Investment Advisor

CONVERSATIONS ON INVESTMENT MANAGEMENT

SECOND QUARTER 2019

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“*Investment is most intelligent when it is most businesslike.*”

-- THE INTELLIGENT INVESTOR, PROFESSOR BENJAMIN GRAHAM --

"HAROLD IS BACK. HE COULDN'T STAND MY 'SELLING LOW' IN OUR STOCK PORTFOLIO!"

All though it seems the investment markets have been far more volatile over the last ten years than in previous decades, volatility is part of investing. The 4th Quarter of 2018, and May 2019, were no exception. Greater volatility can increase the temptation to make emotional decisions, as shown in the cartoon above. This validates the need for a clear investment strategy, an understanding of underlying investment characteristics, and discipline.

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

A Critical Investment Issue – Buffett Says it Again

In a May 6, 2019 TV interview, Warren Buffett repeated a claim he has made many times in the past few years.

> *"I think stocks are ridiculously cheap if you believe that 3% on the 30 year [U.S. Treasury] bond makes sense."*

INTEREST RATES HAVE MOVED EVEN LOWER. The 30 Year Treasury Bond yield was 2.90% then, and is 2.55% in mid-June 2019. Despite long-term bond yields being this low for many years, even ten years past the start of the Global Financial Crisis, Buffett still holds to his view that interest rates will not remain this low. In the same interview, Buffett went on to say:

> *"I wouldn't think you could have these things at these levels [long-term rates, inflation rates, budget deficits], and have that be a stable situation for a long period of time. And I still believe that, but so far I'm wrong."*

ACCORDING TO BUFFETT:

- Stocks are ridiculously cheap "if" you believe long-term U.S. interest rates will stay this low.
- That is a big "if", as he acknowledges.
- He goes on to say, "that's what makes going to work interesting".

We highlighted similar Buffett comments in past issues of *Investment Advisor* because the level of interest rates is a key factor in evaluating investments, and in making investment decisions. We have been consistent in our writings over the past ten years that interest rates would decline substantially and remain low. In that respect, our view has been far different than Buffett's view on this important investment factor.

BUFFETT'S SITUATION IS UNIQUE. Not to be overlooked is that Buffett:

- Makes many statements that should be evaluated in light of his unique situation, which is different than most investors.
- Has a very long-term outlook and generally does not care about short-term losses or economic and political uncertainty.
- Is usually a net buyer of equities personally and for his company, so he favors volatility and short-term declines in prices [to invest more], unlike many investors.
- Has many caveats to his views, which are often overlooked or under reported.

INTEREST RATES ARE EVEN LOWER ELSEWHERE. Back to interest rate levels, many other developed countries have even lower interest yields on their ten year government bonds, including some at negative interest rates.

10 Year Government Bond Yields [June 18, 2019]	
Switzerland	-.57%
Germany	-.32%
Japan	-.13%
France	.01%
Canada	1.44%
Australia	1.37%
United States	2.06%

ARE WE MAKING INVESTMENT DECISIONS IN A WORLD THAT IS STRUCTURALLY DIFFERENT?

Now, more than ten years after the onset of the Global Financial Crisis:

- The impact of low interest rates is really, finally starting to sink in for many investors.
- Important implications for portfolio design likely deserve more attention for the next ten years.
- Investors should consider they may be making investment decisions in a world which is structurally different; a world of much lower interest rates.

OUR KEY BELIEFS IN THIS ENVIRONMENT. As a result of this structurally different investment environment [our view for the last decade], we believe:

- The root causation of lower interest rates is clear,
- The implications are numerous, and
- The opportunities and risks vary greatly depending on the investment approach.

