September 2017

BKI INVESTMENT COMPANY LIMITED – BKI.ASX

BKI Quarterly Report

BKI INVESTMENT COMPANY LIMITED

The Best of Both Worlds

Welcome to the 16th edition of the BKI Quarterly Report, prepared by Contact Asset Management. Typically, we use these reports to share our thoughts on topical issues that are front of mind for many of our fellow BKI Investment Company (BKI) shareholders. This report and previous issues are available on the BKI website (http://bkilimited.com.au). Please subscribe online to receive these reports, as well as other news and information relevant to BKI shareholders.

This report looks at the Active versus Passive investing debate. It is an issue with a number of moving parts and interest groups. Exchange Traded Funds (ETF) are growing in popularity – partly due to their low cost structure but also due to the instant diversification and transparency they provide. In this report, we explain how a Listed Investment Company (LIC) such as BKI compares to both an ETF and traditional managed funds. As always, we try to take a balanced view – on a topic that is causing a fair bit of angst on opposing sides.

However, on this occasion our aim is to highlight the benefit of a low cost, closed-end vehicle that is actively managed by an investment team that are aligned with shareholders. BKI is actively managed and low cost, and therein lies its advantage. This is a rare combination in the Australian funds management industry, which are typically active and expensive or passive and cheap. We believe that BKI offers investors the best of both worlds.

Nevertheless, we do note that the active versus passive management argument does not have to be an either/or choice for investors. There is merit in combining the two in order to effectively diversify a portfolio.

What this report does highlight, and we hope will be an important takeaway for readers, is the importance of fees. BKI is managed by Contact Asset Management for 0.10% - among the lowest rates in the Australian market. The total cost to run BKI (referred to as the Management Expense Ratio) is 0.15%. Thomson Reuters Lipper pegs the average expense ratio at 1.40% for an actively managed equity fund, compared to 0.60% for the average passive equity fund.

Importantly, low cost has not meant low quality or low return. Over the 10 years to 31 August 2017, the return for BKI shareholders beat the market (S&P/ASX300 Accumulation Index) by 2.9% per annum. To put that in perspective, $1 invested into the market index ten years ago would now be worth $1.41. The same $1 invested into BKI would be worth $1.86. Not bad considering that ten years ago, you would have put your money into the market just before the Global Financial Crisis hit!

CONTACT ASSET MANAGEMENT

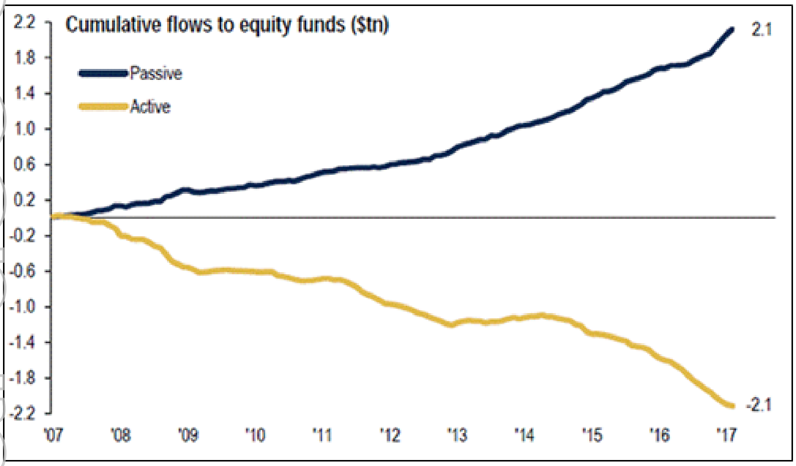
BKI is managed by Contact Asset Management
AFSL 494045

Major trends in the Global Investment Industry – Fund flows

Before we delve into a number of important trends, a definition of active and passive investing is useful. Active investing refers to a more involved process where investment teams are making judgements about market movements and acting on those judgements by buying or selling parts of the portfolio. The goal of active management is to provide superior returns over the long term, in excess of those provided by market movements alone.

Passive investing, on the other hand, refers to an investing strategy that tracks a market-weighted index or portfolio. The most popular method is to mimic the performance of an externally specified index by buying an index fund. The major players in the industry include Vanguard, Blackrock and State Street.

The United States provides a leading indicator into a number of investment trends that are likely to play out in Australia. The prevalent trend is the flight into passive equity funds and out of actively managed funds. As depicted in the following chart, the flows have been significant (the numbers are trillions) and the trend has been accelerating.



