Investment Advisor

CONVERSATIONS ON INVESTMENT MANAGEMENT

FOURTH QUARTER
2021

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> *Investment is most intelligent when it is most businesslike.*
>
> **-- THE INTELLIGENT INVESTOR, PROFESSOR BENJAMIN GRAHAM --**

Doing better than the next person [or not quite as poorly] is not a good standard. Giving the best effort for one's future success is the "better way". This "better way" can apply to relationships, health, spirituality, and yes, finances and investments.

The media and financial industry have incentives and motivations that are often not aligned with the financial "best interest" of each unique investor. Opinions on what to buy or sell, how to think, how to respond to major events…are often not focused on an investor's unique situation. Their report card has a different grading standard.

A tailored approach, which is the "better way", requires knowing key facts that are relevant to each investor. It also requires research, logic, discipline, and avoiding the noise created by voices not aligned with an investor's own "best interest".

As a reminder, recent editions of *Investment Advisor* are available on our website [millercapital.com] under Resources. If you would like more information about our investment services, feel welcome to contact us.

Personal Reflections

While it's worthwhile to have a base investment case, there should also be an expectation that the future can be highly uncertain. September 11, 2001, the Global Financial Crisis, and the Covid-19 pandemic are all examples. As a result, its wise to have sound investment principles that are in place in case the base case is too optimistic.

Over the nearly twenty-five years since leaving the practice of law and entering the investment profession, a few investment principles [the list could be much longer] have become important to me as we develop/ adjust our investment outlook or base case, and advise our clients.

- Always assume that a 50% decline in equity values can occur at any time.
- Never invest cash in volatile investments if that cash may be needed in the next few years.
- Protect against the downside risk first, and the upside can take care of itself if invested prudently.
- Determine how many years of cash flow must be available in less volatile investments or cash to support spending needs until more volatile investments can recover to full value.
- Leverage, or using margin to own volatile investments, is often a recipe for disaster, and tight controls and careful analysis must be utilized.
- Leverage is often a large contributor or even proximate cause of financial damage.
- Be watchful of evidences of excess leverage [by borrowers and lenders] in various sectors and take precautions if necessary.
- The price paid for an investment always matters, especially when that investment is very popular.
- Interest rates matter.
- If "everyone" is doing something, do not give into peer pressure. Make an informed, unemotional decision. Perhaps others are right, but for the wrong reasons. Or perhaps others have a different situation, different incentives, or different motives that are not appropriate for someone else.
- Always know your investment returns and your investment costs ["friction"] that reduce investment results. Know them specifically, as in the actual number. These investment expenses or friction could include management fees, commissions, taxes and other expenses.
- Know what you own and why you own it, specifically not generally.

In addition to investing for individuals, a meaningful percentage of our client assets under advisement are for longer-term trusts, designed to provide for multiple generations. For trustees, many investment guidelines are not only contained in the actual trust document, but state trust laws [often referred to as a "Prudent Investor Rule"] may have standards that must be followed. In those situations, our list above may need to give way to, or be stacked on top of, these fiduciary investment standards. With any trust investment strategy, we strongly advocate for a written Investment Strategy or Investment Policy Statement.

THE BOTTOM LINE: All investment principles should be tailored to each client's own situation; it is the "better way". But it is helpful to have core investment principles to work from for our clients.

Investment Insights

MACRO [BIG PICTURE] INSIGHTS

Current Stock Valuations for the S&P 500 Index Components

The most expensive company stocks [based on the current stock price/forward next twelve months earnings per share also known as the forward P/E ratio] in the S&P 500 are trading at near-record valuations. Yet the full story is more nuanced and context matters.

- The forward P/E ratio for the 100 most expensive company stocks in the index is 46.2, which is in the 97th percentile since 1993 and well above the long-term average of 29.7. Meanwhile, the other 400 company stocks in the index have a forward P/E ratio of 15.1, which is only a slight premium to their long-term average of 13.8. [Source: Glenmede Investment Management, 11/12/2021]
- Worth noting, the 100 most expensive company stocks also have higher earnings growth rates which often justifies a higher valuation. A key issue is whether those growth rates are sustainable. They were not at the prior high in stock valuations in 2000.
- On a forward free cash flow per share basis [as opposed to a forward earnings per share basis], valuations are much more reasonable compared to historical averages.
- For both the forward free cash flow per share ratio, and the forward earnings per share ratio, valuations are more reasonable when adjusted for current interest rates that are much lower than historical averages.

