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BKI INVESTMENT COMPANY

ABN: 89 615 320 262

BKI INVESTMENT COMPANY LIMITED

Quarterly Report

Silver lining

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BKI Quarterly Report

Welcome to the 25th edition of the BKI Quarterly report, prepared by Contact Asset Management (Contact).

COVID-19 – our black swan event has arrived and over a short period of time has had a significant global impact, created an immense amount of uncertainty and ended the longest running bull market in history. The level of uncertainty is resulting in record market movements, reminding us that markets in the short term are irrational. While the current movements appear drastic, volatility is not a new phenomenon and is as old as the market itself. Whether it is innovation, medicine, markets or life expectancy, ultimately there is one consistent trend – an improvement over time.

It is during times of uncertainty that the qualitative factors we consider paramount when investing become increasingly important to investors. We remain invested alongside our fellow BKI shareholders for the long term in profitable, high quality, well managed companies that offer attractive dividend yields.

COVID-19 and Past Pandemics

COVID-19 is evolving rapidly with expert views varying widely. In a short timeframe it has become the focus globally dominating headlines, board rooms, virtual team catch ups and permeated the fabric of our lives. Despite the copious amount of information available on the subject there is not enough data to allow experts to turn those inferences into facts and any non-scientist is simply guessing. At this point there is a level of uncertainty regarding the severity and duration of the COVID-19 pandemic and no ability to reliably quantify the knock-on effects.

Instead, to think through what COVID-19 means, we reflect on past epidemics and their impacts. There have been six documented viral influenza style pandemics during the last two centuries that have become less virulent with the passing of time. Three of these calamities occurred in the twentieth century and their mortality impact ranged from devastating (the 1918 "Spanish" A(H1N1) influenza) to moderate (the 1957 Asian A(H2N2) pandemic) to mild (the 1968 "Hong Kong" A(H3N2) virus). The Spanish Flu which took its toll during January 1918 to December 1920 was the worst pandemic in recorded history and associated with at least 40 million deaths worldwide[2]. Post the Spanish Flu, the S&P500 reaction to the 1921/22 downturn bears a striking similarity to the market at present declining 32%. However, by October 1922, the market had reversed all previous losses and more closing with a gain of 44% from August 1921. The yearly growth rate of industrial production fell 31% by March 1921 but afterwards the momentum of industrial production followed a visible strengthening with the yearly growth rate closing at 42% by December 1922[1].

Importantly, all the lessons of past events come with the caveat being that a lot has changed in the past century. We have gained many advantages against diseases including experience of three better characterized pandemics (1918, 1957, and 1968); knowledge of influenza viruses, capacity to design and manufacture vaccines and antiviral drugs to forestall (if not prevent) infection; and molecular technology that may one day pinpoint the viral components that produce virulence, and thereby identify targets for more effective vaccines and drugs. Currently there are over 100 clinical trials underway globally, with some positive initial results being reported. While no one knows the timing of when this will happen, if at all, we remain hopeful.

The Impact and the Response

Westpac initially forecast the unemployment rate to increase to 11% by June and economic growth to contract by 3.5% in the June quarter. After the Federal Government's massive fiscal response, Westpac reduced its unemployment forecast to 9%. While we are likely headed for a contraction, ultimately, the impact will depend on how long the period of economic suppression lasts, how much difficult-to-reverse damage happens during that period and the policy responses.

Never before has there been such an abrupt, synchronised and global shutdown of so much economic activity so despite bailout packages, rate cuts and massive stimulus efforts this may not be enough to prevent damages to the global economy. The trend of lowering rates in recent years has been described by investor Sam Zell "like having a fire department that wants to wet everything down before the fire even starts." In comparison to the GFC and previous recessions when central banks lowered rates rapidly by circa 5% to stimulate the economy, with a low interest rate environment predating COVID-19 this does not appear to be a feasible option. It appears the fire is here, and we are almost out of water.

US Treasury Secretary Mnuchin warned prior to the US fiscal packages that failure to take appropriate action could lead US unemployment to reach close to 20%, which is higher than the 10% unemployment reached as a result of the Global Financial Crisis and not far off the 25% reached in 1933 during the Great Depression. In Australia it is predicted that we could see the worst recession since the 1930s, at least rivalling the late 80s.

The policy response around the world is extreme with the halt in economic activity expected to have a significant impact on the global economy. In response, the Federal Reserve cut the short-term interest rate to zero and along with Treasury they instigated extraordinary actions to aid market functioning and financial system liquidity. Similarly, in Australia the

Government has announced a record financial aid package, the RBA cut interest rates twice in March to another record low of 25 basis points (bp) and announced the 3 year Australian government bonds to remain fixed at 25bp which is equivalent of a Bond on an insane Price to Earnings ratio of 400x!

In a "whatever it takes" moment, the RBA is providing a three-year facility for the Australian Banks to lend to SME's, while APRA is reducing the CET1 ratio from 10.5% to 8.0% unleashing over $250b of liquidity to support the economy or over 10% of GDP.

