MLC-Platinum Global Fund

QUARTERLY INVESTMENT MANAGER'S REPORT

PERFORMANCE

Fund Size: $923mn	Last Quarter	Last 12 months	5 years (compound pa)	Since Inception (compound pa)
MLC-Platinum Global Fund	5.8%	8.1%	3.9%	10.2%
Morgan Stanley Capital International All Country World Net Index (A$)	6.1%	9.8%	-0.6%	4.6%

Source: MLC Investments Limited and Platinum Asset Management

There were some interesting divergences within and among the major indices this last quarter. The US S&P 500 Index has broken new highs and is now above the apparent ceiling that was established in 2000 and 2007. Money-flows into equities have been strong with institutional allocations the highest in two years and indications that money has been coming out of cash, bonds and commodities to fund equity purchases. As we had anticipated, Japan bounded ahead in response to changes in the Bank of Japan's (BOJ) quantitative easing (QE) policy and the consequent weakening of the yen. Europe continued to be harassed by over-indebtedness with Cyprus being the latest victim requiring resuscitation. After some haggling, which included the unprecedented step of requiring depositors to bear some of the burden, this latest disruption seems to have settled. Even with their apparent superior growth and prospects, the emerging markets of China, India, Brazil and Russia all recorded declines.

To some extent this reflects the strength of the US dollar which is tending to draw money away from the periphery, as we had projected in the December quarterly report, but it also marks a certain ambivalence in markets. While there is growing evidence of improving economic activity in the US, suggested by measures such as consumer confidence, manufacturing activity and rising housing prices, investors are still reluctant to throw caution to the wind. This is shown by the divergence in the valuations of defensive companies versus cyclicals. While the valuations of defensive companies have now climbed to multi-year highs, both in absolute and in relative terms, the performance of cyclical industries such as energy, materials and commodities has been dull and in a relative sense their valuations are low. This is well-illustrated by the sector performance table below.

MSCI* WORLD INDEX REGIONAL PERFORMANCE (AUD)

Region	Quarter	1 year
Japan	**11%**	**8%**
United States	**10%**	**12%**
Australia	9%	21%
Developed Markets	**7%**	**11%**
Hong Kong	3%	16%
United Kingdom	2%	9%
Europe	**2%**	**9%**
France	0%	8%
Germany	0%	8%
Asia ex Japan	**-1%**	**6%**
Emerging Markets	**-2%**	**1%**
India	-3%	2%
Korea	-4%	1%
China	-5%	6%

* Morgan Stanley Capital International
Source: MSCI

MSCI* WORLD INDEX SECTOR PERFORMANCE (AUD)

Sector	Quarter	1 year
Health Care	14%	24%
Consumer Staples	11%	18%
Consumer Discretionary	8%	14%
Industrials	7%	10%
Financials	6%	16%
Utilities	5%	4%
Telecommunication Services	4%	10%
Information Technology	4%	-1%
Energy	3%	0%
Materials	-5%	-5%

* Morgan Stanley Capital International
Source: MSCI

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Overall this has been a profitable period for holders of common shares with the MSCI World Index in A$ terms rising 6.1% for the quarter and 9.8% for the last 12 months. This masked the very weak showing of the BRICs (Brazil, Russia, India and China), with emerging markets as a group achieving only 1.3%. This influenced the performance of the Fund which achieved 5.8% for the quarter and 8.1% for the 12 months.

CHANGES TO THE PORTFOLIO

DISPOSITION OF ASSETS (NET INVESTED POSITION)

Region	Mar 13	Dec 12
Europe	34.1%	32.6%
North America *	23.1%	26.0%
Japan	15.6%	17.4%
Asia	15.3%	16.4%
Australia	0.9%	1.0%
South America	0.5%	0.0%
Africa	0.4%	0.6%
Cash	10.1%	6.0%

Source: Platinum Asset Management

* At 31 March 2013, the Fund had a short position in the US against the Russell 2000 Index of 5.5% (31 December 2012: 4.5%) and S&P 500 Index of 0.5%.

Changes were progressive rather than dramatic with incremental additions to several existing positions and a thinning of highly productive holdings. We added to **Vodafone**, **Carnival Corp** (cruise lines) and **Baker Hughes** (oil field services) and re-entered **TNT Express** when the stock tumbled after the failed take-over by UPS. Holdings of **Halliburton** (oil field services) and **Gilead** (pharmaceuticals) were eliminated after strong gains and **Electronic Arts** (video games) and **Cisco** (internet systems) were trimmed.

Among our Japanese holdings there was elevated activity with some stocks moving as much as 60% in weeks; some were eliminated like **Daiken**, up 50% since entry in October 2012; and others reduced like **Mitsubishi Corp** and **Shin-Etsu**, up 40% and 50% respectively.

Not all our purchases are household names and some might even regard them as somewhat risky. Two such new holdings are **PDG Realty**, a Brazilian home builder and **Jaiprakash Associates**, an Indian based infrastructure owner/builder and home builder. Both have been tainted by having large indebted balance sheets and have been stung by weaker economic activity which has seen their share prices decline to a fraction of their former glory. We think they are worthy of inclusion in the portfolio because of their now reviled status (in markets which only now seem to have tumbled to the dangers of debt) and the substantial equity that is realisable from their significant saleable asset bases. While clearly constrained by tighter credit conditions, both face markets that are benefitting from the drift of people to the big cities and have sufficient scale to meet diverse sections of the market. We believe that neither company need aggressively realise their best assets to meet debt calls and over the next three to five years will achieve strong capital appreciation as market conditions normalise.