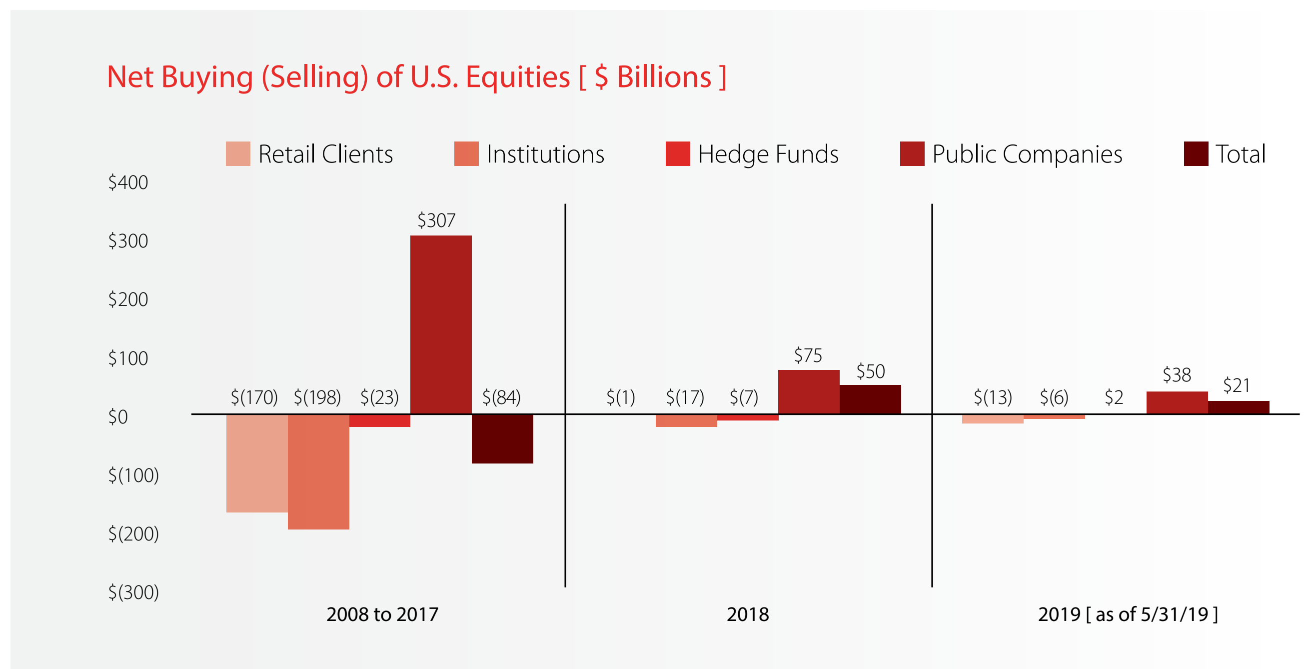
QUESTIONS TO CONSIDER FOR A LOW INTEREST RATE WORLD. In light of persistently low interest rates, a few questions arise from an investment planning perspective:

1. What assumptions are made as to future fixed income returns of a portfolio, and what happens to overall portfolio returns if fixed income yields remain low, or even move lower?
2. What role should fixed income play in the portfolio if their yields remain low, or move lower? Are they viewed as a hedge against equity declines? Are they simply a reserve to cover future cash flow needs? For other purposes?
3. What maturities are appropriate for fixed income investments in the portfolio?
4. Is there more benefit or harm to future portfolio values and returns from low or lower interest rates longer-term, based on how the portfolio is invested?
4. If Buffett is eventually correct and interest rates move higher, perhaps much higher, what adjustments can be made and should be made to the portfolio?

THE IMPACT OF LOW INTEREST RATES ON INVESTMENT PORTFOLIOS. At Miller Capital, we have seen how lower interest rates have impacted portfolios over the last twenty years. Portfolio owners, whether they be individuals, longer-term irrevocable trusts, pension plans, or foundations and endowments, need to evaluate their long-term return requirements and how best to achieve those returns from various investments under a variety of scenarios.

Just One Buyer of U.S. Equities

As highlighted in our last issue of *Investment Advisor,* there was just one meaningful buyer of U.S. stocks in 2018; public companies buying their own stock. The same is true in 2019. In fact, this has been the case since 2008, as shown in the following chart. From January 2008 to the end of 2017, public companies were net buyers of $307 Billion of U.S. equities while retails clients and institutions were net sellers of $170 Billion and $198 Billion of U.S. equities, respectively.



IMPORTANT NOTES

The money flow data summarized in the previous chart comes from a major investment brokerage firm's client trading flows into U.S. stocks, as executed by the firm. A positive value represents "net buying", which is the dollar amount of buy orders less sell orders for all U.S. single stocks and exchange traded funds. All clients that are not retail clients, hedge funds, or public companies are categorized as institutional clients and include mutual funds, pension funds, insurance companies, investment counselors, banks, broker dealers, etc. These values may not be representative of money flows for the entire U.S. equity market, but are reflective of this one firm's client base. Source: BofAML Equity Client Flow Trends 6/4/19, which includes important disclosures and may contain qualifying statements or caveats that may not be included in our article above.

LIKELY CAUSE OF NET SELLING OF U.S. EQUITIES. This net selling of U.S. equities by nearly every group of investors, except for public companies, is not indicative of a euphoric, speculative environment, although such pockets exist. More likely, this net selling of equities since 2008 is the result of continued fear of equities following the 2008/2009 Global Financial Crisis. A similar fear of equities lasted for decades following the stock market Crash of 1929 and subsequent Great Depression.

