investor
REVIEW
AUGUST 2004

MLC – Platinum Global Fund

QUARTERLY REPORT

Performance (as at 31 July 2004)

Fund Size: $3.62bn	Last Quarter	Last 12 months	% pa Compound Return over 5 years	% pa Compound Return Since Inception
MLC-Platinum Global Fund†	-3.3%	18.3%	11.4%	14.7%
Morgan Stanley Capital International All Country World Index (A$)	2.7%	9.5%	-3.1%	7.2%

† SOURCE: MLC INVESTMENTS LIMITED

This was not a great quarter for the Fund. Those geographic areas where we have low exposure were flat or up slightly while those markets where we have plenty of exposure such as Europe, Japan, Korea and India were relatively weak. In addition, the A$ appreciated against most currencies. As a consequence the Fund lost money while the MSCI World Index was up 2.7%.

As we have noted from time to time, Platinum Asset Management's investment style will produce returns that are quite different from that of the MSCI – and this quarter was a case in point.

As one would expect in a year of recovery, the cyclical industries out-performed the defensives. Health care and telecommunications, two of the laggards, have additional problems of their own. The pharmaceutical giants are suffering from patent expiries, disappointing drug pipelines and the latent threat to prescription prices, while telecoms are threatened by the internet.

A conspicuous development has been the massive out-performance of small capitalisation companies versus large caps in the last three and a half years. Valuation differentials have reversed with larger companies now typically being on lower valuations than small companies. Having had some benefit from this trend since 2000, we have been adjusting our position in the expectation of a reversal of this pattern.

Currency

We sense that the highly lop-sided position that many investors had against the US$ has been squared. This, together with our longer term concerns, has caused us to exit the US currency again in favour of the Yen and Euro. We added to the hedge into A$, which is now around 27%, but are ambivalent as to its prospects versus the Euro and believe it will be slightly weaker than the Yen.

MSCI All Country World Index Industry Breakdown (A$)

Sectors	Quarter	1 year
Energy	9.5%	23.3%
Materials	6.5%	14.2%
Industrials	5.7%	13.8%
Utilities	5.9%	12.9%
Consumer Discretionary	0.2%	7.0%
Consumer Staples	-1.3%	6.7%
Financials	0.9%	5.6%
Telecommunications	0.1%	4.5%
Information Technology	-1.7%	0.0%
Health Care	-1.7%	-1.5%

SOURCE: BLOOMBERG

Changes to the Portfolio

It has been a relatively inactive period with our tending to bolster existing and recent acquisitions. In Japan this included adding to the Toyota group of companies at the expense of Citizen Watch. Citizen has been very strong on profit performance and the appeal of its electronic components subsidiary.

One new position was Sumitomo Mitsui Financial Group (SMFG). Along with Mitsubishi Tokyo Financial Group (MTFG), which we also own, we see it taking advantage of the much weakened position of the banking sector and exploiting the advantages it has to expand as a more diversified provider of services to the consumer. Giving us confidence in the transformation of the Japanese financial institutions is a recent surprise contested takeover. SMFG is courting UFJ (which is Japan's fourth largest bank) after the latter entered merger talks with MTFG.

In the US, we have added to Agere, Agilent and AMD and have shuffled the biotechs, after losing Tularik to a bid from Amgen.

In Europe the most significant new purchase is **Alcatel**. This traditional provider of telephone switchgear and other electrical engineering services has morphed into a more streamlined company to focus on *next-generation* communication. By this is meant high speed internet access, Voice over Internet Protocol (VoIP), satellite and mobile communication, as well as converting traditional copper wired networks to function as fully digital systems. These complex solutions go by acronyms like DSLAM (digital subscriber line access multiplexing) or FTTH /FTTN (fibre to the home or to the node). Technical developments are advancing so fast that solutions which were hitherto regarded as compromises are proving more than adequate. So now we find that DSLAMs are allowing the telecoms to continue to use their installed paired copper wires to deliver full video, high speed data and voice to the home. (FTTH is a much more elegant solution, giving remarkable bandwidth with the added attraction of low maintenance costs, though installation involves relatively high initial outlays).

Much as the large telecoms would love to wind back the clock, the internet has permanently changed the structure of their business. **They have no choice but to invest** to protect their existing relationships. Cable TV operators and satellite transmission are eroding their position while the regulatory environment has deteriorated and often forces them to give new competitors access to their networks (eg. pre-selection of carrier).

Alcatel is well placed for this telecom-centric investment boom. Having dominated the global market in traditional closed circuit switching, it has an excellent understanding of the telecoms needs in a digital convergent world. Moreover, it has developed the necessary *kit* (software and hardware) to meet their needs. It is also able to help large corporations move to VoIP by virtue of being a global leader in this arena. The company is behind others in third generation mobile technology, but that may be compensated in due course by its leading position in optical networking. This division has seen sales more than halve since the glory days but metro DWDM (dense wavelength division multiplexing) is improving and prospects are brightening. Traditionally Alcatel has had a lower rating than its peers like Ericsson (which we also own), but this valuation gap now looks excessive.

