MLC-Platinum Global Fund

QUARTERLY REPORT

PERFORMANCE

Fund Size: $3.1 bn	Last Quarter	Last 12 months	5 years (compound pa)	Since Inception (compound pa)
MLC-Platinum Global Fund	1.1%	-0.6%	9.0%	14.5%
Morgan Stanley Capital International All Country World Net Index (A$)	-0.0%	2.3%	2.3%	8.1%

Source: MLC Investments Limited and Platinum

Induced by further government measures to cool the lusty domestic economy, the head-long charge in the Chinese "A" share market faltered badly at the end of February. This then triggered a de-risking exercise by active funds and we saw the yen abruptly change direction and strengthen by 2.5%. As is so often the case, the whiff of uncertainty then alerted participants to other risks and in this case it was the rising defaults in the US sub-prime residential mortgage market. This gave reason for them to reduce their market exposure. The yen rose a little further as borrowers of this cheap funding reduced their positions. The impact was smaller than we had anticipated, seemingly being accompanied by the Japanese themselves placing less money abroad. Of interest, Japanese portfolio outflows have dropped significantly over recent months and are now being exceeded by foreign buying of Japanese assets. Offsetting this though are the mysterious "other" outflows; largely short-term loans to foreigners – the "carry trade" to exploit the large interest rate differential (though exposing the borrowers to exchange rate risk).

For most of March the markets were listless and investors tried to assess the peripheral fall-out both in Asia and the effect of tighter conditions in the derivatives market and its impact on the US consumer. On balance, the attraction of earning yields being above most borrowing costs convinced participants that the global leveraged buy-out game was still intact.

PLATINUM & MSCI* WORLD INDEX INDUSTRY WEIGHTINGS

Industry	Platinum	MSCI
Industrials	15%	9%
Materials	15%	9%
Information Technology	15%	7%
Financials	15%	25%
Consumer Discretionary	10%	8%
Consumer Staples	9%	8%
Health Care	6%	7%
Telecommunications	5%	6%
Services and Media	5%	6%
Energy	3%	10%
Utilities	3%	6%

* Morgan Stanley Capital International

Source: Platinum and MSCI

MSCI* WORLD INDEX COUNTRY PERFORMANCE (AUD)

Region	Quarter	1 Year
Australia	7%	19%
Germany	4%	13%
Brazil	4%	12%
France	0%	8%
Korea	0%	-3%
Japan	1%	-9%
UK	1%	10%
US	-2%	-2%
Hong Kong	-2%	8%
India	-6%	6%

* Morgan Stanley Capital International

Source: MSCI

Platinum® ASSET MANAGEMENT

MLC

MLC-Platinum Global Fund

Looking at market returns, for Australian investors the dollar's rise over the last 12 months from 71.5 cents to above 80.9 cents (up 13% versus the US dollar) has taxed returns while over the last year, the MSCI is almost unchanged. For the quarter the Index has been flat.

CURRENCY

As mentioned earlier, the Australian dollar has been one of the important currencies to own as it, together with other commodity-related currencies, has been climbing systematically. It seems, however, that the yen has had its weak spell (and has been a costly currency to hold) and though it has no yield support, we suspect there is an underlying shift in sentiment taking place. We believe it will gradually strengthen as the Asian block steadily appreciates. We added to our hedging back into the Australian dollar, eliminating exposure to the US dollar.

CHANGES TO THE PORTFOLIO

As the quarter progressed we continued to consolidate our holdings into favoured stocks. We sold out of El Paso, Agco and Union Pacific, each having made a contribution and in the case of the last two, a substantial return. We cut back on the long held position in Carrefour as it ran strongly on speculation of "monetising" its 20 billion euro property portfolio and we finally exited Alcatel which has failed to meet our expectations. Sadly, the company faces a prolonged integration effort as it merges with Lucent and in the meantime, its fierce competitors such as Cisco can forge ahead without these distractions. The loss on Alcatel was some 15% on purchase cost and more in terms of foregone opportunity.

The mid-quarter sell-off allowed us to introduce Microsoft and Aeon. They both fit the theme of quality at barely more than market valuation. Microsoft is presently being characterised as mature, having a blurred vision of the internet and being potentially vulnerable to depredations by Google. That the company will grow more slowly than in the past, we do not doubt, but careful appraisal of each separate income stream reveals a unique buying opportunity of one of the world's more interesting companies.

