

# MLC – Platinum Global Fund

## Q U A R T E R L Y R E P O R T

### Performance (to 31 October 2002)

Fund Size: \$2.34bn	Last Quarter	Last 12 months	% pa Compound Return over 5 years	% pa Return Since Inception
MLC-Platinum Global Fund <sup>†</sup>	-7.9%	-6.7%	15.2%	13.9%*
Morgan Stanley Capital International World Index (Accumulation)	-6.1%	-22.6%	3.2%	8.0%

\* The inception date for the MLC-Platinum Global Fund was 23/06/1994

<sup>†</sup>SOURCE: MLC INVESTMENTS LIMITED

The prospect of war, continuous glum surveys of consumers in the major economies and disappointing earnings guidance all contributed to a miserable quarter for shares. By contrast, the search for income and other factors that are covered later in this report, pushed the yield on long dated bonds back to levels last seen in the 1960s.

There was wide disparity in the performance between geographic regions as well as between industries. Asia generally held relatively firm, showing smallish losses, Wall Street was weak, with the S&P down 5%, while Europe was clobbered (especially during September). Europe's poor showing is partly due to its index having a heavy bias towards financials and cyclical industrial companies. Poor economic performance, disappointing surveys of business and consumer confidence and the obstinate refusal of the European central bank to reduce interest rates all combined to persuade investors to run down their holdings of stocks sensitive to the trade cycle.

### MSCI World Index – Industry Breakdown (A\$)

Sector	3 months	1 year
Industrials	-14.5%	-24.2%
Materials	-10.7%	-13.7%
Energy	-9.7%	-21.0%
Utilities	-9.5%	-31.9%
Financials	-7.0%	-19.9%
Consumer Discretionary	-5.7%	-19.2%
Consumer Staples	-5.0%	-9.7%
Information Technology	-4.4%	-36.4%
Health Care	-2.6%	-25.3%
Telecommunications	1.6%	-36.3%

SOURCE: MSCI

Insurance companies and banks were treated particularly harshly on solvency fears as their listed holdings cascaded down in a somewhat self-reinforcing manner.

On a global basis, as the table below shows, Industrials and Materials were hardest hit with Health Care starting to demonstrate worthwhile defensive qualities. Both Information Technology and Telecommunications picked up late in October.

The Fund's performance during the quarter was disappointing. While we expect to show losses in a down market, we would have hoped to have suffered less than that of the MSCI. When positioning the portfolio with a 2 to 3 year view to favour intrinsically strong companies that will emerge from the present financial dislocation with fewer serious competitors and with the ability to exercise some pricing power, there will be times that we diverge markedly from the index. As we have taken a highly cautious view on the likelihood of the consumer providing powerful impetus to the economy, we are tending to avoid the seemingly predictable components of the market.

We suffered our share of poor stock choices. The most costly was EDS which revealed a significant earnings disappointment and fell by over 60%. Our European insurance holdings were also treated mercilessly as described above and our IT holdings were severely beaten. From point to point companies such as Alleanza, Generali and Allianz fell up to 28%, a considerable over-reaction we believe, while Ericsson, AMD and National Semiconductor typically declined by 25%.

Looking at the actual numbers, the value of the Fund fell by 7.9% over the three months, while losing -6.7% for the year. By contrast, the MSCI world index fell by 6.1% for the quarter and is down 22.6% for the 12 months.