MARKETS CAN BE VERY UNEVEN WITH ONLY ONE BUYER. Despite a large decline in stock prices in the 4th Quarter of 2018, and in May 2019, the U.S. stock market has generally been within 5% of its all-time highs in the 2nd Quarter of 2019. You would think, because of this fact, that investors must be pouring money into the stock market, holding stock prices up at high levels. The data from the previous chart suggests:

- Without large amounts of public company buying, equity selling would have overwhelmed the buying.
- Given all the selling by most investor groups, it is interesting that U.S. equity markets are not lower.
- With public companies as the only material buyer of equities, the equity markets are more vulnerable to declines when the companies are restricted [for various reasons] from buying their stock.

QUESTIONS TO CONSIDER RELATED BY BUYING AND SELLING DEMAND TRENDS:

1. If markets sell off [any market, not just equities] mainly due to headlines or a lack of short-term buying by most investor groups [except public companies] does that mean the investment is less attractive or more attractive, especially if nothing has fundamentally changed?
2. Does the fact the most investor groups [except public companies] are selling equities, or not buying them, mean other long-term investors should be influenced by their behavior and decisions?
3. In past periods when markets are moving much higher and valuations are extremely high [as more investor groups were large net buyers of equities], is that the prudent time to join in the euphoria and buy?
4. In what other area of investing, or in business, or in life, is it typically wise to do what the majority of people have been doing with greater and greater intensity?
5. Is the majority always wrong?

FIXED INCOME MARKETS HAVE SEEN LARGE NET BUYING FROM ALL FOUR GROUPS. On this last point, sometimes the majority is correct, but for the wrong reasons. To illustrate, during the last ten years:

- Massive amounts of money have poured into fixed income investments from all four major investor groups [retail clients, institutions, hedge funds and public companies], with a large amount invested in short-term bonds and cash.
- We suspect most of this investment into fixed income was not due to a view that interest rates would move lower and stay lower, but due to fear of equities.
- In essence, the masses did quite well with their fixed income investments, although the decision was likely made for reasons other than conviction that interest rates would drop dramatically for at least a full decade.

OUR REASONS FOR OWNING BONDS IS NOT A FEAR OF EQUITIES. When appropriate for a client's situation, we have favored bonds over cash for nearly two decades, but not due to a fear of equities:

- We have consistently advocated that interest rates would move much lower and stay lower.
- We felt that fixed income investments [particularly intermediate and longer term maturities] would perform very well;
- We felt that cash would be a very poor investment because the much higher yield from bonds, even if interest rates increased modestly, would still outperform cash.

WHAT IF NET BUYING RETURNS TO U.S. EQUITIES? Back to U.S. equity markets, what could happen in the U.S. equity markets "if and when" the fear of the Global Financial Crisis eventually fades?

- More net buying will likely comes from other investor groups, rather than just from public companies.
- The masses will likely move from being net sellers to net buyers.
- It will then be time to be even more watchful for uncompensated risk [i.e. when realistic future returns are low compared to the risks involved].

Top of Mind Investment Issues

THREE QUESTIONS ABOUT LOWER INTEREST RATES

- Why are U.S. interest rates so low ten years after the Global Financial Crisis, despite trillions in U.S. tax cuts and assistance from the Federal Reserve, and similar efforts by other countries?
- Why did U.S. interest rates moving dramatically lower in the last half of 2018 and first half of 2019 even as the Federal Reserve was moving its interest rates higher in 2018?
- Is something else behind this dramatic decrease in interest rates?

We believe the answer to the last question is definitely "Yes". We believe:

- A fear-based concern over lower interest rates is due to a misunderstanding of the true cause behind lower interest rates.
- This misunderstanding can lead to investment decisions that harm long-term portfolio returns.

Without being more specific on the true cause behind lower interest rates [since we only provide investment advice to our clients], establishing a proper investment strategy and making investment decisions in light of these lower interest rates is both important and timely.

U.S. VS. INTERNATIONAL INVESTING

In a recent interview, a well respected global equity investment manager, Mark Yockey [Artisan Partners] commented on the advantages of investing in U.S. companies compared to international companies. He noted that many key growth industries are dominated by U.S. companies, with a few exceptions.

> *"The U.S. is good at some industries that the rest of the world is not very good at. And some of these industries we dominate [technology, software, biotechnology, healthcare]. As long as these growth industries of the future are dominated by what's going on in the United States, you're going to have the opportunity to invest in things here that you don't have in other parts of the world. I think it's going to be a long time before the Chinese catch up in these new industries. Twenty five years from now it may be a different story.*
>
> *But as long as people continue to innovate in this country and innovation is rewarded…if you are an entrepreneur in the United States, you can benefit a lot from your innovations, and in many other countries, and possibly China, sometimes, but not always, you don't enjoy the benefits of those innovations. It makes a difference."* Mark Yockey, WealthTrack, 5/24/19.

