Investment Advisor

CONVERSATIONS ON INVESTMENT MANAGEMENT

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" *Investment is most intelligent when it is most businesslike.* "

-- THE INTELLIGENT INVESTOR, PROFESSOR BENJAMIN GRAHAM --

One of my favorite books was written by an economist who worked for General Electric and other large corporations from the late 1920s through World War II. Using real life experiences and observations, the author emphasizes how excessive debt, over-confidence, and a failure to change course quickly when the facts change, can lead to economic suffering for a country and a family. The book focuses on protecting against the downside while prudently planning for success. These "lessons learned", summarized above, are good to remember in both good times and bad, and in many areas of life.

We hope you find the articles in this edition of Investment Advisor to be helpful. If you would like information about Miller Capital and the services we provide, please feel welcome to contact us.

Costco on Tariffs

Costco, one of the largest retailers in the world, generates most of its revenue from U.S. stores but imports from non-U.S. suppliers. So how is this retailer dealing with and planning for current and potential tariffs? Here are a few excerpts from Costco's most recent earnings conference call, discussing tariffs:

> *"The next subject I'll touch on is tariffs and their impact on our business. As you know, there are many moving parts and it's extremely fluid, starting with the actions and reactions by both the U.S. and Chinese governments.*
>
> - *What actions are we exploring and taking in some short term and some long term?*
> - *Accelerating shipments before tariffs go into effect; recognizing there's a limited ability to do so, everybody's trying to.*
> - *Working with suppliers to see what can be done to reduce and/or absorb some of the costs.*
> - *In some cases, reducing our commitments on certain impacted items.*
> - *Alternative country sourcing, but again, it's where possible and feasible; it's limited ability that takes time.*
> - *Taking advantage of lower pricing on some U.S. items because of the reverse, if you will,such as pork, nuts and soybeans.*
>
> *In summary, we'll have to see how customers and competitors react to tariffs and what impacts it will have remain to be seen."* – COSTCO CFO RICHARD GALANTI, 10/4/2018

Numerous public companies are making similar comments and are seeing reduced certainty in new orders from Asian supply chain customers most directly linked to the tariffs. If the tariffs are not negotiated toward a more certain outcome, global businesses will make alternative arrangements to deal with the tariffs. Until then, tariffs are creating short-term volatility in business confidence and planning. Companies are beginning to not just talk about tariffs, but are making contingency plans as the uncertainty is starting to impact business operations. For investors, a patient, "businesslike" but nimble approach is better than an emotional reaction

Billionaire Investor Dissects Computer Trading

Stan Druckenmiller is one of the most successful investment managers of the past thirty years. Recently, he discussed how computer program trading is dominating daily trading activity and impacting market prices for a variety of traded assets, including equities, commodities, bonds and currencies [among others]. Program trading often has no correlation to underlying value, but tends to focus on price movements, news headlines, or other unusual factors.

DIRECT INSIGHTS INTO PROGRAM TRADING FIRMS. Druckenmiller has invested with some of these program trading firms to gain insights into their process. He has seen how they can defy common sense and are simply attempting to push prices around irrespective of the underlying fundamentals. Here are a few of his comments on the topic:

“If you really believe in yourself, it’s an opportunity [the distortions from program trading]. But… it makes you question your scenario. They all have many, many different schemes they use, and different factors…and a lot of these [program trading firms] are built on historical models, and I think a lot of their factors are inappropriate because…they’re in an old regime as opposed to a new regime, and the world keeps changing, but they are very disruptive…”.
– REAL VISION INTERVIEW, STANLEY F. DRUCKENMILLER, PUBLISHED 11/13/18

IS PRICE VOLATILITY A RISK OR AN OPPORTUNITY? Although price volatility is often perceived as risk, we feel it can create tremendous opportunity. We have seem numerous situations where common stocks with attractive return potential have been pushed far below our estimate of fair value for seemingly no reason, with no new developments. Program trading that pushes prices much higher or lower due to shear trading volume can be similar to other situations that unhinge the market price from an asset’s longer-term value, such as when the buyer or seller:

- is too emotional and/or irrational
- has a need for immediate action, or...
- simply focuses much more on near-term factors than longer-term factors.

Volatility and distortions create opportunity for those that are both willing and nimbly able to do so, within their investment strategy. Yet such price volatility often makes the opportunity look like a dangerous trap. This is why a disciplined appraisal for each asset’s value, using well-reasoned analysis, is so important in distinguishing between danger and opportunity in volatile markets.

Who’s Buying and Who’s Selling?

