December 2018

BKI INVESTMENT COMPANY

ABN: 89 615 320 262

BKI INVESTMENT COMPANY LIMITED

QUARTERLY REPORT

The Yield Curve and the BKI Portfolio

Of late, much of the global markets commentary is dominated by interest rates and more specifically, the yield curve. For many, discussions around bonds and yield curves can be confusing – partly due to conflicting statements about the relevance of the metric in predicting future market moves. As with many economic indicators, there are lots of theories and no shortage of factors.

In this report, we aim to simplify the discussion and address some of the questions that we receive on the topic in relation to the BKI Portfolio.

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BKI Quarterly Report

Welcome to the 21st edition of the BKI Quarterly Report, prepared by Contact Asset Management. As we approach the end of the year, we wish you and your families a safe and happy Christmas. Thank you for your continued support.

Of late, much of the global markets commentary is dominated by interest rates and more specifically, the yield curve. Consider that in November, Google searches for “What is a Yield Curve inversion?” increased by 3,450% over the same period a year previously! For many, discussions around bonds and yield curves can be confusing – partly due to conflicting statements about the relevance of the metric in predicting future market moves. As with many economic indicators, there are lots of theories and no shortage of factors.

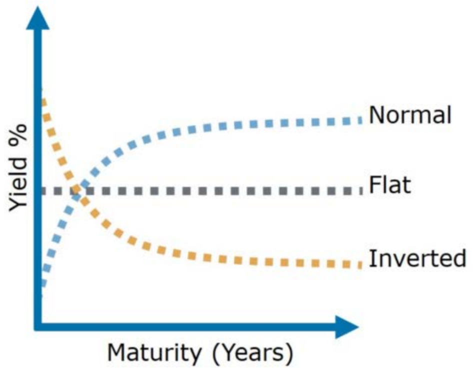
In this report, we aim to simplify the discussion and address some of the questions that we receive on the topic in relation to the BKI Portfolio.

What is the yield curve (in simple terms)?

A yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality but differing maturity dates. The most frequently reported yield curve compares the three-month, two-year, five-year, 10-year and 30-year U.S. Treasury debt.

The yield curve has historically reflected the market’s sense of the economy, particularly about inflation. Investors who think inflation will increase will demand higher yields to offset its effect.

Broadly speaking, there are three types of yield curves:



- A **normal yield curve** is one in which longer maturity bonds have a higher yield compared with shorter-term bonds due to the risks associated with time. A normal yield curve is the most common and generally reflects a stable and expanding economy. The relative steepness of a normal yield curve can provide clues about the current and expected pace of economic activity. For example, a comparatively steeper normal yield curve can reflect accelerating rates of economic growth while a less steep normal yield curve can reflect a slowing pace of economic expansion.
- In a **flat yield curve**, the shorter- and longer-term yields are very close to each other, which is also a predictor of an economic transition. In general, a flat yield curve often reflects uncertain or deteriorating economic conditions.
- An **inverted yield curve** is one in which the shorter-term yields are higher than the longer-term yields, which can be a sign of upcoming recession. Under such circumstance, investors may accept lower long-term yields because they believe economic conditions may deteriorate further and that short-term yields may be lowered to stimulate economic activity.

Why are people talking about yield curves so much lately?

In early December, the two to five year bond yield gap turned negative for the first time in over a decade. Many economists and traders believe that an inversion traditionally signals that something is wrong in the market.

