Miller CAPITAL

Investment Advisor

CONVERSATIONS ON INVESTMENT MANAGEMENT

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CONTENTS

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"MEDICAL SCIENCE HASN'T COME UP WITH A PILL SPECIFICALLY FOR 'STOCK MARKET JITTERS.'"

Fear spreads far faster than confidence. To instill confidence in a large group of people takes time and usually requires persuasion.

It's much the same way in the investment markets. Fear spreads quickly but building market confidence is a gradual process. From 2009 to 2013, confidence in the stock markets was difficult to find. It took many investors until late 2013 to begin reinvesting in stocks. This process began only after the U.S. stock market provided very large returns.

This summer, fear returned to global stock markets. Selling prompted more selling until fear ran rampant. Similar episodes occurred in Spring 2010, Fall 2010, and Summer 2011.

As shown in the cartoon, there's no magic pill for stock market jitters. Investors need a long-term investment plan that matches their financial and emotional ability to handle a volatile market. Education is critically important in developing a proper investment plan. We hope you find the articles inside of interest. Please feel welcome to contact us by phone or email [info@millercapital.com] if we can be of assistance.

INVESTMENT MARKETS – FACTS AND FIGURES

- The current dividend yield for the S&P 500 Index is 2.3% compared to 1.1% in March 2000 and the 25 year average of 2.1%.
- The current ten year U.S. Treasury Bond yield is 2.1% compared to 6.2% in March 2000.
- Today, the U.S. Dollar is 32% higher than four years ago and 18% higher than one year ago [using the U.S. Dollar Index compared to major developed country currencies].
- 48% of revenues for companies in the S&P 500 Index come from outside the U.S.

Benefits of Individual Stocks in Taxable Investment Portfolios

The effectiveness of a portfolio is not just about performance. The ability to achieve personal, family, and business goals is the true measure of portfolio effectiveness. While we use traditional stock mutual funds and low-cost, tax-efficient stock index funds for clients, individual stocks also provide valuable options in achieving a variety of client goals. This is especially true for clients in higher tax brackets with taxable portfolios. Here are a few advantages of individual stocks in meeting client goals:

ADVANTAGE #1: TAX-EFFICIENT ACCESS TO LIQUIDITY. Consider the hypothetical client that invests $1 Million in an S&P 500 Index fund that is now worth $2 Million. Sometime later, that client needs $250,000 for a business opportunity, such as buying a new piece of real estate, or perhaps a family member needs an emergency loan. Hopefully, the client has adequate cash or liquid fixed income investments that can be sold to raise the necessary cash, but perhaps not. Alternatively, the client may need to reduce equities and risk while funding the business opportunity or family need. In the case of selling the appreciated index fund, the 100% gain cannot be avoided upon sale.

Consider the flexibility that can exist with individual stocks as part of the portfolio, rather than all stock index funds. With the individual stocks, it is likely that some stocks have appreciated well above average and some have performed below average or even have losses. The $250,000 of liquidity can be raised by selling stocks that have less gain, substantially lowering the tax liability to fund the opportunity or need. For this reason, some very wealthy families create their own index funds by purchasing individual stocks rather than an index fund. Having the ability to control taxes in the sales decision can save a large amount in taxes.

Because many clients are still active in their existing business, or are open to new business opportunities, or have many family needs among their children and grandchildren, we’ve seen this advantage benefit several clients. These situations can be critically important within a family and highlight how lives can be enriched through investments. Individual securities can offer tremendous liquidity and tax advantages at such key moments.

ADVANTAGE #2: FLEXIBLE CHARITABLE AND FAMILY ESTATE PLANNING. Clients that would like to make gifts to a charity or to family members, either outright or in a trust, have more flexibility using individual stocks with varying cost basis than they do using index funds with an average or single lot cost basis. While cash and bonds can be gifted, stock gifts are often preferred with various supporting rational:

- Elderly clients may prefer to gift higher cost basis stocks to family members to preserve the step up in cost basis at death that applies to low cost basis stocks.
- Clients may prefer to gift low cost basis stocks to charity [outright or to charitable remainder trusts] and preserve higher cost basis stocks that can be sold later, if necessary, at a lower gain.
- Clients that openly discuss and coordinate gifts with their children and grandchildren might find in some years that the gift recipients need cash. As a result, gifts of high basis stock that can be sold with less tax might be more beneficial to the gift recipients.
- More sophisticated family gifts and estate planning may also benefit from the flexibility of a mix of stocks with varying degrees of cost basis, dividend income, and other characteristics, rather than being limited to stock index funds.