One of the largest U.S. based brokerage firms recently released a report on the buying and selling of U.S. equities by its clients. Its clients are broken down into the following categories: retail clients [individuals], hedge funds, institutions and public corporations buying their own stock. The equities being tracked include individual stocks and exchange traded funds [which sometimes own assets other than U.S. stocks].

FACTS ON WHO IS BUYING AND SELLING U.S. EQUITIES. Here are some key findings from the above report, with data updated through 11/24/18. This data comes only from this large brokerage firm’s client base, not from all market participants:

- In 2018, 98% of the net U.S. equity buying has been from public corporations buying back their own stock.
- In 2018, the amount of net U.S. equity buying from corporate stock buybacks has been just under $65 Billion, nearly double the year before, and well above the average yearly buyback of nearly $38 Billion since 2010.
- Since 2008, individuals, hedge funds, and institutions have been very large net sellers of U.S. equities, cumulatively and in nearly every year, while public corporations have been very large net buyers of their own stock.

PUBLIC CORPORATIONS ARE THE ONLY MAJOR BUYERS OF U.S. STOCKS. The reason we find this information interesting is that it shows how public corporations, buying their own stock, have been the only major buyer of U.S. stocks in 2018, and for the past decade. When corporations are prohibited from buying back their own stock [generally starting before the end of a quarterly earnings period and ending after earnings are reported, and also during certain other events such as pending mergers or major transactions], there can be a vacuum created when the largest buyer of U.S. stocks is not buying. This occurred most recently from late September 2018 until late October 2018. When net selling from other categories continues [or becomes stronger in periods of fear or due to tax selling], and public corporations are not buying, there can become a large imbalance of sellers over buyers.

LARGE BUYERS AND SELLERS CAN CAUSE HIGH PRICE VOLATILITY IN CERTAIN TIME PERIODS. When we add in program trading to the four categories of buyers/sellers in the report, the equity markets can become very volatile. Of course, a wave of buying by several categories of clients can create the opposite result of strong buying demand, particular when it is focused in certain stock sectors or companies. All of this just provides another factor to consider when greater volatility can elevate an investor's fear, or confirm an opportunity to take advantage of fear. In the end, successful investing favors a prepared, disciplined approach rather than emotional reactions.

> *"Individuals who cannot master their emotions are ill-suited to profit from the investment process."*
> – PROFESSOR BENJAMIN GRAHAM

Short-Term U.S. Treasury Bonds

Once investment option we include in our fixed income searches is the short-term U.S. Treasury Bond. We typically define "short-term" as maturities of two years or under. Here are a few key features of these bonds:

- Short-term treasury bonds tend to have high liquidity if sold prior to maturity.
- Short-term treasury bonds can often be purchased at little to no commission cost, depending on the broker or custodian involved.
- Yields on short-term treasury bonds have moved substantially higher over the last few years and are now competitive in yields [often higher] compared to Certificates of Deposit issued by banks.
- Treasury bonds are generally subject to state income tax.
- Treasury bonds are backed by the full faith and credit of the U.S. government.
- Short-term treasury bonds can be purchased with a wide variety of maturity dates, matching the desired maturity dates.

Alternative Asset Allocation Approaches

If a portfolio increases in value over time, does that mean that the same percentage of assets should always be allocated to fixed income and cash? Consider the portfolio below that grows from $2 Million to $4 Million over many years and is then rebalanced to maintain an asset allocation of 65% equities and 35% in fixed income and cash. If the client's financial situation has not changed, is it necessary to have an additional $700,000 invested in fixed income and cash just because the portfolio value increased? Perhaps, but it's worth questioning if the rebalancing process has a clear correlation to the client's actual risk and return needs and goals.

Asset Allocation Target	Previous $	Current $	Increase $
Equities	$1,300,000	$2,600,000	$1,300,000
Fixed Income & Cash	700,000	1,400,000	700,000
Total Portfolio	**$2,000,000**	**$4,000,000**	**$2,000,000**
Fixed Income & Cash %	**35%**	**35%**	

TRADITIONAL ASSET ALLOCATION VS. ALTERNATIVE APPROACHES. A recent Wall Street Journal Article discussed traditional asset allocation approaches compared to an alternative approach. [Source: A Better Way to Think About Portfolio Rebalancing, Mier Statman, WSJ 9/23/2018]. The traditional approach tends to select an asset allocation based on estimated returns while keeping risk within a reasonable limit, assuming risk is the potential for volatility or a decline in portfolio value. Yet an age old investing question is:

What is risk? Is risk successfully controlled by limiting the amount of decline in a one to three year period, based on historical results? Or is risk something different for a particular investor?