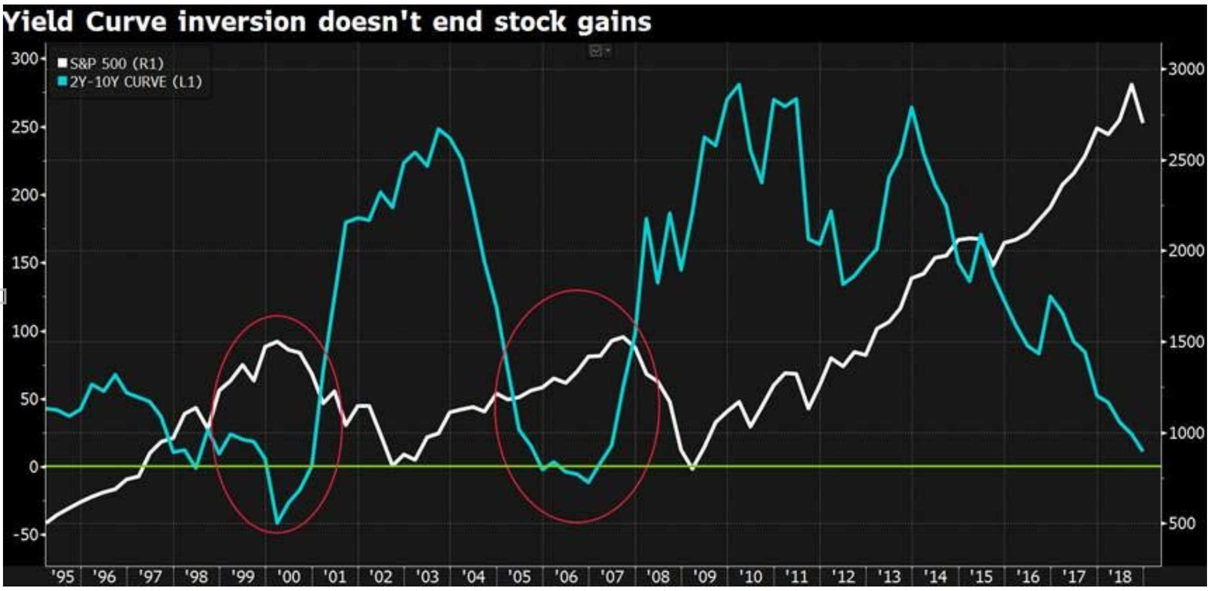
However, there are a few opposing schools of thought. The Chief Global Strategist at JP Morgan Asset Management, David Kelly, noted recently that the curve was distorted because central banks, since the financial crisis of 2008, have pumped cash into the economy by buying bonds. That has pushed up the price of long-term bonds, lowering their yield. Kelly believes that because those quantitative easing programs are structurally built-in to the bond market right now, and because central banks don't play around in the market like investors, the long-term bond market is a bad signal for anything.

Kelly said, *"We're going to need a better measure of what's going on than the yield curve."* This is probably a fair comment as there are other areas of uncertainty: Chinese growth, Trump's trade wars, unrest in France and Brexit to name a few.

While it is true that a recession is often led by an inverted yield curve, there is a lag between when that happens and when a recession starts (the chart from Bloomberg below is illustrative). Also, it is important to remember that an inverted yield curve hasn't led to a recession 100% of the time.

Source: Bloomberg, Market Matters. The red shaded area indicates a recession.

And looking at the S&P 500 relative to the yield curve is also less alarming than can often be portrayed. Generally stocks continue to rise after yield curve inversion.



Source: Bloomberg, Market Matters

We are not suggesting that "*this time it's different*". We are fully cognisant that these are four of the most dangerous words in investing. However, we caution against turning too negative too soon. We remain believers in the old adage that "time in the market beats timing the market".

What does this mean for the BKI Portfolio and our "bond proxies"?

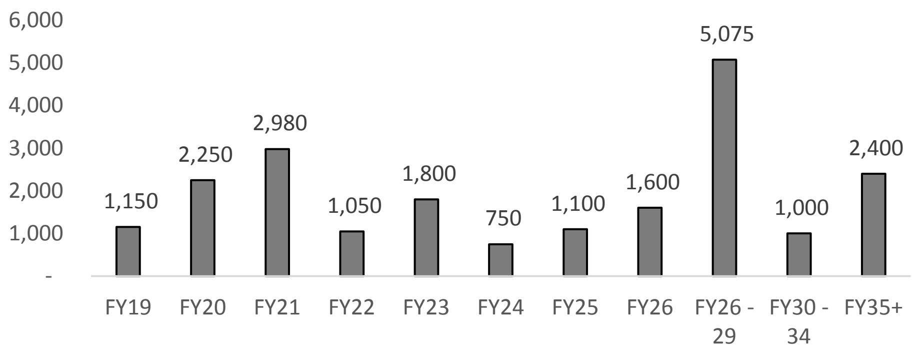
Typically, when the US yields rise, global yields tend to also rise. As such, we saw a large number of economic commentators banging the table over the last 12 months saying that Australian bond yields will move higher, even with the cash rate in Australia likely to stay at 1.5% until the end of 2019.

