



# **Quarterly Investment Manager's Report**

Platinum World Portfolios - International Fund

Platinum World Portfolios - Asia Fund

Platinum World Portfolios - Japan Fund

**31 March 2017**

# Contents

<b>Macro Overview</b>	3
by Andrew Clifford, CIO	

## Fund Updates

PWP - International Fund	8
PWP - Asia Fund	12
PWP - Japan Fund	14

## Feature Articles

<b>Observations from a Recent Trip to China</b>	16
by Andrew Clifford, CIO	
<b>Rediscover Japan</b>	19
by Scott Gilchrist, Portfolio Manager	

# Macro Overview

by Andrew Clifford, CIO

The global economic and political landscape continues to provide a multitude of challenges for investors. President Trump's daily policy pronouncements, the prospect of Marine Le Pen winning the French presidential election in May and, with that, the possibility of France looking to exit the European Union (EU), and China's ever-growing mountain of debt, are just some of the issues that investors need to consider. To add to that, US interest rates are on the rise and valuations of US stocks are at extremely high levels. We could go on and on. Yet, in the face of all these concerns, global stock markets have continued to move steadily higher!

At Platinum, it is our view that the very risks that investors become fixated on are often the source of the greatest opportunities. However, before elaborating on how we see these issues and others playing out for investors, it is worth **reflecting on the key imbalances in the major global economies**, which are not only driving investment outcomes, but also political outcomes.

## Income Disparities – The Real Cause of Global Trade Imbalances

Most readers would be well aware of the massive trade and current account surpluses that China has produced over the last two decades as it became the unparalleled provider of low cost manufacturing of goods. Less well known is that China is not the only country currently running substantial surpluses. In the period post the Global Financial Crisis (GFC), the Eurozone has turned its current account deficit

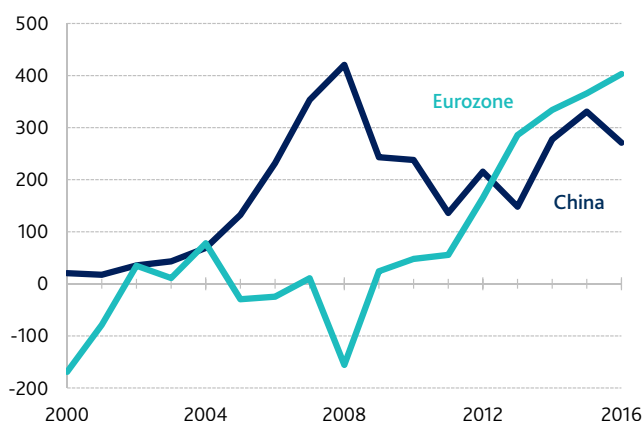
into a surplus in the order of US\$403 billion, and South Korea's surplus has risen fivefold to some US\$100 billion.

**These provide a useful point of reference for China's surplus of US\$271 billion in 2016.**

China's substantial surplus is often attributed to the country's advantages in terms of low labour cost as well as other variables such as cheap industrial land, weak environmental regulation, generous government subsidies, and an undervalued exchange rate. While all of these elements have certainly played a role in making Chinese exports competitive, the fact that the Eurozone and South Korea have substantial surpluses without the benefit of such advantages suggests that there is more to this story of trade imbalance.

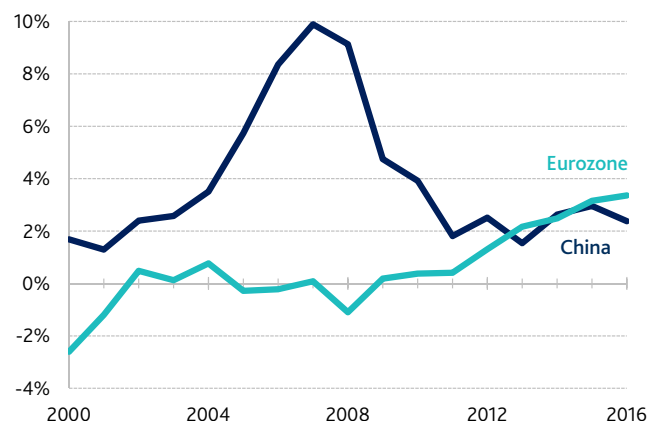
**At the core of the problem in the surplus economies is the distribution of income.** In China, the household share of GDP is unusually low, with household consumption expenditure accounting for only 38% of the economy. The other side of this equation is that businesses and government (more via state-owned enterprises than tax revenues) account for an unusually large share of GDP. This has served China well, as the corporate sector (whether privately-owned or state-owned) was behind the extraordinary investment boom that has driven China's growth to date. But herein lies the problem! **As the corporate sector exhausts its investment opportunities**, with some capital-heavy industries like steel now facing contracting capacity, **it will find its cash flows increasingly exceed its capital expenditure needs.**

China and Eurozone Current Accounts (USD, billion)



Source: IMF, Platinum.

China and Eurozone Current Accounts (as a % of GDP)



Source: IMF, Platinum.

These savings of the corporate sector are the source of China's trade surplus, as they remain in the hands of those who have no way of spending them. Imagine for a moment if these excess funds were instead in the hands of Chinese households rather than a narrow group of private and public shareholders. They would likely be spent on housing, autos, and a range of consumer goods from handbags and shoes to holidays. Moreover, while a good proportion of these goods and services would be domestically produced, there would also be a significant element of imports, such as aircraft, semiconductors, overseas travel and the like, which would drive down the trade and current account surplus. **Such a consumer boom would itself engender significant investment in a range of industries, not only in China, but globally.** It is for this reason that we focus intently on the Chinese consumer – this sector of the economy must prosper if China is to continue its rapid development and transformation.

The income inequality between China's corporate sector and households is also present in the developed world, but there the inequality is more evident in the distribution of income across households. Between 1994 and 2014, the real income of the top 20% of households in the US grew by 16% while the bottom 20% experienced a 4% decline. The growth in income for the majority of US households initially resulted in a consumer boom which was reinforced by the draw-down in home equity via mortgage refinancing until 2008. However, this boom in consumption, together with the resulting debt burden, left the American consumer with little appetite for further spending. Indeed, since 2008, as income further accrued to middle income and wealthy households, debt repayments and savings have become the focus. As is in China, **income is accruing in the hands of those less likely to spend.** If this trend in income disparity were reversed, lower income households would likely display a much higher propensity to spend, not only boosting total consumption, but potentially creating new investment opportunities as well. The rise in income inequality experienced by the US can be observed across most of the developed countries, though the redistribution mechanisms of taxation and government spending have generally been more effective elsewhere, leading to less extreme outcomes.

Interestingly, though, **while income inequality has resulted in substantial trade surpluses for China and, for that matter, Germany and South Korea, the United States saw the opposite outcome.** To examine this issue we need to consider two important relationships that exist in all economic systems. The first is that a current account surplus will always be exactly offset by a capital account deficit. When China, Germany and South Korea run current account surpluses, they are exporting their excess savings via the

capital account to economies that run current account deficits, such as the US, the UK and Australia. The other key relationship to consider is that in a closed economy, all savings will be invested. Savings by definition always equal investment. Thus, in the global economy, which is most certainly a closed system, the excess savings of the surplus countries will be invested elsewhere.

The **export of excess savings by the surplus countries** has been a key to many of the boom-and-bust scenarios seen around the globe. In the years leading up to 2008, these excess savings found their way into the US housing market, in the first instance driving up investment in housing. The secondary effect, though, was to allow households to draw down on their home equity to consume more of their income, thus balancing the investment and savings equation globally by reducing savings in the US. The next destination for the surplus countries' excess savings was investment in the resources sector, notably here in Australia and in unconventional energy resources in the US and beyond. In recent times we have seen these funds finding their way into residential apartments in Australian capital cities and other major cities around the world. The most notable destination, however, has been financial assets. US bonds, shares and property, seemingly attractive as a relatively "low" risk destination, have been key beneficiaries of these excess savings looking for a home.

It is in this context that one might see that **the trade surpluses President Trump rails against are a function of more than just export competitiveness and protectionism.** Excess savings in places like China enabled US households to increase their spending (via home equity draw-downs), thus creating the relative trade positions of the two countries. Had the Chinese been big spenders and their current account turned to deficit, there might perhaps have been a reversal of roles.

## A Possible Rebalancing May Be Under Way

### The Health of the Chinese Consumer

Equipped with this understanding of the interplay between global trade imbalances and income disparities, we can now examine some of the forces that have been influencing markets and causing investors concern.

The one place where there is good news, and thus great opportunities for investors, is China. As explained above, one of the main causes for China's excess savings has been the income disparity between households and the rest of the economy. Ideally, one would hope to see household income growing faster than the economy as a whole and government policy generally favouring such an outcome.

It is not always easy to observe such changes from China's government statistics, but there are numerous signs showing that the Chinese consumer is doing well. Foremost amongst these is the ongoing strength of residential property sales. While the volume of property sales has fluctuated over recent years, the downturns have primarily been in response to government initiatives to curb speculation. When restrictions are removed, sale volumes have typically rebounded strongly. 2016 saw sales of approximately 16 million apartments, compared with the previous peak of 13 million in 2013. While these volumes are enough to cause consternation amongst foreigners, the cumulative volume of apartments sold since 1999, when private ownership of residential property was first legalised, is in the order of 130 million. Essentially, this represents the entire modern housing stock of the country. For the 400 odd million households remaining in communist era housing, it remains a question of affordability. Nevertheless, considerable latent demand for new housing exists. It is also worth noting that mortgage debt, while now growing quickly, is only at about 36% of China's GDP, and that buyer surveys have continually estimated that owner-occupiers account for 85% to 90% of all apartments sold.

