December 2014

BKI INVESTMENT COMPANY LIMITED

BKI Quarterly Report

Stay the Course - Investing for the Long-Term

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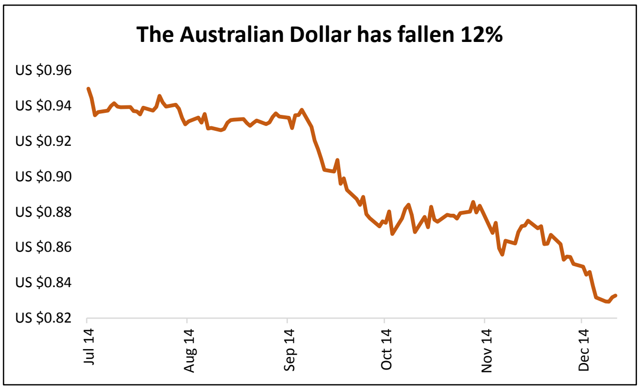
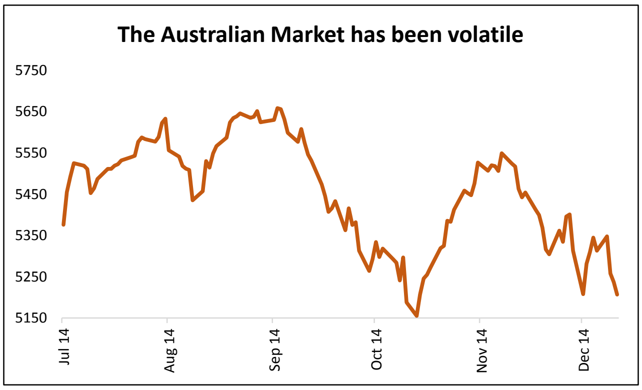
- ◊ Patience Pays Off. Why we like investing for the Long-Term
- ◊ Low fees do matter. Why excitement and expenses are an investors enemy.

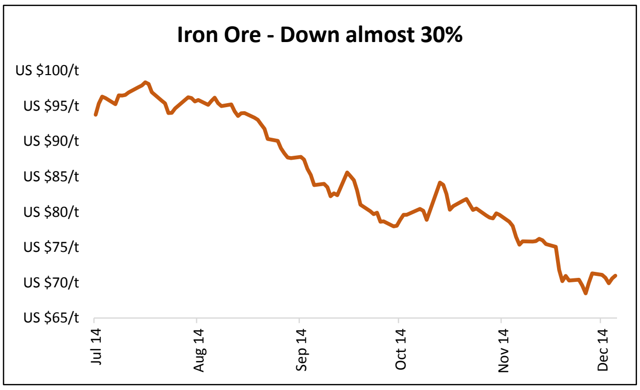
Welcome to the fifth issue of the BKI Quarterly Report. On behalf of all of us here at BKI, we wish you and your family a happy and safe Christmas. We also hope that the information provided in this edition on low cost, long term investing will make for some additional Christmas cheer. Thank you for your ongoing support. Regards, Tom and Will.

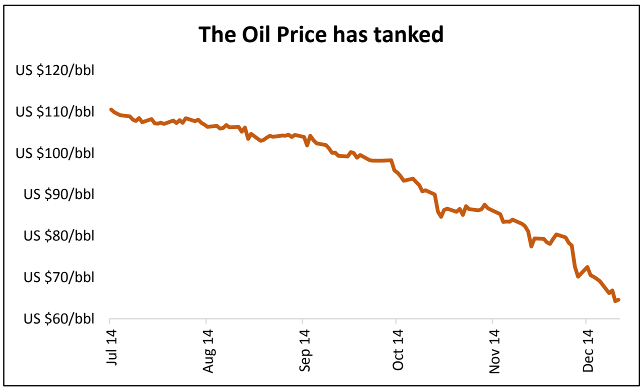
Much ado about nothing? Financial Journalists and market spruikers have been calling both a market boom and a market bubble in 2014, depending on how they feel on a particular day. The reality is that history will most likely class 2014 as a "lacklustre year". The market (as measured by the ASX All Ordinaries Index) has been as low as 5184 points in February and as high as 5640 in August. But despite all this, the market has only moved by 0.5% since the start of January 2014.

It is easy to get caught up in the hysteria of market commentators. The following (very short-term) charts paint a picture of a very volatile world. However, Tom and I believe that a vision for the long term must serve as a guide for action today. Those that keep their focus during trying times are far more likely to emerge as successful investors over the longer term.









Stay the Course - Investing for the Long term

Understandably, a number of our shareholders have expressed anxiety on the direction of the Australian equities market. We urge our shareholders to hold steady during any short-term market gyrations. Don't get caught up in short term macroeconomic issues but stay focused on owning high quality businesses. If the underlying company itself is doing well and is managed by competent and honest people, then the stock price will take care of itself.

