Investment Advisor

CONVERSATIONS ON INVESTMENT MANAGEMENT

SECOND QUARTER 2020

CONTENTS

Mark A. Miller, JD, CFA
President

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

-- THE INTELLIGENT INVESTOR, PROFESSOR BENJAMIN GRAHAM --

Interest rates continue to decline around the world. In our last issue of *Investment Advisor* we unpacked our views on the long-term drivers of lower interest rates and the implications for private investors and trusts. Since then, interest rates have moved even lower as a result of the economic impact of the COVID-19 virus. In our view, these ultimate, long-term drivers of lower interest rates remain intact, and the investment implications for investors are profound, as we've discussed many times in previous issues of *Investment Advisor*.

We hope you find the articles in this edition of *Investment Advisor* of interest during this unparalleled period of investing. If you would like more information about our investment services, please feel welcome to contact us.

Personal Reflections - The Covid-19 Bear Market

I'm often asked by clients and friends what life has been like professionally the last four months, during the COVID-19 crisis. I would say there were only a few tough nights of sleeping, not due to fear but simply waking up with thoughts on my mind. I would grab my phone and send myself e-mail reminders of things to research or follow-up items. But assuming we had a proper strategy for each client, for both the known and unknown, we should never feel fear or panic.

We worked many more hours than normal the last four months. Not only were there more client conversations and portfolio reviews, but there were more issues and opportunities to address than normal. Here are a few examples, by way of illustration:

- Which existing investments are likely to recover more than potential replacement investments over various time periods?
- What tax planning opportunities exist?
- Should cash be increased for certain clients, perhaps selling investments that have not declined in value?
- Is there excess cash that should be invested for certain clients, and if so, in which investment opportunities?
- Which new investment opportunities are so strong that it is worth selling an existing investment at a taxable gain to make the new investment?
- Which form of cash is best; FDIC bank deposits, government money market funds, traditional money market funds, short-term treasury bills or commercial paper, and in what amounts?
- Which investment opportunities not previously researched in depth should now be researched in depth, on a prioritized basis?

The professional stress we feel is primarily out of concern for our clients and the desire to make sure we are making the right decisions for them. We feel a tremendous sense of responsibility for our clients' money, and that can weigh on us, as it should. It comes with the territory and requires a mix of being calm, cool and collected, but not over-confident. We must always question our assumptions and decisions.

It would be perfectly normal for most clients to be more concerned or feel added stress during the last four months, even if they did not express it to us. Yet our longer-term clients have been through many volatile periods over the last twenty years, including the:

- Bursting of the tech bubble/internet stocks in 2000
- 9/11 terrorist attacks
- Iraq War and recession of 2002/20003
- Global Financial Crisis of 2008/2009
- Fears of another economic collapse in the years following the Global Financial Crisis
- Plus many other corrections and bear markets along the way.

Nearly every twenty year period is full of unwelcome political and economic events. These events vary in style and severity, but will always keep coming. So investors and investment advisors should be prepared because investing is full of uncertainties. In that respect, investing is not much different than life.

While we've not been here before in terms of the COVID-19 pandemic and economic shutdown, we've been here before many times in dealing with the potential for investment related panic. Human nature and peer pressure make investors feel better when selling while everyone around them is scared and media headlines are heavily negative, and feel better when buying while everyone around them feels confident and media headlines are constantly positive. That is easy to do. What's not easy, unless you are financially and emotionally prepared, is to avoid following the crowd in emotional times. That's part of what we do for clients; helping them achieve their financial goals and dreams based on a sound plan, logic, and research.

As of early June 2020, investment markets are recovering from the COVID-19 crisis. But whether the virus takes a turn for the worse, or some other unwelcome events come out of left field, it pays to have a prepared mind and well-planned investment strategy while placing a proper filter on information that influences our thoughts and emotions. In that sense, COVID-19 was another curve ball from a sometimes wild pitcher that looks dangerous and pushes many batters away from the plate. Some people will not want to step back up to the investment plate until asset prices are much higher and the media headlines are much more positive.

Effective investing requires discipline to avoid making mistakes that threaten an investor's long-term security and aspirational goals.

Lower Interest Rates Punching Back

The COVID-19 virus has killed and permanently altered the health and well-being of so many people. Given the economic impact, it may seem illogical that so many stocks, bonds, and other asset prices are doing as well as they are. While some stock prices are still quite low, many have fully recovered or are trading at higher prices than before the COVID-19 spread. Lower interest rates are a major factor.