The auto market is another health indicator for the Chinese consumer. Throughout China's economic slowdown over the past few years, the passenger vehicle market has continued to grow. Vehicle sales have grown steadily from 15.5 million in 2012 to 24.4 million. As auto finance is not broadly available, 80% to 90% of these purchases are paid for with cash. There is ample evidence that the Chinese consumer is in good health, which is all the more impressive given that millions of jobs have been lost in the construction and related sectors in recent years. Government policy is generally supportive of higher household incomes. In particular, we would note rural reforms and wage hikes for government workers as examples. The bigger driver, however, is likely to be the relatively fully employed workforce that continues to experience healthy income growth.

### China's Debt Problem

Few observers would likely challenge our view that the Chinese consumer is in good shape. The issue that concerns most is the ongoing growth of China's debt level, with the broadest measures growing by 14% in 2016, reaching 256% of GDP. An examination of the available data indicates that the growth in the use of credit is predominantly attributable to state-owned enterprises (SOEs), which raises the question of whether these funds are being applied productively. Some Chinese banks indicated at our recent meetings that the principal target for their lending to the SOEs is government sponsored infrastructure and related projects. However, fears

remain that this credit is being used to prop up loss-making ventures in order to maintain employment. We think the truth is likely to be a combination of both. **To the extent that loss-making ventures are being supported, this ultimately is a form of fiscal spending by the government and one should treat any such loans as part of the budget deficit.** It is worth noting that last year's supply side reform in the coal and steel industries saw capacity closure, loss of jobs, and significant improvements in profitability – a signal that the government no longer readily accepts the status quo of loss-making SOEs. We would also add that many SOEs are profitable and, as such, are an asset on the government's balance sheet. Ultimately, without greater transparency, there can be no clear conclusion to this discussion. However, we would note that the overall position of government finances in China is extraordinarily strong, and the current debt level is likely to be sustainable for some time.

What all of this means for China is an economy where the consumer sector becomes more prosperous, an aggressive infrastructure building program provides another source of growth in activity, while heavy industry, dominated by SOE ownership, continues to muddle through. In this case, China will ultimately outgrow the problems caused by its investment boom, much as the US has done post its 2008 collapse. Of course, the banking system will continue to experience nonperforming loans, but these are an accounting entry for losses that have already been incurred. However, this pattern of development will likely see China's trade and current account surpluses decline, a process that has already begun in 2016 when the surplus fell by almost 20%.

### Proposed Policy Changes in the US

A declining surplus, as per our earlier discussion, will see China's export of excess savings decline. Before we ponder the implications of this trend, however, it is worth considering the policy changes that have been proposed in the US. It is quite possible that some of the changes proposed will be "positive" for the stock market in the short-term, though are ineffective economic policy. Take, for example, the simple case of a corporate tax rate cut. There is no question that a lower tax rate will initially increase the earnings of companies, all else being equal, thus making them more attractive to investors. The real question is whether these additional funds will encourage US companies to invest more in the US. To some extent one imagines they will, but US company profitability has never been higher than it is today, yet, investment remains subdued. If the current pattern of corporate behaviour were any guide, companies will likely pass additional earnings onto shareholders through dividends and share buy-backs. **Such a result will reinforce the income inequality by funnelling more income to the**

**highest income groups in the economy who have a low propensity to consume.** Similarly, the failed repeal of Obamacare, had it succeeded, would have taken benefits away from the lowest income households, a group with a high propensity to consume.

A variety of measures have been floated to reduce the US trade deficit, from a border adjustable tax system to straight tariffs on imports. Some high level observations can be made. Firstly, if at the core of the global trade imbalances are, as we have suggested, the excess savings in China, Europe and South Korea that are a result of income distribution in these countries, the solution is unlikely to be found in trying to reduce imports. Indeed, when one looks at the extraordinary ecosystem of product design, prototyping, manufacturing, packaging, shipping and logistics found in China's Pearl River Delta, one quickly realises the impracticality of the idea of moving manufacturing back to the US in any meaningful way. According to one contact in one of our recent meetings, manufacturers in the apparel industry who have moved production to Vietnam or Bangladesh still ship their products to China in order to take advantage of the existing supply chain before shipping to Europe or the US. It will be harder than simply finding 25,000 workers in one location to take on the work. This is not to say that tariffs will not reduce the trade deficit, but that it will do so by reducing income (and thus savings) in the exporting countries. The US consumer will face higher prices for a wide range of imported goods, and inward capital flows will decline.

The one policy that the US administration has proposed that has the greatest potential to improve the country's outlook is increased investment in public infrastructure. As we have stated, America's trade deficit has resulted in offsetting capital inflows, but the problem has been finding a productive investment for these funds. Investment in public infrastructure is one possibility. However, a practical challenge is the lack of consensus among the various factions within the Republican Party on these issues and the questionable competence of the new administration. It should be remembered that changing any system, no matter how well thought-out and well-meaning, will always involve a loss to entrenched interests who will fight the changes to the bitter end.

### Political Risk in Europe versus Economic Recovery

In France, the consensus among political commentators is that, while Marine Le Pen will make the final run-off for the presidential election, she is unlikely to win the election. After Brexit and the election of Trump in the US, the confidence of markets in such political forecasts is understandably low. A Le Pen victory will, at a minimum, create significant

uncertainty about France's ongoing position in the EU and the Eurozone. Even if Le Pen does not win, the cloud of uncertainty will not entirely go away as all will be examining the ramifications of the German elections in September and the Italian elections in 2018. With investors focusing on the political risk in Europe, what is not being widely discussed is how the EU's economic recovery is steadily making progress. Between 2008 and 2012, the Eurozone countries lost five million jobs. Since 2012, employment has grown strongly with almost 10 million jobs created with another million added in 2016. Meanwhile, across Europe auto sales and property prices are approaching their pre-2008 levels, and there are signs that demand for credit is starting to rise. There is a possibility that better economic conditions in Europe will begin to reduce the anti-EU/anti-Euro sentiment that is present in parts of Europe. One might also reasonably expect that stronger economic conditions will see stronger personal consumption, leading to stronger imports and peaking in the region's current account surpluses.

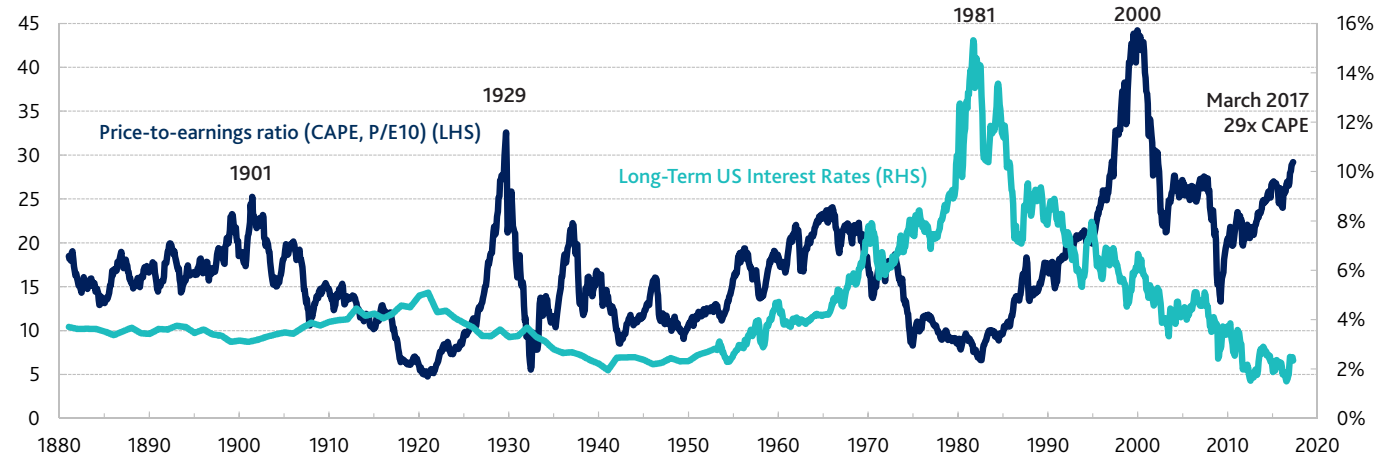
### Markets

The key risk for markets that we are yet to address is rising US interest rates. The US Federal Reserve has slowly started the process of lifting interest rates, with the discount rate increased three times over the last 15 months and now standing at 0.75%. However, it should be remembered that we had been through a period of unconventional monetary policy with quantitative easing (QE). Economists who have modelled the impact of QE suggest that it was worth 2% to 3% of rate cuts. In other words, the effective discount rate was -2% to -3%, and thus, with the removal of QE, the US economy has experienced rate increases equivalent to 2.75% to 3.75%. While this modelling may not be entirely reliable, the point is that we are probably further into a monetary policy tightening cycle than the headline figures suggest. While the US economy and stock market tend to be immune to initial increases in interest rates, ultimately, it will reduce growth and profits, and with that the market falls. **There is probably no more reliable correlation between the stock market and economic variables than the one it has with interest rates.**

In the meantime the US economy continues to show improving strength with the labour market, on some reckonings, as strong as it has been since the 1970s. Of note is that over the last three years the lowest income households have been seeing their income grow faster than the average. Add to this the boost to consumer and small business confidence from Trump's election win and you have conditions that should continue to underpin economic growth. Of course, ongoing good economic conditions may well encourage the Fed to keep increasing interest rates. This



### Cyclically-Adjusted P/E of the S&P 500 Index and US Long-Term Interest Rates



Source: [www.econ.yale.edu/~shiller/data.htm](http://www.econ.yale.edu/~shiller/data.htm)

is a dangerous situation when combined with the fact that the US market is trading on a valuation that is high by historical standards. Indeed, the cyclically adjusted price-to-earnings ratio<sup>1</sup> of the S&P 500 Index has only been at this level or higher in 1929 and 2000, on the eves of the Black Tuesday crash and the Dot Com Bubble burst respectively. While predicting the timing of any sell-off is problematic, the risk of a large sell-off is rising. What could detract this in the short-term is a significant cut to the corporate tax rate. Across our funds at Platinum, we have maintained a relatively low exposure to US stocks, particularly relative to benchmarks and the majority of other managers.

