Investment Advisor

CONVERSATIONS ON INVESTMENT MANAGEMENT

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Miller Capital is a Registered Investment Advisor [RIA] serving individuals, families, business entities, and trusts.

"Investment is most intelligent when it is most businesslike."
The Intelligent Investor, Professor Benjamin Graham

FOCUS

Good people often disagree about the future. After all, "It's tough to make predictions, especially about the future." [Yogi Berra]. We believe certain facts, trends and developments are worth researching and evaluating more than others as competitive advantages and market dynamics are changing more rapidly and dramatically than ever before. The key for us is to keep our **focus on what is clear, important and actionable for each client**.

Miller Capital was founded 25 years ago, in 1999, during the midst of the internet/tech stock bubble. In this issue of *Investment Advisor*, we discuss some key issues comparing that past period to today. We then highlight some current trends and developments in the investment markets, including technology and artificial intelligence; a topic relevant to so many other areas.

If you would like more information about our investment services, please feel welcome to contact us.

Be well!

PERSONAL REFLECTIONS: KEEPING FOCUSED

In our work for clients, we follow a research process to search, prioritize, and evaluate a large amount of information as we design, implement, and manage investment portfolios. Our research process helps us focus our time and activity; moving us to conclusions we hope are clear, important and actionable for our clients.

Consider a day in the life at Miller Capital:

- Reviewing all investment transactions from the prior business day.
- Verifying checklists for client projects and follow-up items.
- Reviewing research reports and articles by various analysts, experts and research firms, determining:
    - Which ones to pass over [not relevant to our work].
    - Which ones to read lightly [to determine if it is worthy of further analysis].
    - Which ones to read deeply, and possibly take further action.
- Monitoring important news, presentations and SEC filings from companies.
- Reviewing various newspapers and magazines for relevant information and ideas.
- Reviewing daily data points on the economy and the markets.
- Making investment decisions.
- Communicating with clients, including through update letters and reports.
- Managing the business to be effective for our clients.

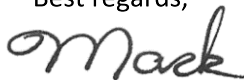
Keeping focus is critical so that our time is well spent on behalf of our clients. As a result, I feel it is fair to ask investment advisors [or any professional advisor] how they focus their work on behalf of their clients and what processes are in place to search, prioritize, and evaluate the landscape in making decisions. At a minimum, if I were the client of an investment firm, I would appreciate knowing:

- What research sources do you routinely utilize in your investment process?
- How do you develop your investment strategy for clients?
- How do you determine risk and return for each investment selection and the overall portfolio?
- Do you use models that are applied to groups of similar clients with virtually identical investment selections and changes, or are investments selections and changes tailored to each client?

To many, the investing world can seem incredibly stressful and confusing at times. If one utilizes the services of an investment advisor, it might be reassuring to know how they are keeping focused on their work. Of course, if investment performance or risk levels are unacceptable, an investment advisor's focus may be of little value to a client; they may be focused on the wrong things. But asking questions and receiving specific follow-up information is important when evaluating investment advisors and their investment process.

That's the way I see it.

Best regards,



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P.S. Past issues of *Investment Advisor* are available on our website [millercapital.com] under Resources.

IMPORTANT QUESTIONS: 25 YEARS AGO vs. TODAY

Miller Capital was founded twenty-five years ago, in July 1999. In the preceding few years, tech leaders like Cisco, EMC, Sun Micro, Intel and Oracle had been generating strong stock returns. New internet/tech companies would take their freshly raised capital and purchase products and services from the tech leaders. Despite a lack of sustainable revenues and large cash flow losses, these new internet stocks soared notably in 1999 and early 2000, with the bubble hitting its peak.

- Many people were day trading, finding it “easy” to make money and even quitting their jobs to trade.
- Investment firms were losing clients who felt they could do better on their own.
- Even non-tech companies like GE and Coca Cola had very high valuations at that time, but the speculative frenzy was strongest in internet/tech stocks.
- Attractive fixed income yields and reasonably valued stocks were shunned, just as they began a significant period of excellent returns.

Yes, some investors cashed out of these bubble stocks near the highs and preserved profits. Yet there were significant and permanent losses of capital from internet/tech stocks that were sold at much lower prices. **Even the S&P 500 Index had a negative return of -.9% per year over the ten years from 2000 to 2009**. [*Source: Ibbotson SBBI©*]

Then vs. Today

With “artificial intelligence” being the current focus of investment markets, many comparisons are being made to twenty-five years ago. I still remember thinking through and working with our clients, including trustees of private family trusts, to navigate that difficult time period, from 1999 to 2003. The trust investment issues were particularly important as trustees have fiduciary duties to uphold, depending on the terms of the trust.