# Platinum Global Fund Q

## Disposition of Assets

Region	Oct 2002	July 2002
Europe	37.6%	37.9%
Japan	18.2%	17.2%
North America	11.8%	14.0%
Other (Including Emerging Markets, e.g. Korea)	12.5%	13.2%
Australia	1.0%	0.8%
Liquidity	18.9%	16.9%

\* The Fund had a short position against the Standard & Poors 500 Index of 1% at 31 October 2002 SOURCE: MLC INVESTMENTS LIMITED

## Breakdown by Industry

Categories	Examples of Stock	Oct 2002	July 2002
Cyclicals/Manufacturing	Schindler, Siemens, RMC, Bayer, Linde, Océ	21%	18%
Retail/Services/Logistics	Hornbach, Jones Lang LaSalle, Fraport	11%	13%
Technology/Hardware	Agere Systems, National Semiconductor, Samsung, AMD	11%	9%
Financials	Assicurazioni Generali, Allianz, Alleanza	8%	10%
Telecoms	Hellenic Telecom, Ericsson, NTT	8%	6%
Consumer Brands	Citizen Watch, Adidas Salomon, Lotte Confectionary	7%	10%
Medical	Yamanouchi, Takeda, Draegerwerk, Novartis, Merck KGaA	6%	6%
Gold and Other	MIM, Barrick Gold, Newmont Mining, Gold Fields	6%	5%
Software & Media	Sky Perfect Communications, Mediaset, Seoul Broadcasting	3%	6%

## Changes to the Portfolio

Platinum's main activity during the quarter was to add to existing holdings. As noted above, the price decay in some areas was astounding. It is ironic that one was criticised during the bull market for taking so-called "directional bets". Now as the market seems to be in free fall, the same observers are doing just that and wishing to avoid the difficult decisions regarding when to purchase. The cases in point are the insurance companies like Allianz (Germany) and Alleanza (Italy). The former is one of the world's premier insurers with premium income of some E60 billion pa, a massive solvency surplus and an AA+ credit rating from S&P. That it squandered resources during the boom is not in dispute. Its management fell in love with the bank assurance model and exchanged a partial ownership of Hypovereinsbank for full ownership of Dresdner bank which went on a balance sheet expansion splurge just in time to catch many of the tail-end bad credits of the boom. Appraisal of Allianz's statutory filings suggests there are still approximately E4 billion of outstanding write-offs although they do not seem to have been caught with the really nasty securitisation strips that many will rue. We believe that Allianz's mistakes are well understood by the market and hence the credit down grade.

This leaves one with an entity that is vigorously addressing its cost base, a giant competing in a capital-constrained industry so giving it that rare quality of pricing power. The main concern of the stock market appears to be directional because each 10% move in equity markets adds or subtracts 14% from the firm's embedded value. The collapse of the share price allowed us to top up our holding late in the quarter when we also added to Generali and Alleanza. Under current circumstances we would treat further price weakness as a buying opportunity.

We have also made modest additions to existing tech holdings and bought Nvidia (US) and LSI Logic (US). As the prospect of recovery is pushed further out, these companies are experiencing investor surrender. Long gone are 'buying the dip' and the illusion of perpetual growth; the focus now is on IT capital spending surveys, the cash burn rate, balance sheet robustness and survival. In many instances tech companies with good growth potential are not even flattered with the ratings attached to dull cyclicals.

We also started to buy China Mobile. This company is the principal provider of mobile telephony in China having 100 million subscribers and covering 21 provinces. The important feature of its business has been the shift of the bulk of its revenue from long term contracts to pre-paid subscribers.



# Quarterly Report (Continued)

This has clearly stimulated growth at the cost of Revenue Per User. The so-called RPU has fallen dramatically and has now stabilised at around US\$15 per month with usage of 209 minutes. With the death of the internet hype, the share has fallen from HK\$80 to \$18 and is on a prospective PE of 11 times. While growth will slow from the frenetic pace of recent years, we cannot identify many factors that will adversely affect the rating from here.

Sales included Pernod Ricard, Givaudan and Stinnes. The first two performed splendidly on account of their defensive qualities but, as suggested in the last quarterly, as markets sell off relative valuations can become misaligned as investors pay too much for perceived excellence only to find later that there was better value elsewhere. Stinnes is in a different category having been bid for by Deutsche Bahn. It was a very successful holding, again bought when its pivotal role in European logistics was poorly priced, earning the Fund nearly 100% in 24 months.

