December 2015

BKI INVESTMENT COMPANY LIMITED

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BKI Quarterly Report

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The Dividend Aristocrats

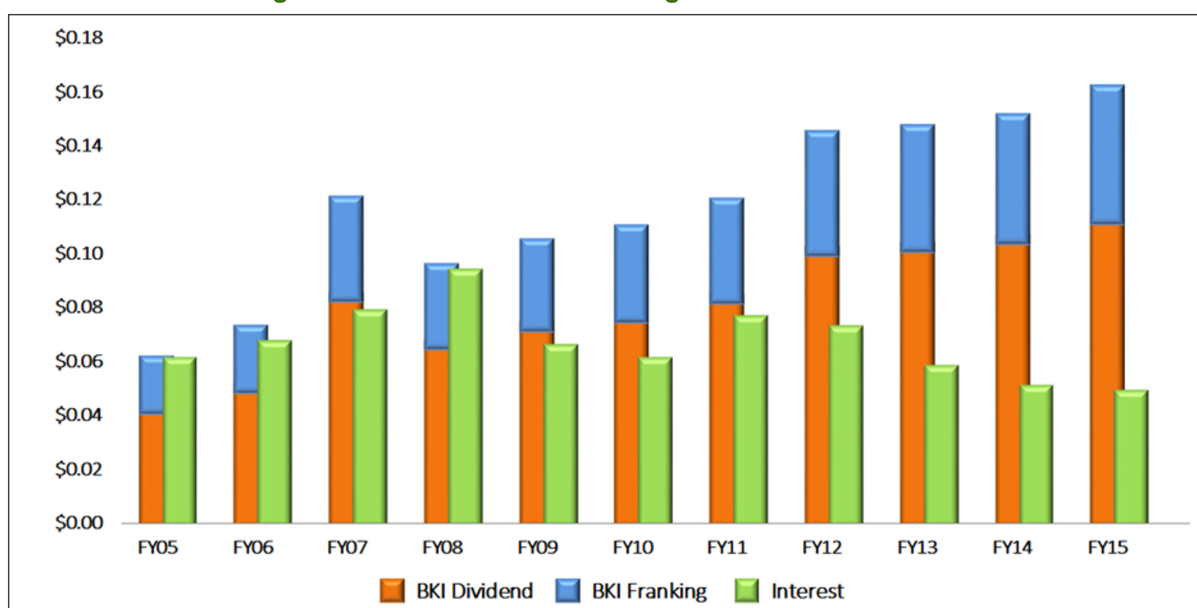
Welcome to the ninth issue of the BKI Quarterly Report. This report, and previous issues, are available on our website at www.bkilimited.com.au. As we approach the end of the year, Tom and I wish you and your families a safe and happy Christmas. Thank you for your ongoing support.

As regular readers are aware, we invest for the long term with an aim to create wealth for BKI shareholders, through an increasing fully franked dividend and capital growth. The goal of providing an increasing dividend stream is very important to us. While we seek investments that offer value and capital appreciation, at BKI we are dividend growth investors more than any other style of investing.

The power of a growing income stream will be the focus of this report. When you purchase shares of a high quality dividend growth stock, you are in a very strong position. A high quality business will compound your investment over time – increasing in value while simultaneously paying ever growing dividends. What more could you wish for?

The chart below is a simplified version of one that we use in all of our presentations. This is at the core of what we are trying to achieve for BKI shareholders. What the graph is telling you is this: if you invested $1 in BKI when the stock listed in 2003 and reinvested the dividends, you would now be receiving 18 cents every year in grossed up dividend income. That's an 18% yield on cost. And hopefully next year that will be closer to 20%. In addition, with all the extra shares from the reinvested dividends, that $1 has grown to $2.80. This has been particularly powerful in a falling interest rate environment where term deposits are low. If you had left your $1 in the bank, your bank balance would be $1.72 and your annual income would be less than 5 cents before you paid tax on it.

BKI: Growing Dividend Income in a Falling Interest Rate Environment



"Dividends may not be the only path for an individual investor's success. But if there's a better one, I have yet to find it."

