MLC-Platinum Global Fund

QUARTERLY INVESTMENT MANAGER'S REPORT

PERFORMANCE

Fund Size: $998.9m	Last quarter	Last 12 months	5 years (compound pa)	Since inception (compound pa)
MLC-Platinum Global Fund	6.4%	21.0%	16.8%	11.3%
MSCI All Country World Net Index (A$)	2.8%	15.7%	16.6%	6.7%

After fees and expenses. Portfolio inception date: 30 June 1994
Source: MLC Investments Limited and Platinum Investment Management Limited for fund returns, and RIMES Technologies for MSCI index returns.
Past performance is not indicative of future performance. The value of an investment may rise or fall with the changes in the market.

Glancing over our quarterly commentary, it feels as though there has been very little change in themes thus far in 2017. To recap, evidence of persistent and **widespread economic expansion** is undiminished. **Raw material prices** have continued to rise and, in the case of rare metals like cobalt, spectacularly.

While both mired in **important**, **yet protracted**, **legislative processes**, there is perhaps a brightening prospect in the US regarding the **tax bill** while the **Brexit** negotiations are revealing the horrors of an ill-prepared plaintiff.

In France, Macron's popularity is declining, while in Germany voters are voicing their fear of unrestricted migration through a strong showing of the right, which makes Chancellor Merkel's position more awkward as she engages with a coalition of disparate interests.

Following on from tighter lending measures, Chinese regulators have added **restrictions on the sale of second-hand property** in several cities as a further attempt to hold back rising property prices. Other measures have produced apparent stabilisation in the upward march in property prices, but strong income growth, continuing migration to the cities and high household savings suggest that these are merely palliatives.

By contrast, **China's 'supply side reform' initiatives** to close obsolete polluting capacity in industries ranging from coal to steel, aluminium, basic chemicals and now power generation, are proving highly effective. As we emphasised in last quarter's report, the implication of these changes are far-reaching. Not only is pollution being mitigated, but the subsequent rise in the prices of these commodities is also placing these industries on a far stronger footing as revealed in significant profit surges. Some are choosing to pay back debt to the banks; others are building their cash reserves while maintaining the full use of these long-established credit lines from their banks. The key point here is that this is **forcing investors to reconsider their bear case on China**.

Among new developments from earlier in the year were the improbable exchanges between North Korea and

MSCI REGIONAL INDEX PERFORMANCE TO 30.9.2017 (AUD)

Region	Quarter	1 year
Developed Markets	**2%**	**15%**
Emerging Markets	**5%**	**19%**
United States	**2%**	**15%**
Europe	**4%**	**19%**
Germany	5%	23%
France	6%	27%
United Kingdom	3%	12%
Japan	**2%**	**11%**
Asia ex Japan	**4%**	**20%**
China	12%	30%
Hong Kong	3%	13%
India	1%	11%
Korea	0%	22%
Australia	1%	10%

Source: RIMES Technologies.

MSCI ALL COUNTRY WORLD SECTOR INDEX PERFORMANCE TO 30.9.2017 (AUD)

Sector	Quarter	1 year
Energy	7%	5%
Materials	7%	21%
Information Technology	6%	27%
Financials	3%	28%
Industrials	3%	18%
Telecommunication Services	1%	1%
Consumer Discretionary	1%	14%
Utilities	1%	7%
Health Care	0%	9%
Consumer Staples	-2%	2%

Source: RIMES Technologies.

Platinum ASSET MANAGEMENT

MLC

the White House. Though obviously highly significant, investors have seemingly taken the view that a negotiated outcome is the most probable, as evidenced by the strength of the Korean won, which is close to its peak against the US dollar, and the Korean stock market, being only 3% short of its all-time high.

Another significant change has been a **strong recovery of the oil price** as pronouncements from shale producers suggested that increases in output at US$50 a barrel will be more constrained than earlier believed. Strong global demand has also tightened the market.

Flows have matched these changing perceptions, with the US market being a source of funds as investors continued to move more into Europe and the Emerging Markets. Once again, Emerging Markets led the rise with an increase of 7.6% in local currency, or 5.5% in AUD terms. Japan and the US each achieved a little over 4% (in local currency) while Europe followed closely with a 3.6% gain.

