Miller CAPITAL

Investment Advisor

CONVERSATIONS ON INVESTMENT MANAGEMENT

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CONTENTS

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"Bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria."

-- SIR JOHN TEMPLETON --

Hopefully, this edition of Investment Advisor provides more insightful investment information than the average robot. Kidding aside, these articles unpack topics we have been discussing with our clients, or that are of interest to us in our work. If you would like to receive information about Miller Capital and the investment advisory services we provide, please feel welcome to call, or e-mail us at info@millercapital.com.

State of the Stock Market

The Dow Jones Industrial Average and most other broad U.S. stock markets, especially the Nasdaq Index, have hit all-time highs recently. After an initial bump up in U.S. interest rates after the 2016 election, most interest rates remain very low, with recent Federal Reserve interest rate increases mainly impacting floating rate loans [such as home equity loans].

INTEREST RATES RELATIVE TO STOCK VALUATIONS. While U.S. stocks have higher valuations than the historical average, based on price to earnings [p/e] ratios and other valuation metrics, interest rates are very low. Interest rates have a substantial impact on stock valuations, both in terms of valuing a specific stock and for the attractiveness of stocks overall compared to bonds and cash. At Miller Capital, when we change the long-term interest rate used in valuing a specific stock, it can have a meaningful impact.

STATISTICS TO CONSIDER. Here are some numbers from twenty years ago [1997], compared to today, helping explain why investment markets have been favorable of late:

YEAR	10 YR U.S. TREASURY BOND YIELD	S&P 500 P/E RATIO[1]	S&P 500 DIVIDEND YIELD	LONG-TERM CAPITAL GAINS - TOP TAX RATE[2]	QUALIFIED DIVIDENDS TOP TAX RATE
1997	6.51%	18.0	1.73%	29.2%	39.6%
2017	2.25%	17.7	2.03%	23.8%	23.8%

KEY POINT. Obviously, the longer the good times last, the more likely investors are bound to become overly excited and over exposed to risk in the investment markets. Yet, there are always attractive investments. The current valuation of the S&P 500 Index masks the fact that some companies have much higher valuations while many others are well below index valuation levels. The key is to be disciplined and to not just close your eyes and run with the bulls, or the robots.

> *"Bull markets are born on pessimism, grow on skepticism,*
> *mature on optimism and die on euphoria." Sir John Templeton*

State of the Investment Industry

COMMISSION RATES. The commission rate for buying and selling stocks and exchange traded funds [ETF] was reduced by several low-cost brokerage firms in 2017.

- The commission for most stock and ETF trades at Schwab, Fidelity, and TD Ameritrade now ranges from $4.95 to $6.95. For new accounts with assets transferred in from another brokerage firm, they will often waive commissions for a certain time period depending on the size of the new account. We have investment advisory clients that hold their accounts at one or more of these brokerage firms.
- At larger, well known brokerage firms such as Merrill Lynch, Morgan Stanley, Goldman Sachs, Wells Fargo and UBS, commissions tend to be negotiated privately. Alternatively, they also offer accounts with no commission for each trade, but with an ongoing fee based on a percentage of account value. We have investment advisory clients that hold their accounts at these, and other, large brokerage firms.

ATTRACTIVE INTEREST RATES FOR MARGIN LOANS. Clients needing to borrow funds temporarily, to provide bridge financing for the purchase of real estate or for other short-term needs, may wish to consider borrowing against their marketable securities; known as a margin loan. Margin loans, as an alternative to traditional financing or the sales of securities, have the following attributes.

- Margin interest rates can often be negotiated at very attractive rates for certain clients, often much lower than the publicly stated interest rate.
- Margin loans can be structured with regular payments of interest and principal, or without regular payments so that the interest charges are added to the margin loan balance.
- The decision to move an investment account with an existing margin balance to a new brokerage firm should factor in the margin features/rates at the new brokerage firm.
- Margin borrowing may be attractive if the alternative is selling investments at a large capital gain or incurring substantial borrowing costs from a traditional lender.
- Margin loans in a securities account can be used both wisely and unwisely, as can any lending option, so caution is in order. The brokerage firm offering a margin loan will have limits on the amount of the loan, depending on the nature of the underlying securities in the account.