The Australian Government has announced a $214 billion, three-part stimulus package in response to the COVID-19 pandemic. The first stage sees a $17.6 billion economic plan focused on keeping Australians in jobs and helping small and medium sized businesses to stay in business. Stage two is a package worth $66.1 billion with new tax measures targeted for small to medium enterprises and individuals, and the Government's third package totalling a whopping $130 billion is a subsidy for businesses to pay workers a fortnightly wage of up to $1,500 per employee.

The End of Our Longest Bull Market in History

As we wrote in our December Quarterly, we were cautious of the high multiple seen in the Australian and global markets. Already low term deposit rates pushed investors into the market to look for yield, thus forcing prices and P/E multiples higher. The search for yield drove strong index gains and the S&P/ASX300 Accumulation index up 26.0% for the year to 30 November 2019. Historically 18.8x was a very high P/E multiple for the index and these higher share prices were certainly placing pressure on the forward earnings of companies. We wrote, "We are again wary of the market expectations of earnings for the year ahead. Very rarely does the market get the earnings per share forecasts right. Curiously, lower interest driven market multiple expansion has broadly offset weaker earnings per share outcomes".

Fast forward a couple of months and no one could have imagined this correction. Since 19 February 2020, the S&P500 and S&P/ASX200 recorded the fastest falls in market history. As shown to the right, the two major bear markets of the 21st century took approximately a year to fall the same amount that we have fallen in the current sell off (red line) after 20 days of trading. The S&P500 is nearly 35% off its high whilst the S&P/ASX 200 is 38% off its high. Except for Black Monday in October 1987, when the S&P500 declined 20.4% in a day we have experienced record percentage declines several times in the last month many followed by similar gains.

Looking over the last 60 years we find market corrections create opportunities for patient investors. On average, the stock market decline during the corrections noted below was around 29% with a subsequent return of 110% over the following five years. Not only did the market regain lost ground following the correction, but for the vast majority of times returned to record territory, often by multiples.

Year	Crisis Event	Index Movement Market Decline	Index Movement 5Yrs Post Correction
1956-1957	Suez Canal Crisis	-18%	100%
1962	Cuban Missile Crisis	-22%	87%
1967	6 Day War - Israel	-22%	85%
1970	1970 Recession	-33%	47%
1973-1974	Oil Shock	-48%	106%
1979	Second Oil Shock	-18%	106%
1982	Recession	-24%	240%
1987	Stock Market Crash	-36%	104%
1990	Iraq war	-13%	121%
1997-1998	Asian Crisis	-21%	28%
2000-2002	Tech Bubble	-50%	98%
2008-2009	Global Financial Crisis	-56%	207%
2011	European Crisis	-19%	107%
2020	COVID-19	-30%	?
Average		**-29%**	**110%**

Source: Francious Rochen

From 1990 through to 2019, the S&P500 increased at an annualized rate of 7.7%. The following highlights the importance of staying invested: if you missed the best day of each year performance drops nearly in half to 3.9% and if you missed the best two days of each year you were up less than 1%. There is a fundamental reason for the historical annualised return of 8% to 10% that equities over 100 years have been achieved. Such an annual return compares very favourably with the 3-year Australian Bond of 25bp. The disparity between the valuation of equities and those of bonds has never been as great as it is now. Instead of trying to time the market we focus on investing through bottom up research and finding value in quality companies.

Volatility is also not a new phenomenon and is as old as the market itself. However, with several major economies experiencing partial or near-complete lock downs these are unprecedented times and we experience a record high spike in volatility.

Increasingly we are seeing companies withdraw guidance and some Investment Banks have ceased coverage entirely, as their Analysts aren't confident of their earnings forecasts. Companies have even begun to delay or cancel dividend payments, well after they have been declared and traded ex-dividend on the market. We have seen one retailer announce the closure of all stores with no indication of when they will reopen and withdraw guidance followed by a share price slump of 30%. Nobody truly knows for sure at this point the severity and duration of this pandemic and in turn no one can reliably quantify the knock-on effects to the economy and thus to company earnings.

Sticking to the Process

During these times of uncertainty Contact and the BKI Investment Committee continue our focus on the fundamentals of each investment. Our approach to investing is straightforward – we aim to buy high quality, dividend-paying companies and hold onto them. We believe that high-quality businesses continue to surprise you on the upside.

We employ a detailed checklist as part of our investment process that helps us to focus on the five fundamental tenets of our approach – Principal Activity, Income, Balance Sheet Strength, Management and Valuation.

Irrespective of wider macro conditions, our stock selection process does not change. For us owning the highest quality businesses is where we believe the BKI portfolio will create the most value for Shareholders. Much of what the BKI Investment Committee and Contact do in assessing businesses is take a long-term view and identify high quality businesses that will continue to deliver high ROE and growing dividends. Owning the best companies can compound capital at a higher rate; it also protects the portfolio on the downside and will ensure we are in a strong position to continue to pay dividends to BKI Shareholders.

We remain invested alongside our fellow BKI shareholders for the long term in quality companies that can stand the test of time.