The revenues from the founding operating system division, now called "Vista", are rock solid. Sales will gradually grow as it finds its way onto most new PCs and laptops. On discounted cash flow models this monopoly alone accounts for much of the company's capitalisation. The real gem though is the strength of the company's distribution network and the demand generated for the so-called Server and Tools division. This business supports applications and is finding even wider demand from smaller businesses seeking packaged solutions for their IT needs. There are other areas that are sleepers such as the loss-making games and entertainment division and the software behind mobility. All this, together with the attempt by Ray Ozzie to reorientate the business away from its (admittedly well-entrenched) monopolistic mentality, suggests that the market is doubting the ability of this champion of bundling to succeed.

Aeon is Japan's largest supermarket operator, and also the country's leading owner and developer of large scale shopping malls. Despite a very difficult consumer market over the past 15 years, Aeon has a strong record of expansion and has increased earnings per share by 11% pa. Our interest stems from the recent acquisition of a stake in Daiei which will raise its share of the Japanese grocery market to 10%, and allow it to exercise superior buying power through the use of its centralised distribution network. In a world that dreams of REITs we are intrigued that the company is given so little credit for its property portfolio.

DISPOSITION OF ASSETS (net invested position)

Region	Mar 2007	Dec 2006
Japan*	24.7%	26.9%
North America	18.2%	15.8%
Western Europe	19.6%	24.8%
Emerging Markets	15.0%	15.1%
Australia*	-2.4%	-2.2%
Cash	24.9%	19.6%

* The fund also has a 4% short position in Japanese Government Bonds.

Source: MLC Investments Limited

* As at 31 March 2007, the Fund has a short position in the US against the Russell 2000 Index of 6.2% (31 December 2006: 7.4%) and in Australia against the SPI 200 Index of 2.4% (31 December 2006: 2.2%) and in Germany against the Dax of 2.0% and in Japan against the Nikkei 225 of 0.8%.

COMMENTARY

Some of the concerns that we have raised in recent reports, regarding easy money and the hunger for risk, took form in late February with failures in the US residential mortgage market. The subsequent sell-off of shares globally was relatively mild, though sharp, and acted as a reminder to market participants that linear extrapolation has its dangers. As there has been thorough coverage of the subject[1], suffice it to

Quarterly Report (Continued)

say that securitisation funding does not remove the credit risk but simply reallocates it, often to people who have little control of the underlying assets. Part of the subsequent market volatility presumably reflected the general call by financial institutions to tighten portfolio specifications and credit controls. Concerns about credit losses and the detrimental effect of adjustable rate mortgage (ARM) resets, and foreclosures on lower-end properties have perhaps some way to unfurl. However, the chatter from the street is at present focused on the bigger picture of the day, namely globalisation and the recycling of 'surplus' savings.

Adherents to this new paradigm believe that the world has achieved that highly desirable state where the developing world's surpluses neatly accommodate the developed world's insatiable consumers. At the same time, new producers supply an abundance of tradeable goods (facilitated by the free movement of capital and know-how, plus seamless logistics) to remove the traditional inflationary bottleneck of labour, that so stunted economic growth in the 1970s and later. The changing composition of developed economies also seems to have flattened the economic cycle. For the moment, these observations are evident though highly dependent on the willingness of those nations with savings to place them where needed. A less plausible notion of the new paradigm is that Central banks have developed such a cunning understanding of all the moving parts of a modern economy as to be able to guide them with intricate precision!

At present, the disregard for risk and the belief that easy funding will persist has virtually eliminated the distinction in valuations between quality and junk. This careless view will not persist forever and hence offers us the opportunity to accumulate great companies that are on valuations almost in line with the market in general[2]. Here we define quality as those businesses with an achievement record that sets them apart, often enjoying dominance of their industries globally and with the prospect to grow in any but the worst circumstances. Their balance sheets are invariably free of debt (on account of their superior profitability) and incremental growth can be achieved and still cast off free cash flow. The paradox is that one can acquire these companies on such relatively attractive terms[3] even though they are in some cases below peak profitability and may benefit from home currency weakness. One explanation is that they tend to be too large to be "privatised" and secondly, some of these companies are perhaps being disgorged as American-based funds choose to increase their foreign holdings. Interestingly these shares are in most cases on free cash flow yields for 2007 that exceed those of US long treasuries; so does their progressive de-rating portend a deflationary future, or alternatively is our analysis plain wrong?!