THE BOTTOM LINE: Saying that the stock market is overvalued or that all asset classes are in a bubble is an easy thing to say. But the reality is more nuanced, even if there is some truth to the saying. Unfortunately, many investors make major investment decisions based on over simplifications. Flexible, tailored investment strategies can navigate a variety of situations.

Inflation vs. Disinflation and Interest Rates – The Key Issue Being Discussed

Nearly every investment meeting these days includes the topic of inflation and interest rates. Interest rates are a key issue impacting asset valuations and economic conditions, and historically inflation has been considered the key factor in determining interest rates. With reported inflation rates being much higher than the recent past, it would be logical to assume interest rates will move much higher assuming a causal link between inflation and interest rates.

The ability to forecast inflation, let alone interest rates, might seem to be a fool's game. A good argument can be made that you should simply invest assuming a wide range of outcomes. Yet, if one assumes interest rates will be double or triple their current levels in three to five years [often the case], it has profound implications on how one with that view might invest. Alternatively, if one assumes a stable interest rate level [or even lower rates], the investment strategy might be far different. For investors desiring a higher long-term return [particularly longer-term trusts], these differences in investment strategy can result in very different outcomes as to wealth creation and the ability to provide inflation protected cash flows, when needed.

Complicating the inflation and interest rate debate is the demographic debate. As detailed in previous editions of *Investment Advisor*, we have long held the view that changing demographics are an important factor in terms of inflation rates and interest rates. Huge demographic changes [global aging, below replacement birth rates, and a sizeable reduction in labor force growth] have occurred in developed nations [Japan being the prime example], and continue to expand out to other countries [developed and emerging]. China is one of the most rapidly aging countries, following right behind Japan.

For the last several decades, interest rates have declined substantially. Up to this point, nothing has changed this long-term trend; not wars, not terrorist events, not large scale federal spending, not central bank expansion of the money supply, and not many other events. Now, we have a new issue; supply chain disruptions and a lack of workers leading to insufficient supplies – and higher inflation. A key issue is whether this inflation is more permanent or could be overcome and return us to a more balanced, pre-Covid balance of supply and demand. **In other words, are we headed back to a modified version of the 1970s with higher inflation and interest rates, or a return to the pre-Covid economy with a combination of both low inflation and interest rates?**

Now a new book is suggesting that the demographic changes will produce inflation, not low inflation; a dramatic change from the recent past. *The Great Demographic Reversal*, by Goodhart and Pradhan, holds the view that the growing number of dependents [under age 15 and over age 65] compared to the working age population [age 15 to 65] has hit a tipping point, and the rate of change toward a greater "dependency ratio" will result in more consumers and fewer producers; in other words – higher inflation.

Jeremy Grantham, co-founder of the large, Boston-based investment advisor GMO, has correctly called several major trend changes, though often quite early. Grantham agrees with the demographic trends and investment thesis of *The Great Demographic Reversal*, believing the tipping point in demographic changes will result in much lower asset prices consistent with lower valuations normal in the 20th Century. [Source: *The Severe Cost of the World's Baby Bust,* Financial Times, 3/13/2021] Here are some of Grantham's key data points:

- Many countries, including Italy, South Korea and Japan, are predicted to see their populations drop by more than half by the end of this century.
- The worldwide fertility rate has already dropped by more than 50 percent in the past 50 years, from 5.1 births per woman in 1964 to 2.4 in 2018 [Source: World Bank]. Population growth of .35 percent in 2020 was the lowest on record and there is no indication this trend will slow down, let alone reverse.
- South Korea recently reported a 2020 fertility rate of .84 [with 2.1 considered the rate at which population levels remain level], the lowest rate ever recorded for a major economy.
- In China, the percentage of people aged 60 or over has risen from 6 percent in 1970 to 17 percent today, and is predicted to reach an astonishing 35 percent in just 30 years.
- An additional data point on China, not included in the article, is that China's population is expected to decline by half this century; from 1.41 billion today to roughly 730 million. [Source: Wall Street Journal 6/21/2021]. While most investors are focused on the next three to ten years, not the next eighty years, the longer-term trend simply magnifies the extent of the current trend, which can have investment implications over the next decade.

