June 2016

BKI INVESTMENT COMPANY LIMITED

BKI Quarterly Report

What do you think about the Banks now?

Welcome to our 11th BKI Quarterly report. This report, and previous issues, are available on our website at www.bkilimited.com.au.

Two years ago, in our third issue of the BKI Quarterly, we wrote an article titled, *"What do you think about the Banks?"* For an income focused, Australian equities portfolio, this is an important question and one that is worth revisiting regularly.

There are several developments over the past two years, many of which negatively impact earnings. A falling interest rate environment, greater capital requirements, management changes, a commodity price downturn and a few scandals all present challenges.

The Australian market returned 3.7% p.a. over the past two years – better than term deposits but below long-term averages. The major banks treaded water with the exception of ANZ which performed poorly. The performance of the market was summed up in a harsh but fair comment by US investor Michael Batnick a few months ago:

> *As you're probably painfully aware, the S&P 500 [BKI comment: you can insert ASX All Ords here] hasn't made any progress over the last two years. If you're feeling a little frustrated, I have some bad news for you, this is how stocks work. The stock market doesn't owe you anything. It doesn't care that you're about to retire. It doesn't care that you're funding your child's education. It doesn't care about your wants and needs or your hopes and dreams.*
>
> *I absolutely believe that stocks are the best game in town. I don't think there is a better way for the average investor to grow their wealth. However, this is called investing and the price of admission is gut wrenching drawdowns and sometimes years and years with nothing to show for it. If you can accept that this is the way things work, you can be an enormously successful investor.*

One advantage that the Australian investor has is tax-effective dividends. For investors in the Big 4 Banks, while capital values are down on 24 months ago, investors collected at least a 10% return in dividend payments. For example, CBA was trading at $80 in late June 2014. It was $73.50 at the time of writing. However, the bank paid $8.36/share in dividend income (before the benefit of franking credits) over the two year period. If you do not need to sell, this is a satisfactory outcome. Financial journalist and historian James Grant says, *"Successful investing is about having people agree with you ... later."*

Our view is similar to that of two years ago – we remain comfortable with our exposure to the major banks. In fact, we are slightly more positive on CBA, NAB and Westpac given the stronger capital position and their relative valuations. ANZ still has a few challenges that concern us. It remains our least preferred major bank.

We don't agree with a lot of the arguments that the pessimists present. It is easy to overplay one data point and say that the sky is falling – we'll discuss some of these misleading statistics. While the bear case is often easier to believe, we caution our shareholders not to fall into a mindset of excessive pessimism, a behavioural trait common among many investors. Morgan Housel, a long time writer for the Motley Fool, makes a salient point on this:

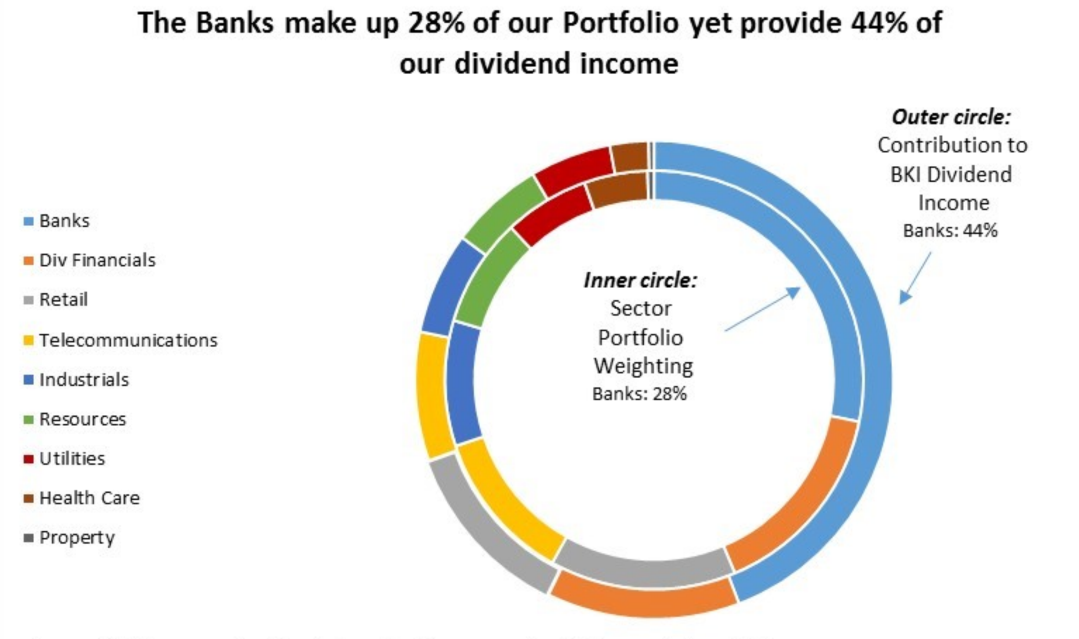
> *My biggest takeaway from economics is that the past wasn't as good as you remember, the present isn't as bad as you think, and the future will be better than you anticipate.*