## Currency

We did not change our currency positions over the quarter. At quarter end, 71% of assets were hedged into A\$; 15% held in Euro/European currencies, with the rest mainly in Korean Won.

## Commentary

The fierce sell off over the last three months has certainly winded the bulls badly as almost any purchase has proved wrong within a short time. Price action in Europe suggests the bulls are in full retreat and in the US there are only pockets of determined resistance. Even so we do not see investors as having done much to reduce their exposures overall.

As we have noted on numerous occasions, we believe the nature of the tech boom and the high degree of *consumer indebtedness precludes a strong economic rebound*. What has become clearer through this last quarter is just how difficult trading conditions really are. This is evident from the many profit warnings and equally from official statistics which show wide-spread retail price deflation. This is true from China to Europe and the US. In each case retailers are selling goods for between 2 to 3% less than last year; this makes overhead absorption considerably more difficult. Further, we are witnessing a change in “behavioural patterns”. In the US consumers are beginning to save again and even more interestingly, there is clear evidence that they are trading-down. This pattern ranges from quasi fashion statements, shoes (Nike) to tobacco (Philip Morris) and Cosmetics (Estee Lauder). It is not clear that this is confined to the US where one might put it down to individual caution and financial strain as evidenced by growing mortgage and credit card delinquencies, both, coincidentally, running at 4.77% as at June.

For the months immediately ahead it is difficult to become particularly optimistic. It seems probable that there will be an easing of credit conditions in Euroland but the high oil price is debilitating to consumers world-wide and the threat of war

is destructive to confidence. On this subject we can look forward to a frenzy of muddled media coverage. What is clear is that the inhabitants of the cradle of western civilisation, Mesopotamia, will not welcome foreign visitors whether UN endorsed or not. Writing in a calmer time of the late seventies<sup>1</sup>, Peter Ustinov, the actor and writer, eloquently observed, “Just over two hundred years ago, the United States emerged like a phoenix from just such a third world. Has she forgotten so quickly what it was like to be poor, and pure, and young? Must she so soon filch the musty robes of power from the wardrobe, and behave as the British, and others did when they were the flagellating fathers of the pupil world? Why this pharisaic impatience with those just fallen from the nest? Is it merely the impatience of the young with those still younger, or is it a trap laid by stealthy nature to try and lure America into a posture which was the cause of her own rebellion, her own birth”.

Pardon this philosophising but military history is strewn with examples of consequences, intended or not, that haunt subsequent generations.

Turning back to developments in markets, we wrote last quarter about the privileged position of the Government Sponsored Enterprises (GSE's) in the US leading them to become giant hedge funds. Their significance in the fixed interest markets has been particularly noticeable in recent weeks as they engage in the so-called convexity trades. This stems from the effect that the *refinancing of mortgages* has upon their balance sheets. To make up for the loss of long term assets as consumers renegotiate their mortgages (to take advantage of lower fixed interest rates), the GSE's have been actively, though indirectly, purchasing long term debt mostly through entering interest rate swaps. The consequence of this is to drive down the yield on long dated securities, giving the impression that the bonds are being priced for deflation. Thus technical factors emanating from the unbridled growth of the GSE's is reinforcing the downward move in long rates.<sup>2</sup> Today the market value of mortgage-backed securities is greater than the Government bond market. From being about 60% to 70% of Treasury debt, securitised mortgages now represent 130%. The GSE's have clearly “shot themselves in the foot” as the “convexity trade” has influenced the shape of the yield curve to the disadvantage of all the financial intermediaries who had hitherto exploited the large spread between call rates and longer term bonds.

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1 “Dear Me” by Peter Ustinov, published by Mandarin 1977, p283

2 Apart from insuring mortgages, the GSE's also borrow and invest in mortgages. In so doing, they attempt to match the terms of their assets and liabilities. However, as rates drop and consumers' refinance their mortgages, these assets on the books of the GSE's are repaid ahead of schedule. This put option of mortgagees causes the GSE's balance sheets to become lopsided — with too little asset duration. (The negative convexity of mortgages causing the duration of assets to decline faster than the duration of liabilities). Hence, the GSE's search for long-dated fixed income assets to redress the balance.