The French election clearly represents a risk to markets, but these types of risk are not easily managed. Usually ahead of such events investors position themselves in a way that results in unanticipated market moves even when the undesirable outcome transpires. With Brexit, while the stock market sold off briefly after the event, it has rebounded significantly and is almost 15% higher today than it was on the day prior to the vote. However, the British pound did take a battering and remains almost 20% lower. With the US election, many investors had expected a significant sell-off in the event of a Trump win and were caught out badly as the market rallied strongly when the event happened. Directly playing these types of outcomes is a difficult game and such speculative strategy is not part of Platinum's approach. We would simply note that our French holdings are multinational consumer product or drug companies whose fortunes are relatively immune to local conditions. In addition, holding cash in the portfolio allows us to take advantage of any sell-off that may occur.

### Outlook

In the years since the GFC, investors globally have craved certainty, and this has driven a preference for perceived low risk assets such as bonds and, in the equity markets, stable earning assets such as consumer goods, real estate and utilities (often referred to as "bond proxies"). Conversely, investors have sought to avoid the uncertainty associated with companies, industries and countries facing any challenges or cyclicity. We think this is precisely where the opportunity for investors lies. The valuations of stocks in China, South Korea, Japan and, to a lesser extent, Europe, remain at attractive levels. Of course, these regions have the very elements of uncertainty and cyclicity that investors have wished to avoid. We are of the view that improving economic conditions in these major economies outside of the US presage a greater willingness by investors to take on this perceived risk, thereby taking advantage of the better returns on offer in these markets. This process has already begun in the second half of 2016 with improving performance in emerging markets, cyclical and financial stocks, and rising yields on bonds.

In the longer term **we could potentially be entering a period where a significant rebalancing of global current and capital accounts substantially changes the dynamics of global capital flows.** In China, this will in part be a natural consequence of the consumer economy taking hold, but likely also requires reform that redistributes income towards the household and away from the state. In Europe and elsewhere, the surpluses may recede as cyclical recovery strengthens and the pressure builds for fiscal spending to redistribute income within these economies. Such a rebalancing would be a healthy outcome in aggregate for the global markets and economies; however, the removal of capital flows from areas that have unduly attracted capital may result in some dramatic adjustments.

<sup>1</sup> The cyclically adjusted price-to-earnings ratio (or CAPE ratio) is current price divided by average earnings per share over the last 10 years, adjusted for inflation.

# Platinum World Portfolios - International Fund



**Kerr Neilson**  
Portfolio Manager

## Performance

(compound pa, to 31 March 2017)

	QUARTER	6 MTHS	1 YEAR	SINCE INCEPTION
PWP Int'l Fund Class A USD	8.5%	7.1%	—	12.7%
PWP Int'l Fund Class B USD	8.4%	—	—	8.9%
PWP Int'l Fund Class D USD	8.4%	6.7%	14.1%	6.3%
PWP Int'l Fund Class G GBP	6.7%	10.7%	—	30.7%
PWP Int'l Fund Class H GBP	6.6%	10.3%	—	16.3%
MSCI AC World Index (USD)	6.9%	8.2%	15.0%	10.7%

Source: Platinum and MSCI Inc. Refer to note 1, page 23.

The last quarter can be characterised as one of positive or improving economic news. This ranged from rising Purchasing Managers' Indices (PMIs) across the globe to hitherto dull spots like Brazil and Russia looking brighter. China exceeded even the optimist's expectations with an acceleration of industrial production and investment, even as the government pressed for closure of redundant capacity in heavy industries like steel and cement. For those harbouring doubts about surveys, do take note that **world merchandise trade is expanding at its fastest pace in seven years** (see chart overleaf).

This broad-based expansion, together with evidence of improving profits, led markets considerably higher, with the **emerging markets taking leadership for the first time in six years**. Throughout these three months there was turbulent inter-sector and inter-market rotation. Importantly, the rise was against a backdrop of the US administration struggling to pass legislation, elections in Europe, the UK commencing the formal process to leave the European Union (EU), and a presidential impeachment in Korea. It was also accompanied by short-term interest rates lifting in the world's two largest economies, China and

## MSCI Regional Index Performance to 31.3.2017 (USD)

REGION	QUARTER	1 YEAR
<b>Developed Markets</b>	<b>6%</b>	<b>15%</b>
<b>Emerging Markets</b>	<b>11%</b>	<b>17%</b>
<b>United States</b>	<b>6%</b>	<b>17%</b>
<b>Europe</b>	<b>7%</b>	<b>10%</b>
Germany	8%	14%
France	7%	12%
United Kingdom	5%	7%
<b>Japan</b>	<b>4%</b>	<b>14%</b>
<b>Asia ex Japan</b>	<b>13%</b>	<b>17%</b>
China	13%	20%
Hong Kong	13%	17%
India	17%	18%
Korea	17%	21%
Australia	11%	21%

Source: MSCI Inc

## MSCI All Country World Sector Index Performance to 31.3.2017 (USD)

SECTOR	QUARTER	1 YEAR
Information Technology	13%	25%
Health Care	8%	8%
Consumer Discretionary	8%	11%
Materials	8%	26%
Industrials	7%	16%
Consumer Staples	7%	4%
Utilities	7%	4%
Financials	5%	25%
Telecommunication Services	2%	0%
Energy	-4%	16%

Source: MSCI Inc



America. The Fed raised the federal funds rate in March by 25 basis points and the interbank rate in Shanghai has risen by a full 1% since December 2016.

**This turn of events plays well to our positioning and this is starting to show in our relative returns with the Fund (Class D, USD) achieving 8.4% for the quarter, an outperformance of 1.5%,** though performance still trails slightly for the year with 14.1% versus 15% by the MSCI AC World Index. As we constantly remind investors, our aim is to achieve strong positive returns over time and, to do this, we meld fundamental research with quantitative modelling. It is by this method that we have arrived at **a disposition of the portfolio which is completely different to that of the MSCI index**, with a heavy weighting in Asia and a low weighting in the US.

Current valuations of the US market – at **2 standard deviations** from fair value – should be considered expensive under most circumstances, whereas the markets we favour offer fair to good value. For example, the US market is on a cyclically adjusted P/E of 28x, while the developed world, ex the US, is on 18x and emerging markets are on 15x.

The holdings that had a strong positive influence on the Fund's performance this quarter included 58.com (+26%), Skyworks (+32%), Cisco (+13%), Reliance Industries (+22%), Jiangsu Yanghe Brewery (+25%) and ENN Energy Holdings (+37%). Detractors were the energy-related stocks, including Inpex (-6%), TechnipFMC (-9%) and Eni (-1%), and some financials like PICC (-1%).

## Shorting

We reduced the short index positions early in the quarter in response to ongoing positive surprises. This involved closing the put options, reducing index shorts and reducing the shorts on individual retail stocks.

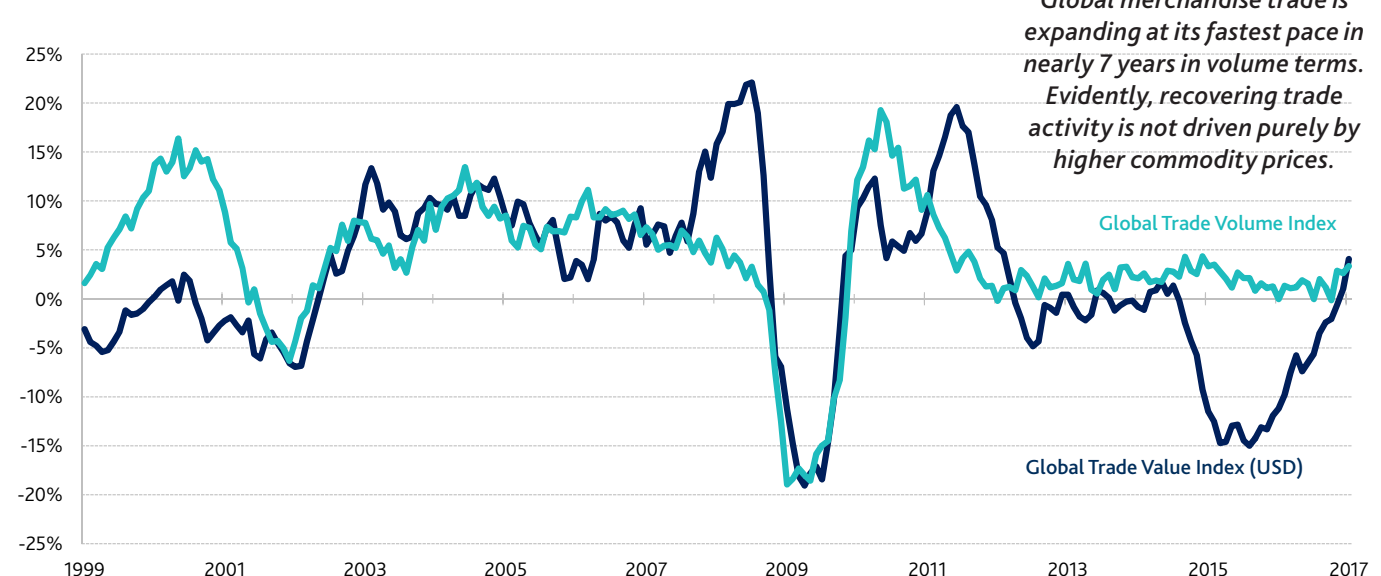
## Currency

There were few changes to our currency positions. Exposure to the Korean won rose in tandem with underlying stock purchases while we actively cut the positions in the Norwegian krone and the British pound. The Fund's holding of the Australian dollar was helpful, on balance, for the quarter.

