October 2019

# BKI INVESTMENT COMPANY

ABN: 89 615 320 262

BKI INVESTMENT COMPANY LIMITED

# QUARTERLY REPORT

*How Do We Assess Business Quality?*

# BKI Quarterly Report

Welcome to the 23rd edition of the BKI Quarterly report, prepared by Contact Asset Management (Contact).

We are often asked what makes a company form part of the BKI portfolio. Since the inception of this Portfolio over 30 years ago, the core tenets of the investment process have remained unchanged. A long-term view is taken with a focus on buying and holding high quality Australian listed companies.

In this Quarterly report, we will focus on how Contact and the BKI Investment Committee assess the quality of a company and how the quality of the BKI portfolio compares.

## *BKI's Objectives and Strategy*

BKI's aim is to generate an increasing income stream for distribution to shareholders in the form of fully franked dividends. As at 30th September 2019, BKI has generated a total shareholder return ("TSR") of 11.9% over the last year and 8.4% p.a for 15 years.

As Portfolio Managers of BKI, Contact are always seeking to find the highest quality businesses that pay growing fully franked dividends so we can recommend them to the BKI Investment Committee. As custodians of your capital, BKI is always looking to own businesses that are moving up the quality ladder, and continue to compound capital.

## *What is a Quality Company?*

Measurement of business quality undoubtedly varies from person to person. Many of the world's greatest investors consider business quality to be a very important component to the investment decision-making process. US investor Seth Klarman, who has realised a 20% compound return since 2008, sums it up perfectly:

> *"Quality matters. Better-quality businesses are more likely to grow and compound cash flow; low-quality businesses often erode and even superior managers, who are difficult to identify, attract, and retain, may not be enough to save them."*

BKI sees business quality as a measure based more on the qualitative features of a business, namely its culture, customers and management, than the quantitative features. For it is often the hidden, unseen aspects of a business that will enable it to generate capital and grow dividends over time.

High quality companies have the ability to generate impressive and sustainable returns on equity ("ROE") over time. As BKI aims to generate an increasing income stream for distribution to shareholders in form of fully franked dividends, let us assess the ROE in light of the dividends paid. Take a company for instance that earns a profit of $10 and pays out $6 in Dividends. It is therefore left with $4 to reinvest back into the business. A quality company, that is well-managed, should be able to re-invest that $4 at a higher rate than paying out the total $10. This in turn compounds capital and enables future dividends to rise. Ultimately, a quality company is inherently more superior, more competitive and has a stronger management team that enables the high ROE. High ROE and the ability to reinvest in incremental growth at that ROE is important.

Many investors in today's market seem overly focused on growth and revenue multiples in determining quality. At Contact, this is not how we see the quality of a company. While we acknowledge that Price to Earnings ratio and EPS growth are important considerations, for us, we see Warren Buffett's comment, made nearly 50 years ago in the 1979 Berkshire letter, regarding ROE as a true benchmark that determines success:

> *"The primary test of managerial economic performance is the achievement of a high earnings rate on equity capital employed (without undue leverage, accounting gimmickry, etc.) and not the achievement of consistent gains in earnings per share."*

In essence, we agree with Warren Buffett that it is the capital employed that determines business quality and not EPS growth alone. If one combines business quality, ROE and valuation, we see that as being the filter for quality and thus provides the investment opportunity. According to QMA research, the months of March, May and August of this year were among the worst months for value factors since 1996. However history has proven where dislocations for value are as large as they are today, namely in 2001 and 2009, the return to value over the following 12 months was +34% yoy and +54% yoy respectively.

## *How do we know if a company is Quality?*

BKI is benchmark unaware and has no specific sector or stock investment limitations and is focused on investing in stocks using the five fundamentals below as part of the stock selection process:

1. **Principal Activity** - Sustainable Business Model, Competitive Advantage, Barriers to Entry
2. **Income** - Dividend Yields, Franking Credits, Pay Out Ratios
3. **Balance sheets** - Debt Levels, Gearing Ratios, Net Interest Coverage
4. **Management and Board** - Alignment, Experience, Skillset, Creating Shareholder Wealth
5. **Earnings and Valuations** - Earnings Profiles, PE Multiples, EV/EBITDA Multiples

The deep quality assessment Contact undertakes forms a critical part of the investment process. For us, the quality features of a business play out in the growth of the fair value of the businesses over time. In determining whether a business is high quality for the BKI portfolio, as investment managers, we ask ourselves up front some initial questions, namely:

- What is the company's reputation with its customers?
- Is the business likely to grow?
- Is it a leader in its industry?
- How does that business treat its people?
- What is the growth outlook for the industry?
- Has management demonstrated sound strategic leadership?
- Are the quality of earnings deteriorating?