Josh Peters, author of *The Ultimate Dividend Playbook*

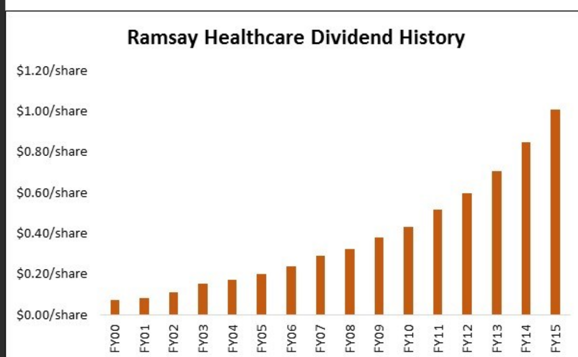
The Dividend Aristocrats

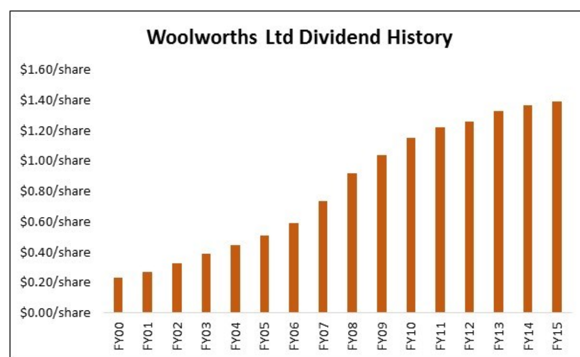
In order for BKI to deliver a growing income stream, we need to invest in quality companies that offer us sustainable and growing dividends. This can be a challenging proposition as very few companies have achieved this over the long-term. Consider the following: there are almost 500 companies in the S&P/ASX All Ordinaries Index. Since the year 2000, only three of them have managed to increase their dividend every year. Only three . . . Ramsay Healthcare Ltd, Woolworths Ltd and Washington H Soul Pattinson and Company Ltd.

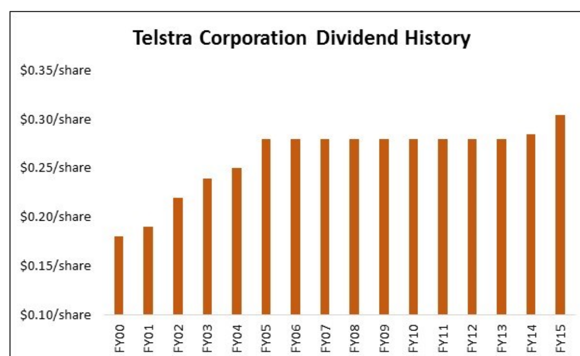
There are another 8 companies that have managed to increase or at least maintain their dividend every year since 2000: ARB Ltd, Blackmores Ltd, Brickworks Ltd, Carindale Property Trust, CSL Ltd, Sonic Healthcare, Seven Group Holdings and Telstra Corporation. Unfortunately, we only own half of them.

Every other stock on the All Ordinaries Index that was listed in 2000 and is still trading today has cut its dividend at some point.

We refer to the companies listed above as the Dividend Aristocrats. The following charts provide a useful illustration of the income growth that a selection of Dividend Aristocrats have generated.







There are a number of companies that have been listed for less than 15 years that have established a strong track record as the next Dividend Aristocrats. We view this as a useful screen for new investment ideas in the BKI portfolio. We will keep these to ourselves for the moment, as we are doing a bit of work on a few of them.

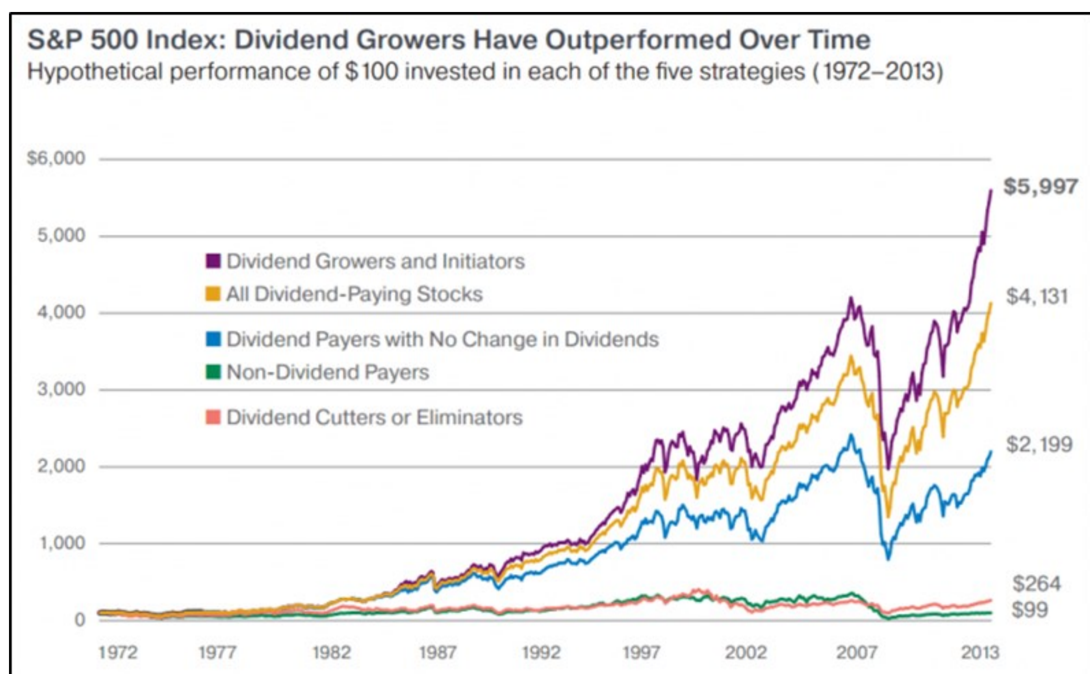
Why do we believe in Dividend Growth Investing?