Tom and I unashamedly quote Warren Buffett quite a lot in our communications with BKI shareholders. He notes that "You pay a very high price in the stock market for a cheery consensus. Uncertainty is the friend of the long-term value buyer."

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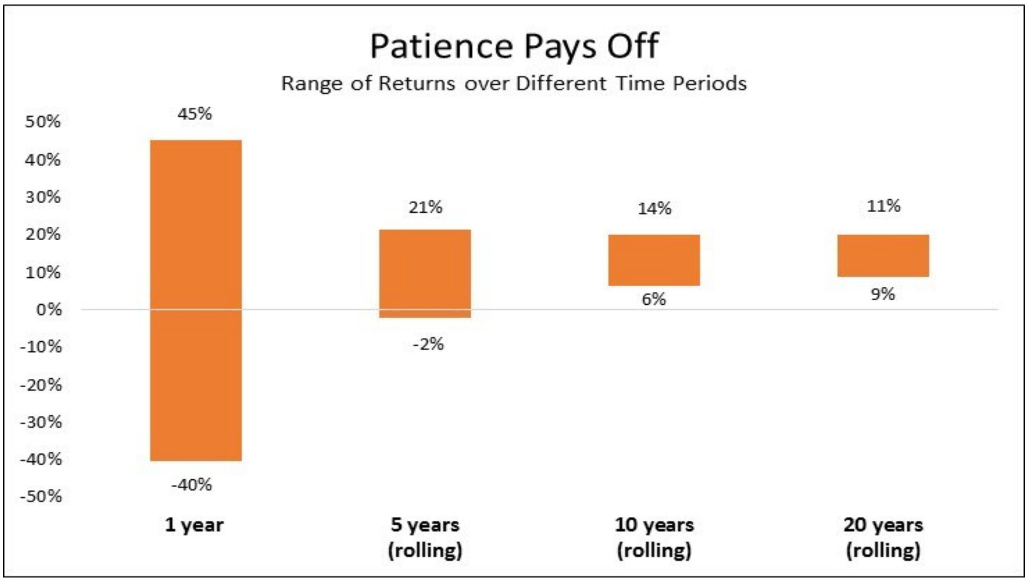
Uncertainty is the friend of the long-term value buyer.

Warren Buffett

Patience Pays Off

The chart below is a powerful illustration on the benefits of long-term investing. We have analysed the ASX All Ordinaries Index over the last 30 years. As you can see in the orange bar to the left, the stock market gave as much as 45% and took away as much as 40% in any given year.



For an investor with a minimum 5-year investment period, an investment in the index would have done no worse than -2% on an annualised basis while offering a return of up to 21%.

If you extend the period to 20 years, you'll see the worst you would have done is +9% annualised while getting +11% annualised in the best case.

The average annual return of the ASX All Ordinaries Index over the last 20 years has been 10.7% p.a. An investment of $100,000 twenty years ago would be worth $763,752 today. Such is the power of patience and compounding returns. Warren Buffett's biography The Snowball notes "Buffett had indeed learned through experience that "when in doubt keep holding" he said. "I've made most of my money sitting on my ass".

Keep in mind that the returns in the above chart are based on an index portfolio. At BKI, we believe that these returns should be enhanced through a focus on bottom-up stock selection of well managed companies, with a profitable history that offer a growing dividend stream.

Assuming history repeats, the longer your holding period, the more predictable and typical your annualised returns become.

Unless investors believe that there is a high probability that they will need to liquidate their savings over the next 5 – 10 years to maintain their living standard, history has shown that there is no compelling reason for long-term investors to abandon stocks no matter how high the market may seem.

Jeremy Siegel, author of Stocks for the Long Run makes the following point:

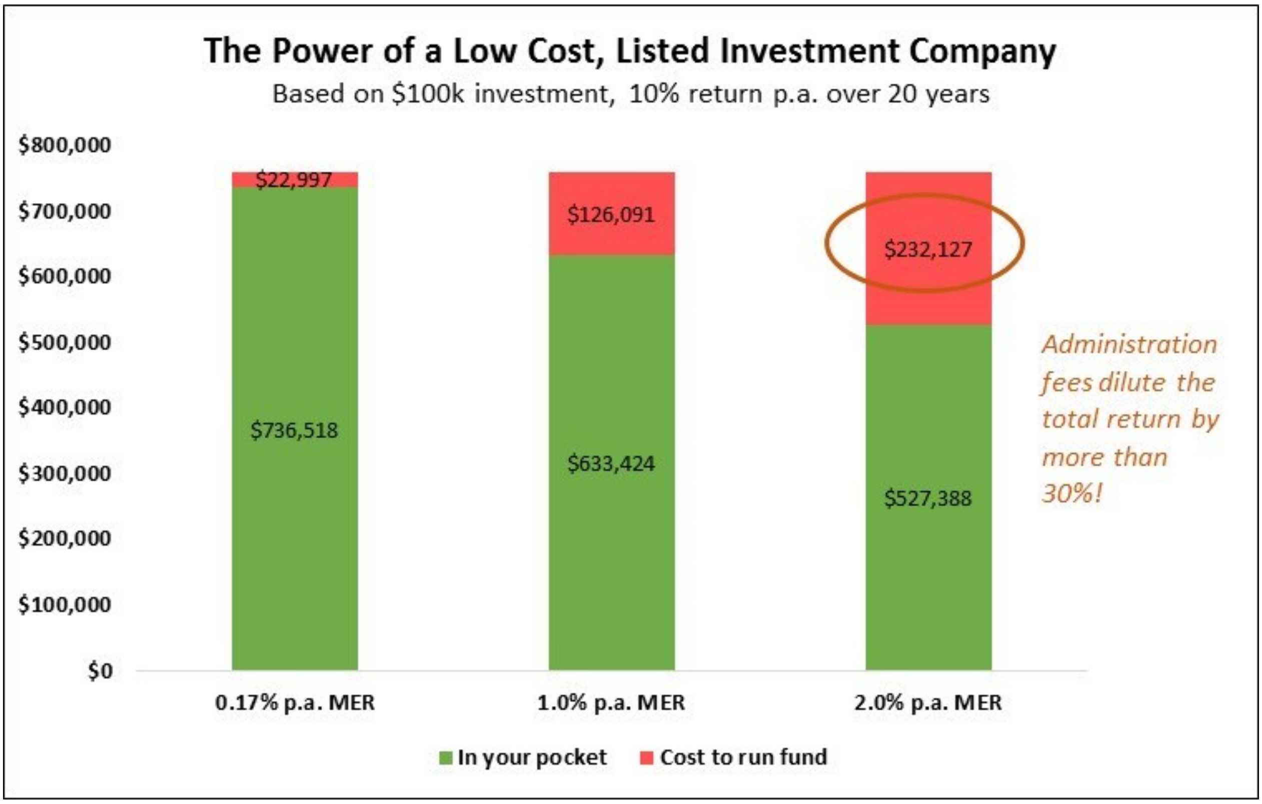
"To be a successful long-term investor is easy in principle but difficult in practice. It is easy in principle because buying and holding a diversified portfolio of stocks, forgoing any forecasting ability, is available to all investors, no matter what their intelligence, judgement or financial status. Yet it is difficult in practice because we are all vulnerable to emotional forces that can lead us astray. Tales of those who have quickly achieved great wealth in the market tempt us to play a game very different from that of the long-term investor."

Excitement and Expenses are Your Enemies

BKI Investment Company is ruthless on costs. Our Management Expense Ratio or MER (the total expenses of the Group expressed as a percentage of the average total assets) is just 0.17%. This compares favourably with our traditional Listed Investment Company peers and is a fraction of the cost that the Australian Managed Funds Industry charges. The Management and Board of BKI are shareholders in the business – we do not charge an external management or performance fee.

A study of 497 managed funds* found the average management cost today to be 1.91% per year- and that's before establishment fees, contribution fees, exit fees, switching fees, buy/sell spreads and performance fees. These high investment fees have persisted despite assets under management growing from under $250m in 1990 to $2.3 trillion in 2014.

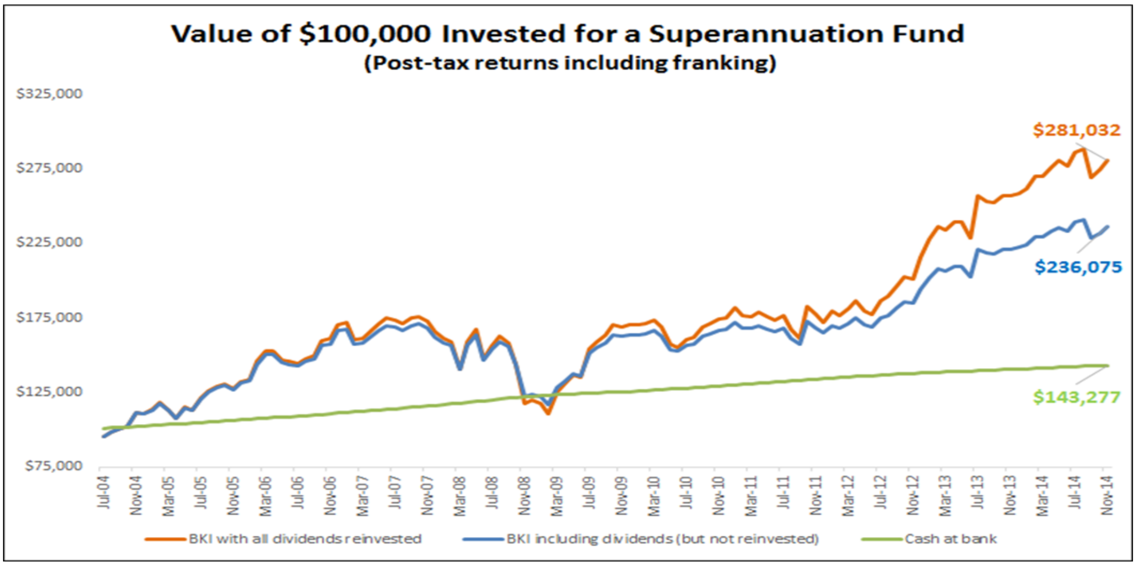
The following chart highlights the damage that excessive fees can do to an Investor's wealth. If we again apply the 10.7% p.a. average annual return of the ASX All Ordinaries Index in the following calculation, one will be staggered to see just how much money is gouged from investors in high fee paying schemes.