We are delighted to witness a more normal distribution of performance across markets, as represented by the MSCI indices, with the action no longer being dominated by the US component. The Fund has clearly benefited from this as well as from the diminution of the 'duration-seeking' or cyclical aversion that characterised the period from 2011 to 2016. Most pleasing of all was that in each geographic area, the funds invested have achieved higher returns than the host market. Consequently, we have been able to add considerable value as a fund manager – ironically, just as the **discussion around passive management** seems to have reached a climax! For the quarter, the Fund achieved 6.4% and for the last 12 months 21.0%. This contrasts with the MSCI AC World Index (A$) achieving 2.8% and 15.7% over the same respective periods.

CURRENCY

As shown in the table below, changes in currency holdings have been minor.

FUND'S CURRENCY EXPOSURE

Currency	30 Sep 2017	30 Jun 2017
US dollar (USD)	34%	33%
Euro (EUR)	15%	16%
Hong Kong dollar (HKD)	12%	11%
Japanese yen (JPY)	9%	8%
Korean won (KRW)	8%	6%
Indian rupee (INR)	5%	5%
British pound (GBP)	5%	2%
Norwegian krone (NOK)	3%	8%
Chinese yuan (CNY)	4%	3%
Australian dollar (AUD)	1%	3%

Source: Platinum Investment Management Limited

SHORTING

We closed the short position against the Russell 2000 Index while maintained the position against the S&P 500 at close to 9%. There has not been much change this quarter.

CHANGES TO THE PORTFOLIO

As we hinted in our last quarterly report, we have become quite excited about the prospects for what we term the 'electric metals'. We have been accumulating our exposure to these companies for some time, which continued this quarter. This decision comes from the work we have done on the changes taking place in the automobile industry regarding **electric drives and autonomous vehicles**. This is obviously a convoluted quest that is weighing heavily on the valuations of traditional auto companies which, as a group, are confoundingly cheap, even with the apparent hurdles they face been taken into account.

FUND'S DISPOSITION OF ASSETS (NET INVESTED POSITION)^

Region	30 Sep 2017	30 Jun 2017
Asia	36.1%	35.0%
Europe	22.1%	20.6%
Japan	16.4%	16.3%
North America*	7.6%	7.7%
Russia	0.9%	0.6%
South America	0.0%	0.4%
Cash	16.9%	19.4%

Source: Platinum Investment Management Limited

^ The net invested positions represent the Fund's exposure to physical holdings (equity and corporate fixed income securities) and both long and short derivatives as a percentage of the Fund's net asset value.

* At 30 September 2017, the Fund had a short position in the US against the S&P 500 Index of -8.8% (30 June 2017: -9.0%). The position against the Russell 2000 Index (30 June 2017: -1.0%) has been closed during the quarter.

TOP 10 HOLDINGS

Stock	Country	Industry	Weight
Samsung Electronics	Korea	IT	3.5%
Alphabet Inc	USA	IT	3.1%
Royal Dutch Shell PLC	UK	Energy	2.7%
Lixil Group Corporation	Japan	Industrials	2.6%
Inpex Corporation Ltd	Japan	Energy	2.5%
Sina Corp	China Ex PRC	IT	2.3%
Kering	France	Consumer Disc	2.2%
Sanofi SA	France	Health Care	2.1%
Tencent Holdings	China Ex PRC	IT	2.1%
Ping An Insurance Group	China	Financials	2.1%

As at 30 September 2017. The table shows the Fund's top 10 long stock exposure (through physical holdings and long derivative positions) as a percentage of the Fund's net asset value.

Source: Platinum Investment Management Limited.

By contrast, manufacturers of automobile electronic components, battery suppliers and their source suppliers have experienced some spectacular gains and in which we have to some extent participated. However, our field trips suggest that **massive battery capacity is currently being built** in anticipation of a Chinese-led blitz on traditional internal combustion engines (ICEs).

At present, it is a guessing game as to the number of electric and hybrid vehicles that will be sold in, say, 2020. There are many imponderables, including range anxiety, the higher initial cost of electric vehicles (EVs), the scarcity of charging facilities and the probable loss of generous state subsidies.[1] What we do know is that all the large manufacturers will have EVs on offer by 2019 and need to sell a certain proportion, even if at low margins, in order to meet their ***fleet* emission quotas** in sophisticated markets.[2] (Daimler-Benz recently alluded to the cost of this in their investor day presentations, suggesting that they anticipate a reasonable, if smaller, contribution margin.)

