Investment Advisor

CONVERSATIONS ON INVESTMENT MANAGEMENT

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CONTENTS

While we have low interest rates on savings and many bonds in the U.S., negative interest rates are prevalent outside of the U.S. For international savers, it's not a laughing matter. These negative international interest rates have a significant impact on U.S. interest rates, global investments, and investment portfolios.

As discussed in our last newsletter ["Single Biggest Investment Challenge", Fourth Quarter 2015], a key challenge is finding good investment returns in a world of lower interest rates. In this issue of Investment Advisor we further unpack the world of low, zero, and negative interest rates and their impact on portfolio income, stock valuations, and estimated returns. The Brexit win elevates this impact.

In our last newsletter, we also discussed the reduction in portfolio returns from capital gains taxes and portfolio expenses [see "Reducing Investment Friction" and "Capital Gains Exposure with Mutual Funds"]. Because of the importance of keeping as much investment return as possible, we provide additional insights into investment fees and how they can vary widely in the investment management industry.

To begin this issue of Investment Advisor we present excerpts from research reports and articles that frame some key investment and economic issues. If you would like to learn more about Miller Capital, please feel welcome to contact us.

Mark A. Miller, CFA
President

Insights of Interest

In 2011, China was adding $1.5 Trillion of global growth in Gross Domestic Product ["GDP", in US Dollars] but today it is 1/3rd that amount at $450 Billion. The industrial and construction portion of Chinese GDP is now declining. [Source: Arthur Kroeber, GaveKal Dragonomics, CEBRI Conference, 3/3/2016].

For an indication of low, zero, and negative interest rates around the world, consider the following yields on bonds issued by the governments of Japan, the United States, and Germany. [Source: Bloomberg 6/24/16].

- A year ago, the yield on the 30 year Japanese government bond [JGB] was just 1.44%. The yield today on this same Japanese bond yield has collapsed to just .14%.
- By comparison, the yield today on the 30 year U.S. government bond is 2.42% and the 30 year German government bond yield is just .49%. The 40 year JGB yields just .16%.
- The yield on the 10 year JGB is negative -.18% whereas the yield on the 10 year U.S. government bond is 1.57% and the 10 year German government bond yield is negative -.05%.

Amount of Global Government Bonds with Negative Yields

[Source: Thomson Reuters, Fitch, Wall Street Journal, 6/2/2016]

5/31/2016:	$10.4 Trillion	1/1/2014:	$175 Billion
4/25/2016:	$ 9.9 Trillion	1/1/2013:	$0
1/1/2015:	$ 1.4 Trillion	1/1/2012:	$0

China's age structure today is similar to Japan's in 1980. In 25 years, China's age structure will be the same as Japan's today. In other words, what took Japan nearly 35 years to age from 1980 through 2015, will take China just 25 years from 2015 to 2040. China is aging much more rapidly than any major economy has ever aged. As Japan has shown, it is hard to maintain higher levels of economic growth when your society is aging so rapidly. [Source: Arthur Kroeber, GaveKal Dragonomics, European Council on Foreign Relations, 4/14/2016]

We have written extensively about demographic trends and their impact on interest rates [see our previous newsletter available on our website]. Bank of America Merrill Lynch recently published a detailed study on demographic issues. [Source: The Silver Economy – Global Aging Primer, Bank of America Merrill Lynch, 5/9/2016]. Here are a few highlights:

- We are living in the midst of the most remarkable demographic transition in history.
- The number of persons age 60+ years is expected to grow to 2.1 Billion by 2050 [vs. 901 Million today].
- We are arriving at "peak youth" for the first time in human history as the number of persons age 65+ years is expected to outnumber children under age 5 by the end of this decade.
- Aging has become a universal phenomenon and by 2050 80% of older people will live in emerging markets.
- Age related spending makes up 40% of government budgets in developed markets.

Countering some of the negative trends in the global economy, the balance sheet of the U.S. consumer is very strong compared to prior decades: [Source: Federal Reserve 12/31/2015 data]

- Total financial obligations of U.S. households are at a multi-decade low, with payments at 15% of disposable income vs. 18% just prior to the 2008-2009 Global Financial Crisis. [Note: total financial obligations includes home mortgage, consumer debt, auto loans, rent, home owners' insurance, and property tax].