CURRENCY	31 MAR 2017	31 DEC 2016
US dollar (USD)	38%	39%
Euro (EUR)	12%	14%
Hong Kong dollar (HKD)	10%	10%
Korean won (KRW)	8%	4%
Norwegian krone (NOK)	7%	9%
Japanese yen (JPY)	7%	4%
Australian dollar (AUD)	6%	7%
Indian rupee (INR)	5%	5%
British pound (GBP)	5%	9%
Chinese yuan offshore (CNH)	-3%	-4%

Source: Platinum. Refer to note 4, page 23.

## Global Trade Value and Volume Year-on-Year Growth



Source: Bloomberg

## Changes to the Portfolio

All of the Fund's holdings in **Level 3 Communications** and **Carnival Corp** have now been sold, having reached our price objectives. We trimmed **Lloyds Bank** and **ICICI Bank** on improved recovery expectations as well as other holdings like Chow Tai Fook and Daimler.

There was a fair amount of topping-up of positions in the likes of Gilead (pharmaceuticals) as its price weakened, Nexon (computer games), as well as Lixil (building products) and Asahi (breweries) on our rising expectations of higher profits as they press forward with the integration of their recent acquisitions and rationalise their activities. The knock-on effect of the lower oil prices allowed us to increase our oil price-sensitive plays like TechnipFMC and Schlumberger.

The two new holdings of significance are **Hyundai Motor** and **LG Chemical**.

Our quant models show decisively that the world's auto industry is as out-of-favour as it has ever been in **30 years**. This is despite high demand in the US, growing demand in other industrialised economies and now a recovery in the emerging market countries. Explanations vary from over-capacity to the threat of car-pooling and the shared economy, disruption by electric vehicles and autonomous vehicles as well as the impact of a possible US border tax. There are also niggling issues regarding residual values and defaults on the leasing books in the US as auto manufacturers have progressively won market share in auto loans at the expense of banks.

This led us to a thorough review of the choices on offer and **Hyundai** stood out for us as one of the more prospective plays. We can point to its supposed superior loan book in the US, which will be important, but essentially it is a company with an unmatched growth record. We like its current product line-up, where SUVs are now all the rage, and the fact that it is disproportionately exposed to important emerging markets. With plants in Russia, China, India and Turkey, there is every prospect of a strong recovery in profits as these markets recover and grow. Seldom do stock stories come without blemishes, and then it comes down to assessing the relative merits of the risks, growth trajectories and valuations. Net of the cash sitting atop its manufacturing activities, Hyundai is now priced as cheaply as it was during the GFC.

**LG Chemical** is in a way related to the above case. It is the world's **leading supplier of electric vehicle batteries** and has supply arrangements with virtually all the major auto companies, led by an interesting reciprocal arrangement with GM. As the change from internal combustion engine to electric drivetrain accelerates, aided by mandated fleet emission standards and subsidies, there will surely be intense competition in the supply chain. But as we have seen in other parts of the auto industry, there has been a consolidation of suppliers and scale will be of paramount importance. There are ambitious targets to be met, like raising the capacity of these batteries from around 250 wh/kg to 300 wh/kg and dropping the cost from some US\$150 per kWh today to US\$125 by 2020. The commitment by LG Chem is huge and involves over 10% of its employed capital and a greater proportion of its R&D budget, with profits still a promise!

## Disposition of Assets

REGION	31 MAR 2017	31 DEC 2016
Asia	32%	27%
Europe	19%	22%
North America	16%	17%
Japan	15%	12%
Australia	1%	1%
Russia	1%	1%
Cash	16%	20%
Shorts	-3%	-9%

Source: Platinum. Refer to note 2, page 23.

## Top 10 Holdings

STOCK	COUNTRY	INDUSTRY	WEIGHT
Samsung Electronics	Korea	IT	3.5%
Tencent Holdings	China Ex PRC	IT	2.6%
Alphabet Inc	USA	IT	2.5%
Lixil Group Corporation	Japan	Industrials	2.5%
Sanofi SA	France	Health Care	2.0%
Eni SpA	Italy	Energy	2.0%
Inpex Corporation Ltd	Japan	Energy	1.9%
Kering	France	Consumer Disc	1.9%
AstraZeneca Plc	UK	Health Care	1.8%
Ping An Insurance Group	China	Financials	1.8%

As at 31 March 2017. Source: Platinum. Refer to note 3, page 23.

For monthly updates of the Fund's invested positions, including country and industry breakdowns as well as currency exposures, please visit [www.platinumworldportfolios.ie/Funds/InternationalMonthlyUpdates](http://www.platinumworldportfolios.ie/Funds/InternationalMonthlyUpdates).

Its traditional chemical activities are prone to cyclicality and issues around marginal investment by the chemical industry in China. This could work to the company's favour as, for example, one third of China's PVC production is manufactured from a highly polluting coal-based process, closure of which could sustain the construction-induced cyclical uptrend in PVC prices. Despite this, LG Chem's shares are trading at close to half of their 2011 peak when the first surge of excitement around the auto battery business drove sentiment. Subsequently, the shares have become a 'show-me' situation as disaffected early owners wilted. Given the company's historical record, the shares at their current price are worth owning without the battery story, but if this bears fruit, the reward could be a handsome one.

## Outlook

We have been emphasising for some time that there has been a huge divergence in the performance of the emerging markets versus the developed markets, with the US streaking ahead of all others. This may have now reached an extreme and the time has come for the other markets to play catch-up. If one thinks about the cause of the emerging markets' problems, they reach back to 2009 when these countries introduced aggressive stimulus to offset weakening demand caused by the GFC. This in turn resulted in the completion of

grand projects with associated increases in supply and, later, overheating. As the authorities moved to reverse and tighten policy, companies experienced the combined hits of rising interest rates, falling commodity prices, exacerbated by the new drilling and fracking practices on the shale fields, and plummeting profits. Weak commodity prices were a boon to the developed markets and, likewise, a burden on the largely commodity-dependent emerging markets, hence the great divergence.

Galloping world trade and the concomitant improvements in the demand for commodities have reinvigorated the emerging markets and profits in 2016 started to outpace those of the developed countries. With their traditionally higher growth rates, this will be reflected in profit growth, but most important of all, the **free cash flow will be far superior to what they were in the last cycle, because of lower capital needs**. Combine this with very modest price inflation and the prospect of more stable interest and exchange rates, and the case is made for significant outperformance in the months ahead. We believe Asia will be at the forefront of this tide, be it Japanese or Korean exporters or the domestic plays in the rest of Asia. With valuations being so disparate, it is likely that the equity markets will reflect this new divergence in distributable profits, and this will reverse investment flows.

# Platinum World Portfolios - Asia Fund



**Joseph Lai**  
Portfolio Manager

## Performance

(compound pa, to 31 March 2017)

	QUARTER	6 MTHS	1 YEAR	SINCE INCEPTION
PWP Asia Fund Class A USD	—	—	—	3.6%
PWP Asia Fund Class D USD	12.8%	5.3%	16.3%	10.7%
PWP Asia Fund Class I USD	—	—	—	7.7%
MSCI AC Asia ex Jp Index (USD)	13.4%	6.2%	17.5%	14.0%

Source: Platinum and MSCI Inc. Refer to note 1, page 23.

Over the quarter the MSCI AC Asia ex Japan Index rose by 10% in local currency terms, or 13% in USD terms.

Performance was generally encouraging across the region, particularly in India and China. The Indian market, having recovered from the “demonetisation” sell-off as we had expected, was up 12% (in local currency, or 17% in USD). Demonetisation was essentially an exercise by the Indian government to swap old currencies for new tender. As the bulk of the new currencies are now in circulation, economic activity quickly recovered. We took advantage of the sell-off to add to stocks that were negatively impacted, and they rebounded significantly over the quarter.

The Hang Seng Index (of Chinese companies listed in Hong Kong) rose 10% (in local currency) over the quarter, as the Chinese economy continued to gather pace, benefiting construction and consumption-related stocks.

ASEAN markets also rose higher, as optimism grew in these export-oriented countries on the back of improving economic activity in China and the US, though somewhat offset by the prospect of US interest rate rises.

## Disposition of Assets

REGION	31 MAR 2017	31 DEC 2016
China (Ex PRC Listed)	37%	26%
China (PRC Listed)	10%	9%
Hong Kong	<1%	<1%
Taiwan	3%	4%
India	14%	17%
Korea	14%	10%
Thailand	5%	7%
Philippines	3%	4%
Vietnam	2%	2%
Singapore	1%	3%
Malaysia	1%	1%
Indonesia	<1%	<1%
Cash	10%	17%

Source: Platinum. Refer to note 2, page 23.