We have seen these scenarios plays out for many clients.

ADVANTAGE #3: LIMITING A DECLINE IN PORTFOLIO INCOME. If equities must be sold, dividend income is often reduced. Equities might be sold for several reasons, such as:

- To provide cash for spending.
- To provide cash for other investment opportunities.
- To provide cash for lending.
- To reduce volatility or risk in the portfolio.
- To make cash gifts, or to make distributions to beneficiaries [in the case of a trust].

The client, whether it be a person, company, charitable entity, or private trust, may wish to avoid a reduction in dividend income. For example, a trust may have a requirement or policy of distributing net income or a percentage of portfolio value to beneficiaries. If the trust funds are primarily stock index funds, there is limited ability to control the reduction in dividend income from the sale, and from the payment of taxes on any gain.

In the case of individual securities, the trust can sell carefully selected stocks based on their tax characteristics, their dividend income, and their risk profile. If the trustees are able to identify stocks that have a low dividend payout, higher risk profile, and higher cost basis, the sale has a more limited impact on the trust's payout capability. This same type of analysis and the related benefits apply to non-trust portfolios as well.

ADVANTAGE #4: MORE PREDICTABLE PORTFOLIO INCOME LEVELS. The dividend income produced by an index fund fluctuates with the addition and deletion decisions made by the index committee. While income predictability may not be important to some clients, individually owned stocks in a client portfolio provide a greater ability to forecast dividend income. While dividend increases cannot be predicted with precision, most stable companies do not reduce dividends absent unusual circumstances. Future dividend increases can vary from previous years, but most companies tend to follow a pattern for increases, always subject to company financial performance.

ADVANTAGE #5: OPPORTUNISTIC PURCHASES AND RISK REDUCING SALES. When a stock market correction occurs, there are usually compelling investment opportunities available. Some stocks decline to a greater degree than merited by fundamentals. Selling a broad index fund to create cash to purchase securities "on sale" might result in taxable gains. With individual securities, some stocks may be available for sale with little or no gain, or with losses that can offset even more sales at a gain, creating a larger pool of cash to purchase attractive investments, at a lower tax cost. Conversely, if it is appropriate to sell equities to lower risk or due to excessive valuations, individual stocks might permit a "pick and choose" approach to selling that reduces risk at a lower tax cost.

ADVANTAGE #6: FLEXIBILITY FOR EVENTUAL BENEFICIARIES. For families with more wealth than average inside of trusts, investing some of the trust funds in individual stocks provides flexibility not only during the life of the trust, but also to the beneficiaries upon termination of the trust. Rather than receiving just stock index funds at termination, receiving some individual stocks as part of the trust termination can provide the beneficiaries with the same financial and planning flexibility discussed previously. We've seen this benefit with several trusts.

WRAP UP. We are not suggesting avoidance of stock index funds. We use them extensively for clients and in trust portfolios, when appropriate. We are simply suggesting there are benefits to a mix of individual stocks along with stock index funds and traditional mutual funds, assuming the expenses, performance, risk and correlation aspects of individual stocks are reasonable.

ECONOMICS – FACTS AND FIGURES

- The Japanese unemployment rate is 3.4%, but wage growth has been negative since 1998.
- The Eurozone unemployment rate is 11.0%, or 91% of the peak unemployment rate of 12.1% in May 2013.
- The U.S. unemployment rate is 5.1%, or 51% of the peak unemployment rate of 10.0% in October 2009.
- The U.S. unemployment rate for persons with a college degree or greater is 2.5%.