We have long held the view, with strong conviction, that interest rates would decline and stay very low. The recent, sharp move down in interest rates is being caused by the COVID-19 economic impact and central bank policies that support debt markets. Interest rates bump up and down in the short-term, but the long-term trend [unrelated to COVID-19] of much lower interest rates [compared to the last forty to fifty years] will remain for quite some time, in our view. The recent "extra" spike down in interest rates from the COVID-19 impact is helping support equity values, for two primary reasons, in our view.

LOWER INTEREST RATES HELPING THE BALANCE SHEETS AND INCOME STATEMENTS OF PUBLIC CORPORATIONS

The Federal Reserve has announced and begun implementing several programs to assist public corporations with the refinancing and new issuance of public debt. This assistance is aimed primarily at U.S. public companies with debt rated investment grade, but some programs are also benefitting non-investment grade companies. The net effect is that U.S. companies are able to issue new bonds at much lower interest rates and longer maturities than was available pre-COVID. Interest rates and new bond issuance was already attractive pre-COVID, but now companies are looking at an incredibly attractive opportunity to extend their debt maturities and lower their interest expense. U.S. companies are taking advantage, just as European companies have been doing for years through the European Central Bank's similar programs. Many large European companies [and U.S. companies with

European subsidiaries] have been issuing bonds at zero or near-zero interest rates for longer-term maturities over the last several years.

We track new corporate bond issuance daily. The next table provides a few examples of new corporate bond issuances during the last few months, not as recommendations but as illustrations. Some companies have higher bond ratings and therefore lower coupon rates, while others are being hit hard by COVID-19. Still, the interest rates available on new investment grade corporate bond issues, at longer maturities, de-risks corporate balance sheets and improves cash flows and earnings through lower interest expense.

New Corporate Bond Issues

ANNOUNCED	COMPANY	YEARS TO MATURITY	COUPON RATE
4/17/2020	Large U.S. Retailer	7	1.38%
		10	1.60%
		12	1.75%
5/4/2020	Large U.S. Insurance Broker	10	2.25%
5/4/2020	Large U.S. Electronics Company	3	0.75%
		5	1.13%
		10	1.65%
		30	2.65%
5/7/2020	Large U.S. Animal Health Company	10	2.00%
		30	3.00%
5/14/2020	Large Global Insurance Broker	10	2.80%
5/13/2020	Large U.S. Consumer Entertainment Company	6	1.75%
5/13/2020		11	2.65%
5/13/2020		20	3.50%
5/13/2020		40	3.80%
5/19/2020	Large U.S. Pharmaceutical Company	5	0.80%
5/19/2020		10	1.70%
5/19/2020		20	2.55%
5/19/2020		30	2.70%
6/1/2020	Large U.S. Wireless Tower Company	5	1.30%
6/1/2020		10	2.10%
6/1/2020		30	3.10%
6/1/2020	Large U.S. Retail and Technology Company	3	0.40%
6/1/2020		5	0.80%
6/1/2020		7	1.20%
6/1/2020		10	1.50%
6/1/2020		30	2.50%
6/1/2020		40	2.70%

Many of these public companies were able to pay off bonds maturing in the next year or two, while reducing their interest cost on those bonds substantially. Combined with lower corporate tax rates, clearly many public companies will benefit from improved balance sheets and lower interest costs. These benefits accrue to the equity owners, and stock values will reflect this economic reality once investors look beyond COVID-19 to an eventual recovery.

LOWER INTEREST RATES POSITIVELY IMPACT EQUITY VALUATIONS

We evaluate equities, real estate or any asset using a variety of models. One model we always use, in addition or in combination with others, is discounted free cash flow or earnings of the asset. In the case of a common stock, we consider future free cash flows, defined as cash flows after maintenance capital expenditures or after all capital expenditures, depending on the company. We calculate the value of those future cash flow streams into today's dollars [present value] using an assumed interest rate and other factors. The lower the interest rate we use, the higher the value of those future cash flow streams for the owner of the equity or stock.

To put it simply,

IF we assume a company has:

- zero free cash flow or earnings in 2020 due to COVID-19 [very unlikely for most companies]
- a significant reduction in 2021 [say 25% to 35%]
- followed by a return to full free cash flow or earnings in 2022 and beyond,
- but a 1% to 2% lower interest rate [used in the present value calculation],

THEN the lower interest rate usually more than offsets the cash flow or earnings declines for 2020 and 2021.

In essence, some common stocks or assets are worth more, despite any COVID-19 impact, because of lower interest rates. If we were to also factor in the lower interest expense on new bonds issued in 2020, replacing higher interest rate bonds, it could further increase the value of the common stock or asset. In our work, the next year or two of free cash flow or earnings normally represents just 5% to 10% of the company's equity value.