A few timeless questions come to mind when thinking through today’s environment:

- What are reasonable future returns estimates for the current portfolio and underlying investments compared to other opportunities that exist? In other words, how would future return estimates reasonably change if the portfolio was restructured [considering any tax implications]?
- Given the goals of the portfolio and the ability and willingness to take risk, should the portfolio be restructured in the current environment?
- Is the portfolio sufficiently diversified when considering any applicable fiduciary duty, controlling investment strategy, or other relevant factors, including the client’s own stated preferences?
- How would the portfolio perform under a stress test scenario, with much lower returns over the next several years? Should adjustments be made to the portfolio as a result?
- Is the potential portfolio return commensurate with the portfolio’s current risk? In other words, does the portfolio have too much “uncompensated risk”? How is “risk” defined [see the next point].
- If a portfolio is restructured to reduce risk, is the risk of the portfolio actually increased if risk is also defined as “the inability to provide sufficient inflation-adjusted cash flows in the future”? There is more than one definition of risk, beyond just the popular definition of “a temporary decline in values”.
- Have the client’s or portfolio’s goals changed over the last several years to such an extent that the entire investment strategy should be updated, especially in light of recent investment returns and market changes, such as the recent increase in cash and fixed income yields?

The Bottom Line: Stress testing portfolio assumptions and thinking about the true definition of risk are also important considerations. Taking time to think deeply about important investment issues is time well spent.

DEMOGRAPHICS: A RAPIDLY AGING WORLD

During the recession of 1954, the late investment counselor Sir John Templeton wrote a letter to clients in which he stated that the four most dangerous words in investing are **"this time it's different."** Yet when it comes to our world's changing demographics, this time is different with:

- Drastic declines in global birth rates.
- Rapidly aging global populations.
- Slowing growth rates [even some declines], in the labor forces of most countries.

Behind Japan, China is the second oldest country by average age, with a collapsing birth rate and rapid aging.

- China has the world's largest elderly population, with more than 280 Million people over age 60.
- Senior citizens now make up close to 20% of China's population, a proportion that is set to rise to 28% by 2040, predicts the World Health Organization.
- The country's fertility rate was estimated at 1.09 last year, just slightly over one birth per woman and significantly below Japan's 1.26. In fact, some areas of China are depopulating, as in Japan [*Source*: China's Baby Bust Is Hard to Reverse, *Wall Street Journal*, 2/13/2024].
- Most of the developed world is close behind China, with birth rates far below the level needed to keep a stable population number. Most countries in Asia, Europe, and the Middle East, and even large parts of India are aging rapidly, even though some countries are considered "emerging" economically.

The U.S. has been an exception to below replacement level birth rates until recently. The U.S. is aging, but much less rapidly than the rest of the world; a powerful exception that can support future economic growth.

- The U.S. fertility rate had remained generally around 2.1 children per woman, or what is known as the "replacement rate," since the 1970s.
- In 2023, the fertility rate in the U.S. fell to 1.62 births per woman, a 2% decline from a year earlier, and the lowest rate recorded since the government began tracking it in the 1930s. [*Source*: Fertility Rate Falls to a Record Low Amid Social Shifts, *Wall Street Journal,* 4/25/2024]
- The difference for the U.S. is its historical inflow from immigration and a birth rate that still remains higher than most developed countries.

The Bottom Line: We believe that changing demographics are already having a major impact on investment realities and opportunities, and these impacts should grow stronger over time. As to how to invest in light of these demographic trends, we have clear views and our convictions have grown stronger. A rapidly aging world has a dramatic near-term and long-term impact on inflation, interest rates, and structural trends, in our view.

INVESTMENT INSIGHTS

We organize our investment research into four categories:

1. Macro: Big picture economic, demographic, geopolitical, and financial issues.
2. Trends & Developments: A broad range of topics that impact investment decisions.
3. Industries: Insights within certain industries.
4. Micro: Insights from companies that impact their own securities, or other research categories.

Here are a few insights on the first two of these research categories:

Macro

Breaking Away: Lowering Prices to Gain Competitive Advantage

Inflation during and after the Covid Crisis has been significant. From the Global Financial Crisis [2008] until the start of the Covid Crisis [2020], most companies had little pricing power. As the severe Covid shutdowns began to loosen, it seemed most companies were looking to raise prices as much as reasonably possible. These increases were logical to the extent they were covering their costs. But many companies also saw a one-time opportunity to lock in higher revenue and profits and "make up" for the previous decade's lost pricing power.

In a significant break from this Covid pricing "make up" strategy, several leading companies are aggressively controlling costs and reducing prices [or price increases]. The proximate cause for this change in pricing strategy is due to customers saying "no more" and closing their wallets to higher prices, or shifting their purchasing patterns. Companies that are lowering prices or even introducing their own lower cost products are beginning to gain significant market share and volumes from less competitive sellers. As a result, we are entering a more disinflationary period for goods, similar to the pre-COVID era, as evidenced by reported results at some large, publicly traded retailers and consumer branded goods companies.