A DWINDLING SERVICE – MANAGING INDIVIDUAL SECURITIES. The number of investment firms that manage individual securities [stocks and bonds] is dwindling. A growing trend in the financial planning and investment industry is for advisors is to exclusively use index funds or exchange traded funds, often outsourcing this investment service to an outside firm or automated computer program, hence the term "robo advisor" and the reason for our cartoon. A few other related developments include:

- A sub-trend in the industry is for financial advisors to focus only on financial planning with little or no specific investment advice other than broad asset allocation recommendations. This limits the advisor's liability and lessens regulatory compliance requirements, but may not be best for the client.
- For investors with larger, taxable portfolios [above $1 Million], the ability to find and retain a qualified investment advisor that monitors individual securities along with index and mutual funds is becoming more difficult.
  - For investors owning individual securities with substantial unrealized gains, the interviewing of a new investment advisor should include discussions on how these tax-sensitive securities will be managed.
  - Of the dwindling number of investment firms that do manage individual securities, they may not manage securities unless they are part of their own model or approved list of securities. Alternatively, the firm may recommend selling the securities promptly, or over time according to a pre-approved plan with the account owner. If unrealized gains are substantial, this may not be the best approach and may generate a large tax liability. Large taxable gains can be just as detrimental as high investment fees.
  - A majority of our clients [including individuals, closely held entities, and trusts] have taxable portfolios over $1 Million that often include individual stocks and bonds. Some clients come to us owning individual securities with substantial unrealized gains that require careful attention and planning, rather than automatically selling them at large gains.

Ear to the Ground: Company Insights on Three Key Topics

When reviewing conference calls of public companies, management will often provide valuable insights not only about their own company, but about competitors, industries, business trends, and the economy. Here are some paraphrases of company comments on three topics that are of interest to us.

INTEREST EXPENSE CAN STILL GO LOWER. After several years of low interest rates, you would think most public companies had refinanced all their debt at lower interest rates. However, many companies issued non-callable bonds in years past and, depending on various factors, may need to wait until the bonds mature before they can eliminate their higher interest payments. In addition, many companies with callable bonds refinance them in stages, picking the most attractive bonds to call and gradually adjusting bond maturities over time.

Today, there are still many companies that can dramatically lower their interest expense as non-callable bonds mature over the next few years, while also extending their overall debt maturities in a very positive manner. The refi boom for public companies has slowed down but still has more potential to lower public company interest expense. However, companies must be careful not to excessively borrow, using lower-cost debt.

CURRENCY IMPACT FROM U.S. DOLLAR. For most U.S. public companies with significant foreign operations, the strength of the U.S. Dollar has been detrimental to their reported financial results and is frequently highlighted in their reported results and conference calls. Consider the following changes in the U.S. Dollar:

- From mid-2014 to early 2015, the U.S. Dollar increased by 25% against a basket of other developed country currencies [measured by the U.S. Dollar Index - DXY].
- From early 2015 to just prior to the 2016 election, the U.S. Dollar stayed in a range around this elevated level.
- From just prior to the 2016 election through June 2017, the U.S. Dollar increased by nearly 10% but then declined by nearly 10%, bringing the U.S. Dollar back to pre-election levels.

As of today, the U.S. Dollar is still 20% higher than at the start of its 2014 rise, but has stayed within a range for the last 2½ years, despite volatility along the way. Currency volatility is to be expected. But the U.S. Dollar's 20% rise from a few years ago appears to have stabilized, for now. Despite the fact many companies hedge some currency impact, a more stable U.S. Dollar provides these U.S. companies with better planning ability and decision making, and this is coming through in recent management comments.

TECHNOLOGY CHANGES. Several public companies are echoing the following comments on technology changes:

- The amount of data produced by autonomous vehicles, the internet of things [multiple sensors on a variety of devices used in day to day activities], and traditional and cloud internet data, will overwhelm existing data infrastructure and require massive new investment in a variety of areas. By 2020, the average person will generate 1.5 gigabytes [GB] of data per day. [1 GB equals 1 Billion bytes or units of digital information]. However, the average autonomous car will initially generate 4,000 GB of data per day, not including the internet of things. [Source: major U.S. semi-conductor manufacturing company].
- New wireless data transport technologies [such as 5G wireless] will massively increase the speed of wireless data transmittal, assuming supporting infrastructure is developed. Mobile traffic in 2017 is expected to be 2x the 2015 level, and in 2020 is expected to be 6x the 2015 level. 5G will just be getting started in 2020 by most estimations, with even greater traffic increases coming after 2020. [Source: major U.S. wireless tower company].

We realize that stock index investing is all the rage, and for the "index only" approach to equity investing it is not considered helpful to listen to what a company's management says. Yet many of our clients, similar to Charlie Munger [see the next article entitled "Stock Index Funds: Buffett vs. Munger"] do appreciate the advantages of individual stocks or own stocks with substantial, unrealized gains. So we have a duty to these clients to research and assess industry and company developments. As to the benefits of using individual stocks in taxable investment portfolios, please refer to the Fourth Quarter 2015 edition of Investment Advisor, available on our website under Insights.

Stock Index Funds: Buffett vs. Munger

Stock index funds are wildly popular. Consider the following facts:

- Since 2007, nearly $1.5 Trillion has flowed into U.S. stock index funds while nearly $1 Trillion has flowed out of U.S. actively managed stock funds. [Source: Goldman Sachs].
- In addition, nearly 70% of actively managed stock funds are actually very similar to an index fund. [Sources: Cremers, Martijn and Petajisto, Antti, How Active is Your Fund Manager? A New Measure That Predicts Performance (March 31, 2009).; Cremers, Martijn, "Active Share and the Three Pillars of Active Management: Skill, Conviction and Opportunity" (Volume 73, Number 2, December 28, 2016). Financial Analysts Journal.]