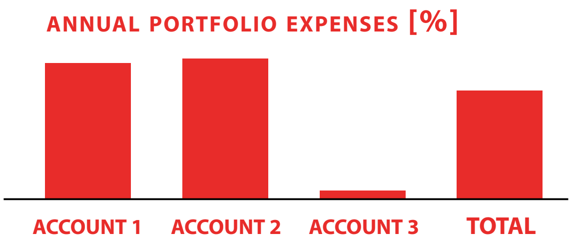
Reducing Investment Friction

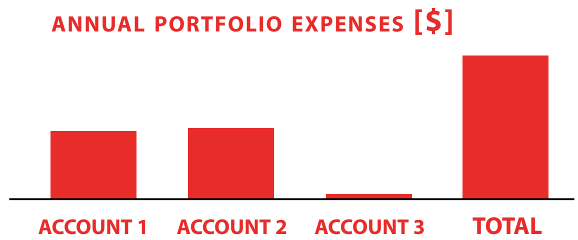
Spending time with the leader of a prominent American family office recently, the concept of "investment friction" was mentioned. The main measurable detractors from investment returns [other than inflation] are investment expenses and taxes on portfolio income, including capital gains. As an engineer finds excessive physical friction to be detrimental, so to should an investor or investment advisor find excessive investment friction to be detrimental. Note the term "excessive". Some investment securities, mutual funds, and outside managers are worth their higher fees. The key is knowing the amount of fees being paid, and whether they are justified.

Investment friction is measurable. For taxable portfolios, friction analysis requires knowing two sets of numbers; total investment expenses and total capital gains. For non-taxable portfolios, total expenses are the key.

MEASURING INVESTMENT EXPENSES

- Determine the percentage amount of these investment fees and expenses [by account, by custodian and consolidated for the total portfolio], by dividing the dollar amount of expenses into the market value.
- Determine the total dollar amount paid for investment fees and expenses including fees paid to an investment manager, and expenses for specific sub-investments selected by the investment manager [such as mutual funds and index funds]. These fees can be measured in dollars by account, by custodian, and consolidated for the total portfolio [all accounts].
- If commission trading costs are material, they could also be considered as part of the investment expense analysis.





Clients with larger accounts tend to have access to lower cost investments in certain categories. In addition, the design of the portfolio impacts the investment choices and expense levels. Some clients have strong preferences in the area of portfolio design, so not all investment expenses are due to an investment advisor's decisions.

MEASURING TAX FRICTION

- Determine the net long-term and short-term capital gains by year, by custodian, or by outside manager [if multiple managers are used at the same custodian], and for the total portfolio.
- Depending on the client situation, analysis of taxation on interest and dividends may also be appropriate to know.

BOTTOM LINE. Clients should feel entitled to know their investment friction; what they are paying in investment expenses [both in dollars and percentages] and the amount of capital gains [which reduce the reported pre-tax investment returns]. Unfortunately, the investment industry has done a poor job of revealing the amount of investment friction in a portfolio. It is not normal, unfortunately. Many Investors struggle to receive clear investment performance information, let alone clear expense and tax information. This information is available, and clients are entitled to ask for these numbers and receive them in a clear manner, such as in the charts we have provided.

PERSONAL FINANCE – FACTS AND FIGURES

- For a 65 year-old couple, the probability of at least one person reaching age 80 is 89%, for reaching age 90 is 47%.
  - > For a 65 year-old man, the probability of reaching age 80 is 62%, and for reaching age 90 is 21%.
  - > For a 65 year-old woman, the probability of reaching age 80 is 72%, and for reaching age 90 is 33%.
- In 2006, the average annual income generated by $100,000 invested in a six-month Certificate of Deposit [CD] was $5,240. In 2014, the same amount invested in the same CD, generated an average annual income of $130.
- Private fixed residential investment [housing investment] as a percent of Gross Domestic Product [GDP] has averaged 4.6% over the last 60 years. Today, private fixed residential investment stands at 3.3% of GDP. Source: Home Depot CEO Craig Menear, Goldman Sachs Global Retailing Brokers Conference, Sep. 10, 2015.
- The share of 18-34 year-olds living with their parents was 31% in 2015, compared to the longer-term average of about 25%. This current, elevated level appears to have peaked and has trended down modestly over the last year. Source: Bureau of Labor Statistics [BLS].
- Nearly 1.6 Million new households were formed in the last year [June 30, 2014 to June 30, 2015]. This is a significant increase from the level of new household formations between 2008 and 2014, which fluctuated between 500,000 and 1 Million per year, well below the average prior to 2008. Source: Census Bureau.
- Today, the average mortgage payment of U.S. homeowners is 12.4% of household income compared to the 40 year average of 19.6%. Source: JP Morgan, Q3 2015 Guide to the Markets, U.S.

