Platinum Capital Limited
30 September 2007 Quarterly Report

Performance

It is increasingly apparent that the trend of world stock markets has been set by the conviction that the world is "growing stronger for longer". Years of underinvestment by many processed commodity industries, ranging from mining to refining, has resulted in dramatic price rises, a surge in profitability and explosive gains in their market valuations. Australia, with its abundant natural resource base, has been a prime beneficiary of this trend and has enjoyed a fifteenth year of uninterrupted growth.

We have been inadequately positioned for this trend even though we were early to recognise the significance of China and India in terms of the physical off-take of the commodities they lacked. This view found expression in holdings such as MIMS and Noranda. We then moved too aggressively into the one laggard in the piece, Japan, with the logic that growth would be good for one of the world's leading exporters. Ideal positioning, however, called for maximum exposure to highly cyclical companies and financials and for currency exposure to be hedged fully into commodity-rich currencies. We were not so positioned.

GEOGRAPHICAL DISPOSITION OF PLATINUM ASSETS

Region	Sep 2007	Jun 2007
North America	28%	27%
Japan *	22%	24%
Emerging Markets (including Korea)	19%	18%
Western Europe	18%	21%
Cash	13%	10%
Shorts	27%	29%

* The Company also has a 11% short position in Japanese Government Bonds

Source: Platinum

MSCI* WORLD INDEX COUNTRY PERFORMANCE (AUD)

Region	Quarter	1 Year
Hong Kong	19%	27%
Brazil	16%	66%
India	15%	38%
Korea	9%	22%
Australia	7%	31%
Germany	-1%	24%
US	-2%	-2%
UK	-4%	3%
France	-5%	5%
Japan	-5%	-10%

* Morgan Stanley Capital International

Source: MSCI

For those of us trying to read the tone of the market the surprise has been the relatively mild sell-off of equities in the face of a clear "market failure" in the credit area. Skyrocketing share prices since the Fed cut short-term rates by a surprising fifty basis points simply reemphasises the bullish sentiment of the day.

During the latest quarter our cautious positioning barely helped our performance. We were not fully hedged back into the local currency so the strength of the Australian dollar acted as a lead weight even as overseas markets recovered strongly.

There was benefit to be had from profitably closing out a number of short positions but the scope for this was limited as markets resumed their uptrend in a matter of days. The speed of this recovery was unexpected and has cast doubt on the value of some aspects of our protective strategy.

The Company returned -1.8% pre-tax for the quarter and 1.4% for the 12 months versus the MSCI World Index of -0.8% and 4.6% for the same periods. The five year and longer numbers are still very respectable.

The following Platinum Net Asset Value figures (cps) are after provision for tax on both realised and unrealised income and gains.

31 July 2007	31 August 2007	30 September 2007
165.20	166.03	162.22

Source: Platinum

Currencies

We presently have no US dollar exposure. We are 29% long the Australian dollar, 25% long the Japanese yen, 21% long the European currencies with the balance in underlying Asian currencies.

There follows a brief description of the market's recent travails. Just as all seems to be progressing smoothly along comes a surprise. On this occasion it was related to sub-prime lending. Regular readers will not be surprised by such an outcome having been exposed to a high dosage of disapprobation about easy lending and cheap money leaving lenders unrequited for the risks they run. It was a surprise, however, to discover the extent to which supposedly deep markets could freeze almost overnight.

The **common belief had been that securitisation dispersed the risk.** This contrasted with earlier times where problems from careless lending would emerge in the banking system, eventuating in a rationing of credit and the withdrawal of lines in the face of credit losses and equity write-offs. This most recent episode of securitisation not only segregated originators from eventual owners but co-mingled and geared the resulting collateralised debt obligations, CDOs,* the volatility of which was consequently magnified. When trouble struck those trading in these markets became uncertain as to the inherent value of their paper which resulted in sharp markdowns. At these lower prices, many lacked the will to transact at all. At the same time, several leading banks were discovered to have established off-balance sheet entities that were also heavily geared. Fortunately the central banks were willing to tide over most of those institutions caught with long-term lending obligations funded with short-term money but not before we were all reminded of the risks of high leverage.

* For more coverage on this topic, please see the John Hempton article on our website at the following link: http://www.platinum.com.au/images/us-finance.pdf

Gradually the freeze has thawed and as the quarter ended many of the signs of stress diminished and it was almost back to business as usual. But not quite. The leveraged buy-out brigade, a.k.a. private equity, is in some instances reneging on deals or at least attempting to renegotiate terms. The banks are trying to extricate themselves from some of their more extravagant commitments, faced with contingent liabilities they never envisaged would be called upon. They are now reluctant to lend to "nobodies" and even among themselves there is a clear divide between big and small institutions, with poorly funded long-term lenders, such as RAMS or Northern Rock, needing to find new owners as losses have impaired their solvency. The global write downs by the banks will alone run to many billions. It is also possible that as these special off-balance sheet vehicles are brought back on balance sheet, capital constraints will lead to equity raisings.