- Total U.S. credit card debt outstanding is nearly 20% lower today than it was at its peak in 2009.
- Total U.S. household leverage [measured by household liabilities as a percentage of total assets] has declined substantially, from a high of nearly 22% just prior to the 2008-2009 Global Financial Crisis to a recent level of just over 15%.

CONCLUDING THOUGHTS. Reading the above summaries, one might conclude that:

- the world is getting older and is slowing down economically,
- causing inflation [primarily in discretionary items] and interest rates to decline,
- but U.S. household debt levels remain much lower than in previous decades due to lifestyle changes.

Even if one agrees with these conclusions, it does not necessarily mean that potential equity/stock returns are dramatically lower. In fact, lower interest rates can have a beneficial impact on earnings and the relative attractiveness of stocks compared to cash, bonds, and other alternatives [see next article], unless those lower interest rates are due to recession conditions or negative geopolitical risks/events [such as the unexpected Brexit win].

For many years, these factors have led us to reassess fixed income strategies to protect against interest rate declines to the low levels we now experience. Many investors have been so convinced that interest rates will increase to higher levels that they have not protected their portfolios from the potential of low interest rates [and lower income] for the foreseeable future.

What Warren Buffett Says About Low Interest Rates and Stocks

Warren Buffett recently said that if interest rates were guaranteed by the government to be zero for the next 50 years, the Dow Jones Industrial Average should be at 100,000, more than five times higher than the current level. [Source: Warren Buffett Interview on CNBC, 5/2/2016]. A few caveats:

- no one can guarantee interest rates will be zero for that long, and
- even if our government would make such a guarantee, it may not be believed.

Despite the unrealistic hypothetical, Buffett's point is that if interest rates are expected to remain very low for a long-enough time period, the value of equities can increase [all other factors being stable] because:

- most stocks are valued based on the present value of future earnings, dividends and/or cash flows and that value increases when a lower interest rate is used in the calculation of present value, and
- the value of those earnings, dividend streams, and cash flows tend to increase in value relative to low yield or even negative yield cash and bonds.

CONTRARY OUTCOME FOR STOCKS ASSUMING INTEREST RATES INCREASE. If interest rates are assumed to increase to higher levels, then future earnings will be negatively impacted by higher interest costs [unless a company is debt free] and the present value calculation is lower when a higher interest rate is used to calculate present value. For those assuming interest rates will move high higher, or at least back to levels seen five or ten years ago, stocks might look modestly expensive to very expensive today. In fact, many investment firms with this view are holding higher than normal amounts of cash, waiting for lower prices and better values once interest rates increase.

CONCLUDING THOUGHTS. Even though many investment advisors say they do not consider economic factors or interest rate predictions into their work, interest rates impact nearly every estimate of future investment returns. The impact of interest rates on investment strategy or future return estimates is a worthy discussion to have with an investment advisor, even if they respond by saying they do not have an investment view on economics or interest rates.

Another Reminder on Potential Capital Gains from Mutual Funds in Taxable Accounts

In several previous editions of Investment Advisor, we have highlighted the potential for capital gains from mutual funds owned in taxable accounts. Some popular mutual funds have unrealized gains of 40% to 60%.
If these mutual funds were to sell stocks in the fund at large gains, these unrealized gains convert to realized gains and are paid out as taxable capital gain distributions to those owning the mutual funds in taxable accounts. While taxes are only one factor in making investment decisions, mutual funds with large levels of unrealized gains should be purchased only after careful tax consideration, especially for investors in higher tax brackets.

Understanding Investment Advisor Fees - Three Layers Of Fees With Four Different Approaches

Evaluating investment fees charged by investment firms is a challenging task. They are so many different types of fees and types of investment firms, along with confusing terminology. It can be difficult to know what questions to ask and how to interpret the answers. Providing some clarity on investment fees is the goal of this article, with a focus on investors seeking an investment advisor for a portfolio of $1 Million or more [our typical client]. This topic could be its own Whitepaper, but we'll do our best to cover some basics in this article.