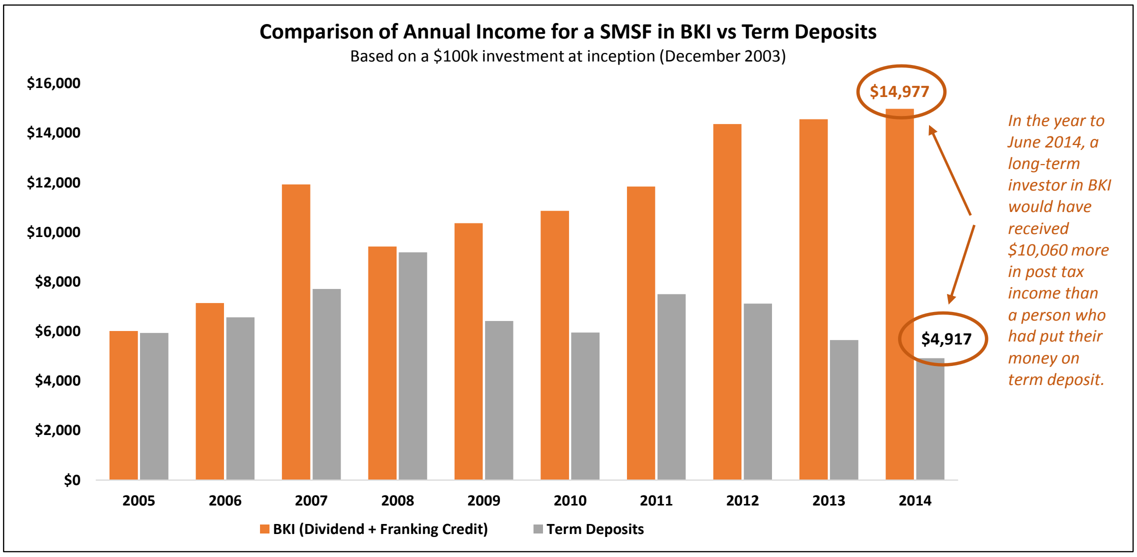


On top of this, BKI takes a disciplined approach to trading. We do not over trade the portfolio—BKI turnover is very low by industry standards. We prefer to hold good quality, well managed, income producing companies for as long as possible. We believe this approach is the best way to generate shareholder wealth.

Investing is not a pursuit where one gets paid for activity. Rather, one gets paid for being right. And, as we highlighted earlier in this article, an investor has more chance of being right if they take a long-term view. However, the reality is that most investors cannot resist the temptation to constantly buy and sell. By doing so, the hyperactive investor increases costs, decreases tax benefits and misses out on the benefits of long term investing.

As Tom and I discussed in one of our early Quarterly Reports, dividends and franking credits are remarkably valuable for a long-term investor. We find the following charts particularly illustrative.





A long-term Self-Managed Super Fund (SMSF) investor that had allocated $100,000 to BKI in December 2003 would have an investment now worth over $280,000 when the benefits of franking credits (based on a company tax rate of 30%) are included. In the last financial year, that investor would have received after tax income (dividends plus the benefit of franking credits) of almost $15,000 on that initial $100,000 investment.

The $15,000 is more than three times more than the SMSF would have received in term deposits. This is the power of compounding returns, discipline and, of such great importance, patience!

Will Culbert (December 2014)

BKI INVESTMENT COMPANY LIMITED

Office Level 2, 160 Pitt Street Mall
Sydney NSW 2000
Telephone +61 2 9210 7000
Fax +61 2 9210 7099
Web www.bkilimited.com.au
ABN 23 106 719 868