This train of thought has led the broader market to believe that the local bond yield will rise, leading to an increase in debt costs for Australian corporates. This situation has emerged a few times over the years, and on the back of it, we have received numerous questions on the outlook for long-term interest rates. Specifically, investors have asked what that means for BKI's investments in some of the "bond proxies", notably APA Group (APA), Sydney Airport (SYD) and Transurban (TCL).

While we recognise the importance of interest rates on the valuations of businesses, we have witnessed on several occasions the market being overly pessimistic on the impact of rising rates on the bond proxies. Stocks with large levels of headline debt such as TCL, APA and SYD get caught up in this scenario every time this occurs. These three companies in particular are better than that. They fix long dated debt out 10-20 years at levels well within their scope of payback.

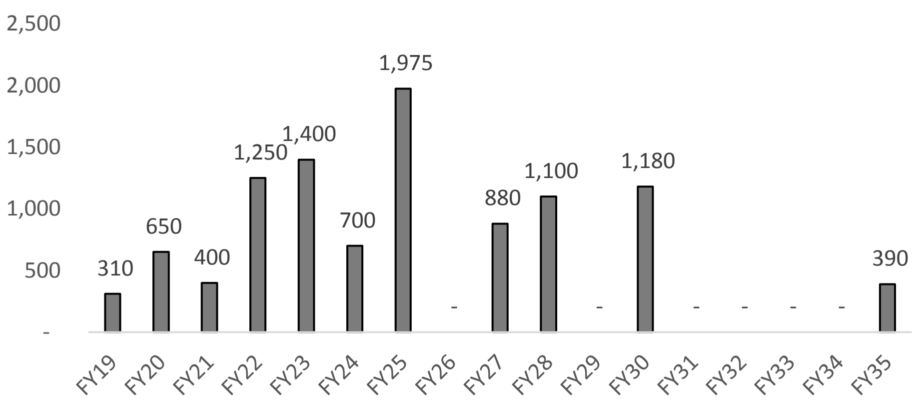
For example, Transurban recently announced that their Westlink M7 project has priced AUD$345m fixed rate 12-year, AUD$195m fixed rate 15-year and AUD$75m fixed rate 20-year senior secured notes in the US private placement market. The majority of this raising will be used to fully repay all of M7's remaining term bank debt, which is due to mature in August 2019 and August 2021.

The chart below, taken from the Transurban 1H18 Results Presentation in February 2018, shows TCL's group debt maturity profile as at December 2017. TCL's weighted average maturity of their debt is 9.3years, with an average weighted average cost of debt in Australian Dollar terms of 4.9%.



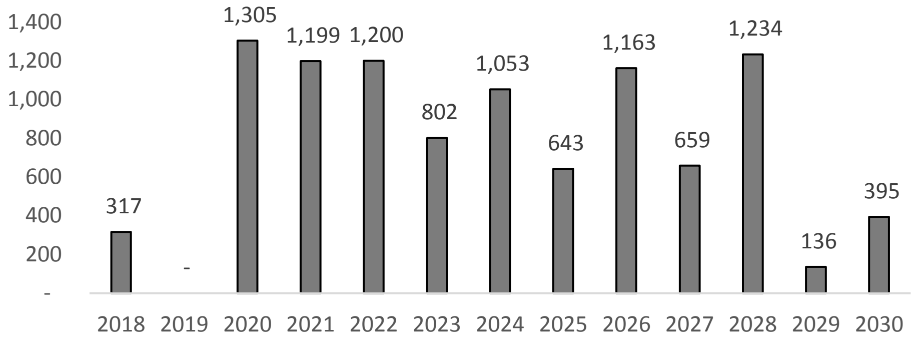
Source: TCL Results Presentation, Contact Asset Management

The chart below, taken from the APA FY2018 Results Presentation in August 2018, shows APA's debt maturity profile as at 2 July 2018. APA's weighted average maturity of their debt is 6.9years, with an average weighted average cost of debt in Australian Dollar terms of 5.7%.