There are four main investment advisor service models that we see most often in the industry. Some investment advisors use more than one approach, and there are other approaches and fee arrangements besides the four we will be discussing. The names we provide these different approaches are our own, to provide clarity.

Without getting into excess detail, there is a difference between investment management [the advisor makes the investment decisions and implements the decisions, as previously authorized by the client] and investment consulting [the advisor recommends investment decisions but the client implements the decisions]. This distinction is beyond the scope of our article, but should be part of the process in evaluating an investment advisor. At Miller Capital, we offer each service separately, or in combination.

APPROACH 1: "IN HOUSE" INVESTMENT MANAGER

The "In House" Investment Manager selects individual stocks and bonds for clients using their own research process. In most cases, the purchase or sale of a security has a commission, which varies depending on which custodian holds the account. The only on-going investment management fee is charged by the investment manager and is deducted automatically from the account [if previously approved by the client] or paid by client check after the client receives an invoice. The "In House" Investment Manager, for purposes of this example, does not use mutual funds or index funds or other outside investment managers, but simply invests in individual stocks and bonds they select.

EXAMPLE 1: The "In House" Investment Manager's fee is 1.00% per year, or $10,000 per year for a $1 Million account [Layer 1]. The custody firm charges $10 each time a stock is purchased or sold [Layer 2], but that fee is separate and in addition to the investment manager's fee, and no part of that fee is earned by the investment manager. Assuming there are 20 stock purchases and/or sales per year, the total cost for one year is:

Table 1: "In House" Investment Manager

$1 Million Portfolio		ANNUAL FEES Dollars	% of Assets
Investment Manager Fee	Layer 1	$10,000	1.00%
Custody Firm Trade Fees	Layer 2	200	0.02%
Total Costs - One Year		**$10,200**	**1.02%**

SUMMARY: With this approach, most of the investment fees are paid to the "In House" Investment Manager [Layer 1], and the trading costs are minimal [Layer 2], and there are no fees paid to outside fund managers or products [Layer 3]. The use of individual bonds would change this example modestly in terms of the trading fees. This approach relies on the investment performance of the "In House" Investment Manager, since they are making all investment selections.

APPROACH 2: INDEX INVESTMENT MANAGER

Over the last 25 years, a new approach to investment management has grown substantially; using index funds that attempt to replicate investment market returns. While investors can use index investing on their own without hiring an investment manager, using an Index Investment Manager results in a fee paid to the investment manager and an additional, separate fee for the index fund.

EXAMPLE 2: The Index Investment Manager's fee is 1.00% per year, or $10,000 per year for a $1 Million account [Layer 1]. The custody firm charges $10 to $30 each time an index fund is purchased or sold [$20 average assumed], but that fee [Layer 2] is separate and in addition to than the investment manager's fee, and no part of that fee is earned by the investment manager. In addition, the index funds that are purchased [Layer 3] charge an internal fee [.30% annual fee average is assumed]. Assuming there are 10 index fund purchases and/or sales per year, the total cost for one year is:

Table 2: Index Investment Manager

$1 Million Portfolio		ANNUAL FEES Dollars	% of Assets
Investment Manager Fee	Layer 1	$10,000	1.00%
Custody Firm Trade Fees	Layer 2	200	0.02%
Index Fund Management Fee	Layer 3	3,000	0.30%
Total Costs - One Year		**$13,200**	**1.32%**

SUMMARY: With this approach, there is an additional layer of annual fees for the index fund [Layer 3]. Trading costs tend to be modest. Index funds can invest in a wide variety of categories, including stocks, bonds, commodities, real estate and others.

APPROACH 3: OUTSOURCING INVESTMENT ADVISOR

The Outsourcing Investment Advisor provides investment strategy services to their client but then selects outside investment managers to make the actual day to day investment decisions of which investments to buy and sell. As with the Index Investment Manager, this Outsourced Investment Advisor approach results in a fee to the investment advisor [Layer 1], and a separate, additional, ongoing fee [Layer 3] for the day to day, outside investment manager that may be part of a mutual fund or direct engagement [often referred to as "separate account management"]. Index funds can also be used in this approach, which can lower the costs of Layer 3.