## Top 10 Holdings

STOCK	COUNTRY	INDUSTRY	WEIGHT
Alibaba Group	China Ex PRC	IT	3.8%
Jiangsu Yanghe Brewery	China	Consumer Stap	3.3%
LG Corp	Korea	Industrials	3.3%
Tencent Holdings Ltd	China Ex PRC	IT	3.0%
Ping An Insurance Group	China	Financials	3.0%
Kasikornbank PCL	Thailand	Financials	3.0%
CNOOC Ltd	China Ex PRC	Energy	2.8%
Midea Group	China	Consumer Disc	2.6%
Axis Bank Ltd	India	Financials	2.6%
Ayala Corp	Philippines	Financials	2.5%

As at 31 March 2017. Source: Platinum. Refer to note 3, page 23.

For monthly updates of the Fund's invested positions, including country and industry breakdowns as well as currency exposures, please visit [www.platinumworldportfolios.ie/Funds/AsiaMonthlyUpdates](http://www.platinumworldportfolios.ie/Funds/AsiaMonthlyUpdates).

As expected, the Fund's Chinese stocks were contributors to performance, including **BBMG** (a dominant cement producer in norther China) +20%, **58.com** (online classifieds) +26%, **ENN Energy** (natural gas utility) +36%, and **Jiangsu Yanghe Brewery** +24%. Elsewhere, our Indian banking exposure also contributed to performance, with **Yes Bank** up another 27%, bringing its annual return to 69%. Key detractors were our energy exposures (CNOOC).

## Changes to the Portfolio

We sold out of positions that have reached our estimation of fair value, such as **Yes Bank**, **HDIL** (Indian real estate developer) and **UPL** (Indian fertilizer company). Funds raised were deployed into more prospective ideas.

We started positions in **Hon Hai Precision Industry** (also known as Foxconn), the largest and the lowest-cost manufacturing contractor for popular electronic products like the iPhone. Hon Hai supplies key components, and its increasingly efficient and sophisticated processing technologies are boosting its negotiation position vis-à-vis its clients. The company's cost position continues to improve with the application of its in-house made robots, which anecdotally have drastically reduced the use of manual labour and improved product quality. These two trends in Hon Hai's operations as well as its prospective growth trajectory appear under-appreciated by the market, with the stock trading on 11x 2017 earnings.

Another new addition to the Fund was **Midea Group**, one of the top manufacturers of household appliances in China. After years of consolidation, China's home appliance industry is now dominated by only three key players, with one in every three air-conditioners or fridges sold made by one of them. This has allowed these companies to gain pricing power, and product prices have been rising over the last few years while raw material prices fell!

Midea has recently branched out into robotics with the acquisition of a top-tier German robotics company called Kuka. Kuka is a dominant supplier of car manufacturing robots to the likes of Volkswagen, BMW and Mercedes Benz, while also expanding into general industrial robots for other areas such as the manufacturing of electrical appliances. Midea has invested billions of dollars to upgrade its manufacturing processes with automation and robotics over the last few years. It is worth observing that improving product quality was as important a reason for this investment as cost reduction. The underlying change reflected here is that Chinese consumers are demanding better quality products and the future of the Chinese factory is one that may run 24x7 in the dark, lined by robots! On 12x P/E, with

the robotics optionality being largely an added bonus, valuation is tantalising indeed.

## Currency

CURRENCY	31 MAR 2017	31 DEC 2016
Hong Kong dollar (HKD)	26%	21%
US dollar (USD)	18%	26%
Indian rupee (INR)	14%	17%
Korean won (KRW)	14%	10%
Chinese yuan (CNY)	9%	9%
Australian dollar (AUD)	7%	17%
Thai baht (THB)	5%	7%
Chinese yuan offshore (CNH)	-2%	-17%

Source: Platinum. Refer to note 4, page 23.

## Outlook

China and India are undergoing structural reform to better their longer-term outcomes, and their longer-term prospects remain bright.

In India, with the banking system having been through a clean-up and better institutions (particularly around bankruptcy laws) having been put in, and with progress taking place in the power sector, the country indeed appears to be on the cusp of a long-awaited capex cycle which will accelerate growth nationwide. However, given the enthusiasm with which the market has already embraced the Indian market, improvement in economic activity first has to catch up with the market's optimism.

China is showing very few signs of retreating from its reform agenda. The government continues to force closure of excess production capacity in heavy manufacturing industries, which has led to a significant rebound in commodity prices. While another major fiscal stimulus is unlikely, given the improvement in construction activity and private sector capital expenditure, one can expect a continuation of infrastructure projects which this country of immense population and geographic reach still needs. Against the backdrop of the ongoing rebalancing of China's economy, we have kept the Fund's China exposure to the sectors and companies with lower risks and more favourable growth prospects.

# Platinum World Portfolios - Japan Fund



**Scott Gilchrist**  
Portfolio Manager

## Performance

(compound pa, to 31 March 2017)

	QUARTER	6 MTHS	1 YEAR	SINCE INCEPTION
PWP Japan Fund Class A USD	5.3%	7.0%	19.5%	15.6%
PWP Japan Fund Class B USD	5.8%	—	—	4.9%
PWP Japan Fund Class D USD	5.7%	7.6%	20.1%	13.5%
MSCI Japan Index (USD)	4.5%	4.3%	14.4%	5.4%

Source: Platinum and MSCI Inc. Refer to note 1, page 23.

## Disposition of Assets

REGION	31 MAR 2017	31 DEC 2016
Japan	95%	90%
Cash	5%	10%
Shorts	-2%	0%

Source: Platinum. Refer to note 2, page 23.

## Currency Positions

CURRENCY	31 MAR 2017	31 DEC 2016
Japanese yen	72%	72%
US dollar	28%	28%

Source: Platinum. Refer to note 4, page 23.

The portfolio (Class D, USD) was up 20% for the year and 6% for the quarter. This quarterly progression was against a somewhat more volatile backdrop than overall performance suggests, with the US dollar weakening against the Yen after Christmas. Japanese Government Bond 10-year yields remain at 0.05%. Within the portfolio there were some significant price moves, both up and down. The Fund owns a group of companies with very low valuations, some of which are now highlighted for improved operational performance. Quite a few large holdings were weak as the focus of the market shifted to a more defensive footing following the excitement around “reflation” towards the end of last year. The Fund’s avoidance of Korea was a missed opportunity with the Korean stock market rising in tandem with the Korean currency.

## Portfolio Positioning

### Sector Breakdown

SECTOR	31 MAR 2017	31 DEC 2016
Information Technology	27%	24%
Industrials	19%	14%
Consumer Discretionary	15%	14%
Financials	9%	13%
Materials	8%	9%
Energy	6%	7%
Telecommunication Services	5%	6%
Health Care	5%	2%
Consumer Staples	-1%	1%
TOTAL NET EXPOSURE	93%	90%

Source: Platinum. Refer to note 5, page 23.

For monthly updates of the Fund’s invested positions, including country and industry breakdowns as well as currency exposures, please visit [www.platinumworldportfolios.ie/Funds/JapanMonthlyUpdates](http://www.platinumworldportfolios.ie/Funds/JapanMonthlyUpdates).



## Changes to the Portfolio

It was an active quarter for the portfolio. **AIN Holdings** (pharmacy chain) was sold after the share price rose 400% over the last three years. **Ube Industries** (chemical company) was sold after a period of strong performance. Other portfolio holdings that have more than doubled in the last twelve months are also being sold. A range of small holdings were sold and some new positions were initiated.

Towards the end of the quarter, Kerr Neilson and I spent seven days in Japan, visiting 34 Japanese companies in Tokyo and Kyoto, including almost all of the Japanese holdings in the Platinum World Portfolios - International Fund and roughly half of the Japan Fund. This was partly the impetus for the activity referenced above. Of the 34 visits, almost two-thirds required further work, a percentage indicative of not only the prior work done to identify attractive investments, but also the valuation dispersion evident in the Japanese market.

The key development of the quarter was the refinement of portfolio positioning towards companies with both attractive valuations and medium-term opportunities, particularly relative to current holdings. This process continues.

## Outlook

On the recent company visits in Tokyo we met an extensive range of market participants with varied views on the Japanese stock market. This is in addition to our ongoing dialogue through regular company visits in Sydney and our access to a wide range of resources across the global financial markets. As one digs deeper into the psychology of a market priced at the same headline level as in 1990 – almost thirty years ago, a range of subliminal worries become evident. One discussion at the forefront for domestically-biased corporates is demographics, due to government predictions of a base case population decline from 130 million to 60 million over the next four decades. This obviously changes

the investment focus for housing, insurance and other domestic industries. Of a more recent nature, the sabre-rattling in North Korea and the Chinese naval excursions are seen as significant reasons for concern. The recent upheavals at Toshiba and Takata as well as older examples such as Olympus bring back residual corporate governance concerns. Obviously, the worry of another large earthquake or tsunami is ever present. Recently, the front page of the newspapers has focused on questions about Prime Minister Abe's conduct and the potential for his removal, just when political stability in Japan stands in stark contrast to many parts of the world. There are also many discussions of the inheritance tax and the delayed increase to the GST. However, behind these discussions the underlying concern with the most impact is the topic of government debt. This is a topic with an ever-present emotional response at any Japanese entity, especially the banks and insurers, but also for housing, healthcare, consumer and other domestically-focused industries.