"My biggest takeaway from economics is that the past wasn't as good as you remember, the present isn't as bad as you think, and the future will be better than you anticipate."

Morgan Housel

Bank shares are an important driver of BKI income

Where are we coming from? BKI's aim is to create wealth for our shareholders, through an increasing fully franked dividend and capital growth. We aim to do this by thinking long-term, adopting a disciplined investment process and managing our costs as prudently as possible. From a Portfolio Management perspective, the Banks account for BKI's biggest sector weighting and, importantly, provide BKI with a significant income stream.



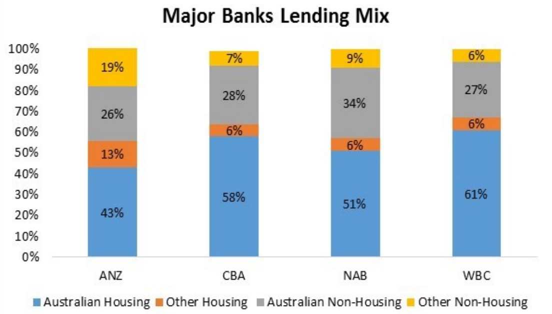
Source: BKI Management estimates based on income received in January to June 2016

What are the main issues impacting the Banks?

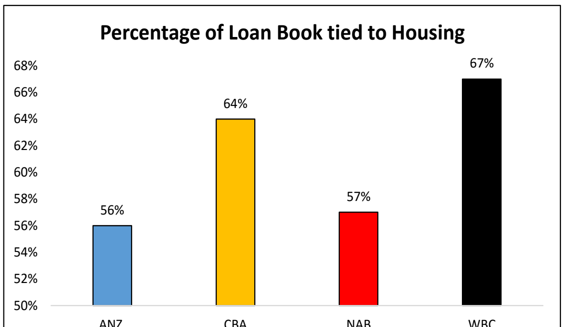
The banking industry is a complex one and there are plenty of issues to consider when investing in the sector. In this note, we highlight a small number of the bigger issues playing on investors' minds. The questions we get the most often relate to the Australian housing market, the bad debt cycle and the outlook for dividends. Let's consider each in turn.

Exposure to the Housing Market

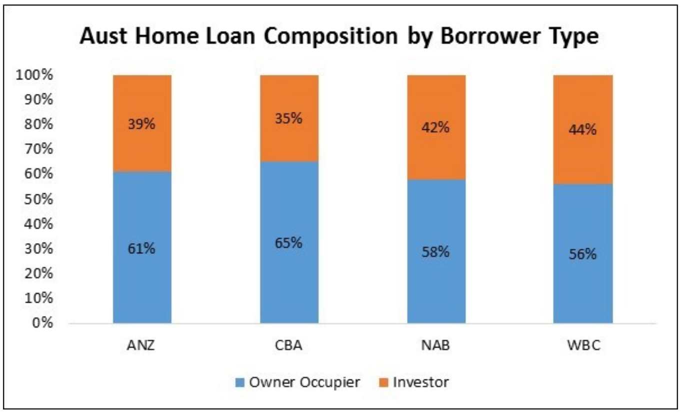
The following charts provide a useful background into the importance of housing to the Australian Banks.

