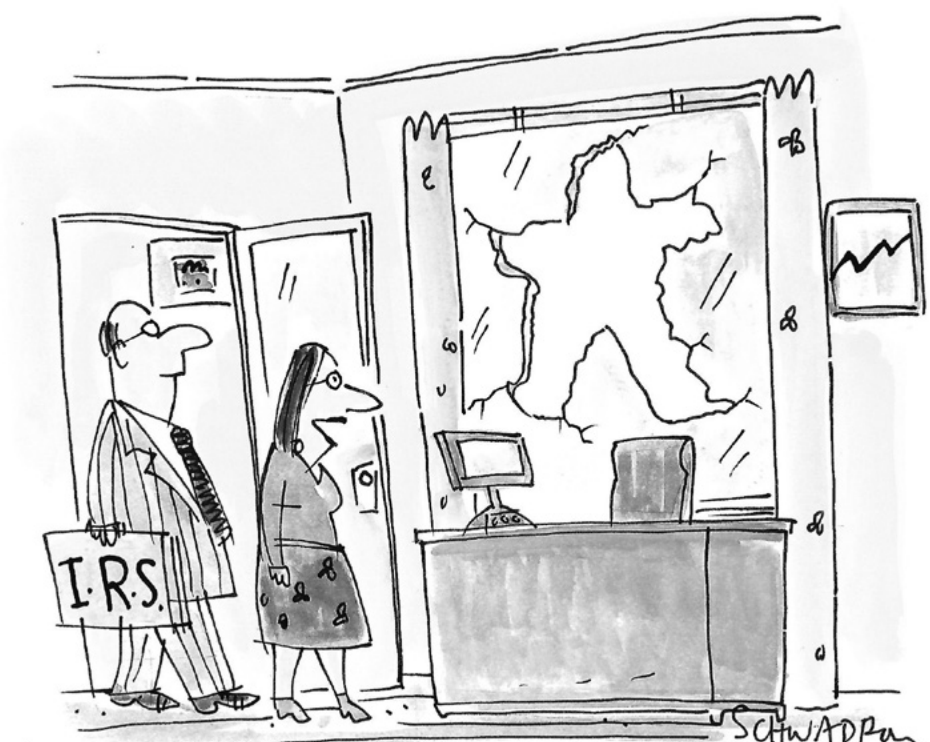
Investment Advisor

CONVERSATIONS ON INVESTMENT MANAGEMENT

SECOND QUARTER 2015

As we head toward summer, April 15th fades from our memory, hopefully. Given the appreciation of equities over the last several years, one of the most relevant investment topics is the impact of higher tax rates on taxable portfolios. The saying "you can run, but you can't hide" comes to mind from the cartoon below.



"SIR, THERE'S AN IRVING R. SCHWARTZ TO SEE YOU."

Mark A. Miller, CFA
President

This issue of Investment Advisor discusses the following topics:

We hope you find this newsletter of interest. Please feel welcome to call us or e-mail us [info@millercapital.com] if we can be of assistance.

How One Successful Family Radically Changed their Approach to Asset Allocation

Just over forty years ago, a successful Midwestern family sold their industrial business for a very large amount of cash. Their next challenge was figuring out how to invest all of their money. Their investment journey is told in a wonderful, privately published book "The Long Search for a Better Way – The Evolution of a Tailor-made Investment Strategy".

The story picks up in 1914, when the founder of the corporation transferred all of the stock into what's known as a generation skipping trust, for the benefit of the extended family and future generations. Generation skipping trusts can shelter assets from estate taxes for a very long time. In 1974, this Midwestern family [via the directors of the corporation and the trustees of the family trust] decided to sell their large industrial business to a publicly traded corporation for cash. At the time of the sale of the industrial business in 1974, and for the next forty plus years, this generation skipping trust oversaw the wealth of the family that was owned in, and managed by, the corporation.

QUESTIONING CONVENTIONAL WISDOM. This family [we will call them the "J Family"] provides a real-life lesson for why an investor's investment strategy and asset allocation should be customized, not generalized. The J Family initially approved an asset allocation of 60% equities and 40% fixed income and cash; admittedly a "follow the crowd" decision. Several years later, the family revisited their asset allocation, unpacking in much more detail what their asset allocation should be, given their unique family goals and risk tolerance.