Lowell Miller, author of The Single Best Investment: Creating Wealth with Dividend Growth wrote the following:

> *The very attention we place on rising dividends puts us squarely in the position of "owners" of a company, of true investors who understand that a satisfying and reasonable return from a stock investment isn't a gift of the market or luck or the consequence of listening to some market maven, but it is the logical and inevitable result of investing in a company that is actually doing well enough, in the real world, to both pay dividends and to increase them on a regular basis.*

US investor Ben Reynolds who has penned a number of articles on investing, writes "Dividend growth investing is a style where one looks for businesses with a high likelihood of rewarding investors with increasing dividend payments". We believe that this style of investing dovetails nicely into the BKI Investment philosophy for a number of reasons:

- A focus on sustainable dividends naturally leads us to the quality businesses. In order to pay a sustainable dividend stream, the company is likely to be generating reasonable earnings or cash flows. Businesses that can raise dividend payments year after year very likely have a competitive advantage.
- This quality tilt helps in volatile markets or recessions. High quality dividend growth stocks have historically performed better than the broader market during downtowns, when investors again focus on the importance of solid earnings and dividends.
- A company that pays consistent dividends must be more selective with growth initiatives, because some of its cash flows are paid out as dividends. This more careful scrutiny over capital allocation decisions most likely adds to shareholder value.
- Our focus on sustainable dividends does mean that we avoid a lot of IPOs. This is not a strict rule but is the case more often than not. It is difficult for BKI to justify investing in a speculative IPO when it doesn't pay any dividends. We are prepared to wait and pay a slightly higher price for a reliable income stream once a company has delivered a few solid results. Stocks are like anything else. You can't buy the best quality at the cheapest price.
- Our focus on sustainable dividends means that we save a lot of time. Forty percent of the stocks in the S&P/ASX All Ordinaries Index failed to pay a dividend in FY15. Unless there is the potential for an income stream, BKI will not invest in it. This approach eliminates a lot of stocks and thus, gives us more time to find better businesses to invest in.
- It works. It should come as no surprise that businesses with strong competitive advantages and long histories of rising dividends tend to do better than mediocre businesses. The following chart from Oppenheimer Funds Management in the US does a wonderful job of illustrating this. Dividend growers have outperformed over time, with less risk.



- Finally, it makes us focus (yet again) on the long term. Dividend growth stocks reward long term investors by increasing dividend payments year after year. The Ramsay Healthcare example is illustrative. A savvy investor could've bought Ramsay Healthcare for $1.00 per share on New Year's Eve 1999. Even if that person did nothing . . . if they didn't even reinvest their dividends, that investor would have collected $1.01 in dividends in 2015 alone and collected $6.15 per share in total dividends over the last 15 years. The investor has been paid back six times over in dividends alone, not to mention the fact that the single $1.00 RHC share is now worth over $65.00.

Philip Fisher, author of the timeless investing book Common Stocks and Uncommon Profits wrote: "If the job has been correctly done when a common stock is purchased, the time to sell it is – almost never". We admit that we harp on about the importance of patience and the long-term a lot, but the Ramsay example also speaks volumes to Fisher's approach. Successful US investor Seth Klarman summed it up well when he said: "*The single greatest edge an investor can have is a long term orientation*."

The first cut is not always the deepest

As we noted above, a high quality business will compound your investment over time – increasing in value while simultaneously paying ever growing dividends. These types of investments are not easy to find. Of the 500 companies within the All Ordinaries today, 232 of them were paying a dividend in 2007. Of those, 132 are paying less in dividends per share today than they were in 2007. And 33 of those are no longer paying a dividend at all.

The decision to cut the dividend is a significant one for Boards and Management. A dividend reduction is often a signal of the Board's declining confidence in future prospects.

Sometimes these events are short-term in nature and may be the result of a one-off or external issue. The number of dividend cuts by financial companies during the GFC is an example. However, under normal business conditions, a dividend cut often signals deeper operational issues or financial stress. And the turnaround often takes longer than expected, if the business manages to turn around at all.

