – located just over the horizon!

Unfortunately, the valuations of these windmill manufacturers are presently too high for our liking and do not adequately account for the attendant technical risks.

Fuel cells, a technology that set the platinum metal market alight 30 years ago, are now becoming an economic reality. The fundamental component of a PEM (proton exchange membrane) fuel cell consists of two electrodes, the anode and the cathode, separated by a polymer membrane electrolyte. Each of the electrodes is coated on one side with a thin platinum catalyst layer. The electrodes, catalyst and membrane together form the membrane electrode assembly. Hydrogen fuel dissociates into free electrons and protons (positive hydrogen ions) in the presence of the platinum catalyst at the anode. The free electrons are conducted in the form of usable electric current through the external circuit. The protons migrate through the membrane electrolyte to the cathode. At the cathode, oxygen from air, electrons from the external circuit and protons combine to form pure water and heat. Individual fuel cells produce about 0.6 Volt and are combined into a fuel cell stack to provide the amount of electrical power required. The magic of these systems is that they are scalable and thus able to fulfil a large range of power generation requirements at high fuel efficiency. When combined with ancillary systems such as fuel reformers, gas purification filters, sensors and electronics, fuel cells become a technically viable but not yet economically attractive power source.

The ultimate goal of the PEM fuel cell developers is penetration of the automobile engine market with annual sales of $182 billion. Daimler, Chrysler, Ford Motor Company and Ballard Power Systems are rapidly developing automobile and bus prototypes to meet the stringent requirements of the USA Environmental Protection Agency and the Californian Air Resources Board. The Californian legislation requires that beginning in 2003, a minimum of 10% of vehicles sold by automobile companies meet low or zero emission vehicles standards.

Daimler produced their first fuel cell powered automobile prototype in 1994 which had a 50kW cell weighing 800kg. Recent prototypes with the same power output have a 300kg cell and the aim is to produce a 50kg cell at a price of DM30 per kW. Daimler's subsidiary XCELLSIS has operated fuel cell buses in Vancouver and Chicago for the last three years and received community support for their quiet and clean operation. The six buses carried over 200,000 passengers and travelled over 173,000 kilometres during the trial. Further orders for small fleets of buses will see the next generation of fuel cell vehicles in full commercial service in 2003.

The main "pure play" fuel cell commercialisation companies have negligible sales, large sales growth projections and an impressive array of competition. Some will succeed but many will go the way of their predecessors of the "dot com" bubble. The realities of the business world such as slow adoption of new technology, supply chain management and quality assurance all apply to these new technology companies. We prefer those companies with real businesses and existing proven management who will benefit peripherally from these new industries. Two examples are Linde, which has technology and construction capacity for hydrogen production, and Johnson Mathey with their catalyst technology and patents. Johnson Mathey's core technology is the deposition of platinum catalyst onto the fuel cell membrane. Through innovation, the required amount of platinum per car has been cut from 1kg to 50 grams while the target remains a further fivefold reduction. Underlying growth in platinum consumption has been around 5% per annum and to meet further growth in demand, Anglo American Platinum Corporation, the largest producer of platinum, is planning a 50% increase in production by 2006.

Other exciting technologies which will participate in the future reregulated and environmentally driven electricity generation industry include microturbine, solar panels, large new technology batteries and flywheel energy storage systems. Once again, blue sky prevails at the moment, with limited surety of invested capital. We will remain vigilant!

Kerr Neilson
Managing Director

August 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

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For a greater insight into our process, please visit our web site at *www.platinum.com.au*

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