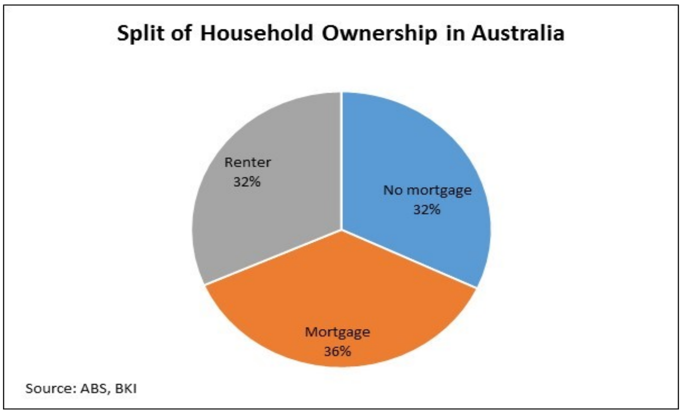


Source: Company reports (1H16), BKI, Morgan Stanley



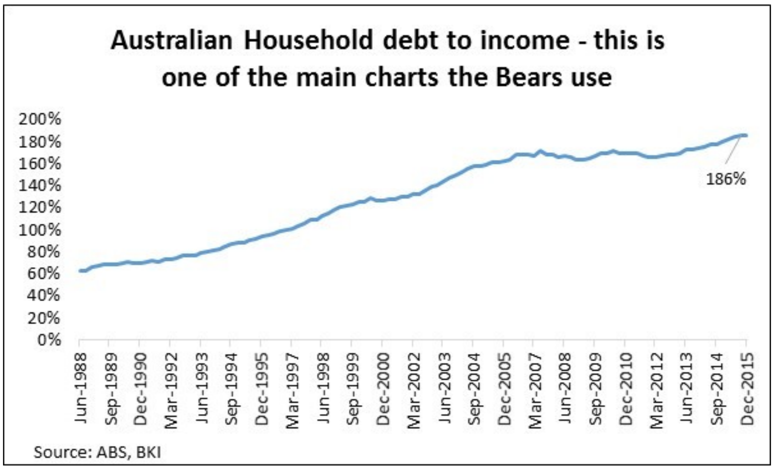
Source: Company reports (1H16), BKI, Morgan Stanley





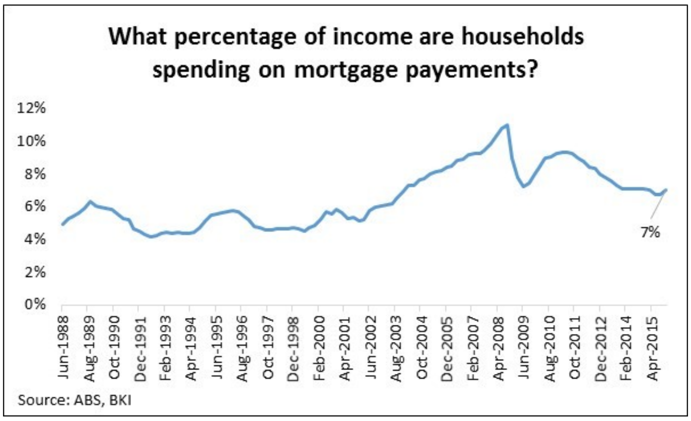
The bears and doomsayers, particularly a number of US hedge funds looking to short our banks, point to the following issues[1]:

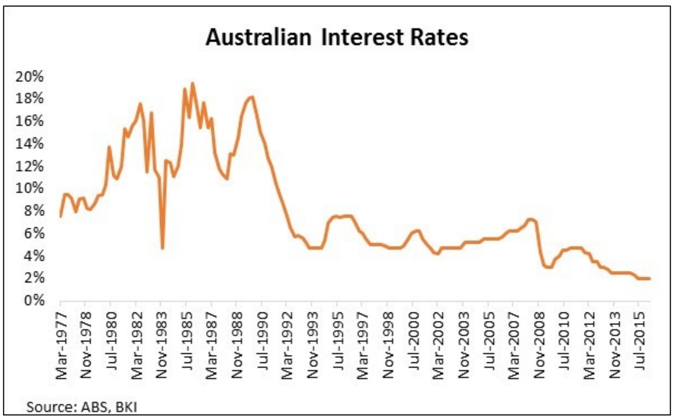
- The record ratio of house prices to incomes and banks targeting "asset rich and income poor" investors are two signs the Australian housing market is poised for a fall
- Banks have consistently lent to borrowers who would never be able to repay
- Lower interest rates since the peak in 1990 have merely encouraged Australian households to maximise leverage to speculate on residential property