Source: APA Results Presentation, Contact Asset Management

The chart below, taken from the SYD 1H2018 Financial Results Presentation in August 2018, shows SYD's debt maturity profile as at 30 June 2018. SYD's average maturity of their debt is mid-2024, with an average weighted average cost of debt in Australian Dollar terms of 4.8%.



Source: SYD Results Presentation, Contact Asset Management

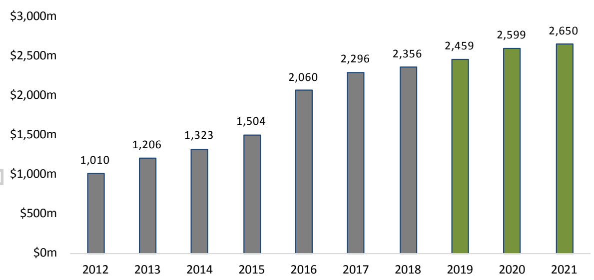
We have remained positive on the long-term investment case for all three companies, right through the yield curve cycle, and each time such an event occurs it has presented an attractive buying opportunity.

> *"Securities prices rise and fall much more than profit, introducing considerable investment risk. Why is that so? Primarily, I think, because of the dramatic ups and downs in investor psychology"* Howard Marks

To ensure the debt profile is stable and can be serviced, we ensure the core business is sound. APA, SYD and TCL all boast resilient revenues, capable management teams, growing distributions and yield. If the slowdown scenario does play out, as the inverted yield curve might suggest, we expect these core infrastructure stocks will outperform the broader market. The resilient revenues point is an important and often overlooked one. Transurban is a very good example. Periods of increasing long bond rates are generally tied to periods of inflation. As a toll road operator, Transurban has CPI escalators tied in to its tolling contracts. Simply put, if inflation increases, so does toll revenue. Further, there are many of the Transurban tolls that cannot be lowered as a result of deflation.

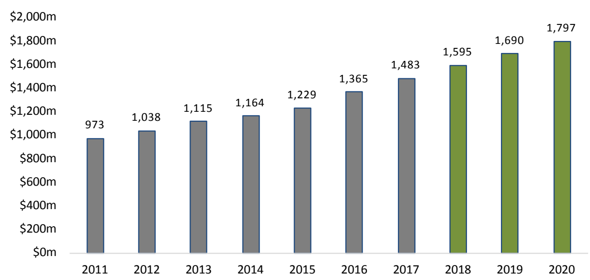
Similarly with Sydney Airport and APA Group, the resilient revenues should be maintained. In its Master Plan 2039, Sydney Airport expects international travelers passing through its terminals to double over the next two decades and underpin an expected 50% increase in passenger numbers (from 43.3 million in 2017 to 65.6 million in 2039). In our opinion, Sydney Airport is an attractive way to invest in the growth in Australian tourism.

APA Consensus Revenue Expectations



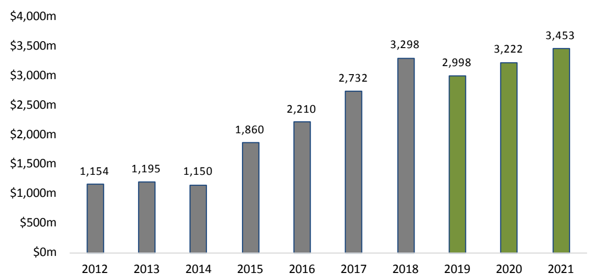
Source – Bloomberg, Contact Asset Management