Walmart - Overall inflation for Walmart was up about half of last year's increase, including mid-single-digit deflation in general merchandise and low-single-digit inflation in food and consumables. The company generally expects these trends to continue, overall, for the rest of the year. Walmart's lower prices relative to most of its competitors are enabling it to reach more customers, receive more visits per customer, and invest more in automation to lower costs and to provide greater conveniences. [*Source: Walmart Fiscal Q1 2025 Earnings Call,* 5/16/2024]

Costco - As inflation has leveled off in its stores, Costco's members are purchasing more discretionary items. Costco is using its strategy of greater value to gain market share, and it introduces new Costco developed products to replace national brands that will not lower prices sufficiently. The trend in prices is more frequently changing from "how high can we go" to "how low can we go to gain competitive advantage for the future". Consider the following from Costco's most recent earnings call:

- "On the inflation front, it's more of the same from last quarter. Across all core merchandise, inflation was essentially flat [this quarter] with fresh foods close to zero and slight inflation in food and sundries being offset by some deflation in non-foods."
- "We're intentionally creating incremental value for our members by delivering lower prices wherever possible. We believe our strategy of delivering value to drive unit volume and member satisfaction is the winning combination for us. In that vein, our buying teams are constantly aware of changing costs … and are ensuring that we are capturing all cost decreases quickly so that we can pass on incremental value through price reductions." [*Source: Costco Fiscal Q3 2024 Earnings Call,* 5/30/2024]

Price cuts are now extending to fast food restaurants, food suppliers, and many other areas. It is not just a feature of the two companies above, which have long held low prices or high value as a core strategy.

The Bottom Line: High prices are causing a loss of customers and volumes. For companies that focus on the upper end or luxury segments, low pricing is usually not the favored strategy. But by and large, to keep customers and gain share, lower prices are returning front and center as a key competitive strategy – a break from the Covid era strategy of charging higher prices to the fullest extent possible.

Trends & Developments

Artificial Intelligence ["ai"], Semiconductors, and Auto Electrification

While there are many implications from new ai systems being rolled out, some less publicized implications are being discussed by companies that are deeply involved in the ai and semiconductor industries.

Lam Research, a major supplier of semiconductor equipment for the manufacture of semiconductor chips, cites industry growth from data center ai applications, primarily for high end chips. But it also points out the growth that is coming from automotive.

> "The unit volume in automotive isn't nearly as high [as "ai"], but the content growth is enormous in some of these electric vehicles and autonomous vehicles."
> [*Source: Lam Research CFO at the Bank of America ML Tech Conference,* 6/4/2024*]:*

Cadence Design, a key provider of semiconductor design software, has also cited automotive as a key growth driver going forward, although it is coming later than the current data center growth. With electrification and differentiation within the vehicle growing, Cadence expects to see expansion of silicon content from $400 per vehicle today [typical for a regular internal combustion engine] to $2,000-$4,000 per vehicle at decade's end. With 100 Million autos sold each year, that is $200 Billion to $400 Billion more of silicon content each year. [*Source: Cadence Design CEO, Morgan Stanley TMT Conference,* 3/6/2024]

In addition to greater unit sales of semiconductor chips, these chips are becoming more three dimensional and more complex, as the chips go higher, not wider [similar to buildings in New York City]. This trend higher [3D] requires advanced organizing or packaging of the entire chip to use space more efficiently. Our view over the last ten plus years has been that semiconductor manufacturing capacity is insufficient to produce all kinds of chips, but especially the most advanced chips. As demand for advanced chips [more memory and more compute power] grows, the demand outlook for supporting lower to mid-level chips is also quite positive.

The Bottom Line: The semiconductor industry is increasing in complexity and is requiring much larger amounts of capital for capacity expansions and for research and development. This reality is allowing key companies in the semiconductor sector to solidify and extend their competitive positions, but valuation analysis is crucial.

Artificial Intelligence ["ai"]: No Budget = No Problem

Large amounts of money are being allocated for ai hardware, software and related services. One might wonder where all this money is coming from. Much of the current spending is coming from the large technology and cloud services companies seeking to be at the front of the line for ai capabilities they can then offer to their own customers. But "normal" companies are also facing issues of how much to spend on internal ai projects.

Eli Lilly is an interesting case when it comes to ai spending. This large pharmaceutical company, like most other large companies, is evaluating ai solutions. Lilly's Chief Information and Digital Officer Diogo Rau said he felt the enthusiasm for the technology during the drugmaker's annual budget planning cycle.