Portfolio Income Clarity as a Valid Client Preference

There has been more attention paid in the last several years to comparing investment returns with comparable index returns. This is understandable since the industry tends to charge so much for so little return above comparable index returns. Yet in real life, with actual clients, the stability and clarity of portfolio income [interest and dividends] is also an important consideration.

WHEN EVALUATING RISK TOLERANCE, PORTFOLIO INCOME IS A FACTOR. We are not dismissive of the attempt to match or outperform and index, but risk is also a key factor in portfolio design. Having a portfolio with more stable, predictable income provides a measure of comfort to many clients. Such portfolio income provides clients with the ability to plan; to move forward with lifetime goals with less fear.

PORTFOLIO INCOME IN TIMES OF MARKET TURBULENCE. Outperforming an index is a nice achievement. Yet when index returns are highly negative, outperformance is of little comfort to many clients. Stable portfolio income and clarity into future income levels are of high value during times of turbulence and fear in the investment markets; changing the emotional component when evaluating risk. After all, if the client is unable to emotionally handle turbulent investment markets, the portfolio design was either inappropriate or the client was not as educated as they should have been, or both.

TAKE AWAY. It varies by client, but combining the pursuit of required and desired returns with a measure of portfolio income stability and clarity is often a preferred approach. For other clients, it is all about raw performance with little or no regard for portfolio income levels, stability, or predictability. These topics are worthy of discussion in the portfolio design process.

Single Biggest Investment Challenge

In mid-2009, an unusual, thought provoking investment lecture was given. The speaker, Richard Hokenson, suggested that the single biggest challenge facing investors and investment advisors, was operating in a new world in which interest rates were on their way to zero [Richard Hokenson, CFA, The Race to Zero, Lecture at the Sage Advisory Conference, August 2009]. At the time, this view was not given much credibility. We spent considerable time evaluating the research supporting the lecture, and asking follow-up questions of Hokenson.

KEY QUOTES FROM HOKENSON'S 2009 LECTURE. In Hokenson's lecture, he made these provocative statements which highlight his conclusions:

> *"My task is to give you a perspective on the world using a demographic prism. And if you can come away from this session with nothing else, it is hopefully the recognition, the realization, that you are making operating decisions, investment decisions, in a world that is structurally and fundamentally different from the past. We've not been here before. I know in our business the four most dangerous words can be 'this time it's different', but demographically the world is different. Because for the first time ever in the history of the planet, we are confronted by a situation of more and more countries [the people in those countries] choosing not to replace themselves in the population pool...having more brothers and sisters than children. Global population which is today roughly 6.9 Billion will probably never get to 8 [Billion] before it begins to shrink. When I first started doing this work thirty some odd years ago, the major concern at that time was population explosion. Now we're confronting the issues about population implosion…shrinking populations. The United*

States is a very, very powerful exception to that. We are the only developed country with a replacement level birthrate. That's a super powerful exception. We are one of the few countries in the world, not just the developed world but the total world, that can say in the year 2050 we will have a growing population."

"The most important economic/investment conclusion that comes out of this aging world is the world is engaged in the race to zero interest rates. Japan is winning that race. It's not necessarily a race one wants to win. It puts enormous pressure on money managers in terms of providing high returns".

"In conclusion, the key challenge is finding good investment returns in a world, on average, of lower interest rates and lower returns."

Six years after this lecture, many of Hokenson's predictions have come true. In fact, in 2015 we not only have zero interest rates on short-term Treasury Bills in the United States for the first time, but negative interest rates in many European countries for longer-term government bonds. Interestingly enough, Hokenson is quite bullish on the economic future of the United States and stocks; despite his views that global economic growth and interest rates will continue to decline. For an update on Hokenson's views from 2013, during a temporary period of rising U.S. interest rates [known as the "taper tantrum"] see "Still Racing to Zero," CFA Institute, November/December 2013, available on the Internet via Google search terms "Still Racing to Zero CFA Institute".