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The rise of Vanguard and Blackrock is coming at the expense of just about everyone else in the asset management business. Vanguard in particular has been a major beneficiary of the trend to passive investing through its exchange-traded funds, smart-beta offerings and low-cost index products.

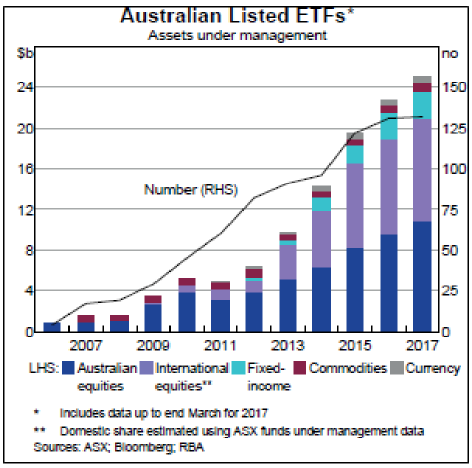
One commentator noted, "What Vanguard is doing in the asset management industry has been compared with what Amazon.com is doing to retail. Both have hit tipping points and are now making life incredibly difficult for companies that had been enjoying the status quo."

The numbers are quite staggering. In July alone, Vanguard investors poured in an estimated US$23 billion, taking inflows for the seven months to US$229 billion. Put another way, Vanguard is luring US$100 million in flows every half an hour!

The Australian ETF market, although much smaller than its US counterpart, has also been growing rapidly. According to a Reserve Bank of Australia (RBA) Bulletin released in June 2017, Australian ETF assets under management have more than tripled since 2012, to be around A$25 billion.

There are 134 ETFs listed on the ASX and exchange-traded funds account for 1.5% of the local stock market capitalisation. The chart on the right highlights the growth in the segment and illustrates that the Australian ETF market is more concentrated in equity ETFs, with fixed income ETFs accounting for a relatively small share.

ETF turnover in Australia has recently averaged around A$60 million per day, equivalent to roughly 1% of total ASX turnover. In comparison, ETF turnover in the US totals around US$100 billion per day and accounts for approximately one-third of all trading for US stocks.

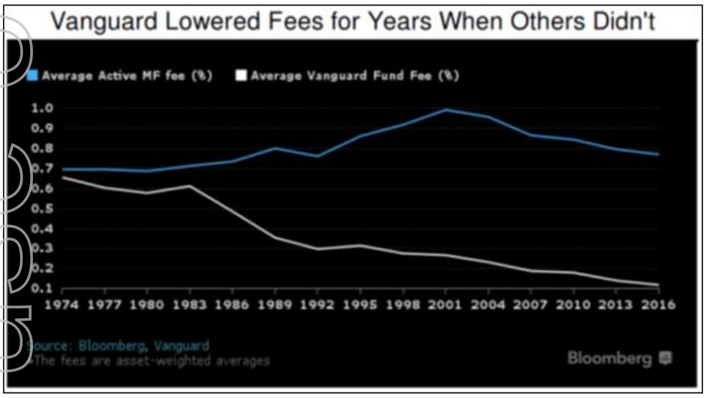


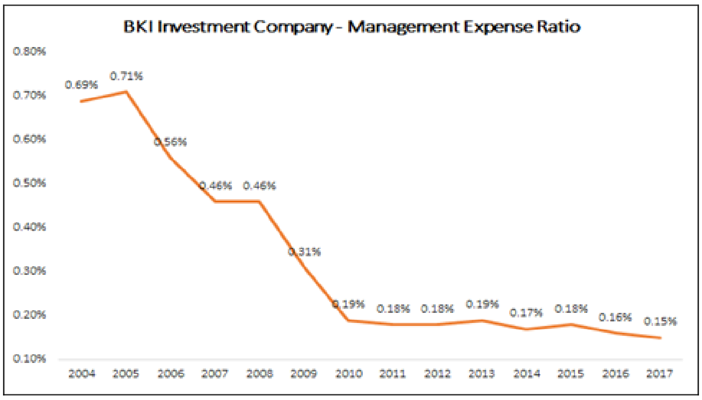
The biggest driver of the trend . . . Fees

Vanguard's edge has come from a 30-year history of lowering fees. While other passive fund managers in the market have similarly priced products, no one else is seeing the same levels of inflows.

In an article for Bloomberg Intelligence, Sean Casey noted that "Vanguard benefits from its 30-year reputation for continually lowering fees, even during periods when costs weren't a concern for investors, such as the 1990s. While Vanguard started in 1974 with fees similar to those of other mutual fund managers, the spread widened over the years as the company became known as the lowest-cost provider. Vanguard's 30 years of fee cuts stem from its mutual ownership structure, under which fund investors are the shareholders."