We take a more pragmatic view

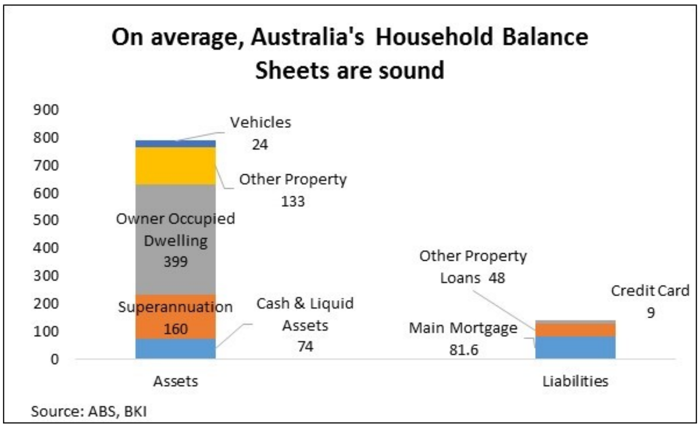
Despite the headlines of excessive house prices and mortgage stress, there are a number of compelling arguments that dispel the "housing bubble" theory. We have spent a lot of time trawling through the ABS, RBA and the Big 4 reports and take comfort from a number of factors. Firstly, the charts below illustrate the positive impact that record low interest rates are having on debt serviceability. On average, 7% of household income is needed to meet mortgage repayments. This is similar to the average over the last thirty years, but does come with the caveat that we are in an environment of record low rates.



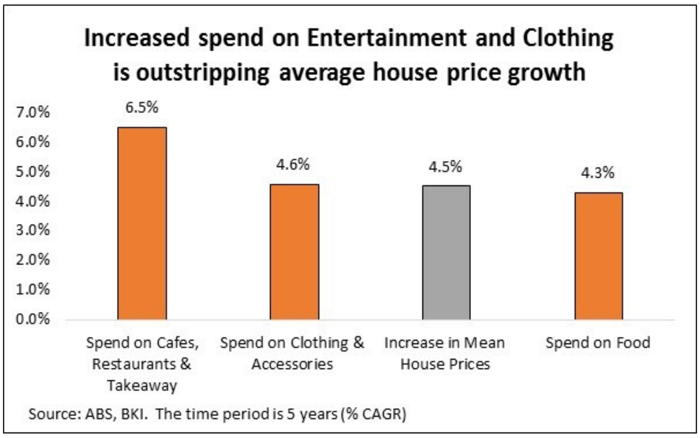


A number of other points are worth mentioning:

- 32% of households have no mortgage. 30% of households have no net debt.
- At the other end of the spectrum, 26% of households have total debt equal to more than three times income. This is obviously the risk area, however according to the RBA only 6% of homeowners have been late with a mortgage payment[2].
- In fact, most homeowners are ahead on mortgage payments. At CBA for example, the average mortgage holder is 28 payments/months ahead. There is some buffer in place if employment becomes an issue. Employment is crucial in the debate on the sustainability of the housing market.
- Owners with a mortgage pay on average $450/week on housing costs. This has not changed a lot from five years ago in real terms. Average rent is $376/week. Average weekly earnings are $1,146/week.
- The average retiree (65-74) has $308k in Superannuation. With this and other savings, the risk engendered by very low interest rates is investment in ever riskier sources of yield.
- The average amount owed on homes in Australia is $81k and the average value of those homes is $400k, implying a national LVR of 20%.



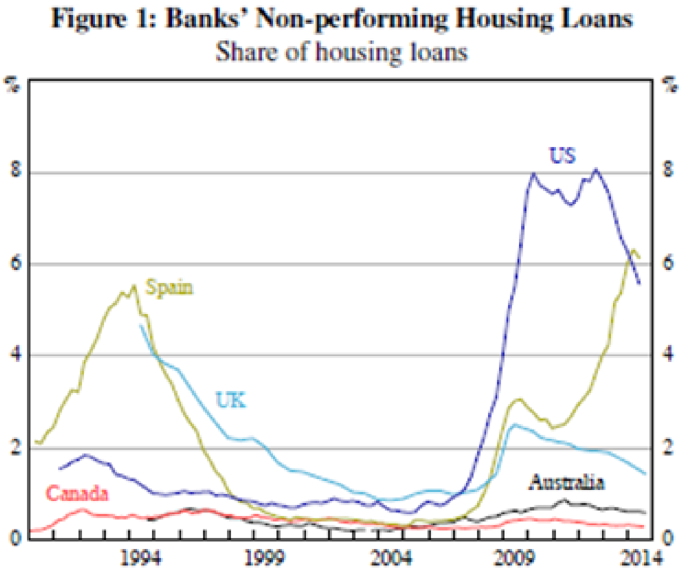
Consider also the relative price appreciation of housing. Over the past five years, the Australian consumer increased the amount they spend on eating out and clothing more so than housing. This confirms to us that many Australians are doing as well as ever. Household net worth is at record levels and people are still spending on discretionary items. A quote from columnist Doug Larson resonates here: *"What some people mistake for the high cost of living is really the cost of high living."*



We highlight the statistics above to provide a balanced view. However we are cognisant that we are in an environment of record low interest rates. This could provide a false sense of security for some. While we believe that interest rates will stay low for some time, we do caution that debt levels are still high historically and serviceability would become more difficult if rates increased. This would obviously impact the banks and also negatively impact other parts of the economy.