A recent survey of Japanese investors highlighted a surprising divergence between younger respondents and their elders who experienced the 1980s' bull market. The widespread concerns discussed in the paragraph above and the lack of energy in the younger generation of investors seem discordant with our recent experience of improved disclosure, improved balance sheets and ongoing efficiency improvements in many companies. If you visit Tokyo, and we suggest it for an enjoyable interlude, you will find a safe, cheap modern city with some of the best food in the world complete with inspiring architecture in a clean and green environment. We saw widespread signs of fundamental change across the Japanese economy. Beer prices and package delivery tariffs have been stagnant for many decades and now appear to be inflecting. A recent company plan included a product rationalisation from 80,000 varieties to just 8,000, with no loss of market coverage or range. At the centre of this swirling discussion is an unemployment rate close to the lowest ever experienced by the nation. It is hard for many to reconcile these seeming contradictions.

Perhaps the combination of a cyclical improvement in global demand, a new found confidence in Japan's place in the global manufacturing complex, a growing group of industries with fundamental tightness, surging inbound tourism, the upcoming 2020 Tokyo Olympics, and an ongoing improvement in corporate behaviour is leading to an underlying sense of national confidence after three decades of steady behaviour in the face of grinding deflation. The lack of protest and sense of national cohesiveness is remarkable.

The myriad of debates relayed above won't be resolved in the near-term. The global economic trends will continue to flow through and across Japan. Given the valuation dispersion evident in the market and the opportunities we can identify, the Fund remains fully invested in Japanese equities.

## Top 10 Holdings

STOCK	COUNTRY	INDUSTRY	WEIGHT
Nexon Co	Japan	IT	3.6%
Mitsubishi UFJ Financial	Japan	Financials	3.6%
Lixil Group	Japan	Industrials	3.3%
Inpex Corporation	Japan	Energy	3.3%
Canon	Japan	IT	3.3%
Kyocera Corp	Japan	IT	3.2%
Sumitomo Mitsui Financial	Japan	Financials	3.2%
Hogy Medical	Japan	Health Care	3.1%
Nintendo	Japan	IT	2.8%
NTT	Japan	Telecom	2.8%

As at 31 March 2017. Source: Platinum. Refer to note 3, page 23.

# Observations from a Recent Trip to China

by Andrew Clifford, CIO, Platinum Investment Management Limited

In late March I visited China, meeting people from a wide range of different businesses and backgrounds. Many of the meetings were with representatives of unlisted businesses, which ranged from distributors of consumer products, commodity traders, Internet-based finance companies, to small state-owned coal miners and regional banks. This type of schedule differs from our usual meetings with management of listed companies, but over the years we have found that these trips provide a very different perspective on China from our traditional schedule and, as such, can offer valuable insights on what is always a rapidly changing landscape.

## The Rise of Local Brands

One meeting was with the distributor of fast-moving consumer products (shampoos, soap powder, etc.) that represented a very large and successful multinational company in a region within Guangdong province. He highlighted that one of the challenges for the business was the rise of new local brands. In the past, these start-ups had been kept out of the market because of the sheer cost of large scale advertising on TV and in print. The advent of digital advertising has opened a door for these companies and, what is more, it enables them to target very specific groups, such as 15 to 25 year old women. Interestingly, many of these new brands are having success with products priced at a premium to foreign brands. Together with digital marketing, e-commerce is a distribution channel that has also reduced the barriers for smaller local companies. A meeting with a company that manages the online presence for some of the smaller multinationals in China highlighted that selling online is much more than just setting up an e-store on T-Mall (the Alibaba e-commerce platform) and sitting back and waiting for sales. There is an ongoing daily need to adjust the offering, put on promotions, bid for keywords and the like. According to the distributor we spoke to, this poses another challenge for his multinational principal who, while well aware of the need to respond to these challenges, simply cannot move fast enough.

The rise of local brands highlighted in these discussions comes as a direct contradiction to the often-heard mantra in the financial markets that the multinationals have a sustainable advantage in China due to concerns around

product safety. An amusing story, though, is that of one successful local company which had given itself a name and brand to create the impression as if it were a Korean company. This worked well until China's recent fall-out with Korea for facilitating the US anti-missile defence installation which led the Chinese government to direct its patriotic citizens to avoid all things Korean!

The other observation on local brands came from the auto market. An industry expert (an American who has had a long involvement in the Chinese market) reported that the difference in quality between good local Chinese carmakers and foreign brands is by and large imperceptible to the Chinese buyer. This may well be somewhat of an exaggeration, but the independent JD Power survey on product quality actually supports the claim with respondents citing only a minor difference between local and foreign makes in terms of product quality. Of course, more important than perceptions are sales, and numbers have spoken louder than words with the domestic producers' market share having risen from 30% in 2012 to over 40% in 2016. In this period, China's passenger vehicle market increased by approximately 10 million vehicles annually, of which 5.7 million were supplied by domestic brands in 2016.

## The Ubiquity of Alipay

Alipay is an electronic wallet or online payment system that grew out of Alibaba's e-commerce platform in much the same way that PayPal had developed hand in hand with eBay. In China, however, Alipay has evolved to be much more than a way of settling online payments and, in the absence of a deep network of credit card and EFTPOS terminals, has become the way of settling essentially any transaction. Payments can be made from the app on one's mobile phone directly to the recipient. Setting up an account is straightforward and funds are transferred into and out of one's Alipay account via one's Chinese bank account. The best news for merchants is that no fees are charged, making the system very attractive. What we were continually told by the locals is that there is simply no longer a need to carry cash, ATM cards or credit cards, as everyone from the street vendor of snacks to taxis and organised retailers accepts Alipay. This claim I suspect is somewhat exaggerated and was difficult to test, as, without a Chinese bank account, I

couldn't complete my own registration. Alipay claims to have 450 million active users and settles 200 million transactions daily. Annual transaction value is estimated at US\$3 trillion. Needless to say, Alipay has many competitors, most notably, Tenpay, which is Tencent's e-payment platform and is integrated with the hugely popular WeChat app. It is once again an interesting example of how China has bypassed the developed world's approach and may well be moving to a cashless system faster than the West.

While the transfer of funds within Alipay attracts no fee, the platform hosts a universe of services by third parties from which Alipay does make money. One company we met is in the business of providing small (RMB 1000, or A\$200) short-term (30 days) loans to university students. The company is having great success and incurring only a trivial level of nonperforming loans. The key lending criteria are based on the credit rating data provided by Alipay, which of course has quite a rich pool of data on the applicant's payment history. This is notable because a group of consumers are gaining access to credit they never had. Similar businesses operate in the field of small business loans. In these transactions Alipay makes money only from the sale of the credit rating data. Other products on the Alipay platform include managed funds and insurance.

If the Alipay model were replicated in developed markets, the implications for credit card issuers and merchant acquirers as well as others who make a living off the payment system could be quite dramatic. Of course, this may be easier said than done, but undoubtedly many will be trying to emulate Alipay's success. Ant Financial, the company that owns Alipay, is currently privately owned. But the listed Alibaba Group has a right to purchase 33% of Ant Financial's shares when it becomes listed. Alibaba is presently a top ten holding in the Platinum World Portfolios - Asia Fund.

## The Pearl River Delta

In Taiyuan, the capital of Shanxi province, we met with managers of the local Foxconn plant. Foxconn is part of the Hon Hai group, the world's largest contract manufacturer for electronics and best known for manufacturing iPhones for Apple. This Foxconn plant is a producer of components for the Hon Hai group. Taiyuan is coal mining territory and some 500 km from the coast, not quite the typical location for this type of endeavour. The Taiyuan operation, however, has an impressive 75,000 person workforce, up from 50,000 a year earlier. When one thinks of the challenges of hiring and training 25,000 workers in a year, the idea of moving this type of operation to the US becomes difficult to imagine.

Another meeting in Guangzhou later in the week with an expert in the design and manufacture of IT products made it

even more apparent that President Trump's plans of moving this type of activity back to the US, to any significant degree, has little chance of success. In the Pearl River Delta at the south-eastern end of China, there is an entire ecosystem of service providers, from design, manufacturing and packaging to logistics and transportation, that deliver goods to the rest of the world at extraordinarily low cost. For the individual with a product idea simply sketched out on a piece of paper, there are service providers who will turn the sketch into CAD drawings and create working prototypes using 3D printers, all at a trivial cost. Or, more questionably, if you would just like to copy someone else's products, there are providers who will reverse-engineer the product right down to the semiconductor and printed circuit board level. Of course, custom packaging can readily be created for your "new" product. All of this can be done in a matter of weeks, and from your desk anywhere in the world. Once you are ready to produce, there are traders who can provide standard components, and who, because of the extraordinary volumes they handle, will supply to you well below list prices. And then, of course, there are plenty of contract manufacturers.

Then comes the logistics side of the equation. If, for example, you wanted to sell your new widget on eBay, you can have the whole fulfilment and shipping run out of China.

Assuming you earn at least US\$0.75 on your product, you would, we were told, in most cases be able to afford to offer your customers free shipping to anywhere in the US! The one downside to this is that the delivery time is measured in weeks. The most telling story is that many apparel and footwear manufacturers who have moved production to places such as Vietnam and Bangladesh are shipping their products to Shenzhen prior to shipping to the US or Europe, in order to hook into the logistics and fulfilment supply chain of the Pearl River Delta.

## Supply Side Reform

An important development in China during 2016 was the supply side reform in the steel and coal industries. A directive from the State Council early in the year called for sub-scale plants and mines and those not meeting environmental or safety standards to be closed. The policy was directed at the state-owned enterprises (SOEs). Historically, such directives from the centre have often had little impact, but this time, and perhaps as a result of President Xi's consolidation of power within the Communist Party, the directive was followed. It is estimated that 85 million tonnes of steel capacity and 290 million tonnes of coal capacity have been closed down, though, admittedly, some of these closures were of capacity that was not operational. Production limits were also placed on remaining coal mines which were restricted to 272 days of production annually. The response

to these measures was a more than 100% rise in coal prices in less than six months and a return to profitability for the steel and coal industries. This is all well known.