An alternative approach worth considering [perhaps in coordination with the traditional approach], is determining how many years of portfolio income or spendable cash flow [pre-tax or after-tax] should be covered by less volatile assets. Some investors may feel comfortable with three or five years of coverage, while others may prefer ten or more years of coverage, depending on a variety of factors, both personal and financial. Perhaps risk is better controlled by answering the following question:

How many years of portfolio income or cash flow distribution coverage is necessary to protect against:

a] the reduction of dividend income from equities in times of financial distress until those dividends recover, or b] sales of equities during times of financial distress [allowing equity prices to recover]?

WHAT RISK IS BEING PROTECTED AGAINST? If this asset allocation approach differs from the traditional approach, a discussion can lead to a tailor-made strategy for the client. Other approaches can also be developed, but the best ones are tailor-made to the client's risk and return needs and goals; understanding that risk can be thought of, and impact long-term returns, in a variety of ways. But with any evaluation of risk, a key question is what is being protected against?

DECLINES IN SHORTER-TERM PORTFOLIO VALUE VS. PROVIDING FOR LONG-TERM SPENDING NEEDS.

For many clients, the ultimate risk is not shorter-term changes in portfolio value, but failing to have sufficient cash, after taxes and inflation, to meet long-term spending needs. Viewed in that light, the traditional asset allocation approach [protecting against shorter-term declines in portfolio value] may need to be re-evaluated so as to not be the only approach for the portfolio's investment strategy.

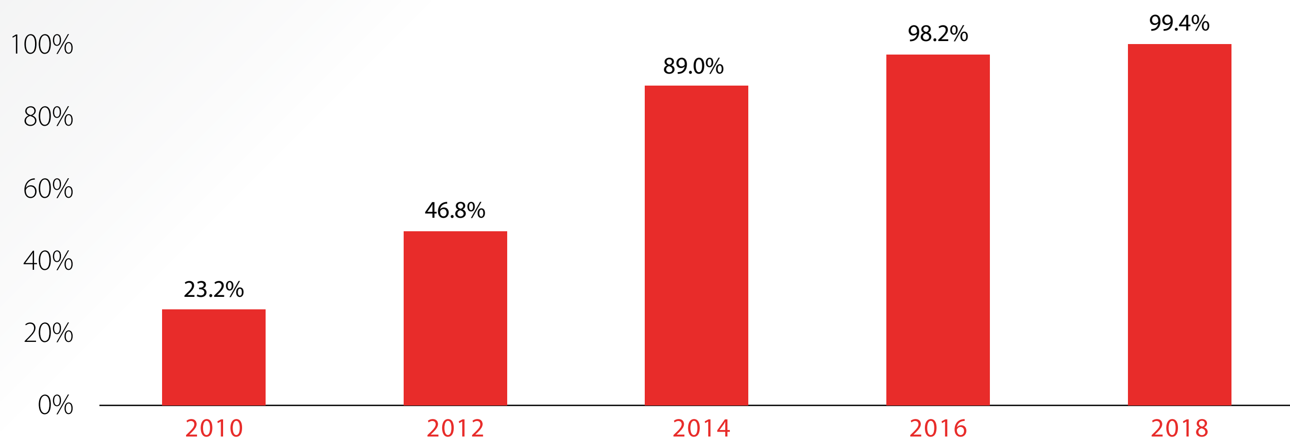
As the Wall Street Journal article suggests, there are other ways, perhaps better ways, to arrive at a proper asset allocation. In our view, there is no one "better way", but thinking beyond one traditional approach is usually better for an investor's confidence in the process. It is the investment advisor's responsibility to provide the client with education and alternatives leading to a "tailor-made" asset allocation strategy.

Index Investing – How Much of a Good Thing?