This is important. From a Portfolio Management perspective, we look at charts like the one above and make the following conclusion – if a household starts to hit challenging times, they are going to pay the mortgage ahead of buying discretionary items. In that situation, the Banks will fare better than the Consumer Discretionary stocks.

It is also worth considering that maybe the Australian Banks have simply been more disciplined lenders than their international peers – the following chart[3] paints a powerful argument for this.

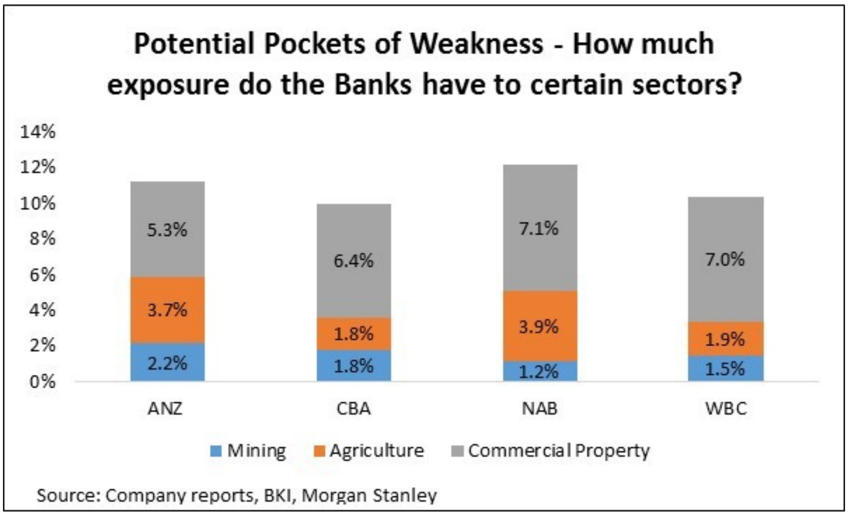


Finally, the RBA also seems more comfortable. In June, it noted that "*Housing prices had grown moderately over 2016, following a small decline at the end of 2015. Housing credit growth had eased a little . . . following increases in mortgage rates and the strengthening of banks' non-price lending terms in response to supervisory actions.*"

What do we expect to see in the near-to-medium term?

(i) Impairments

Two years ago, we said that we thought that we were very close to the bottom of the bad debt cycle and that impairments and provisions would slowly increase. This is happening and is expected to continue. This does not cause us undue concern, this is the nature of investing in banks. There will undoubtedly be a number of large loan losses, some are starting to come through already as seen in the most recent bank results. However, as depicted in the following chart, the collective risk appears to be manageable.

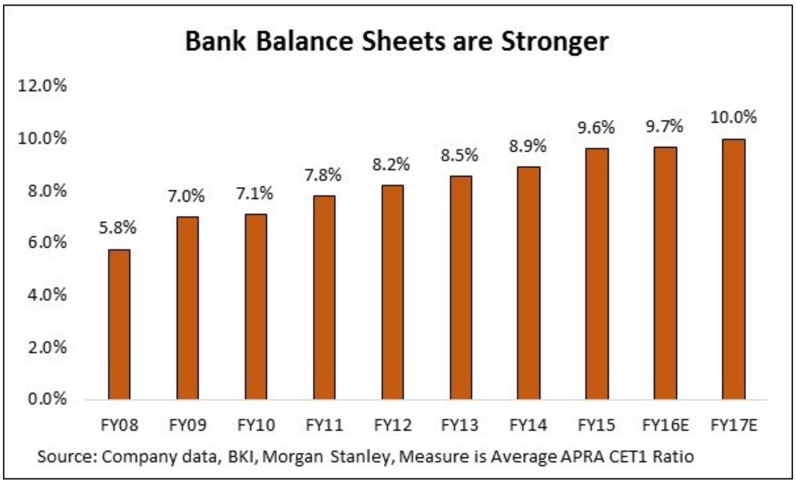


(ii) Dividends and Capital Position

Dividend growth is now expected to be more muted after strong dividend growth post-GFC. ANZ cut its dividend already and DPS will likely track sideways in the near term. ANZ remains our least preferred of the Big 4 banks. We have 4% of the Portfolio invested in ANZ compared to CBA (9%), NAB (8%) and WBC (7%). The market is most optimistic on the Commonwealth Bank dividend, although growth in that dividend is expected to be low single digit at best.