Once comfort is taken in answering those questions, which forms part of Contact's detailed 100-point checklist, as well as having met management, we present investment ideas to the BKI Investment Committee. Final investment decisions are approved through the BKI Investment Committee.

BKI seeks to buy a high quality business when we see it trading at a reasonable price. Without an attempt at valuation, one is simply speculating and not investing.

To protect capital, once a company is deemed to be high quality we are cognisant to not simply investing in a business because it pays a high dividend yield. Investors can get caught out in owning potential value traps. Using the previous $10 example, we are wary of companies that earn the $10 but pay out the full $10 in dividends and do not invest for growth. Even worse, we occasionally see scenarios where a company earns $10, and then pays out $12, funding the dividends from debt. Great businesses have solid balance sheets to support future growth.

You may ask why the obsession with dividends forms part of the BKI investment process. In deeming quality, it is important to consider the dividend trajectory. In the book *Triumph of the Optimists: 101 Years of Global Investment Returns*, the authors studied the period 1900 to 2000. They found that a portfolio that included dividends would have generated nearly 85 times the wealth generated by the same portfolio relying solely on capital gains. As BKI's aim is to generate an increasing stream of franked distributions to shareholders, we are always mindful not only on the sustainability of that path, but as the evidence highlights, having that focus will also generate a higher return over the long term.

There are 45 companies currently held in the BKI portfolio, a selection of some of the higher quality names on the Australian Stock Exchange. With a universe of over 2,100 companies listed on the Exchange, Contact believes there are only around 90 companies making it into the BKI investable universe.

## *What do we like to do when we own Quality companies?*

Once a quality company is in the portfolio, at BKI, we do not want to get in the way of that company compounding capital. When you own a high quality company, it has the ability to compound capital at a higher rate. To compound at higher rates we therefore strive to keep our turnover low. For if you exit and enter a position, you need to be right twice. Famously it has been said by Terry Smith there are only two types of people:

> *"Those who can't market time and those who don't know they can't market time"*

The most comprehensive study on the impact of portfolio turnover by Fundsmith (UK) in 2018 highlighted that an active Equity Fund takes on average 23% of the absolute return in costs from portfolio activity. It was also found there is also a direct correlation by trading frequently and poorer performance. The BKI portfolio for the year to 30 June 2019 had only

$76.6m of disposals, of the Total Investment Assets of $1.23b, an incredibly low divestment rate of 6.2%. BKI's low turnover is an advantage, as we own high quality businesses and let the compounding work for us. Charlie Munger, summed it up perfectly, the power of owning quality companies and keeping turnover low:

> *"A great company keeps working when you're not. A great company will eventually earn more and more and more while you're just sitting and doing nothing. And a mediocre company won't do that. So you're harnessing a long range force that will help you. It's very important. These mediocre companies, they by and large are going to cause a lot of agony and very modest profits. If you do fine, you've got to sell it and find another one. It's a lot of work. Whereas you just buy one great company, and if you get the right thing at the right price, you just sit there."*

Importantly, in this case it is the BKI shareholder that has the luxury of sitting there and waiting. BKI is always on the hunt to add quality companies to the portfolio, or take advantage of situations where quality companies are trading at material discounts to its fair value. Over the past year, Contact has had over 600 interactions with company management, industry contacts or sell side analysts as we work to improve our investment returns and quality universe. For the year to 30 June 2019, BKI invested over $170m into the market.

The ability to forecast the path of success for selected high quality companies is difficult. David Dreman, a respected US investor and publisher of the *Journal of Behavioural Finance* who has written several articles on the difficulty of forecasting. One study, conducted over a period of 35 years, concluded that the ability to forecast ten consecutive quarters within +/-5% was 1 in 50 billion. With a market obsessed in forecasting accuracy, we believe we are actually in a forecasting error cloud, trying to deliver forecasting accuracy is simply noise. This presents opportunities for BKI when a company may miss a short-term earnings consensus target (in most cases set externally) and therefore the market throws the baby out with the bath water. A penny miss here or there, means little in our view to the long-term fundamentals of owning a high quality business. Great pride is taken in the analytical work we do and therefore many of the recommendations that were added to the BKI portfolio over the last 12 months, were scenarios where we took advantage of moments of share price weakness for BKI to buy securities, that in our view, still today trade at a material discount to its fair value.