The first four companies that fit this mould are Cisco, Microsoft, Ericsson and Samsung. Each has clear dominance of its place in today's electronic highway and market place (the mobile Internet) and while one can take issue with aspects of each of their businesses, in general they are hard to fault. One exercise we do is to project the likely free cash flow for the next three years and net this off (together with current net cash holdings) against the current capitalisation to arrive at the entity's 2009 price earnings ratio (PE). On this basis, three of them are on forward PEs of less than 10 times.

Apart from the information technology sector where we have deployed about 15% of the Fund, we have similar exposure to industrials and materials. In the case of industrials it is companies like Siemens, Bombardier, Mitsubishi Heavy Industries, Yokogawa Electric and JGC each of which is trading at well-below peak profitability and yet serves markets that face a growing backlog of under-investment, be it public sector transport or neglected services such as power generation or new endeavours such as alternative energy. Exposure to materials reflects our two themes of tightening agricultural commodity supplies, and the growing capacity constraints in pulp (and paper). Mosaic is the world's second largest potash producer and a major supplier of general fertilisers. Apart from the near-term pressures exerted by the bio fuel subsidies, we see longer-term pressures which will also benefit Ajinomoto, the world's leading producer of lycine, an amino acid feed supplement. Our strongly held view is that the market is underestimating the impact of China and India and the demand for pulp is gradually gaining acceptance with spot pulp prices having risen by 30% in US dollars in the last year.

1 Of the entire US residential mortgage market of $9.7 trillion, sub-prime constitutes approximately $1.2 trillion. By value, about 5% of US mortgages are delinquent while some 14% (and rising) of sub-prime mortgages are delinquent. Reasonable estimates are that cumulative defaults on the 2006 sub-prime mortgages are around 20%. Suppose 20% of 2006 sub-prime mortgages default and the severity of those defaults is say, 30% then the total credit losses would be about 6% of the pool – $35-40 billion. This compares with the US financial industries' annual pre-tax profits of around US$430 billion.

2 An important observation is that the PE of the US market itself, say 15.5 times, understates the broader level of valuations on account of the heavy weighting of the financial sector that is typically trading on 10 or 11 times forward earnings.

3 By measures such as cost to sales or PEs, they are towards the lower end of their 15 year range.

The other component in materials is the 3% in major gold producers. These have been hibernating as the mines have failed to meet production forecasts and costs are running much higher than anticipated. Perversely this strengthens our resolve!

The areas where we are clearly under represented against the world's top 5,000 companies are financials, energy and utilities. It should be emphasised here that our 'weightings' are a consequence of individual stock-picking combined with themes, rather than a macro overview. It so happens that we are not able to find many financials that interest us relative to other opportunities. Those that do are mostly in Japan which is on the cusp of a reflationary pulse with the increase of land and property prices now migrating to the provinces and into residential accommodation. It is remarkable that after 14 years of deflation, that some find it so difficult to visage observable trends in a positive light!

In energy our exposure is to Royal Dutch Shell, and Areva, the world's leading integrated nuclear producer (from mining yellowcake through to plant building and fuel recycling). Shell is a gift we believe on a PE of less than 9 times, a 4.5% dividend yield and is showing all the signs of contrition for its fleeting dalliance with corporate pretence.

You may query the relatively high commitment to those areas which can peter out in the latter stages of an economic boom. We would share the same reservations but point to the individual holdings and the fact that this cycle has been characterised by surprisingly weak investment in basic infrastructure, particularly in the West. In addition, we are very comfortable with the growth prospects and valuations of our more defensive holdings.

OUTLOOK

The de-risking episode that was recently witnessed, following the mortgage problems in the States will have left a scar on perceptions of derivatives and of the reliability of some funding sources, with adverse consequences for housing and leverage buyout (LBO) financing. Global growth remains solid with Asia continuing to grow the fastest and with the gilt coming off some Western economies. Most forecasts expect company earnings to slow into single digits in the developed markets, but the systematic de-rating of the larger companies suggests this is well anticipated. The portfolio is positioned in companies that are generally operating well below their peak earnings capacity and yet face an environment that should favour sales growth and are on valuations that are sound. We believe this and the shorts we are running on highly valued small stock indices will protect investors in what we believe to be the later stages of the economic cycle.

Kerr Neilson
Managing Director

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

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