EXAMPLE 3: The Outsourcing Investment Advisor's fee is 1.00% per year, or $10,000 per year for a $1 Million account [Layer 1]. The custody firm charges $10 to $30 each time a mutual fund or index fund is purchased or sold [$20 average assumed], but that fee [Layer 2] is separate and in addition to the investment advisor's fee, and no part of that fee is earned by the investment advisor. In addition, the mutual funds that are purchased [Layer 3] charge an internal fee [.75% annual fee average is assumed], which is separate than the investment advisor's fee. If a separate account manager is used, rather than a mutual fund, the fees for Layer 3 could be similar. Assuming there are 10 fund purchases and/or sales per year, the total cost for one year is:

Table 3: Outsourcing Investment Manager

		ANNUAL FEES	
$1 Million Portfolio		**Dollars**	**% of Assets**
Investment Manager Fee	Layer 1	$10,000	1.00%
Custody Firm Trade Fees	Layer 2	200	0.02%
Outsourced, Outside Manager Fee	Layer 3	7,500	0.75%
Total Costs - One Year		**$17,700**	**1.77%**

SUMMARY: With this approach, there is an additional layer of fees [Layer 3] paid to the day to day, outsourced/ outside manager. Sometimes, all three fee layers are bundled together in one fee on the client's statement, but split between the three investment firms privately [not displayed to the client].

APPROACH 4: HYBRID INVESTMENT ADVISOR

A Hybrid Investment Advisor uses a variety of investment management tools for clients;

- internally managed securities [in house],
- index funds, and
- outsourced, outside managers [via mutual funds or separate account management].

We consider Miller Capital to be a Hybrid Investment Advisor. Being an effective Hybrid Investment Advisor requires dedication of adequate time and resources to investment research of individual securities and outside managers. Clients often have unique investment needs and preferences that can be served by a Hybrid Investment Advisor, using a custom approach, as illustrated below:

- high net worth clients with appreciated individual securities [i.e. lower cost basis stocks] may prefer or require monitoring and management of these securities rather than an automatic sale with large tax consequences,
- some clients may prefer lower costs and the stronger tax and risk control available from internally [in house] managed securities [either in whole or in part],
- some clients may prefer an index fund approach [in whole or in part] with lower costs and tax efficiency in taxable accounts, foregoing the benefits available from individually managed securities,
- some clients prefer a focus on outsourced, outside managers [in whole or in part] despite the higher fees,
- many clients prefer a hybrid or combination of the above approaches.

At Miller Capital, our hybrid approach also gives us an advantage in serving new clients coming from other investments firms that use another investment approach; providing a sensible, flexible transition plan.

EXAMPLE 4: The Hybrid Investment Advisor's fee is 1.00% per year, or $10,000 per year for a $1 Million account [Layer 1]. The custody firm charges $10 each time a stock is purchased or sold, and $10 to $30 each time a mutual fund or index fund is purchased or sold [$20 average assumed], but these fees [Layer 2] are separate and in addition to the investment advisor's fee, and no part of that fee is earned by the investment advisor. In addition, the index funds that are purchased [Layer 3] charge an internal fee of [.30% is assumed, on average]. The mutual funds that are purchased [Layer 3] charge an internal fee [.75% is assumed, on average], which is separate than the investment advisor's fee. If a separate account manager is used, rather than a mutual fund, their fees [Layer 3] could be similar. Assuming there are:

- 20 stock purchases and sales per year,
- 10 fund purchases and/or sales per year,
- 1/3rd managed internally [in house], 1/3rd in index funds, and 1/3rd in outsourced, outside manager funds, the total cost for one year is:

Hybrid Investment Advisor

		ANNUAL FEES	
$1 Million Portfolio		**Dollars**	**% of Assets**
Investment Advisor Fee	Layer 1	$10,000	1.00%
Custody Firm Trade Fees - Stocks	Layer 2	200	0.02%
Custody Firm Trade Fees - Index/Funds	Layer 2	200	0.02%
Index Fund Management Fee [1/3 of portfolio]	Layer 3	990	0.30%
Outsourced Manager Fee [1/3 of portfolio]	Layer 3	2,475	0.75%
Total Costs - One Year		**$13,865**	**1.39%**