## *Where does BKI Portfolio sit on the Quality curve?*

To highlight the view of quality, it would be helpful to take a snapshot and compare the BKI portfolio to the S&P/ASX300 Index. Below in Table 1are comparisons on Valuation. In Table 2 on Capital, it shows that, in comparison to the S&P/ASX300, the BKI portfolio has a lower PE and lower gearing whilst generating stronger ROE and Dividend Yields.

As can be seen below in Table 1 on Valuation, the BKI portfolio for both 2019 and 2020 is cheaper on a PE basis multiple than the market as well as having a lower gearing ratio. This means the BKI portfolio is in effect paying less to achieve a relative higher calibre portfolio. In 2019, the BKI portfolio was 15% cheaper than the market and had 30% lower gearing. The low gearing is incredibly important, as it will enable the companies in the BKI portfolio to support future growth, as they are also high ROE companies.

### Table 1: Valuation

| | Price to Earnings | | Net Debt / EBITDA | |
|---|---|---|---|---|
| | 2019 Actual | 2020 Estimate | 2019 Actual | 2020 Estimate |
| BKI Fund | 16.2 | 15.6 | 0.9 | 1.0 |
| ASX 300 | 19.1 | 16.7 | 1.3 | 1.1 |

Source: Consensus Factset at 25th September at Weighted Median

Table 2 on the following page highlights the ROE and Dividend Yield (pre-franking) of BKI against the S&P/ASX 300. Both are output measures of business quality. Pleasingly, the BKI portfolio sits above the market in both ROE and Dividend Yield (pre-franking) for 2019 and 2020. There is also a material gap between the ROE and expected Dividend, indicating the stocks in the BKI portfolio have a wide margin and strong ability to reinvest for growth. The higher Dividend Yield is obviously very important to BKI shareholders.

Table 2: Capital

| | ROE | | Dividend Yield (pre franking) | |
|---|---|---|---|---|
| | 2019 Actual | 2020 Estimate | 2019 Actual | 2020 Estimate |
| BKI Fund | 13.7% | 13.2% | 5.2% | 4.9% |
| ASX 300 | 11.3% | 10.8% | 3.3% | 3.4% |

Source: Consensus Factset at 25th September at Weighted Median

On stock specific examples within the BKI portfolio, Magellan Financial Group ("MFG") and ARB Corporation ("ARB") are worth highlighting for two different reasons. MFG was a new position established in early 2019, deeming at the time of buying a high quality company due to its focus on its people, culture and customer, alongside trading at a material discount to Contact's assessment of fair value. The results they reported in August 2019, confirmed the quality, where MFG delivered a standout ROE of 63.5%, with dividend growth of 38% year on year. Since purchasing, MFG has delivered an 89% return to the BKI portfolio. ARB, as a separate example, has been owned in the BKI portfolio for over 10 years and has delivered a compound average growth rate ("CAGR") of 19.3% p.a. for 10 years. ARB has a strong and aligned management team, having increased dividends every year over the last 15 years with the exception of 2015 when the dividend was held flat. ARB's ROE over the last 10 years has been 23.1% p.a., indicating an incredible ability to compound capital and reinvest for growth.

## *Conclusion*

Owning the highest quality names is where we believe the BKI portfolio will create the most benefit for shareholders. Much of what the BKI Investment Committee and Contact does in assessing businesses is qualitative in nature. The calibre of a company is very important, and we always try to not overpay for an investment. However, while it can be difficult to pay a seemingly-high price for a business in the short-term, we believe that in doing so you can achieve a great investment over the long-term by owning a high quality business, that delivers high ROE and growing dividend yields. Owning the best companies not only has the ability to compound capital at a higher rate, it also protects the portfolio on the downside. To end we think Charlie Munger sums it up perfectly:

> *"We've really made the money out of owning high quality businesses."*

## Sources


(1) Quotes are from the website www.mastersinvest.com
(2) Turnover impacts to performance from the Fundsmith 2018 AGM
(3) Book, Contrarian Investment Strategies by David Dremann
(4) Book, Triumph of the Optimists: 101 Years of Global Investment Returns, by Elroy Dimson
(5) Statistics on returns are from the Factset Database


## Disclaimer and Important Information