<u>Commentary</u>

One's guiding principles following the bursting of the Internet bubble in 2001 should have been:

1. that the **Federal Reserve Board would act vigorously to support economic activity in the face of weakening activity** (even if Japan has shown that force-feeding credit is no use if people do not wish to borrow or lend);

2. that the world would continue to experience a **different type of cycle to anything seen since the 1950s**;

3. and that the trade-threatening mercantilist policies being followed in Asia would be **accommodated by the recycling of surpluses** back into the assets of the deficit nations and this would sustain order in the currency markets.

During the course of economic history there have been a number of events that have been paradigm changing. **What we are living through now is the entry for the first time of something like 30% of humanity onto the world capitalist stage.** This, in simple terms, is suppressing the cost of labour and transferring jobs dependent on traded goods and some services to lower cost centres. It is also bolstering the profit share of capital in general, hence the super rents we have highlighted in past quarterlies, and disproportionately rewarding the nations and owners of those resources in inadequate supply due to insufficient earlier investment in the face of weak commodity prices. Until these bottlenecks are alleviated through supply responses or substitution heightened rewards will continue to accrue. This in turn has positive implications for resource-backed currencies and negative implications for chronic borrowers.

Platinum to date has been overly concerned about the durability of the recycling process, fearing that credit defaults and/or chronic weakness in the US dollar would create circumstances beyond the control of the central banks. We coincidentally underestimated the willingness of

Western consumers to borrow. Having taken this stance, we were set on a path of unrewarded caution.

Where does this leave us now? As we noted in July, the outcome from these trade driven (mercantilist) policies is a **wall of liquidity which will find expression in asset prices at the source of the imbalances.** Early and aggressive interest rate cuts by the Fed have the appearance of bailing out the system; they certainly have the effect of **raising the tempo of the asset chase**.

There remain some warning signs. Firstly, the gold price has begun to move to yet higher ground even when expressed in strong currencies such as the euro. Secondly, the Chinese buyers of longer dated US Government paper have been absent from the market since the May auction. This incidentally was probably what sparked off the complicated rebalancing of duration by funds and institutions that unleashed the sub-prime cascade.

Importantly, the recycling process that is at the heart of the equilibrating act, which compensates for trading imbalances continues. Those creditor countries attempting to manage their currencies' exchange rates are now recycling to the short-end of the yield curve and perhaps into real assets.

Markets that have built-up rapid momentum and those with a surfeit of internal savings have moved to new highs while most of those dependent on foreign savings are still below their earlier peaks. There has clearly been a change of mood although mostly at the extremes. Those with strong internal drivers continue to flourish while those with weaker fundamentals are partially ignored.

Domestic inflation of asset and other prices potentially threatens the *status quo*. Food inflation is difficult to contain if it is caused by a global repricing of resources - see previous commentary on our agricultural theme. To dampen down asset speculation the Chinese authorities have been proactively introducing selective measures. As we noted last quarter, the Taiwanese tried virtually everything to control asset prices post their currency float but the pressure was inexorably upwards. An important measure to watch is the *rate of change* of urbanisation in China: deceleration would forewarn of a tightening in labour supply and potential wage inflation. For the moment, though, all the indicators point to the growing intensity of speculation in China and, increasingly, in neighbouring countries and further abroad.

Conclusion

Towards the end of the tech bubble we gradually shifted away from trendy areas to find refuge in non-tech "boring" companies. Today, there is not as wide a valuation gap between hot and cold. The areas of relative safety are the non-leveraged, non-resource, large capitalisation, global companies which display modest operational gearing. Many have records of years of uninterrupted growth and yet have been partly overlooked by investors focused on buy-out candidates or believing the commodity boom is all compelling. That is not to say we cannot find a large number of interesting investments in Asia which on account of their perceived peripheral participation in the glamour areas, are still modestly valued. We are, therefore, **managing a barbell strategy**. This can be characterised as participating at the margin of the asset bubble centred in Asia and offsetting this with a large helping of quality, globally dominant players trading at below trend valuations. If growth continues to be strong we will enjoy the slip stream and if it turns out to weaken we should avoid the nasty surprises.

Post quarter-end we reduced our shorts to 22%. We still, however, do not wish to be too exposed to the currencies of those nations dependent on others' *largesse*.

We believe our long duration themes such as data mobility, infrastructural deficiency, the pulp and agriculture commodity cycle etc, are well on track. That most of the companies we are invested in have virtually no debt is an important consideration as is our very limited exposure to financial companies and the Western consumer. Japan is now widely perceived as a relic of an earlier industrial age but our exposure there is concentrated on companies that are participating in the current boom of world growth without the financial risk. **Like other large capitalisation companies they may attract the interest of Sovereign funds now looking to invest in real assets as opposed to paper claims ie. bonds and bills.**

We rue our earlier overcaution and cannot for the moment identify factors that will dislodge the drivers behind the current upward trend in most equity markets. We have accordingly adjusted to a more optimistic investment stance.