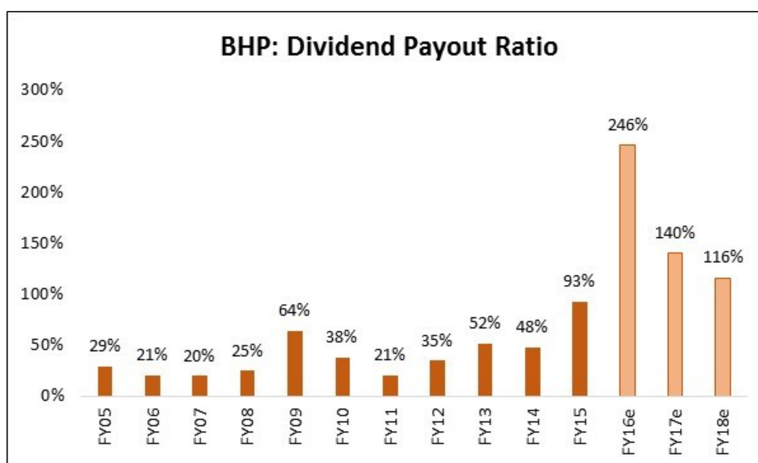
Billabong International Limited provides the horror story of dividend cuts. Billabong listed in 2000 and was a market darling for many years. In mid-2007, an investor at the IPO had turned a $1 investment into almost $7 from capital gain and dividends. The company cut its dividend in late 2008 in the wake of a change in strategy, a failed acquisition binge and excessive debt. The stock had traded lower during the GFC, as all stocks did. However, if an investor sold shortly after the first dividend cut, they would have still walked away happily having made five times their money. The turnaround never turned! The annual dividend income from Billabong International is now zero and the $1 invested in 2000 is now worth $0.25.

Many stocks within the Listed Property Sector also have a chequered history with dividend payments. Tom and I often get asked why we have very little exposure to Property Trusts. The volatility of dividends, as displayed in the following charts of GPT Group and Mirvac, two of the larger companies in the sector, is a significant reason Listed Property companies rarely meet the BKI criteria.

What about the BHP Dividend?

There is a lot of media speculation and market attention on whether or not BHP will abandon its "progressive" dividend policy. Given the context of this report, we think it appropriate to provide our view on the matter. In short, we expect that BHP will abandon its progressive dividend policy and be forced to cut the dividend. As the chart below shows, and based on consensus expectations, BHP would have to payout almost 250% of its earnings to maintain its progressive dividend policy.

The payout ratio is an important measure and one we focus on. If a business is paying out all of its income as dividends, it has no margin of safety. When a business downturn occurs, the dividend must be reduced.



Recent comments by BHP management were reinforced at the Annual General Meeting. BHP will allocate capital toward high returning growth projects and maintain a strong balance sheet ahead of maintaining the progressive dividend policy.

We have reduced our exposure to BHP in recent months. While we recognise that BHP is starting to offer valuation appeal, if BKI has an investment decision where it is a close call between value and income, then income wins. We are concerned about a material reduction in the BHP dividend and we believe we are better served by investing our money elsewhere.

Final thoughts

Dividend income is a very important way to build wealth and one has to be vigilant about the sustainability of that income. At BKI, we seek to invest in high quality dividend growth stocks for the long-run. We believe that high quality dividend growth stocks with strong competitive advantages offer us the best available mix of current income, growth, and stability as compared to other investment strategies and styles.

We are very wary of companies that change their dividend policy for the worse.

We do not dispute that there are exceptions. A lot of companies cut their dividends in the GFC and have been increasing them ever since (the 4 Major Banks are prime examples). We do not recommend a mindless approach that if a company is set to reduce its dividend, then sell indiscriminately. However, a dividend cut is a call to action to revisit the fundamentals of the company. Is the balance sheet at risk? Is management changing strategy? Are the competitive dynamics of the industry changing? If a stock you own reduces its dividend, it is paying you less over time instead of more. This is the opposite of what should happen. In some cases, you need to admit the business has lost its competitive advantage and reinvest into a more stable business.

This is the approach that BKI management takes in looking after your Company. We understand the wealth creation effects of a growing income stream. We have a robust approach that looks at a number of investment fundamentals when deciding to buy, hold or sell a stock. We look at the business, the industry, the financials, the people running it and what we deem to be an appropriate valuation. And, at the core of this, we look at the dividend income and the sustainability of that income. We believe that this is the best approach to create long term wealth for shareholders.

Will Culbert (December 2015)

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