From an investing standpoint, this raises a host of opportunities. From earlier work, we followed the battery component path and acquired positions. But from here, ironically, the most certain opportunity may lie in the simpler companies that provide the basic metals. Nickel, copper and cobalt are prospective. The problem with cobalt is its scarcity, with current mine production barely achieving 100,000 tons a year and 65% of which coming from the perilous Democratic Republic of the Congo!

We find **nickel the most interesting** from an investment perspective. There are still huge stocks, a consequence of the mining boom and subsequent oversupply. At the current price of under US$5 per pound, perhaps 25% of world output is cash flow negative, and there is the added uncertainty around supplies of nickel-rich iron ore from Indonesia and the Philippines. However, we think such concerns are missing the more pertinent point that, of the annual supply of new material, which runs at 2.2 million tons, **only about 950,000 tons are suitable for battery making**. Considering that each 60 kWh Chevy Bolt NMC battery may contain as much as 23 kg of nickel, it does not take too many vehicles to start to tighten the refined nickel market.

Substitution is always a risk. As we are seeing with cobalt, which has seen the price triple in two years to US$30 per pound, efforts at thrifting are already producing results. The new cathode blends are reducing the cobalt load in NMC batteries from one-third nickel, one-third manganese and one-third cobalt (1:1:1) to a ratio of 8:1:1. These are due to for release in 2020.

The tightening of the nickel market may take time to play out, because stocks of the metal are still large, though off their peak levels. We have invested around 6% of the Fund's portfolio in potential mining beneficiaries.

There is a further 7% of the portfolio in **hydrocarbon plays**, representing an increase from earlier in the year. To fund these positions we have tended to **reduce our bank exposure** as well as trimming some of our **high-flying internet and e-commerce holdings**.

OUTLOOK

The great puzzle is the preference investors are showing globally towards bonds (nominal assets) over equities (real assets). This tea party is all the more bewildering when one considers that earnings growth from the middle of last year has been accelerating while bond yields have been strengthening (i.e. bond prices have been falling), and in the face of that, equity withdrawals have sped up, as have bond purchases. We know that the central banks are insensitive buyers – together, the European Central Bank (ECB), the Bank of Japan (BoJ) and the Bank of England (BoE) are **buying US$175 billion of bonds per month**, and that baby-boomers change their risk preferences as they age. But what is so interesting about bonds? The hole caused by central bank purchases[3] is being assiduously filled by the issue of corporate debt. Such is their excitement that bond investors have driven the yield of subprime European paper to below that of sovereign US paper. To put some numbers to the foregoing, corporate debt in the US has risen uninterruptedly from US$1 trillion in 2011 to US$1.54 trillion in 2016. At the same time equity ownership in the US has fallen by some US$500 billion.

1 These subsidies presently average around US$5,000–7,000 per battery-powered electric vehicle (BEV), with the outliers being China, at around US$10,000 per BEV, and Norway, at about US$20,000 per BEV. The high initial cost of EVs may be the greatest impediment with current calculations suggesting a through-life payback of, say, seven to nine years. For example, the cost of the electric drive train is similar to that of an ICE, but the battery adds anything from US$8,000 to US$15,000 per vehicle. However, battery technology is bounding ahead with lithium nickel cobalt aluminium oxide (NCA) cathodes storing as much as 250 Wh per kg, twice that by the cheaper and more stable lithium phosphate (LFP) cathodes. Interestingly, the **cost of the metal content** of, say, a lithium nickel manganese cobalt oxide (NMC) 811 battery is around 20% to 25% of the cost of the entire battery pack, leaving lots of scope to reduce the packaging and related costs. At present, the Nissan Leaf is estimated to be acquiring battery packs from LG Chemical at close to US$140 per kW. The general view is that once battery packs are available at US$100 per kW or lower, EV manufacturers will be able to match the cost of an ICE driven car.

2 In the US, for example, the Corporate Average Fuel Economy (CAFE) hurdle is currently 35.5 miles per gallon (MPG), which will rise to 54.5 MPG by 2025. On 28th September 2017, China's Ministry of Industry announced that by 2019 at least **1 in 10 cars sold in China** must be so-called new-energy vehicles (NEV).