Earnings and dividend growth assumptions are scaled back for most sectors. In our view, few sectors now offer the same valuation and yield as the Banks.

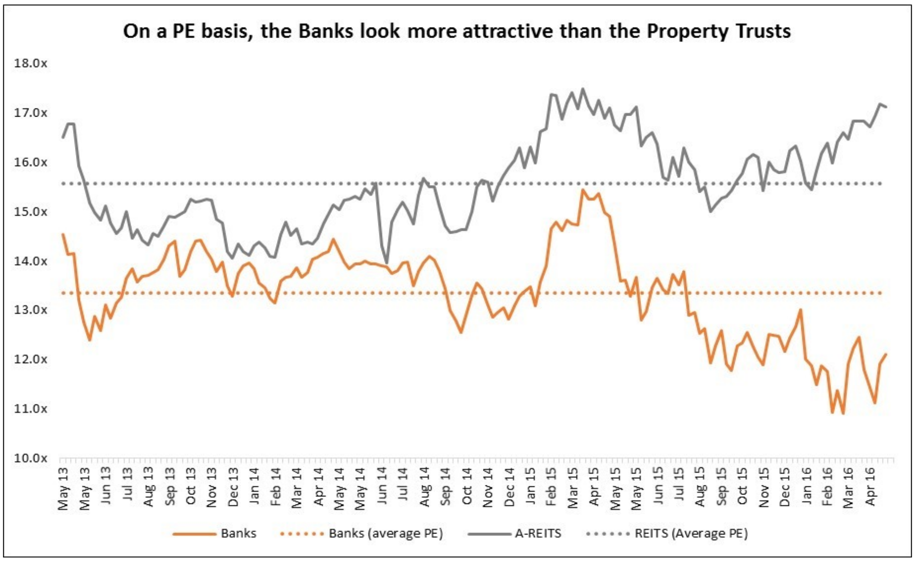
The other matter which gives us comfort is the stronger regulated capital position of the banks. We are prepared to wear some dilution to return on equity for a stronger banking system. We also think that the stringent capital requirements for the banks acts as an additional Barrier to Entry. This may discourage "the disrupters" from taking share.



Final thoughts

In a time when very low interest rates drive investors to take on higher risk in search of yield, one point does stand out. Traditionally retirees were urged to have a strong balance of high quality fixed interest assets in their portfolios. Today, that is difficult. Globally this era of the lowest interest rates in recorded history also leads to that issue—investors being forced into higher risk securities.

On a relative basis, the Banks look more attractive than most other sectors. Banks are one of the few sectors that are trading on Price-to-Earnings multiples below their long-term average and offer better yield than history. The following chart which shows the comparative valuations between the Banks and the Real Estate Investment Trusts is illustrative, and relevant in a Property market discussion.



While dividend growth is expected to be lower than we are accustomed to, the income that we receive from the banks will continue to be very important for BKI.

A number of small and mid-cap stocks are now trading on what we consider to be excessive valuations. There are plenty of companies that we like and will continue to slowly increase our exposure to in a disciplined manner. We believe the patient investor will be rewarded.

Other than valuation, we continue to believe that there are a number of reasons to stay invested in the Banks. They offer:

- Sound returns and oligopolistic pricing power
- Balance sheets that will continue to strengthen
- Steady loan growth
- Potential for further cost management and asset rationalisation
- Offer a far more attractive dividend yield versus term deposits, and
- The benefits of franking credits

Will Culbert (June 2016)

[1] "Fears over asset-rich income-poor home investors", The Australian Financial Review, 2 May 2016

[2] Source: RBA Research Discussion Paper: Mortgage Related Financial Difficulties—Evidence from Australian Micro Level Data (November 2014)- referring to HILDA survey about the previous 12 months

[3] Source: RBA Research Discussion Paper: Mortgage Related Financial Difficulties—Evidence from Australian Micro Level Data (November 2014)

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