The interesting insights came from meeting with people who were familiar with some of the coal mine closures that took place in Shanxi. They described the closure of two small mines in the province owned by a local SOE, which not only had low output, but also very short mine lives. These were mines that had in recent years been loss-making. Asked why they had not been closed earlier, the response was simply that the local SOE had responsibilities to maintain employment in the province, though a fund established by the central government to compensate redundant workers had allowed them to pay laid-off workers sums equal to two years' wages. Asked about any outstanding debt to banks on these operations, we were informed that the burden of these debts was now being borne by the SOEs in other operations, which are now very profitable.

The other interesting observation is how the local provincial government and banks view the issue of overcapacity in industries. As the coal industry has now returned to profitability in Shanxi, the local government has seen a significant rebound in taxation revenues, and presumably also benefits from being the owner of profitable entities. The coal mine closures and the production restrictions have created shortages in the coal market, and the production restrictions have been removed. However, in Shanxi, the provincial government is considering making the limit on production days a permanent measure, having seen the benefits of a profitable industry.

Similar benefits have been felt in the banking system. The coal and steel industries collectively account for around RMB 7 trillion in debt, and the unofficial view was that nonperforming loans were running as high as 40% of the total loans. Today, post the supply side reform, the vast majority of these loans would be performing. This makes the cost of redundancies of RMB 100 billion look very attractive for the government who otherwise would have ultimately been on the hook for these nonperforming loans. Many are sceptical about the sustainability of this supply side discipline in China, and, undoubtedly, some closed capacity has been re-opened, given the more favourable market conditions. However, we also heard from banks that were refusing to provide working capital loans to steel and coal companies that needed funding to restart operations.

One foreign businessperson that we met on the trip referred to the unholy trinity of local governments, local SOEs and local banks that keeps capacity open where it should be closed, ensuring that the next new area of growth would be overwhelmed by excess capacity. The success of this supply side reform has potentially broken this nexus, though this risks being too strong a conclusion. Certainly, there is discussion of these reforms being applied to other areas where the SOEs are responsible for excess capacity in the market.



# Rediscover Japan

by Scott Gilchrist, Portfolio Manager, Platinum World Portfolios - Japan Fund

Given the resoundingly negative and sometimes apocalyptic view of Japan held by a wide range of foreigners, it is always with some trepidation that I board the flight to Haneda Airport in Tokyo, only to arrive and find a gap between perception and reality. Japan isn't Zimbabwe or Venezuela, as sometimes described. It even feels awkward to write that sentence. While Japan has undoubted problems, there is a cohesion and stoicism inherent to the local population which has withstood three decades of grinding deflation and centuries of irrepressible change. In today's uncertain world, Japan's stable political system stands out with virtually no protest or social unrest. In perhaps the most striking repudiation of the negative views of Japan, the country's unemployment rate is now lower than seen in many decades. Prices are starting to rise in some sectors after decades of stagnation. While strident predictions of the future are perilous at best, I think it is an interesting exercise, and likely a financially rewarding one, to ponder what Japan might look like if it does indeed see a paradigm shift after thirty years of a post-bubble, deflationary regime.

The founders of Platinum have been visiting Japan for almost three decades, so my recent trip with Kerr Neilson and other colleagues to visit 34 Japanese companies was a longitudinal study of one of the longest bear markets in the financial market history of the developed world. While we were working like bees on detailed company and industry analyses, we spent a little time walking around Shinjuku Gyoen National Garden and the Imperial Palace and sampling the local cuisine. The atmosphere was pleasantly subdued as the arrival of the cherry blossoms was two weeks hence. One meal in particular brought the overall conundrum into context. We sat at a counter top made of silky untreated Nagano cypress in a superbly designed small restaurant, and were treated to a meal of a quality hard to find anywhere in the world at a price a fraction of what might be expected. The value, quality and uniqueness of the offering, combined with a wide variety of experiences in a safe, clean, green and attractive environment, go a long way to explaining Japan's resurgence as a tourist destination.

Over seven days in Tokyo and Kyoto we met with 34 companies, plus most of our regular contacts and a set of security analysts. It was a very productive sequence with almost two-thirds of the company visits prompting urgent

further work. The quality of the meetings has also noticeably improved with the majority conducted in English. There was a sense of a genuine attempt to assist us with our lines of enquiry, rather than stonewall, as seen so often in the past. Unprompted, the mostly diminished envoy on the other side of the table would often offer financial targets and talk about profitability.

The broad Japanese stock market is currently at the same level as it was in 1990, almost three decades ago. During this time, the Dow Jones Industrial Average has risen by 700%. The German stock market has performed with similar strength. Global bond and real estate markets have produced stellar returns. The absolute and relative return of the Japanese equity markets over the last three decades has had a deep and profound impact on investor psychology. Currently, this is expressed as a set of subliminal concerns, the true depth of which only surfaces after a detailed discussion. The list of longer-term worries includes demographics, corporate governance, natural disasters, North Asian competition and future tax increases. More recently, the headline concerns have centred on North Korea, Chinese naval excursions and Prime Minister Abe's security of tenure. Where concerns can be expressed, they are most likely being addressed by the relevant authorities and assessed by the financial market.



One discussion at the forefront for domestically-biased corporates is demographics, due to government predictions of a base case population decline from 130 million to 60 million over the next four decades. This obviously changes the investment focus for housing, insurance and other domestic industries as the nation would retreat to a handful of major conurbations. In Japan, fertility is a complex

topic involving public health, marital relations, economics and working hours. Sitting across the table from a Japanese man and woman attempting to explain the century long development of male/female relationships is a fascinating study. In brief, the absolute primacy and misogyny of the male of the elder generation has been denied by the current generation. This is not unique to Japan in Asia. A revised set of terms of engagement has been negotiated, but not yet fully implemented. The fundamental human impulse has not been lost. This undeniable demographic trajectory is well understood by all levels of society, and recent improvements to working hours have been made with this in mind. This change in the work-life balance started a few years ago, but has now spread and is implemented in legislation. Immigration is almost certainly not the main solution, although it might contribute. Projections by Japanese corporates who sell baby supplies to the domestic market show a benign medium-term outlook with a slow and manageable population decline for the next decade as the children of the baby boomers move through the system.

Behind all of the underlying concerns is the key issue: the structure and stability of the overall financial system. Most Japanese debates end with or sidetrack into it at some stage. This topic is particularly pertinent for financial markets today as the Japanese system moves along an experimental path which other mature democracies are likely to follow in future decades. In the official accounts, the Japanese government will have more liabilities than assets within the next 12 months. This seems problematic at first, but when considered in the context of the Japanese system, the global network and a slowly growing world economy, it is perhaps not of primary importance. It is hard to estimate the total financial assets in Japan, but it could be around US\$80 trillion, which makes the overall debt burden seem less onerous, especially when the obligations are to internal entities and the country as a whole has a large net foreign asset position. Nevertheless, it is a complicated topic, and our best efforts have failed to identify the underlying plan. The recent suggestions from foreign experts seem ill conceived, particularly with regard to practical implementation. Our conclusion is that there isn't a master plan, and thus there remains a high degree of path dependency which obviously has a large impact on future asset prices, inflation, currency and the local economy. In summary, Japan is a functional and competitive economy which, due to a past major financial event, is financed inappropriately and will eventually undergo a financial restructuring, probably without too much major disruption, but with outlier cases of systemic breakdown. This seems rather similar to many other nations and perhaps the global system.

Credit Suisse estimates that the data volumes flowing across Reliance Industries' new mobile phone network in India after six months of operation exceed those of any other global network, including developed markets and the core Chinese networks. After decades of post-Cold War experience, it should no longer surprise us how the dynamism and "invisible hand" of capitalism continues to improve the lives of people across the globe against the odds. The last decade saw more people brought out of poverty than any prior period. The correlation with smartphone proliferation is strong. The global population centre is Asian and, while Japan is perched on the edge of this region, the connection has deep roots. Indonesians respect the Japanese for their assistance in recent decades. Suzuki owns the leading car manufacturing and distribution business in India. A meeting with an investor who owns the first foreign accounting practice in Burma talked of the omnipresence of Japanese corporates throughout the country. Itochu's work with Thailand's Charoen Pokphand Group to purchase 10% of CITIC Limited, a key subsidiary of China's first state-owned investment company founded at the command of Deng Xiaoping, talks to Japan's deep connection with Thailand. Itochu was the first Japanese trading house to return to China in 1972, and is now only one of a multitude of Japanese companies operating and manufacturing in the world's largest economy by physical volumes. Pigeon has a 50% share of the Chinese market for high-end feeding bottles and other baby goods through a wide range of physical and online channels. Minebea recently built Cambodia's largest building to increase its manufacturing capacity. We recently saw Minebea's world-record, commercially-manufactured, smallest ball bearing with an outside diameter of 1.5 millimetres and a selling price of a hundred dollars each. Nippon Ceramic makes a range of its ultrasonic and infrared sensors in both China and the Philippines and in fully automated factories in Japan. Sumitomo Metal Mining runs two high-pressure acid leach



Ball bearing size compared with a rice grain.  
Source: Minebea



facilities in the Philippines, mixing waste ore with sulphuric acid at high temperature and pressure to recover high quality nickel and cobalt for Panasonic and, through it, Tesla's battery production and its new Model 3 production facility in Nevada. As Asia grows, Japan will benefit. As Asia becomes richer, the people will increasingly gravitate towards the higher quality products, experiences and culture found throughout Japan.