A NEW, THOUGHTFUL PROCESS. The family advisors sought many outside opinions as part of their in-depth research on a new asset allocation decision. After much study and discussion, the J Family replaced their original asset allocation with a very different asset allocation process and result. A new asset allocation was adopted which set the amount of fixed income and cash at five times the corporate dividend payout of the previous year. As a result, the equity allocation increased from 60% to 85%, with the other 15% being held in high quality fixed income and cash. While this may seem like an aggressive asset allocation, the J Family [via their trustees and advisors] deemed it appropriate for the long-term family trust and the family beneficiaries.

ORIGINAL ASSET ALLOCATION [1974]		REVISED ASSET ALLOCATION [1980]	
Equities	60%	Equities	85%
Fixed Income/Cash	40%	Fixed Income/Cash*	15%
Total	**100%**	Total	**100%**

** Five times previous year's corporate dividend payout*

One of the outside opinions sought was that of Peter Bernstein, a respected expert on asset allocation and risk. Bernstein congratulated the J Family advisors, and the lead family member in particular, on their revised asset allocation approach:

> *"The secret of your success was the explicit specification of the problem. That is what makes the solution so convincing. As you wisely say, most people get into trouble simply because they don't know what their problem really is. They are ignorant about the character of their problem, because they are never able to decide what it is they are trying to achieve. Your achievement is in being explicit and precise about exactly how you would determine 'when it is raining.'"*

FOCUSING ON THE PROCESS. Fortunately for the J Family, this substantial change in asset allocation occurred in 1980, just before one of the greatest equity bull markets in U.S. history. Yet it was the process and well-reasoned analysis that was a key achievement for the family, not the result. In a letter explaining the new asset allocation to the family members, the following key points were made:

> *"Probably the most important policy break-through was escaping the notion that our ratio of equity to fixed income investments should follow some generally accepted norm, e.g., 50/50, 60/40, 70/30, etc. As touched on earlier, we now view our municipal bond fund as a sort of contingency reserve that could be used to supplement curtailed dividend income during a period of severe economic crisis. Having adopted this policy, the ratio of equity to fixed income investments becomes a resultant geared to our particular and somewhat unique situation, rather than to some arbitrary standard of conventional wisdom."*

And in a letter to family members a few years later, after the new asset allocation policy had been placed into operation, the J Family advisors expanded on their unique view of risk and why their new asset allocation [termed "dividend continuation reserve"] was appropriate for the family investment portfolio:

> *"Most investors use the academics' idea that risk is directly related to the volatility of the portfolio returns. We, on the other hand, have opted to use a more parochial approach, namely that "risk is the possibility of not having sufficient cash to do something important", which in our case is paying dividends to you. This so called "dividend [continuation] reserve" concept of providing reserves to meet future cash requirements is the keystone of our overall investment strategy; and, more than any other single thing, is the factor that differentiates our approach from that of most other investors."*

DEFINING THE KEY ISSUE. For the J Family, the ability to generate increasing long-term income payouts, adjusted for inflation, was the most important factor in determining their proper asset allocation. The fact that fixed income and cash holdings can reduce the impact of declines in equity values was less important. Fixed income and cash were merely an emergency, or rainy day fund, to offset potential reductions in stock dividends during a severe economic decline, as occurred in 2008 to 2009.

CONCLUSIONS. What worked for the J Family, what was important to them, and how they viewed risk may not be relevant to other investors. Another investor's custom asset allocation process may result in lowering exposure to equities, or other equity-like assets, rather than increasing them like the J Family. Yet the J Family story is important because of their process, not their result. They asked the right questions. They identified their key concerns and risks. They developed a solution that addressed these factors rather than accepting a standard approach or accepting conventional wisdom. Despite the title for this article, that's not a radical idea at all.