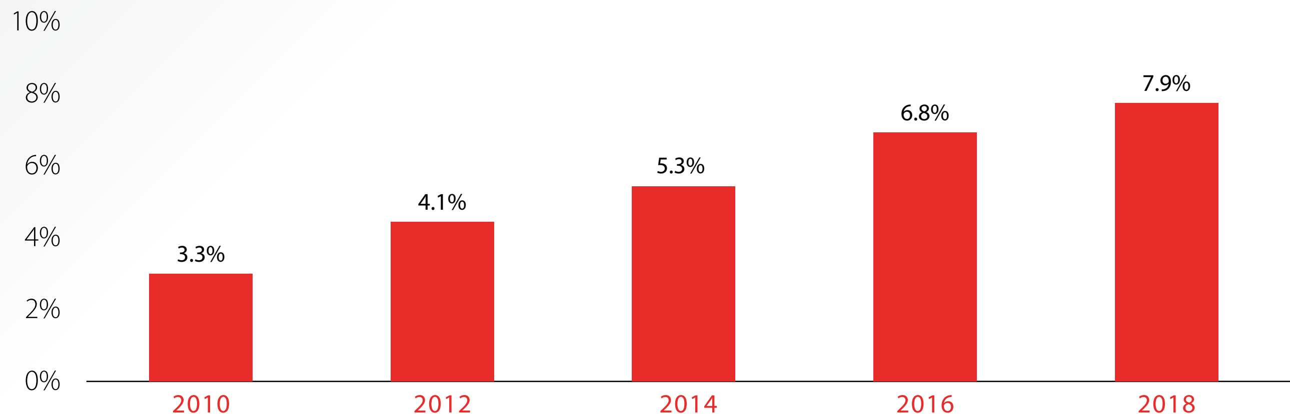
Investing in broad based U.S. equity index funds, particularly the S&P 500 Index, has become very popular. The amount of funds flowing into these passive index funds has grown dramatically. Conversely, "actively managed" funds that select investment securities unrelated to following a pre-determined list [the "index" approach], have seen large outflows from their funds. We have seen various estimates, but consensus seems to be that nearly 50% of all U.S. equity fund assets are in index funds. [Source: Morningstar Assets Under Management Data as of 5/31/18]. A recent report from Merrill Lynch estimates that the percentage of assets managed in U.S. equity index funds has nearly doubled over the last ten years. [Source: Merrill Lynch Equity & Quant Strategy Report, 9/24/18].

INDEX FUNDS ARE CONTROLLING MORE EQUITY DOLLARS AND PUBLIC STOCK OWNERSHIP.

As further evidence of the growth of index investing, it is estimated that Vanguard, one of the largest equity index managers, owns more than 5% of the outstanding, freely tradeable stock [float] of nearly every public U.S. company. This is a dramatic increase since 2010, as shown in the chart below.



Looking at the same report, Vanguard owns nearly 7.9% of the market value of the S&P 500 companies, nearly 2.5 times greater than in 2010. Clearly, investors are indexing, and there are many other managers besides Vanguard [Blackrock, Fidelity etc…] that are also becoming large owners of the same stocks in index funds.



ACTIVE FUNDS MANAGED LIKE INDEX FUNDS INCREASE THE INDEX EFFECT. In addition to the money pouring into U.S. index funds, a large and growing number of active funds are investing similar to the index funds, purchasing many of the same stocks. If the nearly 50% of active funds that are more like index funds are added to the index fund category, the total of equity funds that are effectively managed as index funds is arguably closer to 75% of all U.S. equity dollars, not the estimated 50% owned in actual index funds. Buying into each U.S. stock in an index, regardless of underlying value, is becoming the dominant approach among U.S. equity fund investors.

SHORT-TERM INVESTING ALSO GROWING IN POPULARITY. In addition to the massive move toward index funds, short-term investing is also becoming prevalent. While estimates vary, one large equity manager cites a study that the average holding period for a stock has declined from nearly three years in 1980 to ten months as of 2017. [Source: Longleaf Partners, 2nd Quarter 2018 Report]. A short-term focus on general news headlines and company announcements has led to more frequent trading with market prices often becoming unhinged from longer-term fundamentals. As mentioned in our second article, this creates opportunities to buy and sell at very attractive prices, when the market over-reacts to short-term or over-emphasized events. But this is nothing new. Investing typically finds investors with varying time horizons as they make investment decisions.

TRULY ACTIVE EQUITY INVESTING PROVIDING GREATER DIVERSIFICATION. For investors that truly appreciate diversification in not only their underlying holdings, but also in their investing styles, a truly active approach to investing, focusing on long-term, underlying value, is becoming more highly differentiated from the index approach. For those willing to invest in the road less traveled, the active approach can still have low turnover and tax-efficiency [for taxable accounts], but with very different risk and diversification factors than the index approach. It requires discipline to focus on the long-term when the short-term is volatile, but a well-reasoned appraisal of value can provide the foundation for that required discipline.

To be clear, we use index funds for both equities and fixed income. They work very well for most portfolios. The question is how much of a good thing is enough? As equity index funds become more popular and more concentrated in the popular, large stocks, the alternatives to index funds are worthy of more consideration.

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- We offer both investment management and investment consulting services.
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