3 Governments have commandeered their own bond markets: Of the US treasury market of US$20 trillion, the US Fed owns 12% and a further 20% is owned by foreign governments. In the world's second largest bond market, Japan, the BoJ owns 45% of the US$8 trillion on issue while the ECB and the BoE respectively own 20% and 30% of their government bonds in issue!

(Continued)

We have not discovered the secret to this phenomenon. If the world's finances are so perfect, as suggested by the current pricing of equities, why is there still such need for central banks to continue with quantitative easing? What we can observe is that as investment banks now play a minor role as market makers, the reach-for-yield is narrowing the rate differential between quality and trash dramatically, and bond managers appear to have reduced their portfolio hedging, such that when one wishes to reposition a portfolio, it is neither easy nor swift.

All this points to **fewer stabilisers** in bond markets should there be that pause caused by the proverbial embarrassing question across the dinner table. In response to the popular question "where will the **next eruption** come from", we might proffer **liquidity, and bond liquidity in particular**, well ahead of the standard favourite, China.

Kerr Neilson
Managing Director
Platinum Asset Management

Please visit www.platinum.com.au/journal/ to read:

***The Rise of Asia*, a recent presentation given by Kerr Neilson at the NAB Asia Development Congress in Shanghai, providing an in-depth look at Asia's tectonic transformation and its importance for global investors.**

***Why Indices Lead Investors Astray*, a paper presented by Andrew Clifford, Platinum's CIO, at the Portfolio Construction Forum, illustrating the fundamentals of value investing through a real-life case study.**

MACRO OVERVIEW

By Andrew Clifford, CIO, Platinum Asset Management

An important development that is not receiving the attention it deserves from global investors is the "supply side reform" that is under way in the Chinese economy. These reforms are important, because:

1. They are bringing about a step change in profitability for the industries that are seeing capacity closures, not only within China, but also across the globe.
2. The improving profitability in previously over-supplied industries in China will lead to a reduction in non-performing loans[1] in the banking system and, with it, a significant reduction in the risk of a financial crisis in China.

The supply side reforms address a key weakness in the structure of China's economic system, namely, the coalition of local governments with local banks to develop and bankroll local state-owned enterprises (SOEs). This pattern of local development contributed to significant over-capacity in a wide range of fast growing "commodity-like" industries (such as steel, cement, glass and chemicals) and, with it, a growing burden of non-performing loans for the banking system. When the downturn came, the importance of employment for the sponsoring government meant a great reluctance on all three parties to close loss-making capacity.

As discussed in our March quarterly report, supply side reforms were initially focused on the steel and coal sectors. Redundancy funds were provided by the central government to compensate laid-off workers, easing local governments' reluctance to follow through. The State Council directed the closure of sub-scale plants as well as operations not adhering to environmental and safety standards. It should be noted that these directives related to SOEs, not private enterprises. Having said that, "unapproved" plants built by private firms, notably in the steel sector, were also targeted for closure.

It is estimated that steel capacity has shrunk by 13% and coal by 10% since the start of 2016, resulting in significant improvements in the profitability of these industries. Prices for Australian coal exports are up nearly 100% since early 2016.

Initially, there was much scepticism when the supply side measures were announced. Over the last 15 years Beijing had announced plans to close sub-scale and polluting plants on a number of occasions, with little effect. Even if some capacity was closed, it would reopen within weeks or months. Most observers therefore expected a similar outcome with this recent round of directives from the centre. However, this occasion does appear to be different. For plants to qualify for redundancy funds, they first had to be decommissioned.

Supply side measures have since been extended from steel and coal to other industries such as PVC and aluminium. What is probably more significant though is that anecdotal evidence shows that environmental regulations are being policed strictly, which is resulting in capacity closures across a broad range of industries. Another variable is that banks are simply not prepared to extend financing to industries where there is excess capacity, whether that be as a result of following central directives or for purely commercial reasons. The upshot is that small private operators that have closed for commercial reasons and were hamstrung in restarting capacity may now be viable with higher prices.

Another observable development is the consolidation that has started to occur, with significant transactions resulting in the merger of cement groups, or the merger between the country's largest coal producer with one of the large power generation companies. There is also clear evidence in government statistics (for what they are worth) and company accounts that investment in oversupplied industries has collapsed.