The concept of the focus on low fees for shareholders is comparable to the BKI Investment Company experience. While the BKI history is shorter than Vanguard, there are striking similarities in the fee charts shown below.

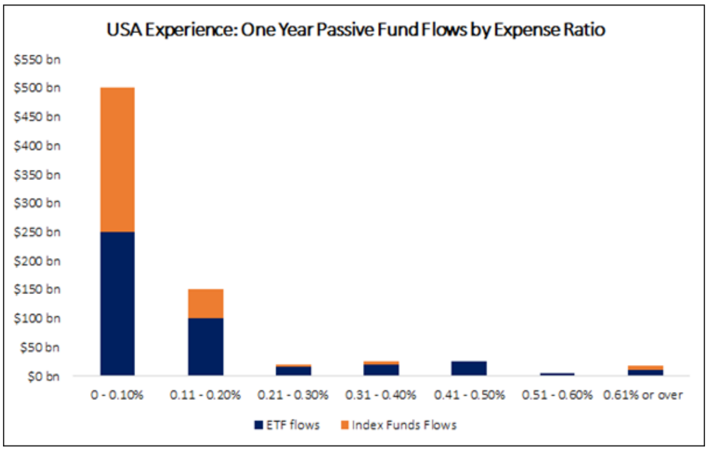




Source: BKI Investment Company. The MER is the percentage of the company's assets that go towards running the entire LIC each year. It includes management fee expenses and all operating expenses. BKI does not charge shareholders a performance fee. BKI does not have any borrowings, thus shareholders are not charged any finance costs to service company debt.

Even at the very low end of index funds fees, investors are calling for more. Of the estimated US$730 billion flowing into passive funds in the US in the last year, US$500 billion went into funds charging 0.10% or less, as shown in the chart on the right. This should be causing significant concern for asset managers that are charging high fees and generating index (or sub-index) returns.

The focus on fees is also increasing in Australia. At a presentation we attended recently, a Financial Services CEO made the comment that "Price is King".



What are the big asset managers doing about these trends?

The majority of large asset managers have baulked at launching ETFs because of the revenue slippage compared to traditional investment vehicles. On average, for every $1 billion in assets, Australian ETFs bring in $2.4 million for issuers (0.24% average fee). With that same $1 billion it would generate almost $7 million in fees in an active mutual fund (0.70%) and $18 million in a hedge fund (1.80%). US Index funds are a lower rate again, at an average fee of 0.11%.

To date, the pain for traditional mutual funds has been postponed due to buoyant equity market conditions. As a group, US active mutual funds have seen outflows almost every month in recent years, yet their total assets have gone up. There has been a similar phenomenon for a number of Australian Fund Managers. However, if the market reverses, asset level declines could be exacerbated by outflows.

What are the critics of ETFs saying?

The significant trend towards passive asset management is destroying the economics for the businesses of many traditional active asset managers. As a result, this has created tension, with many of the harshest critics of ETFs being underperforming managers with shrinking asset bases. Before we look at some of the concerns being voiced, it is important to define some characteristics of exchange-traded funds.

- The RBA Bulletin referred to ETF's as "investment funds that are traded on an exchange and typically track a specified benchmark index. Most commonly, these benchmark indices are equity indices."
- Units in an ETF are created by an entity known as an ETF issuer. The funds are open-ended, which means that units can be issued or redeemed at any time. ETFs are also required to have a primary market maker, who is obliged to show quotes for buying and selling units in the ETF that fall within a narrow range of the Net Asset Value. This issue of units and existence of a market maker is different in a closed-end fund such as BKI where there is a specific number of shares on issue. A buyer of BKI shares needs to find a seller on market. The only way that BKI (the Company) can issue new shares is through a corporate action event such as a dividend reinvestment plan, a share purchase plan, a placement or an entitlement offer.
- The RBA Bulletin goes on to discuss a few concerns and potential risks that have been raised about ETFs. It notes that "these concerns have generally been focused on: liquidity risk; counterparty and collateral risk that are typically associated with synthetic ETFs; as well as complexity of alternative ETF structures. Liquidity in the ETF market could decrease in times of market stress, particularly if market makers and/or Authorised Participants withdraw from the market."

The Synthetic ETF products concern us more so than the traditional ETF products and we've seen the Synthetic ETFs come under more scrutiny in recent months. The RBA notes that "Synthetic ETFs rely on a counterparty paying the return of the ETF without holding the benchmark, so there is some risk that the counterparty could default or not be able to pay the return (if they have not sufficiently replicated the return of the benchmark)."