The results of the past forty years pushes back against the view of *The Great Demographic Reversal*, as interest rates have declined dramatically even as the dependency ratio has been increasing for decades. As to whether a tipping point has been reached, that's difficult to know until the inflation numbers change and stick, beyond the recent Covid-19 impact. An in-depth study of inflation over the last eight centuries concludes that most large increases in inflation were preceded by a rising birth rate. [Source: *The Great Wave: Price Revolutions and the Rhythm of History*, David Hackett Fischer, economic historian at Brandeis University, 1996]. Based on recent trends, beyond the recent Covid-19 impact, global birth rates are declining rapidly, with no indication of a turn up, despite government policies in many countries encouraging more children.

The principal point of *The Great Demographic Reversal* seems to be that the lower inflation and interest rates of the last forty years were due to China's ability to produce goods at much lower costs, and that ability is coming to an end. However, there are many offsets to this view:

- Many other countries are replacing China as a lower cost producer, including countries such as Vietnam, Bangladesh, and many in Africa.
- More people may work beyond age 65 than in past, once the Covid-19 impact is over, especially as more countries may extend the retirement age and tie it to longer life expectancy, as Denmark has done.
- While the labor force may not be growing as fast in the future to produce goods and services, spending on goods by those in retirement, or over age 65, tends to drop materially; fewer cars are needed once commuting to work stops and fewer household items are needed as downsizing occurs, for example.
- Technology and automation look poised to accelerate in the areas most impacted by slowing growth in the labor force.
- Finally, there are powerful exceptions to the demographic trends. In the U.S., for example, our population should continue to grow nicely over the next several decades due to a higher birth rate and immigration.

Recency bias occurs when recent trends are improperly forecast into the future. The Covid-19 supply chain problems and accelerated pace of retirements/leaving the work force for health concerns are at very high levels. Making assessments of long-term inflation rates, and interest rates, requires more information beyond the current Covid-19 impact. The longer-term downward trends in inflation and interest rates were clear and showed no evidence of reversing prior to Covid-19. Will Covid-19 change that trend permanently, or at least for a substantial number of years?

THE BOTTOM LINE: This interplay of inflation and interest rates is a critical factor to be evaluated when establishing an investment strategy, even if the range of potential outcomes requires flexibility. Interest rates matter, a lot.

INDUSTRY INSIGHTS

Transportation Industry

One of the large factors in the jammed up supply chain system in 2021 is a massive driver shortage in the trucking industry. The lack of a sufficient number of truck drivers over the last five to ten years has become

much worse in 2020 and 2021. The American Trucking Association [ATA] estimates that in 2021 the truck driver shortage will hit a historic high of just over 80,000 drivers. The driver shortage is most acute in the longer-haul (i.e., non-local) truckload market. This figure is the difference between the number of drivers currently in the market and the optimal number of drivers based on freight demand. [Source: ATA Driver Shortage Update, 10/25/2021]

There is no single cause of the driver shortage, but some of the primary factors include:

- High average age of current drivers, which leads to a high number of retirements;
- The federally mandated minimum age of 21 to drive commercially across state lines poses a significant challenge to recruiting new drivers;
- The pandemic caused some drivers to leave the industry, plus truck driver training schools trained far fewer drivers than normal in 2020 and 2021;
- Lifestyle issues, notably time away from home, especially in the longer-haul market.

At current trends, the driver shortage could surpass 160,000 in 2030. This forecast is based on driver demographic trends, including gender and age, as well as expected freight growth. The ATA estimates that over the next decade, the industry will have to recruit nearly one million new drivers into the industry to replace retiring drivers, drivers that leave voluntarily, or involuntarily (driving records or failed drug test), as well as additional drivers needed for industry growth.

With somewhere between 75% to 85% of all U.S. finished goods moved by truck [depending on the data source], trucking companies that are best able to adapt will not only thrive from normal growth, but from market share gains taken from competitors. It truly is a case of the strong becoming stronger, even as railroad may take some share from trucking longer-term. Identifying the winners, but not overpaying for opportunities, is key.