Disposition of Assets (Net Invested Position)

Region	Jul 2004	Apr 2004
Western Europe	33.0%	31.9%
Japan*	26.3%	25.8%
Other (emerging markets eg. Korea)	11.4%	13.2%
North America*	2.9%	0.3%
Australia	1.7%	1.7%
Cash	24.7%	27.1%

SOURCE: MLC Investments Limited

* At 31 July 2004, the Fund has a short position in the US against the Standard & Poor's 500 Index of 2.7% (4.4% at 30 April 2004), 4% against the Russell 2000 Index, 3% against the NASDAQ Index (6.7% at 30 April 2004) and 1.8% against the Nikkei Index (3.6% at 30 April 2004).

Breakdown of Fund's long investments by Industry (% of assets)

Categories	Examples of Stocks	Jul 2004	Apr 2004
Cyclicals/Manufacturing	Toyota Motor, Schindler, Siemens, Linde, Océ	22%	22%
Financials	Credit Agricole, Mitsubishi Tokyo Financial, Mitsui Sumitomo Insurance, Nordea	15%	16%
Medical	Takeda, Schering, Novartis, Merck KGaA, GlaxoSmithKline	9%	8%
Technology/Hardware	Agere, Infineon Tech, Samsung, AMD, Sun Microsystems, NEC	8%	9%
Retail/Services/Logistics	Veolia Environ., Deutsche Post, Hornbach, Mitsubishi Corp	7%	7%
Consumer Brands	Henkel, Adidas Salomon, Lotte	7%	7%
Software/Media	Sky Perfect Communications, Seoul Broadcasting, Newscorp	7%	7%
Gold and Other	Shell, Barrick Gold, Newmont Mining, Gold Fields, Noranda	6%	7%
Telecoms	Alcatel, Ericsson, NTT Docomo	6%	4%

SOURCE: PLATINUM

Commentary

The downward shift in expectations for world growth, together with some disappointing releases and company announcements, is tending to worry investors. Clearly, households are feeling the squeeze from **weak real wage growth** and from the delayed impact of higher costs, notably fuel, and the expiry of the tax refunds (in the case of the US).

We subscribe, however, to the view that employment will gradually rise in synchrony with the expansionary trend and that this will allow real wages to grow. The recovery has now been in effect for over 2.5 years in the US and it would be a very odd cycle indeed for it to abate on its own. It is too early to conclude that a significant shift in consumer behaviour has taken place. We have not been able to detect signs of debt aversion yet. However, the Federal Reserve Board's suppression of real interest rates ameliorated the downturn and has created some distortions in our view. Yes, the Fed has now moved the short term cost of money up a second notch to 1.5%, as was widely anticipated, having waited more than twice as long as normal to start the rising rate cycle. The peculiar part of the **puzzle is the behaviour** of the longer end of the interest rate curve. Without clear evidence of foreign government intervention or other extraneous events, the yields on the **long bonds** have been edging down for some while now. This indicates perhaps that we are back to the earlier debate about inflation versus deflation.

Contrary to the popular view that inflation is a regular cyclical phenomenon, it can be shown that there have been long periods of economic history when prices have been stable to flat. In his excellent book, *The Great Wave**, David Hackett Fischer identifies four episodes of great waves of inflation since the middle ages followed by **protracted periods of price stability**. These coincided with the Renaissance, the Enlightenment and much of the 1800s. This latter episode is particularly interesting for it was a period which included civil wars, mass population growth and migration, and, indeed, the discovery and production of significant amounts of gold. Prices were flat for some 80 years. They spiked around times of war but then fell back to earlier levels. What is more, this price stability seems to have been evident across continents. In each of these periods of price stability, Fischer identifies that real wages rose, **returns on capital diminished** (rents on land and bond yields) and importantly, inequalities narrowed after a noticeable lag. (This in itself led to significant improvements to the crime rate and a drop in moral turpitude in general).

Now clearly we are addressing decades rather than the more intimate time horizons our clients favour. However, we have long believed that the early **1980s witnessed the taming of inflation** in developed countries and that we may experience a similar pattern seen in the 19th century. Behavioural psychology can explain the unwillingness of investors to believe in this new paradigm. This is particularly so when historically the benefits of financial leverage have so helped borrowers. As many clients will know, we strongly believe the **property boom** in the US, Australia, the UK etc is a **direct consequence of tax and interest rate distortions**, combined with a latent trust in the "inflation bail-out". Globalisation, with its facilitation of the free movement of goods, capital and technology, is clearly lubricating the arbitrage of labour costs between East and West. The unpopular dislocation it implies can however be expected to result in periodic temptations towards protectionism. Further, we are not suggesting all prices will be flat, on the contrary we suspect that **many commodities will reach new higher clearing levels** as a consequence of expanded markets. These may, however, be off-set by continued pressure on the prices of traded manufactured goods.