A ONE-TWO PUNCH BACK VS. COVID-19

Investors should not lose sight of the powerful benefits of lower interest rates, assuming the economy does not enter a deep, prolonged recession or depression. As we've discussed with clients, there is a potential decision making trap known as "recency bias"; that is, projecting the recent past too heavily and/or too far into the future. Many people are surprised the stock market has held up so well after the initial collapse in stock prices during February and March 2020. But the market anticipates recoveries. Even so, what has not been appreciated enough, beyond a possible economic recovery, is the powerful one-two punch provided by lower interest rates.

- The first punch being lower interest costs and improved balance sheets via extended debt maturities.
- The second punch being lower interest rates used to value the future free cash flows or earnings of an asset, be it a stock, real estate or other investment.

Life is about people, not money, and COVID-19 has delivered a sad, lasting blow to many. Markets moving up are of little consolation. We are simply providing one partial but powerful explanation for markets holding up better than expected during COVID-19, while acknowledging speculative trading is always pushing some investment prices far too high. COVID-19 exemplifies a constant, important investment issue; having an open mind to consider when the recent past should not be projected too heavily and/or too far into the future, but also considering which recent events will result in a profoundly different future.

As stated on the cover, lower interest rates are a powerful investment factor and the implications for investors are profound. A critical issue is whether an investor believes interest rates are an important valuation factor, whether they believe interest rates will stay low, and how to act upon these beliefs, if at all.

Investment Research Insights

DEMOGRAPHICS

- Last year the rate of growth in U.S. population was 0.48%, the lowest since 1918, which ironically was the year of the Spanish flu during the horrific conditions of World War I. Since 1909, which was the starting year of annual population statistics, the average yearly growth was 1.2%. The figures were even weaker in the major economies outside the U.S. The latest comparable figures were 0.20% for Europe, unchanged for China and -0.40% for Japan. [Source: Hoisington Investment Management]
- In 2015, China's working age population started to decline for the first time in modern history as its aging process began to accelerate. China is one of the fastest aging countries, behind Japan.
- Unlike China, India's working age population is continuing to increase substantially and will be nearly 40% larger than China's working age population in thirty years [2050].
- The U.S. is one of the few countries, developed or developing, with a growing population, helped by its immigration. While aging like most countries, the U.S. is a very powerful exception to most countries that will be experiencing declining populations over the next thirty years.
- Texas, North Carolina, Georgia and Florida will account for nearly half of U.S. population growth between now and 2040. These states are experiencing and will likely continue to experience a significant influx of people requiring homes, schools, offices, restaurants, and roads.
- In the last 200 years, the country with the fastest aging process [measured by the number of years for the percent of population aged 65 plus to rise from 7% to 14%] is Japan. **For Japan, it took 26 years [from 1970 to 1996] to age this quickly.** No other country has come close to Japan, with the U.K. [45 years from 1930 to 1975] and Spain [45 years from 1947 to 1992] taking nearly twice as long for this aging process.
- In the next 20 years, nine countries will experience a similar to faster aging process as Japan, showing how quickly the world is getting older [see next table]. This projection brings many significant investment implications, in our opinion.

Number of Years for Percent of Population Aged 65 Plus to Rise from 7% to 14%

COUNTRY	NUMBER OF YEARS	CALENDAR YEARS
Japan	26	1970 - 1996
U.K.	45	1930 - 1975
Spain	45	1947 - 1992

Countries Below are Currently in a Rapid Aging Process [Aged 65 Year Plus]

China	27	2000 - 2027
Singapore	27	2001 - 2028
Chile	25	2000 - 2025
Jamaica	24	2009 - 2033
Sri Lanka	23	2004 - 2027
Tunisia	23	2009 - 2032
Thailand	22	2003 - 2025
Brazil	21	2011 - 2032
Columbia	20	2017 - 2037

[Source: Richard Hokenson, Society of Actuaries, 2018 Investment Symposium]

ON THE RECENT BEHAVIOR OF LARGE INVESTMENT FUND MANAGERS

- As of mid-May 2020, large fund managers were holding nearly 20% more cash than the average. These cash levels were above the highest levels seen during the Global Financial Crisis of 2008/2009 but similar to cash levels after the 9/11 terrorist attacks. [Source: BofA Fund Manager Survey, May 7 - 14, 2020, with surveys of 223 fund managers managing nearly $650 Billion in assets].
- Only 1/3 of these fund managers were taking higher than normal risk during the above survey period, one of the lowest readings of the last twenty years.
- Institutional investors and hedge funds of one of the largest U.S. brokerage firms have been large net sellers of equities [individual stocks and exchange traded funds] year to date, and cumulatively since 2008. The only net buyer of equities year to date, and cumulatively since 2008, has been corporations purchasing their own stocks. *[Source: BofA Equity Client Flow Trends, week ending May 22, 2020].*

NOTES:

FOLLOW-UP:

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.