SYD Consensus Revenue Expectations



Source – Bloomberg, Contact Asset Management

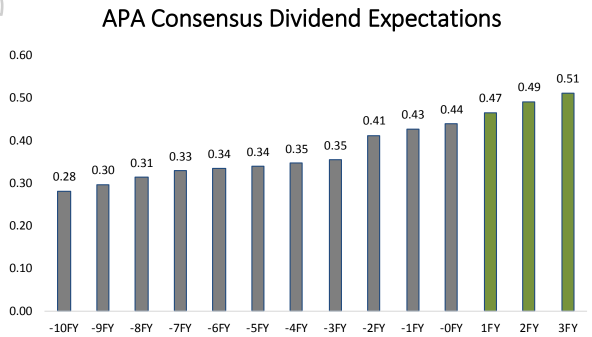
TCL Consensus Revenue Expectations



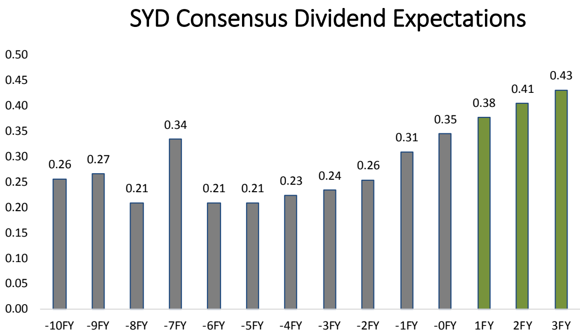
Source – Bloomberg, Contact Asset Management

In addition, while they are not monopolies in the true definition of the word, they are close. We believe that owning monopolies is a good strategy – competition is bad for the investor!

As time goes on, we have learned that our best approach is to buy high quality businesses and hold onto them. If an opportunity arises for us to buy more at attractive prices, then that's what we do. This has been our experience with APA, Sydney Airport and Transurban in recent years – BKI has consistently (yet selectively) increased our holdings in these companies.



Source – Bloomberg, Contact Asset Management



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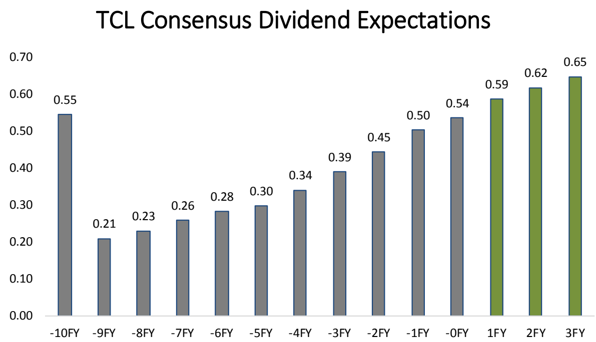

Source – Bloomberg, Contact Asset Management

The issue of owning quality businesses is an important one. Below, we lean on the words of others to articulate our similar thoughts:

"At the end of the day, in order to build wealth, there is a simple approach which we have followed for 17 years: investing for the long term in high-quality companies purchased at attractive valuations—investing in companies that will survive the crises of our civilization and the short-term irrational behaviour of our economic system." Francois Rochon, Giverny Capital

"What makes a good business model? It primarily rests on structural competitive advantages, those inherent features that prevent rivals from entering a company's business and/or competing effectively with it. Common examples would be natural monopolies or oligopolies, enduring brands, network effects, high switching costs and economies of scale. Perfect business models don't exist, but many come close to varying degrees." Frank Martin, Martin Capital

"We think a rigorous discipline of buying quality companies, when priced right and run by honest, intelligent management teams, offers the best defense against challenging macro conditions" Allan Mecham, Arlington Value Capital

"More recently, our equity investment framework has drawn us to larger market capitalizations and we have learned to "pay up" for certain higher-quality companies with market-dominating positions." Dan Loeb, Third Point

A few final thoughts as we head into 2019

There are a number of interesting dynamics dominating our conversations as we look forward to 2019. As discussed above, there are headwinds emerging. That is expected. The global economy has enjoyed a sustained period of above average growth. The issues at the front of mind for most investors is rising rates, the ongoing US-China trade war and Brexit.

Domestically, the focus is on the high prospect of a new Federal Government, tighter credit conditions and the impact of house price declines.

Yet, these macro conditions are out of our control and it is easy to get caught up in the negative. We expect there will be several periods of opportunity for long-term investors in the year ahead and that patience will pay off.

We believe that the BKI portfolio is well placed as we head into 2019. We have a healthy level of cash, which is now close to 10% of the portfolio. The recent de-rating of the market has created more opportunities for BKI. We own forty-eight companies in the portfolio with a range of sector exposures. We will continue our objective to buy high quality businesses and hold on. Our aim is to maintain a portfolio that is durable to withstand most market risks.

Sources used: Business Insider, Bloomberg, Investopedia, Masters Invest

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