A digression to suggest that there may be an outcome different to that of recent decades. We favour the view that **the burden of debt will ultimately squash the growth trajectory** and that the pump priming need not necessarily cause widespread inflation. In this instance, US short term interest rates which are a full 1.5% below the base line of the 1994 trough, may not rise as far as might be expected. Currency instability is likely to play an important part of the adjustment process.

Turning to other markets, notably those of Asia. The curious phenomenon has been the absence of follow-through buying by domestic investors. Back in the halcyon days of the 1990s "Tiger economies", domestic investors exhibited furious enthusiasm for their share markets. Valuations were high, PEs typically in the high 20s to 30s, and there was no interest in discussing inscrutable subjects such as the marginal return on factor inputs etc. Now that these economies are growing again and financial rectitude has returned at both the national and company level, and compliance is stronger, it seems that foreigners are the only interested players. The scars of the 1998 IMF crisis do not seem to have healed.

Who will then take up the running from the foreigners? This may be necessary if the traditional pattern is followed and foreigners continue to exit their positions. Between late January and April of this year, foreign funds have been transferring their attention away from markets like China, India, Korea and Thailand to Japan. In some cases this is having an impact on their foreign exchange reserves and causing their domestic rates to rise. Once investment fund flows stabilise it will be interesting to see whether exchange rates take away some of the pressure that would otherwise be exerted by higher interest rates alone. This might indeed alleviate some of the pressure on the US dollar.

Some observers are cautious in the aftermath of the Indian election and the formation of a new coalition government under the Congress party. Our interpretation is that the decline of the stock market reflects the inevitable cooling off after a very strong run. The compromises that the new coalition may be forced to accept are in our view no more worrying than the dangerous Hindu nationalist card that the BJP periodically play. The economy is continuing to grow healthily and under Prime Minister Manmohan Singh it seems that reform is still fully on the agenda.

It is too early to assess the degree to which the credit freeze will impact China. Inflation, particularly in basic foods, is rampant (some grain prices up over 30% on last year) and the official CPI is trending upward with July prices being 5.3% higher than last year. Early reports on the sale of cars and heavy construction machinery suggest a sharp contraction of demand (20% and 60% respectively). However, the less visible markers, such as the loss of revenue to the Provincial authorities from the cessation of land sales and news on the sale of the stock of new housing, has still to surface. At this stage we are inclined to believe

that a manageable slowing will be achieved from what was evidently an unsustainable and **disorientating pace**. Here we are relying on the sheer excitement of the new order to carry the economy over this adjustment phase.

An issue that we feel receives less emphasis than it should is the country's **impending water crisis****. Industrialisation and a higher protein diet is placing an unsustainable burden on available water supplies. Domestic planners are increasingly concerned about the faltering flow of the Yellow River. This is showing a worsening trend and failing to even reach the coastal province of Shandong for extended periods of the year. In addition, the depletion of aquifers is evident with the water table of the North China plain falling precipitously. (This area accounts for 40% of the nation's grain harvest, which itself is 75% dependant on irrigation). There are schemes to divert some 40 billion cubic metres of water a year from the Yangtze but these flows are relatively insignificant in terms of the increasing needs caused by rapid urbanisation and industrialisation. More efficient usage will be essential (and the statistics show the country to be way in excess of world standards in terms of tonnes of water used per tonne of steel or paper produced) but the **longer term implications for employment and agricultural prices is of world significance**.

As China continues to grow, albeit at a less hectic pace, its neighbouring suppliers like Japan and Korea will enjoy the slip stream. Neither of these North East Asian countries is growing fast but on balance it is probable they will continue to grow. In the case of Europe, rather than having specific macro economic views, it is the quality of the companies and their prospects that drives our portfolio construction.
On account of the changes of investment fashion, invariably there will be industries and individual companies that become neglected.

Conclusion

World growth seems to be slowing somewhat on account of pressure on real incomes and the dislocation we have alluded to in earlier notes.
As is common, analysts' forecasts were getting well ahead of themselves and this is likely to lead to specific disappointments. We believe **the peak of earnings momentum** has passed which together with a tightening of liquidity, caused by resources being diverted to real activity, **will limit broad market advances**.

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Platinum Asset Management

* The Great Wave, David Hackett Fischer, 1996, Oxford University Press
** World Watch Magazine, July/August 1998 issue, Worldwatch Institute

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

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

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