While Beijing has been successful to date with these supply side measures, we should consider why this "central" control over a large and disparate group of enterprises should hold. In the first place, there is an industrial logic that would be recognised by any Western businessperson. SOEs are "owned" by the government and consolidation makes more sense than fierce competition amongst what are essentially sister companies, and better profits mean higher taxes.

In reality, the ability for Beijing to have created this outcome is most likely a resultant of the consolidation of power by China's current leadership. It is clear that local politicians, managers of the SOEs, government employees (particularly those with the responsibility of enforcing these reform measures) and bank executives understand that if they do not comply with Beijing's policies, there is a real risk of loss of job and, for the more serious infringements, potentially time behind bars.

The reason that these changes deserve serious attention from global investors is that they have dealt with one of the key weaknesses in China's economic system. Together with the reforms in the financial system that have brought under control the rapid growth of the shadow banking sector, the supply side reform measures have substantially reduced one of the key risks for the Chinese economy and, indeed, the global economy. It also means that resources in the economy will progressively be applied to the more dynamic private sector where opportunities abound.
The focus of investments in China today is clearly on those areas dominated by the private sector, such as electric vehicles, robotics, biotechnology, and e-commerce. The only SOE-dominated area where we can observe significant investment is infrastructure, which is a result of the One Belt One Road initiatives and which we think will have significant benefits to the broader economy.

[1] In this sense we are referring to "real" non-performing loans, not the declared numbers which most likely understate the problem and which we assume will continue to grow for the moment as they catch up with reality.

[2] Based on the MSCI All Country World Net Index (A$).

The main note of caution we have in regard to China is the shorter-term outlook for the next six to 12 months. The government has once again been broadening restrictions on residential property purchase and financing in cities where demand and prices have been strong. The result has been a slowdown in new property sales and, with that, the potential deferral of construction activity. Residential construction is a significant contributor to economic activity. Our view is that the Chinese residential market is fundamentally under-supplied (I urge you to read Kerr Neilson's recent paper, *The Rise of Asia*, available on our website at www.platinum.com.au/journal/, for an outline of the key factors underlying China's demand for urban housing), and therefore this area of activity will remain robust for some time to come. Nevertheless, there may be some loss of momentum in economic growth in the months ahead.

MARKET OUTLOOK

The world's other major economies appear to be in good health. European and Japanese economies are continuing on a path of steady improvement, and the US continues to grow strongly. This co-ordinated global growth is providing a strong backdrop for global markets. Indeed, returns for Australian investors from global shares have compounded at over 16% p.a. for the last five years.[2] Returns of this magnitude should lead one to be cautious about the outlook for future returns. This view is, however, somewhat at odds with the opportunities that are presenting themselves at an individual stock level, where we continue to find companies to buy at attractive valuations. Usually we would not associate the ready availability of interesting opportunities with markets that are at dangerous levels.

When we look around for risks in markets, our key concern is US interest rates. This is particularly worrisome because of the extraordinary crowding by investors in bond markets around the world, making this, in our view, the mostly likely scene of any accident in financial markets. We could see higher rates potentially disrupt the US economy and global markets in a number of ways.

The first is the traditional rate cycle of the US Federal Reserve. History tells us that as rates are increased, eventually the US economy will respond and slow down, and before that is even readily apparent, the US stock market will start to fall, taking with it most other global equity markets. Making assessments about the exact timing of such events is highly problematic. Currently, rising labour costs are the key concern for inflationary pressures and further rate rises. However, it is questionable whether companies are in a position to pass on any increased costs to consumers. For example, Target recently raised their minimum hourly wage to US$11, with a commitment to raise it further to US$15 by the end of 2020. But given the brutally competitive environment in retail as a result of e-commerce, price rises seem an unlikely prospect. However, one assumes that rates will at some point rise to a level where there is economic and market impact.

The other potential issue is a blow-out of the US budget deficit as a result of President Trump's proposed tax plans. If the proposed tax cuts come to fruition, the financing requirement could cause significant upward pressure on US bond yields. Given the lack of success of the Trump administration in its efforts to pass reform agenda to date, markets appear to be putting little weight on the prospects of these tax cuts being passed, at least as initially proposed. We can add little to this debate, but tend to favour the view that Trump's tax plans will need to be significantly watered down to have any chance of success. Clearly though, political events of the last two years suggest that one shouldn't be complacent, particularly given investors' current enthusiasm for debt securities of all types across most geographies.

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

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