HERE ARE A FEW OF OUR OWN THOUGHTS ON THIS TOPIC:

- U.S. investors have a strong bias toward U.S. equities compared to international equities, which has worked out quite well over the last ten or so years.
- A diversified portfolio will usually include an allocation to international equities.
- Factors such as currency risk, geopolitical risk, economic risks, and fundamentals are all part of the allocation decision, i.e. how much to invest in international equities.
- The U.S. business ecosystem is very advantageous, which adds to the bias toward U.S. equities.

Our Focus on Serving High Net Worth Clients

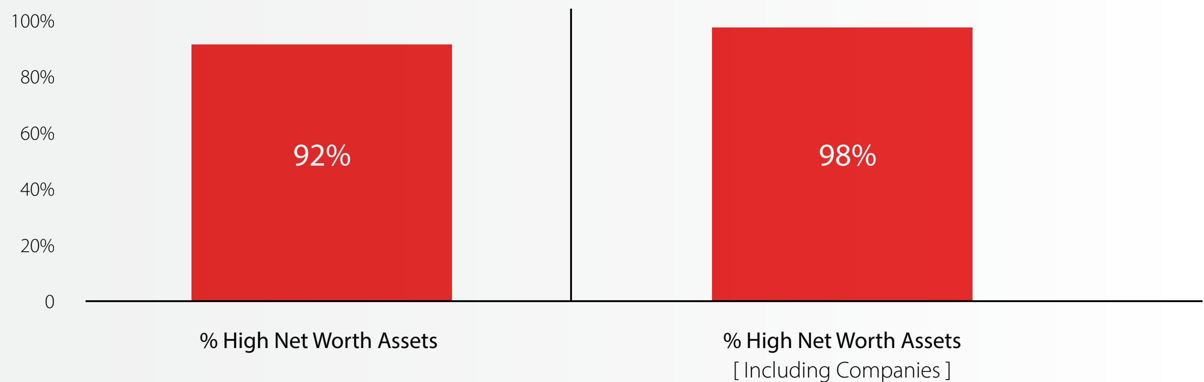
For twenty years, Miller Capital has focused on serving high net worth clients [defined later] with larger portfolios. Whether these portfolios are owned by individuals, irrevocable trusts, or private companies, we tend to serve clients with taxable portfolios that prefer a tailored investment approach. Often, our clients have other financial opportunities or situations that benefit from our counsel.

AN INTERESTING QUESTION FOR INVESTMENT ADVISORS. One interesting question that is rarely asked of investment advisors is their average account size, average client size, and the average percentage of clients and accounts managed for "High Net Worth" clients. While investment firms define "High Net Worth" differently, the Securities and Exchange Commission [SEC] defines it precisely.

AT MILLER CAPITAL:

- 92% of assets we manage are for High Net Worth clients [including irrevocable trusts], as defined by the SEC.
- 98% of assets we manage are for High Net Worth clients [including their private company accounts].
- The other assets we manage are for family members of High Net Worth clients [children, parents etc.].

Miller Capital: Our Focus on High Net Worth Clients [Assets under Advisement]



FOCUS AND CONFIDENCE GO HAND IN HAND. Focus is critically important in any successful endeavor. Focusing our services and counsel on High Net Worth clients allows us to:

- Concentrate on investment and financial issues that are most relevant and important to our clients.
- Share ideas and concepts that are applicable to many of our clients.
- Reduce administrative time spent on small accounts for smaller clients that do not share similar investment and financial issues with our High Net Worth clients.
- Develop innovative solutions for our clients.
- Spend additional time providing tailored investment letters, reports, and recommendations to improve client confidence in our strategies, and to prompt helpful discussions.

While we focus on serving High Net Worth clients [including trusts and private companies] with portfolios above $2.0 Million, we often work with clients below that amount if they are likely to move above that amount over time, or for other reasons. While this is a guide, our most important guiding principle in this area is to work with good clients; clients that can benefit from our work and that can also improve the quality of our work that benefits other clients.

It is clear to us that working successfully with and for High Net Worth clients requires and deserves our focus. Focus allows us to do our best work for our clients, and allows them to be confident in our work for them.

Focus and confidence; two words that we strive to achieve at Miller Capital.

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/companies, and private trusts [serving individual and corporate trustees].

CAUTIONARY DISCLOSURE

Investment Advisor is written and published by Miller Capital for educational purposes only and is not intended to be relied upon for investment decisions, tax or legal advice. We only provide investment advice to our clients. Any specific securities, companies, industries, and concepts mentioned, or examples provided, are: illustrative for educational purposes only; should not be considered, in any manner, as recommendations of Miller Capital; are not a forecast of future events or returns.