Peter Warnes, Morningstar's head of equity research, is particularly cautious of the rise of synthetic ETFs. In a July 2017 article, he noted:

> *"I get apprehensive, even anxious, when I hear or see the word 'synthetic' used in the financial and investment world. I recall synthetic collaterised debt obligations among other synthetic or rocket science-engineered derivatives causing major grief in the aftermath of the GFC."* Warnes' views do not extend to all ETFs, but those where synthetics give rise to a *"potential counter-party risk, as the ETF is not matched with the underlying assets or benchmark."*

Jim Cramer, the colourful host of CNBC's Mad Money, recently made the case against investing in ETFs. While he noted that spreading risk by owning a diversified portfolio of stocks can be smart, it is not smart if it is spread over good and bad stocks.

> *"I don't want to own all the stocks, I just want to own the best ones".*

Matt Kadnar and James Montier of GMO (a Boston based asset management firm with FUM of approximately US$80 billion) recently released a White Paper titled "The S&P 500: Just Say No". They wrote:

> *The decision to be passive is still an active decision – and we would suggest one with important risks that investors are not paying adequate attention to today. As more and more investors turn to passively-managed mandates, the opportunity set for active management increases. A decision to allocate to a passive S&P 500 index is to say that you are ignoring what we believe is the most important determination of long-term returns: valuation. At this point, you are no longer entitled to refer to yourself as an investor. You may call yourself a speculator, but not an investor. Going passive eliminates the ability of an active investor to underweight the most egregiously overpriced securities in the index.*

Howard Marks, of Oaktree Capital, covered a number of issues in a recent Memo titled "Yet Again?" On Passive Investing, he wrote:

> *Passive investing is done in vehicles that make no judgements about the soundness of companies and the fairness of prices. More than $1 billion is flowing daily to "passive managers" (there's an oxymoron for you) who buy regardless of price. I've always viewed index funds as "freeloaders" who make use of the consensus decisions of active investors for free. How comfortable can investors be these days, now that fewer and fewer active decisions are being made?*
> *I'm not saying that the passive investing process is faulty, just that it deserves more scrutiny than it is getting today.*

Alan Kohler, publisher of The Constant Investor, has been one of the most vocal critics domestically. In an article published in The Australian in early September, Kohler argued that there are two inherent problems with ETFs:

> *"They are a bad way for a person to invest, since you are effectively choosing companies according to size rather than quality, and in many cases, the larger they are, the worse they are. They are now being overused, to the point where the stock market is becoming a Ponzi scheme, supporting itself through fund flows that are just going into the "market" rather than choosing individual companies."*

The ETF and LIC comparison

While we recognise that there are some concerns about ETFs, there are some obvious benefits for investors. As the RBA Bulletin notes:

"There are several aspects of ETFs that make them attractive to investors, particularly retail investors. They provide:

1. *Low management fees*
2. *A cost-effective means of diversifying portfolios using a single product*
3. *The ability to trade throughout the day*
4. *Transparency of the fund's holdings."*

We argue that a Listed Investment Company such as BKI does all these things. And more.

BKI also offers investors:

5. A growing stream of fully franked dividends
6. The ability to pay out fully franked special dividends
7. Closed pool of capital enables the Investment Committee to focus on investment fundamentals rather than worry about inflows or outflows
8. Strong corporate governance that protects shareholders welfare
9. Active management that aims at enhancing returns to shareholders
10. Alignment of the BKI Board and Investment Managers - we are also shareholders in BKI

Active management is something we believe in wholeheartedly. We also believe in keeping costs low, highlighted by Contact's Investment Management fee of only 0.10%. The BKI Investment Committee has 190 years of collective industry experience (average of 27 years) and has enough grey hairs to recognise attractive opportunities when they arise, regardless of what a stock's index weight is. We take an active approach and constantly assess the market and decide if there is a buying (or selling) opportunity. We believe this is the most effective way to create long-term wealth for shareholders.

We remain focused on keeping BKI debt-free, which differs from some of our LIC peers. We know that leverage, when combined with stock market volatility, equals dynamite. Thus, we keep BKI far away from it. Also, we are cognisant of the finance costs that some of our LIC peers pay away each year, most of which are not included in their MER calculations, despite being a legitimate cost of running the Company.

Our goal is simple - we aim to generate sustainable, long-term returns (via capital growth and dividends) via sensible active investment management. At a very low cost. We are shareholders alongside you. As a result, for the investment universe targeted by BKI, the Board and Investment Managers have invested in Listed Investment Companies such as BKI rather than ETFs.

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