Increasing Portfolio Returns after All Taxes, not just Income Taxes

When it comes to taxable portfolios for high tax bracket clients, taxes can be a large drag on portfolio returns, even more so than management fees and transaction costs. Consider the following key points:

- **Applicable Tax Rates on Portfolio Income.** The top federal income tax rate on ordinary income and short-term capital gains is 39.60%, without considering the additional 3.8% Net Investment Income Tax [from the Affordable Care Act or ACA] and state income taxes. The top federal income tax rate on qualified dividends and long-term capital gains is much lower, at 20%. Adding the ACA tax and depending on the state income tax rate, the top combined tax rate can be 50% or more on ordinary income and short-term capital gains, and 30% or more on long-term capital gains. For most other taxpayers with large portfolios and above average income, the federal tax rate on ordinary income and short-term capital gains is typically 25% to 35%, and the federal tax rate on long-term capital gains is 15%.

- **Favoring Qualified Dividends and Long-term Capital Gains.** Shifting portfolio income from ordinary income and short-term capital gains to qualified dividends and long-term capital gains creates tremendous tax savings, if it can be done consistent with the client's investment strategy and risk/return needs.

- **Control over Capital Gains.** Having control over portfolio holdings can also lead to delaying long-term capital gains for longer periods of time. Active mutual funds do not permit full control over the timing and amount of capital gains. For clients in higher tax brackets with taxable portfolios, this lack of tax control is a major disadvantage.

- **Municipal vs. Taxable Bonds.** Prior to the most recent tax increases, clients in the 25% to 35% federal tax brackets could often own selectively purchased taxable bonds for portfolio diversification, without sacrificing too much in after-tax returns versus municipal bonds. Given the new, higher tax brackets, the after-tax return of municipal bonds are more difficult to match in taxable bonds. However, municipal bonds have risks that certain taxable bonds [including corporate bonds] do not share. It is not just a comparison of after-tax returns that needs to be considered.

- **Other Planning Tools.** There are many other techniques to efficiently manage taxes on portfolio income, including the effective use of Roth and Traditional IRA accounts, harvesting tax losses to use against future gains, and the use of tax-favored securities such as dividend paying timber REITs, to name just a few.

- **Index Funds as an Alternative.** Stock index funds, especially in the U.S. large cap category, can provide excellent tax-efficiency during the holding period. We use these index funds for many portfolios, when appropriate. However, for high tax bracket clients with large taxable portfolios, individual securities can provide unique planning opportunities that are not available with index funds, in areas beyond just income tax planning. We have seen numerous situations where individual securities were used to accomplish important client, family, and charitable objectives that index funds and active mutual funds could not accomplish.

IMPACT OF OTHER TAXES ON WEALTH CREATION/PRESERVATION. While it is prudent to focus on after-tax returns, one should consider all taxes, not just income taxes. Saving income tax with better portfolio tax structure may pale in comparison to saving multiples of that amount through proper gift, estate, generation skipping and charitable tax planning. As always, please consult your own legal and tax counsel for estate planning and tax advice.

China Rising or Falling? Implications on the Margin

China poured more concrete in just three years [2011-2014] than was poured in the U.S. in the entire 20th Century. [Source: Making the Modern World: Materials and Dematerialization, by Vaclav Smil] This was all part of the economic miracle that saw unprecedented growth in China, attributable to the greatest migration of rural residents to urban living.

CHINESE GROWTH RATES ARE CLEARLY SLOWING. Now, the media is full of stories about slowing economic growth rates in China. This growth slowdown is clearly impacting many parts of the Chinese economy. With the increased sophistication of robotics, much higher wages in urban China, and many other factors, more manufacturing is moving back to the U.S. and other developed countries, or into even lower cost countries, such as Vietnam. Despite slowing Chinese growth rates, the amount of growth in units [whether it be measured in U.S. Dollars or Chinese yuan] is still substantial and far outweighs the growth of any other country.