Warren Buffett has contributed to the popularity of stock index investing, advocating the S&P 500 Index fund for most non-professional investors. The topic of index investing came up again at the most recent Berkshire Hathaway annual meeting in May 2017, with Buffett and his long-time investment partner Charlie Munger expressing different views on the topic of investing for their heirs.

MUNGER DIFFERS FROM BUFFETT. During the Q&A session of the Berkshire annual meeting, Buffett praised the S&P 500 Index as the most attractive equity investment option for his wife, should she survive Buffett. Of course, Buffett's wife will have way more in inherited assets than she will ever need, according to Buffet, so the specific investment strategy may not be particularly important to maintaining and supporting her lifestyle. However, Munger stated that he had a different view for his heirs when it came to owning the S&P 500 Stock Index compared to Berkshire Hathaway stock. In the Q&A session, Munger responded to Buffett by saying:

> *"The Munger's are different…I want them [my heirs] to own the Berkshire [stock]…I recognize the logic of the fact that the S&P [500 Index] algorithm…is very hard to beat…but I'm just more comfortable with the Berkshire [stock]."*

Buffett responded that the S&P 500 Index can protect family heirs from unwise decisions and the solicitation of others. Munger responded to Buffett saying:

> *"Oh well, if you're going to protect your heirs from the stupidity of others, you may have some good system [owning the S&P 500 Index] but I'm not much interested in that subject."*

CAVEATS APPLY. In all of the comments made by Buffett about stock index funds, many caveats apply. One can't simply take Buffett's comments at face value without appreciating all the past qualifiers he has made, including that if any investment, including an index fund, is significantly overvalued then it is not an attractive investment. Munger's response deserves the same caution, because although Berkshire owns a diversified mix of businesses and investments, it is still just one stock.

FIDUCIARY INVESTING FOR TRUST/ESTATE BENEFICIARIES CAN BE DIFFERENT. Most trustees of a trust [or estate] would not find it prudent to own a large percentage of assets in just one stock, unless there was a mandatory direction in the governing trust document [or Will] to do so. Even with a mandatory direction in the governing document, trustees [or executors] must exercise caution not to blindly follow a mandatory direction to own a specific asset without considering whether the very purpose of the trust [or estate] is jeopardized as a result. When it comes to investing for a trust or estate, fiduciary duties require a high level of analysis and different rules and laws often apply. Again, such nuance is not possible in a public Q&A session.

A WELL-REASONED, SUITABLE APPROACH IS KEY. A key takeaway for us from the insightful Buffett vs. Munger debate on stock index funds is that even great investors, including others such as Sir John Templeton, can have their own unique views and approaches. Buffett and Munger have a different level of personal wealth than nearly all others, but their comments on these topics of personal investing are thought provoking and appreciated. At Miller Capital, the decision as to whether to own stock index funds, individual stocks, or active mutual funds, is unique to each client's best interests, needs and preferences.

Porter's Five Forces: More Relevant than Ever

In 1980, Professor Michael Porter published a seminal book on business strategy; *"Competitive Strategy, Techniques for Analyzing Industries and Competitors"*. While change is a constant in business, the rapid rise and fall of companies and industries from technological change is breathtaking.

THE IMPACT OF AMAZON AND OTHER DISRUPTIVE TRENDS. Even Warren Buffett has said on numerous occasions that nearly every business and investing decision must consider the impact of Amazon, and other disruptive trends and companies:

> *"The effect, I would say just of Amazon, but [also] others that are playing the same game,… the full effect on industry is far from having being seen. I mean it is a big, big force and it will/already has disrupted plenty of people and it will disrupt more."*
>
> *"We don't make any decision involving the manufacturing of goods, the retailing, whatever it is, without thinking long and hard about what the world will look like in 5, 10 or 20 years with that really, hugely powerful trend."*

[Source: Warren Buffett, Berkshire Hathaway Annual Meeting Q&A, 2016.]

THE FIVE FORCES: We have found that Porter's five forces are very important to consider in evaluating any public company, along with company management/governance, current valuation, and future return potential. Here are Porter's Five Forces of competitive strategy for industries and companies which are detailed in his book:

1. THREAT OF NEW ENTRANTS
2. BARGAINING POWER OF BUYERS
3. BARGAINING POWER OF SUPPLIES
4. THREAT OF SUBSTITUTE PRODUCTS OR SERVICES
5. RIVALRY AMONG EXISTING FIRMS

1) Based on projected earnings; Source: S&P, Factset.
2) 1997 tax rates prior to Taxpayer Relief Act of 1997, signed into law on August 5, 1997. Same for dividend tax rates.

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).