Reminiscing by some of our hosts reminds one of the excesses of corporate Japan in the 1980s. "We spent money, made acquisitions and operated our company with no regard to financial returns or cash flows... Debt was freely available..." was a stylised comment made by some of the older executives we have met. They quickly followed this up by contrasting it with current behaviour which could easily be from a modern financial management textbook. Nevertheless, there is a wide dispersion of behaviour across the system. This is partly due to the lack of an active market for corporate control. It is easy to find companies where the breakup value is multiples of the current valuation. Behind-the-scenes efforts to effect change at these entities are thwarted in many different ways. Overall, the numbers show a record level of dividends and record value of share buy-backs, clearly evidence of continuing changes of behaviour. Further change will come, but it will occur in typical Japanese style. The pace is accelerating.

Yamato pioneered Japanese package delivery to households in the 1970s and has built an unrivalled network covering the archipelago servicing Rakuten, Amazon, Yahoo Japan, Start Today, other e-commerce companies and the whole of society. In the beginning, they struggled against the historical regulations and bureaucracy dating from feudal times which dictated the flow of goods along paths and routes. It was a grinding battle, the aftermath of which can still be seen today in the competitive dynamics of the industry. Similar societal and economic structures are evident today across the economy. For each example of dynamism, such as Nagamori-san, the founder and CEO of Nidec, Inamori-san, the founder of Kyocera and KDDI, or the early days of Sony, there is an example of corporate atrophy or capture. It feels as though the generation of leaders who rose through the bubble years are seeing out their dotage in leadership positions rather than allowing the rise of energetic younger members of the next generation. Some companies such as Nissan, Takeda and Sony have brought in foreign leadership with mixed results. Others have retreated into irrelevance as they adopted a castle type mentality while their competition in the West accessed all the help they could find across academia and industry. One example of this is Nikon, which is now struggling after losing the lithography business to ASML and is facing a rejuvenated

Canon whose Tokki division builds the key capital equipment for Samsung's OLED mobile screens. While Mikitani has built an interesting entity in Rakuten, the visionary for the broader sector, perhaps the "one-eyed dragon", is Masayoshi Son of SoftBank. While the purchase price of ARM Holdings is high on many metrics, his track record with Yahoo, Alibaba, Vodafone Japan and now Sprint is a long string of global achievements.

From our detailed company and industry work, a surprising number of global capacity constraints are becoming evident across chemicals, semiconductor components, electrical components, and some complex manufactured items. Perhaps after almost a decade of slow global growth and reluctant spending by corporates, bottlenecks are now starting to appear. Minebea is expanding their production capacity for miniature ball bearings for which they have a 60% global market share as they have reached their capacity of **255 million units per month!** In a domestic context, the construction and IT sectors are seeing wage growth. This has yet to spread across the economy, although a recent survey, which showed small company wage growth rising faster than large companies for the first time in the 22 year history of the data series, is just one strong data point in an overall robust picture.

We hear repeatedly that fully automated Japanese manufacturing is now competitive with low-cost labour for a wide range of products, especially higher-end complex goods. Thirty years ago, Fanuc was manufacturing electric motors in a fully automated factory using a robotic workforce, which reminds one of Japan's lead at the time, just as the shift to China and other low-cost labour countries built momentum. While the perception of Chinese manufacturing competing against developed world incumbents is widespread, a parallel reality is that many Japanese companies compete against each other on the basis of fully automated factories in Japan competing against labour-intensive factories in low-cost labour areas. While Fanuc was an automation pioneer, the knowledge is widely dispersed across the country. Hogy Medical is an assembler of surgical kits for domestic hospitals. Their recent factory expansion reduced staff numbers from 200 to below 20 while doubling capacity. Toyota Industries, Daifuku, Omron and Mitsubishi Electric are only a small number among the companies providing equipment and services in this area. Fanuc, Nabtesco, Yaskawa, Harmonic Drive and many others produce the components and robots for the production lines. There are many production processes which are hard to automate, or where flexibility is required, and these factories will remain in China, Vietnam, Cambodia, India or wherever the necessary combination of infrastructure, personnel numbers and quality can be found. However, Japanese-based manufacturers such

as Canon, Alps Electric, Icom will retain their positions. Lixil was adamant that one of their fully automated factories would be competitive if they are required to manufacture in the USA.

Over the last 19 years, Platinum's Japan strategy (the Australian-registered Platinum Japan Fund) has generated a track record of a compound annual return of 15% (in AUD).<sup>1</sup> The MSCI Japan Index (in AUD) has risen 2% per annum. Performance over the tenure of the Platinum Japan Fund's four portfolio managers has been strong, a testament to the culture of the firm, the investment style and longevity of the founders.

<sup>1</sup> Calculated using the Australian-registered Platinum Japan Fund's unit price and representing the Platinum Japan Fund's combined income and capital return for the period from inception on 30 June 1998 to 31 March 2017, net of fees and costs (excluding the buy-sell spread and any investment performance fee payable), pre-tax and assuming the reinvestment of distributions. Historical performance is not a reliable indicator of future performance. The Platinum Japan Fund is not offered to investors resident outside of Australia and New Zealand. Its historical returns are provided herein for the sole purpose of illustrating the long-term track record of Platinum's Japan strategy.

## A Historical Note

*Nishiyama Onsen Keiunkan, a small property located in the town of Hayakawa, about 110 miles southwest of Tokyo, has been open to guests for about 1,300 years. Not only does this mighty age make it the world's oldest hotel, but it also makes it a striking piece of world history. The Onsen was founded in the year 705 A.D. – roughly 225 years before the establishment of [a united] kingdom of England and approximately 300 years before Vikings made their way to America. Since then, 52 generations of his descendants have kept the stay in the family including the recent facilities upgrade.*

*Nishiyama Onsen Keiunkan is 13 years older than the world's second-oldest hotel, which also stands in Japan, but the third-oldest wasn't founded until hundreds of years later – in 1120. Zum Roten Baeren, in what is now Freiburg, Germany, was constructed before that city was established. And since that time, it's survived devastating world events, from the Black Plague to two World Wars.*

– by Zachary Kussin, The New York Post



Nishiyama Onsen Keiunkan in Japan, the oldest hotel in the world.  
Source: Keiunkan

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1. The Fund's returns are calculated using the Fund's net asset value attributable to the relevant share class (where applicable) and represent the Fund's combined income and capital returns for the specified period. The Fund's returns are pre-tax and are net of fees and expenses (excluding investment performance fees, if any). The investment returns shown are historical and no warranty can be given for future performance. Historical performance is not a reliable indicator of future performance. Due to the volatility in the Fund's underlying assets and other risks associated with investing, investment returns can be negative, particularly in the short-term.

The index represented is, as the corresponding benchmark for the relevant Fund, as follows (each the "Index", as the context requires):

- Platinum World Portfolios - International Fund — MSCI All Country World Net Index (US\$)
- Platinum World Portfolios - Asia Fund — MSCI All Country Asia ex Japan Net Index (US\$)
- Platinum World Portfolios - Japan Fund — MSCI Japan Net Index (US\$)

Index data has been sourced from MSCI Inc. Index returns include dividends, but, unlike the Fund's returns, do not reflect fees or expenses. It should be noted that the Investment Manager does not invest by reference to the weighting of the Index. The Fund's underlying assets are chosen through the Investment Manager's individual stock selection process and, as a result, the Fund's holdings may vary considerably to the make-up of the Index. Index returns are provided as a reference only.

The portfolio inception dates for each active share class of the relevant Fund are as follows:

- Platinum World Portfolios - International Fund:  
Class A USD (Accumulating) (ISIN: IE00BYRGQX37): 27 April 2016  
Class B USD (Accumulating) (ISIN: IE00BYRGR076): 2 December 2016  
Class D USD (Accumulating) (ISIN: IE00BYRGQZ50): 16 November 2015  
Class G GBP (Accumulating) (ISIN: IE00BYRGR290): 27 April 2016  
Class H GBP (Accumulating) (ISIN: IE00BYRGR308): 4 August 2016
- Platinum World Portfolios - Asia Fund:  
Class A USD (Accumulating) (ISIN: IE00BYRGR522): 10 March 2017  
Class D USD (Accumulating) (ISIN: IE00BYRGRD06): 16 November 2015  
Class I USD (Accumulating) (ISIN: IE00BYMJ5524): 19 January 2017
- Platinum World Portfolios - Japan Fund:  
Class A USD (Accumulating) (ISIN: IE00BYGRF20): 11 January 2016  
Class B USD (Accumulating) (ISIN: IE00BYGRH444): 23 December 2016  
Class D USD (Accumulating) (ISIN: IE00BYGRJ67): 16 November 2015

The inception date for the purpose of calculating the returns of the Index, as contained in this publication, is taken to be the inception date of Class D of the Fund, being 16 November 2015.

2. Regional exposures represent all physical holdings and long derivative positions (stock and index) as a percentage of the Fund's net asset value.
3. The table shows the Fund's top ten long stock positions (including any physical holdings and long derivatives) as a percentage of the Fund's net asset value.
4. The table shows the Fund's major net currency exposures as a percentage of the Fund's net asset value, taking into account any currency hedging.
5. Sector breakdown represents the Fund's net exposure of any and all physical holdings and long and short derivatives (stock and index) as a percentage of the Fund's net asset value.

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