Dresdner Kleinwort Wasserstein do some interesting quantitative studies to assess market expectations. The recent findings are that share analysts have down-graded their implicit growth expectations to a 15-year low. Their forecasts have shown a pattern of steady deterioration but bottom-up estimates have in the past invariably proved to be too high. Some markets, notably in Europe, now seem reasonably valued, but expectations in the US are still high. We have often commented on the unreal expectations that the protracted bull market embedded in forecasts and DrKW's findings are that US long term earnings expectations through the nineties rose on an almost continuous trend versus nominal GDP.

The expectation is presently for long term earnings to grow at 2.6 times nominal GDP *even though, with the single exception of the nineties, the quoted sector's earnings growth has always trailed behind money GDP.*

Among other important developments are the outcome of the German elections and the proposed buying of shares by the Bank of Japan. Another four years of rule by the SPD in coalition with the Greens is generally seen as negative by those who were hoping for economic reform to re-energise the moribund economy. Germany has been stagnating for some time and it may come as a surprise to learn that real GNP has risen only 12% over the last ten years, barely better than Japan's 10% and well behind the US figure of about 40% and Australia's 50%. Germany's unemployment rate of four million is in stark contrast to its more agile neighbours who moved early with labour reform.

The message coming from the Bank of Japan (BoJ) to buy shares directly from banks is a significant departure from its former position and at this stage it may merely reflect political intrigue among the ministries to give the Prime Minister more breathing space. One needs to recall earlier protests by the public regarding the use of taxpayer's funds to bail out the banks. It is possible, however, that by invoking a sense of crises, the BoJ will be able to nationalise some of the risks within the banks and ultimately free up capital for more productive uses. Even so, it is our contention that the main problems within Japan are proper financial intermediation and the debilitating effect of deflation rather than bad bank loans alone. The statistics clearly point to large corporations reducing their debt and meeting capex from their own resources but it is the small companies that are feeling the funding squeeze and going under. To be more than a short term palliative, the BoJ will need to expand the money base faster than hitherto and on this point there is as yet no clarification.

## Outlook

There are many issues to trouble investors. The immediate concerns relate to consumer behaviour in the face of potential war, high fuel costs, weak employment growth and doubts as to whether low or even falling interest rates can reignite the growth flame. It is very clear that companies have become more cautious so one cannot expect buoyant investment spending until the profit cycle has started to recover.

Our problem as investors is to assess whether this dreary outlook is now fully reflected in specific share prices. We cannot know because as we have noted in the past, this bear market will be accompanied by a *gradual erosion of valuations.*

We do observe that there is not the normal gnashing of teeth and misery that would be associated with a bottom of the bear market. Against this however, is the astonishing destruction of prices. One way of assessing this is to observe the divergence between stock prices and their moving averages. We suggest that these are now stretched to extreme levels, particularly in Europe. At the very least, this could point to the prospect of a bounce, if not a bottom.

On historic valuations our holdings look attractive. For example, in Europe we think the average PE of our holdings on forward earnings is around 13 times while our holdings in Korea and Japan are around 16 times. The figures for the US are distorted by losses from some of our companies and that creates a negative PE. That there will be companies that fall short of our hopes is inevitable but price declines have left many company capitalisations back to levels seen before the boom and even earlier.

We feel reasonably confident to be selectively buying now.

Kerr Neilson  
Managing Director

**If you have any questions about your  
investment in the MLC – Platinum Global Fund,  
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**131 831**

**from anywhere in Australia or**

**0800 442 550**

**from New Zealand**

**For a greater insight into our process, please visit our web site at [www.platinum.com.au](http://www.platinum.com.au)**

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