The trucking industry challenges have been a large factor in the supply chain bottlenecks this year, leading to a re-imagination of the entire transportation system and networks. U.S. railroads are transforming their facilities to provide more storage and trucking solutions in new regions. Just as Amazon, UPS and FedEx have large warehousing and sorting hubs near most large cities, the railroad companies are expanding their facilities to provide more solutions to shippers of goods. Given the lower energy costs and labor costs to transport by rail versus most other forms [particularly long-haul trucking], the traditional returns on rail assets look poised to increase longer-term. This is particularly true if manufacturing of goods internationally for U.S. customers returns to be U.S. manufactured. This “railroad transformation” is in the early innings.

THE BOTTOM LINE: With more manufacturing returning to the U.S., internet commerce actually accelerating, and difficulty with attracting new workers, the nation’s transportation networks are starting a major restructuring. As with so many industries, scale is required for the large spending needed to adapt to new realities. Large, incumbent players have the scale required, as either a transport company or customer. Yet when the changes are this large, there will be disrupters that pierce through and capture new opportunities. Yesterday’s transportation industry is entering a “step change” period of transformation.

Semiconductor Industry

Many semiconductor manufacturers and suppliers are achieving their financial goals several years earlier than projected due to stronger than anticipated demand. There is often an assumption that this industry's growth will return to lower, historical rates. Yet most leading companies in the industry believe historical growth rates are too conservative and growth rates will be higher in the future. In addition to the growth rate of chips, their complexity is increasing dramatically which benefits leading edge manufacturers and suppliers that can provide the required solutions, and gain market share.

The key lesson from the past five years is that growth trends have been partially underestimated due to tariff uncertainty with China in 2018 to 2020, and Covid uncertainty in 2020 to 2021. But even had these uncertainties not arisen, underlying demand was increasing at a materially higher rate than in the past. Much higher investment will be necessary to meet higher growth trends in the future.

Consider the following estimate from a leading company in the industry:

- There are an estimated 40 billion connected devices in use today, roughly five per every person on the planet [7.8 billion people].
- In ten years, this number is expected to grow by over eight times, or 350 billion connected devices, roughly 41 per person [assuming population growth to 8.5 billion people]. [Source: ASML citing International Data Corporation 9/29/2021]

THE BOTTOM LINE: As with any positive trend, the key investment issue is identifying the proper way to participate in the opportunities, but also using proper risk management such as not overpaying and having diversification. Much principal has been lost paying too much for an opportunity.

MICRO [COMPANY LEVEL] INSIGHTS

Rising Employee Costs in a Low Inflation Future?

Companies are and will be pressured to provide zero cost health insurance plans and new defined benefit pension plans. You heard that right….traditional pension plans will be making a comeback.

The labor force in the U.S. is not growing nearly as fast as in the past. There are not enough younger workers to replace the vast number of older workers leaving the labor force due to full or partial retirement. To attract and retain qualified, younger employees there will be new thinking required and new benefits provided. This has been normal in Silicon Valley for the last twenty years, with unique benefits such as free chef prepared food, free dry cleaning, free child and pet care and the like. But traditional pension plans seemed to be a thing of the past, replaced by 401k plans where employees incur the risk of future investment returns and funding levels.

To offset the higher cost of employee wages and expanded benefits, automation will be adopted at increased levels to offset inflationary employee costs. Companies will spend far greater amounts to lower much higher employee costs and core production and services costs [including transportation]. The battle is on to attract and retain employees while also reducing costs.

Deere & Company [John Deere] recently agreed to substantial pay and benefit increases, and notably agreed to provide a defined benefit pension plan to newly hired union employees. At the same time, a large publicly traded meat processing company is significantly expanding its spending on robotic/automated food processing systems to address worker shortages and higher worker costs. Aging demographics means fewer, younger workers, which will lead to inflationary employee costs while dramatically improved robotics and technology automation will lead to reductions in a variety of company costs. It may well be that employee costs could increase at higher rates in the future, while other cost savings offset them, allowing for greater inflation in some areas of the economy and lower inflation or actual deflation in other areas.

THE BOTTOM LINE: The winners in this trend of higher costs in some areas versus cost savings in other areas will be those companies that can invest in new technologies. This trend is not new, but the level of investment required for the difference-making technologies is reaching a level at which very large companies have a distinct advantage. It's worth keeping an eye on the suppliers of these technology solutions, regardless of whether larger companies use their scale to win, or smaller companies use their agility to compete.

ABOUT MILLER CAPITAL

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- We offer both investment management and investment consulting services.
- We represent individuals, corporations, investment partnerships/companies, and private trusts [serving individual and corporate trustees].

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