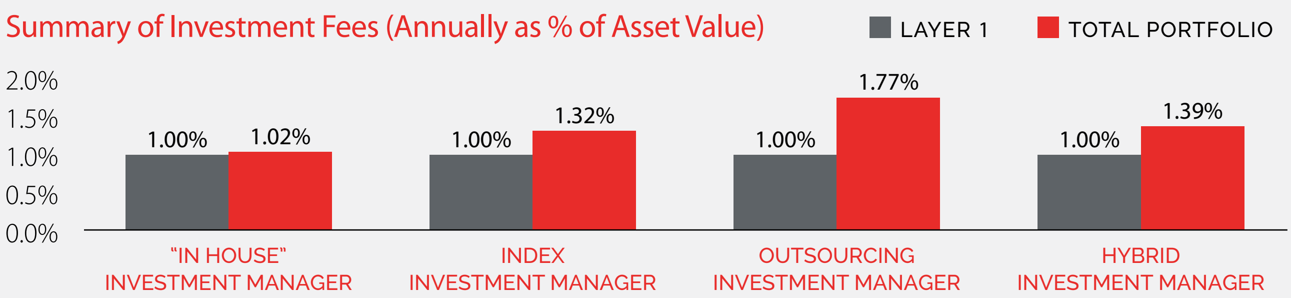
SUMMARY: With the hybrid approach, more can be allocated to in house/internally managed securities and index funds to lower overall costs. In fact, we have clients that prefer using all in house/internally managed securities with no additional layer of management fees [no Layer 3]. Some other clients prefer a complete outsourced approach, or a combination of approaches. We provide a recommendation and various options for clients so that they can defer to our recommendation or request their own preference, after full disclosure to them.

In terms of fees at Miller Capital [full fee schedule available upon request]:

- our investment management fees start at .85%, rather than 1.00% [Layer 1] for investment management,
- many of the index funds and mutual funds we use have much lower costs than the .30% and .75% illustrated above [Layer 3],
- with a hybrid approach, we aim to keep outside manager fees [Layer 3] below .25% for the total portfolio,
- our fees decline on a percentage basis for larger portfolio amounts.

SUMMARY CHART OF TYPICAL INVESTMENT ADVISOR FEES. Here is a recap of the various investment advisor and trading fees provided in our examples for the four approaches we see most often for $1 Million plus portfolios:

Summary of Investment Fees (Annually as % of Asset Value)



OTHER FEE ISSUES. While we have provided four popular investment management approaches and we cannot cover all alternatives and variations, here are a few other points to keep in mind:

- There are a broad range of fees within each of the four approaches we provided.
- Some investment firms include other services as part of their investment management fee, or in addition to their investment management fee, including financial planning and tax preparation.
- Some investment advisors have multiple fee options or are willing to negotiate the amount of fees [discounts for certain types of assets or accounts] or type of fee [hourly, fixed annual amount, or percentage of assets managed].
- There are lower and higher cost offerings provided by firms in these four approaches, and other approaches.
- An excellent resource in evaluating an investment advisor that is regulated by the SEC [Securities and Exchange Commission] is a document called ADV Form 2A and 2B, which is available on the sec.gov website, and must be provided by the investment advisor upon request of a prospective client. Our Form 2A and 2B including our full fee schedule can be found there, or will be provided by us upon request. Certain smaller investment advisors are regulated by states, rather than the SEC, but these state regulated investment advisors should provide similar information to prospective client.
- It may be appropriate and helpful to obtain legal advice or, in some cases, retain the services of a consultant before hiring an investment advisor.

CONCLUDING THOUGHTS. Investment management fees and commissions costs can be one of the largest expenses for a portfolio. Understanding what fees are charged, by whom, and for what, is a basic investment question that should be asked of any investment advisor and clearly answered by any investment advisor.

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).

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