EFFECTIVE RISK MANAGEMENT - PROTECT AGAINST CHANGES TO BASE CASE VIEW. We have been designing and managing investment portfolios with this demographic prism in mind since 2009. However, just as important as factoring in the risk of lower interest rates, is keeping an open mind that this trend could change unexpectedly, due to unforeseen forces. So while we believe interest rates will remain low, on average, and could go lower, effective risk management requires us to guard against the opposite outcome.

It is interesting to see more of the investment profession finally give more credence to Hokenson's views. If and when Hokenson's views become mainstream, it will be wise to take note. When the majority finally comes around to a new view in large numbers, common sense suggests to be cautious. After all, being aligned with the vast majority [the crowd] is often a dangerous place to be in the investment world.

Capital Gain Exposure with Mutual Funds

Actively managed stock mutual funds normally distribute capital gains in the last two months of the year. Given the many recent years of positive returns, undistributed gains are quite large for many mutual funds. For taxable portfolios, it's that time of year when new investments into active stock mutual funds requires careful consideration of capital gain exposure. Even recent investments into active stock mutual funds deserve attention if large capital gains can be avoided.

As an example, one of the top performing [over ten years] actively managed U.S. stock funds has over 60% of its market value represented by appreciation, or unrealized gains. This top mutual fund is managed by a very experienced, long-tenured team at an excellent investment firm. It is on our list of preferred stock mutual funds for non-taxable client accounts.

For taxable accounts, buying this fund late in the year could expose a client to a large capital gain in just a few months. In October and November, most mutual funds estimate their year-end capital gain distribution that will occur later in the year [the actual distribution date], so investors can plan ahead. Even after the distributions in December, the large amount of remaining, unrealized gain in the fund [commonly referred to as "capital gains exposure" or "imbedded gain"] is still a concern for taxable accounts.

Broad stock index funds typically don't declare capital gains, and capital gains can be controlled using individual stocks. Actively managed stock funds are an important option in the investment process, but they clearly have tax disadvantages for certain taxable accounts that must be considered and monitored.

Serving Trustees as Investment Advisor

At a recent conference on fiduciary investment best practices and litigation [largely involving private trusts], there were two key points of emphasis made by a prominent, fiduciary investment litigator:

1. IF ASKED TO SERVE AS A TRUSTEE, BE VERY, VERY CAREFUL…especially if you are not a professional trustee. By professional trustee, the litigator didn't mean the well-educated professional that might be able to figure it out. The litigator meant a professional that spends a significant amount of time serving as trustee for many trusts and regularly improves their knowledge of the professional standards and practices [continuing education]. In fact, another attorney speaking at the conference said to "run" when asked to be a trustee, unless you meet this standard of professional trustee. At Miller Capital, our work in the trust area involves serving as an investment advisor to trustees, focusing solely on investment issues.

2. IF YOU ARE SERVING AS A TRUSTEE, ACT LIKE IT. There are many standards of practice for effective trustee services yet failure to attend to these standards is strong evidence of failure. For example, if a trustee fails to actively review 1] the trust portfolio and 2] compliance with the prudent investor rule or 3] the terms of the trust, the trustee is an easy target for unhappy beneficiaries. Infrequent and insufficient communication with beneficiaries, a lack of meaningful memos [empty files], limited communication among co-trustees, and generally low levels of adherence to trust administration needs, are all acts or omissions that can be labeled as a "failure to act as a responsible trustee".

The conference was effective in conveying a high level of respect for the duties and responsibilities of effective trustees in the modern trust world. It also elevates our desire to serve as an effective investment advisor to trustees, whether the trustees are banks, private trust companies, attorneys, CPAs, other professionals or family members. Trustees face numerous challenges as a fiduciary and our role, when retained by a trustee, is help them navigate the investment challenges involved with a trust. Trustees may fully delegate their investment management duties to us, or simply seek our input as an investment consultant. Either way, serving trustees is a worthy endeavor and a core investment focus of our firm.

ABOUT MILLER CAPITAL

- Miller Capital was established in 1999 and is independently owned and operated.
- We are a Registered Investment Advisor.
- We offer both investment management and investment consulting services.
- We represent individuals, corporations, investment partnerships, and private trusts (serving individual and corporate trustees).