> "I walked out of there with twice as much money from my boss and the rest of the executive committee because everybody wanted to get invested in AI," he said. Rau, who reports directly to the CEO, said the company set up a pool of money just for funding AI initiatives. He serves as a sort of trustee for how it is doled out, but it doesn't take away from any other investments the technology department is making.

> Rau declined to say exactly how much money is going to AI but said "it's a lot….We always want more money...but now we have more than we know what to do with," he said, adding "there's a lot of pressure on us to innovate." [*Source:* Nvidia Benefits From Surge in Corporate AI Spending*, Wall Street Journal,* 2/28/2024] The article went on to say that of 400 U.S. CEOs surveyed last year by KPMG, 72% said generative ai is a top investment priority.

Dell Technologies has direct insight into spending on ai by its customers. Its CEO, Michael Dell, who was at the center of the internet/tech spending boom in the late 1990s, commented on the large amount of ai spending:

> "I'm quite optimistic about the impact here. I think it is a big unlock of productivity and will be a catalyst to overall economic expansion and growth."
>
> "There are other companies who are saying, 'Wait a second, we can get a 20% or 30% productivity improvement here. Whatever the budget was. Forget about that. Now we're going to go do this because it's too big of an opportunity to let it go by.'
>
> If you took any specific organization and you said, 'Oh, let's say, they didn't adopt the PC or the Internet or ai'…they wouldn't probably be around now, right? People are talking about 15% productivity gains, 30% productivity gains…[if] those numbers are anywhere near correct…you would be derelict in your responsibilities as an officer and executive of a company if you weren't figuring out how to go get that."
> [*Source: Dell Technologies CEO at Bernstein Conference,* 2/9/2024]

The Bottom Line: Back in the internet/tech stock bubble of the late 1990s and early 2000, much of the technology related spending proved unsustainable. Cash flows never sufficiently developed to sustain such high levels of ongoing tech spending. Some of that is true today with ai spending. Much less of ai spending is coming from new start-up companies at this point, but it is sometimes coming from off-budget, special funds. How much of the current spending is repeatable versus a one-time build-out is an important issue to consider.

WHY IT MATTERS: CLOSING THOUGHTS

While we utilize index funds in certain situations, an index fund is a sum of its underlying holdings and these holdings can become uncorrelated to a client's goals and objectives. As a reminder, nearly twenty-five years ago the S&P 500 Index became highly concentrated in overvalued stocks, including non-tech stocks like GE and Coca Cola. An investment in the S&P 500 Index Fund on January 1, 2000 produced a negative return over the next five and ten years [cited previously]. The probability of negative returns over a five and ten year period is low for this index, yet there are times when an index fund may not meet goals and objectives of certain clients.

Buffett vs. Munger

As we have written about in past issues of *Investment Advisor*, Warren Buffett has often said he would recommend his heirs simply invest a large portion of any inheritance in an S&P 500 Index Fund. Yet his partner, the late Charlie Munger, has said he would never advocate that approach. Munger prefers a tailored portfolio that does not rely on the composition of five hundred stocks selected by an index committee.

Back to Templeton

Prior to founding the Templeton Funds [now owned by Franklin Templeton], most of Sir John Templeton's career was focused on investment counsel to individuals, trusts, and companies, similar to our focus at Miller

Capital. Templeton was known for taking a comprehensive view of the world; on economics, geopolitics, and a wide variety of trends and developments, including at the industry and company level, similar to our approach at Miller Capital. We resonate with Templeton when we read and listen to his investment views.

In "The Templeton Letter" [July 29, 1954], Templeton made many observations on:

- The strongly increasing stock market even as the economic data was declining, which was baffling several investors he was speaking with at the time.
- The surplus of funds for investment relative to a shortage of top-quality stocks available for new funds.
- The high valuation of many stocks and the attractiveness of other stocks he was purchasing.
- His view on proper asset allocations or weightings based on relative values in various markets.

The Bottom Line: Whether it's Buffett, Munger, or Templeton, different approaches can be reasonable; that is what makes each investment firm unique. Even in the world of private trust investing, the popular approach of highly diversified portfolios using low-cost index funds [advocated by Modern Portfolio Theory and favored in various trust investment guidelines such as the Restatement [Third] of Trusts and Prudent Investor Rule] has been subject to re-examination over the past fifteen years. What matters most, in our view, is that the investment approach is tailored to the client's needs and is logical, reasonable and implemented effectively.

Finally, as we see more private wealth pass from one generation to the next, having a plan for how that wealth impacts the next generation is a very important consideration. We have seen how a thoughtful client estate plan can positively impact the lives and family harmony of the next generation, including for charitable causes. **Planning for what really matters is time very well spent.**

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

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