Currencies

The US dollar and Hong Kong dollar account for 48% of the portfolio, followed by the Euro and European currencies 35%, Asian currencies ex Japanese yen 14%, Japanese yen 1% and the Australian dollar 1%.

COMMENTARY

In December we highlighted the likely shift of funds away from cash and perhaps bonds into equities, caused partly by unsatisfactory yields but more importantly, because of improving sentiment. There has been a change in perception about tail risk (market disruptions from unexpected sources) and a widely acknowledged acceptance that the principal Central Banks, now wholeheartedly joined by the BOJ, will do what is necessary to suppress interest rates until their economies begin to grow again. This realisation has encouraged investors to push-up share prices well-ahead of earnings revisions. In other words, the surge in share prices since August 2012 has been mainly driven by the price-to-earnings expansion. It is not that hope has buried fear and this can be shown by the continuing preference for defensive companies, which are now at extreme valuations, both absolute and relative, to their long-term history; a 30% premium in fact. At the same time, companies with more cyclical characteristics reveal some evidence of neglect. The interesting point here is that this valuation bias is as true in the US as in other markets. This is strange given the fact that US companies have delivered the most impressive earnings improvements since the crisis and that the market as a whole has expectations of low anticipated variability of returns in share prices, as predicted by the VIX[1]. This probably means we should expect some rotation to other markets in coming months as their underlying fundamentals gradually improve. As it stands, markets are displaying a fine balance between gradually improving expectations, but with sentiment still tinged with uncertainty. Valuations in markets outside the US are 15 to 20% lower; this should provide upside potential.

Quarterly Report (Continued)

In the last quarterly report we expressed general optimism based on improving economic factors, change in risk tolerance and attractive valuations. While the latter has deteriorated somewhat in the intervening three months because of strong upward share price moves, prospects for the other two variables have probably improved.

What can unsettle this seemingly finely balanced opportunity?

As a sense of well-being is predicated on Central Banks maintaining control of **cheap money** and encouraging credit growth, anything that disrupts this **intravenous feed** can be expected to unsettle markets.

- **Inflation** is seen as the most likely disruptive threat but it needs great selectivity of data to find evidence of it picking-up speed. Even in countries with relatively weak currencies like the United Kingdom, inflation is still remarkably subdued reflecting under-utilised resources while in the US, the general price index seems to be heading lower.
- Ironically, the more subdued growth rates in emerging markets, together with a strong supply response to recently elevated prices of commodities, is helping to **subdue raw material prices**. So while demand continues to grow, for the moment it seems that supply is more than adequate. Improved energy self-sufficiency for the US is the big topic of the day but we should not lose sight of the fact that the supply-demand balance for liquid hydrocarbons is as tight as it has ever been. The gap between supply and demand globally is a mere 2 to 3 million barrels per day out of consumption of 87 million barrels per day.
- **Political disruption** could be another destabiliser and here again one would be hard pressed to identify wide-spread civil unrest caused by fiscal austerity. In fact, the European Union seems to be softening its position on budget deficits and seems willing to extend the time scale for fiscal rebalancing.
- **Earnings shortfalls** cannot be ruled out and analysis of the extraordinary resilience of US company profits reveals that productivity gains have been kept by companies. Obviously, European and Japanese companies do not, as of yet, have the same buoyant domestic economic conditions.
- **Currency manipulation** which causes undue competitiveness could also produce negative surprises for corporate earnings. With the weakness of the yen, European manufacturers face renewed competition which must impinge on their profitability. By the same token, a strong US dollar will have some adverse effects on foreign earnings translations as well as international competitiveness for US-based companies.
- **Suppression of borrowing costs** to well-below long-term clearing levels seem bound to create misallocation of capital but this for the moment is a more distant threat. By way of example, the search for yield is enabling emerging countries which were former credit outcasts to sell sovereign bonds at well-below double digit yields and indeed companies within these countries are engaging in cross-exchange borrowing. This over-dependence on foreign funding was indeed the cause of problems for parts of Asia in the late 90s but it is our view that it is far too early to make a similar call.

It is not as though we have become born-again believers in QE as we remain convinced that the steps now being taken, to ameliorate what is essentially a deleveraging cycle, will have some longer term negative consequences, particularly the misallocation of capital. However, markets are still tinged with caution and we are finding investment opportunities without having to stretch expectations beyond the probable. Useful markers in the months ahead may be a weak gold price in US dollars (reflecting improving confidence), relative strength among banks (revealing improving economic conditions and falling solvency fears) and upward trending bond yields (suggesting an improvement in underlying growth and the demand for credit).

OUTLOOK

After the strong start to the year it would be unusual if there was not some backfilling of prices as investors wait for more confirmation of their hopes both on the economic and company earnings fronts. We are encouraged by the large divergence in stock price behaviour and the fact that there are interesting companies we can buy at attractive valuations. There is certainly no shortage of social and economic issues that need to be addressed around the world but so long as yields are suppressed, investors will be faced with the difficult choice about how much risk they should carry. This should give sound companies a solid underpinning.

Kerr Neilson
Managing Director

1 VIX is a ticker symbol for the Chicago Board Options Exchange Market Volatility Index, a popular measure of the implied volatility of S&P 500 Index options. Often referred to as the fear index, it represents one measure of the market's expectation of stock market volatility over the next 30 day period.

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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