IMPORTANT ECONOMIC CHANGES ARE TAKING SHAPE IN ASIA. China is looking to decrease its dependency on exports of low end manufactured goods, while increasing the production of advanced goods and services. As Chinese wages increase and air and water quality worsen, these are natural progressions for China. Because China has large financial reserves, it can smooth out the currency and debt gyrations for many companies and countries in Asia and beyond, while transitioning to a more advanced economy. For example,

- China has announced ventures with countries such as Laos to build major railways and ports for them so that Chinese goods can be exported and sold there, and commodities can be imported to China. A recent agreement for a new rail line from the Chinese-Laos border into Thailand is a good example. China provides the financing for the construction, payable in a stable Chinese currency. Chinese companies are well positioned to receive most of the construction contracts. China also receives orders for the advanced construction equipment needed to build the port, all financed by China. The risk of a spike in the U.S. Dollar [that can ruin the economic outcome of the port construction project or the terms of the debt repayment] is limited.
- China has announced construction projects with Pakistan [China–Pakistan Economic Corridor (CPEC), part of the greater Chinese Silk Road Initiative], Russia, India, and many African countries to permit for the export of Chinese goods and/or the importation of foreign commodities. True to form, China can finance part or all the projects while gaining preferred status for construction contracts and underlying goods and services needed to complete the project. Rather than buying a $350,000 Caterpillar bulldozer payable in U.S. Dollars, the bulldozer may be a $200,000 Chinese model payable in Chinese currency, with attractive interest rates and other terms.
- The original Silk Road was a network of trade routes that allowed the exchange of goods and ideas between Asia and Europe, including between the Roman Empire and China's Han Dynasty, towards the end of the first century B.C. Now China wants to build a new network of roads, railways pipelines and shipping lanes connecting China to South Asia, Southeast Asia, Central Asia, Africa and Europe, including major connections with Moscow, Istanbul, and ports in Rotterdam, Netherlands and Venice, Italy. [Source: Xinhua, various articles]. This is the core of the new 21st Century Silk Road Initiative.

INCREASED TRADE IN CHINESE CURRENCY. In essence, China is looking to replace the U.S. Dollar for trade in emerging markets, primarily in Asia, and at the same time, transition its economy into more advanced/high margin industries. The amount of Asian trade taking place in Chinese currency is moving up strongly, from 7% three years ago to 31% today. [Source: Beijing's Yuan Push Bears Fruit, Wall Street Journal, May 27, 2015]. As the U.S. Dollar could appreciate over the next decade due to its scarcity [fewer U.S. Dollars sent overseas for less imported oil and manufactured goods], an alternative is clearly possible. A stable Chinese currency and attractive Chinese financing terms could set the stage for a more stable economic and financial environment in Asia. If energy prices remain lower for longer, the Asian story only gets better. Countering this potential is the fear among China's neighbors and potential investment targets that China may ask for too much in return for its investment in their region, or take away their unique culture. So China must tread carefully as it seeks to transform its economy and benefit the economies of greater Asia.

MORE ECONOMIC STABILITY OFTEN LEADS TO HIGHER VALUATIONS. Despite a slowing China, a more stable Asia could create more confidence, less volatility, and higher valuations for assets, including stocks, in the Asian region. Key factors to watch are the amount of trade that is taking place in the Chinese currency and possible approval of China's request for membership in the IMF system of special drawing rights [SDR]. Admission into the SDR system is the next step for China's currency [the renminbi] to be recognized as a major global trade currency and potentially a reserve currency in the Asian economies. The IMF decision will likely take place in November 2015, with major implications for China's further influence in the global economy; the last major event being China's entry into the World Trade Organization in 2001.

MONEY COULD FLOOD INTO CHINA [AND ASIA] LIKE NEVER BEFORE. If China gains entry into the SDR system, it is quite likely that China will open itself to more foreign investment. Traditional stock index funds [and bond funds] will add much more in Chinese securities to their index components. Chinese and Asian interest rates are likely to decrease materially as bond yields are driven lower from new bond buyers, providing a boost to both the Chinese economy and broader Asia. Massive buying of Chinese shares could take place by the large index funds, beyond the current ownership in just emerging market index funds. As a result, we wouldn't be surprised to see additional shares in large, state owned Chinese enterprises be sold to index funds that are "forced to buy" at very high valuations. In this case, the index funds might be used as a tool by the Chinese to raise hundreds of billions of dollars to fund its social programs. This is one downside to traditional index funds; valuations are not a strong consideration when adding companies to the index.

CONCLUSION. For most clients, investment in Asian equities [not necessarily Chinese companies] involves smaller percentages, if at all. So we view this entire discussion as being "on the margin" for most client portfolios. In terms of investment opportunities for Asian equities, they are vast and varied, including index funds, active mutual funds, and separately managed accounts, with the ability to exclude certain areas [such as Japan and/or state owned Chinese companies] and to favor certain other areas.