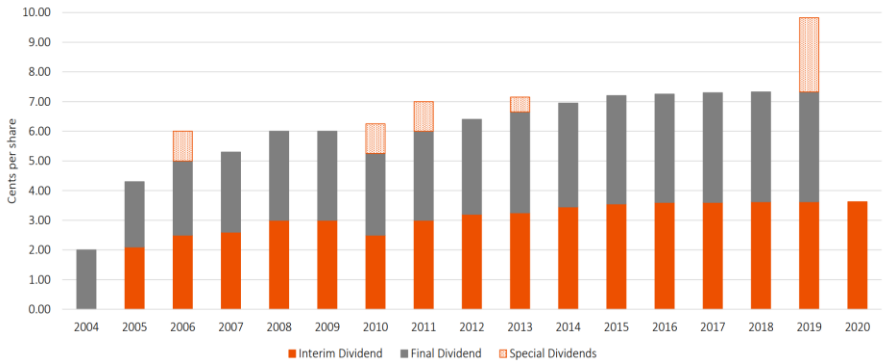
There's Always a Reason to be Optimistic

Daniel Kahneman who won the Nobel prize in Economics in 2002, catalogued how people react to various stimuli, which he separates as "System 1" and "System 2," or the experiential and cogitative. System 1 is effortless, automatic, fast, opaque, parallel processed and can lend itself to errors. It is also highly emotional, precisely because it is quick. This contrasts with System 2, which tries to be logical, serial, and self-aware. It makes fewer mistakes than the experiential system. Most of the trouble in investing and human nature resides in our inability to use much of System 1. We try to use System 2 thinking.

The current volatility is reminding us of the famous quote by Voltaire, "History never repeats itself; man always does." We forget that over the last 60 years market corrections presented themselves as fabulous buying opportunities. Investments made by BKI during the GFC are a prime example of this. In this period some of BKI's best investments were established and existing quality names were added to at a fraction of their intrinsic value as short term, System 1 thinking prevailed.

For example, BKI participated in the Commonwealth Bank $2.0 billion capital raising at the offer price of $26.00 per share. Since then BKI has received $42.68 in fully franked dividends from the Commonwealth Bank. We also participated in the Wesfarmers Limited $2.5 billion entitlement offer at the offer price of $29.00. Since then BKI has received $22.75 in fully franked dividends from Wesfarmers. Some other corporate actions and major investments made during 2008-2009 included National Australia Bank, Westpac Banking Corporation, BHP Limited, ARB Corporation, SEEK, ASX Limited, Ramsay Healthcare and Woolworths Limited. All these companies have lifted profits and generated returns to shareholders in the form of growing dividends, franking credits and special dividends all while maintaining a solid balance sheet and growing their position in their respective markets.

While the short term remains unclear, as it was during the GFC, as evident below, our portfolio has delivered stable and growing dividends over the long term. It is investments like those noted above that enabled BKI to pay out $1.06 per share, or over $700 million, in dividends and franking credits to shareholders since listing in 2003.



The benefit of BKI being a closed end Listed Investment Company is very evident in these times. Amid the short-term uncertainty and volatility, just as we experienced in the GFC, this structure enables us to think long term and invest in businesses on a ten-year view without the short-term pressures of redemptions. In essence, it allows us to think like business owners and not be influenced by the manic-depressive entity as described by Ben Graham that is "Mr Market". It allows us to look at current valuations and find the opportunities, once again, in quality businesses like the ones in our portfolio that can continue to generate strong returns in the form of dividends and capital returns for BKI shareholders.

Despite the uncertainty and negativity around the world we constantly remind ourselves there is plenty to remain optimistic about. We truly believe that as a society we have made enormous improvements overtime in many areas including; 1) Reducing the number of people living in extreme poverty, 2) Improvements in immunisation, 3) Increase in access to fresh water and 4) Significant improvements in literacy.

Conclusion

The spread of COVID-19 in a short period of time has made an enormous impact around the world. While nobody can quantify the impact it will have, history has proven to us that diseases and illnesses have plagued society for centuries and we have overcome them. Importantly, the world is fundamentally improving overtime across multiple facets of our society and these improvements particularly around healthcare are a powerful tool.

At BKI, we have the benefit of thinking long term as co-investors in the company. Uncertainty is once again creating opportunities for patient, long-term investors, so we'd like to conclude with a quote from our 2010 Annual Report outlook statement: "With market negativity comes opportunity. This correction is providing the long-term investor yet another chance to deploy funds in quality companies that have the ability to distribute dividends, have strong business models, robust balance sheets and proven boards and management teams and are trading at attractive valuations"

Sources

(1) Growth: From Microorganisms to Megacities by Vaclav Smil and AASE Economics
(2) Crosby, 1989; Patterson and Pyle, 1991; Johnson and Mueller, 2002).
(3) François Rochon: The Art of Investing — Going Beyond the Numbers
(4) Triumph of the Optimists: 101 Years of Global Investment Returns, by Elroy Dimson
(5) Statistics on returns are from the Factset Database

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