Two Keys to Effective Investment Strategy – From "The Good Judgment Project"

Two famous economists and investors during the Great Depression, John Maynard Keynes [British] and Irving Fisher [American] were financially devastated from the stock market crashes in the United Kingdom and United States in 1929. Just days before the 1929 crash in the U.S., Fisher famously declared that stocks were likely to have reached a permanently high plateau. His name was forever linked to the 1929 stock market crash. While Keynes was less vocal at the time, he was just as bullish and just as harmed, professionally and financially, by the events of 1929 and the immediate aftermath during the Great Depression.

FISHER STAYS THE COURSE. Fisher never changed his approach to economics or investing. After the stock market crash, he believed the economy and stock market would quickly and fully recover. He borrowed more money and purchased more stock even as stock prices continued to decline much further. Near the end of his life, Fisher owed nearly $10 Million [in today's dollars], was living with relatives, and had lost all of his assets to creditors.

KEYNES CHANGES HIS APPROACH. Unlike Fisher, Keynes changed his investment approach. Rather than basing his investments on economic predictions [which led to trouble for both Fisher and Keynes in 1929], Keynes changed his investment approach and adopted what could be described as a "Warren Buffett approach"; buying quality stocks at good prices, focusing on companies that could perform well in virtually any economic situation. His new investment approach worked. Keynes produced stellar investment results after the 1929 crash until his death in 1946, outperforming the stock market by about 6% per year during that 25 year period in which he managed the Cambridge University endowment fund. [Source: Tim Harford, "How to See into the Future", London School of Economics and Political Science, Lecture Series, February 5, 2015].

Keynes regained his substantial net worth and investment reputation [leaving his reputation as an economist aside]. In a famous quote attributed to Keynes, the famous economist and investor said,

> *"When the facts change, I change my opinions, what do you do?"*

INSIGHTS ON DECISION MAKING FROM A MAJOR RESEARCH STUDY. Whether it relates to business decision making or investment decision making, a ground-breaking study called the "Good Judgment Project" found two keys to effective decision making:

1. **Keep Score** – Measure results of decisions so that effectiveness can be evaluated.
2. **Have an Actively Open Mind** – Decision makers that enjoy discussing and learning from opposite views, and are willing to change their minds when appropriate, tend to be better decision makers. At times it is proper to have the fortitude to stand by your convictions, but this trait is more effective when combined with an open, questioning mind.

KEY POINTS. As a takeaway from this discussion, here are some key points to consider when evaluating investment advisors:

- Ask your investment advisors about their major assumptions, why they hold them, their degree of confidence in these assumptions, and at what point they would admit their assumptions were incorrect.
- Make sure an investment advisor is always providing relevant investment performance, but keep an open mind when receiving explanations of the quality of the performance.
- Investment advisors that propose standard solutions while rarely changing course or providing logical explanations that are unique to the client may be lacking an open mind.
- Some of the best questions from clients or prospective clients are the simplest questions that are not specific to investments, but to business or life in general, such as:
  - *What is the last major mistake in judgment you made for your clients?*
  - *Did you communicate this mistake to your clients, and if so, how?*
  - *What did you learn from your last major mistake?*
  - *How often do you deviate from conventional wisdom in your profession, and provide a recent, specific example?*
  - *What do clients say they like about your investment approach, and what negative feedback have you received about your investment approach?*

These types of questions should never be off limit and should provide the basis for a healthy, insightful discussion with your investment advisor. Many potential clients do not know what questions to ask, which is why referrals from others can be so helpful.

FURTHER INSIGHTS FROM THE J FAMILY. Going back to the book about the J Family [in our first article], consider the following key lessons they learned, which dovetail nicely with this concept of keeping an open mind:

> *"The really important lesson lies in not what we did, but in how we did it, and the common denominator of the 'how we did it' was involving ourselves with some very smart and well respected people, many of whom were not initially in agreement with where we trying to lead them. In addition to involving ourselves with a lot of smart people in the 'Better Way' journey, a second important aspect of the 'how we did it' was the challenging of conventional wisdom, and herein lies another important lesson..."*

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