



# Investment Advisor

CONVERSATIONS ON INVESTMENT MANAGEMENT

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QUARTER  
2018

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Mark A. Miller, CFA  
President

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

-- THE INTELLIGENT INVESTOR, BEN GRAHAM --



WISDOM is more than knowledge of facts, even deep knowledge. Many people with knowledge and problem solving skills fail to translate those talents into true wisdom. Yet, nearly every organization or great event in history has examples of true wisdom.

True wisdom uses knowledge to

<i>solve problems &lt;</i>	<i>&gt; establish an <b>environment of service and trust</b></i>
<i>create <b>opportunity</b> &lt;</i>	<i>&gt; <b>motivate</b> the pursuit of <b>admirable goals</b></i>

Cited in our article on defining risk is Robert “Tad” Jeffrey, president of a major mining equipment manufacturer and later the founder of a large family office. Although I only met Tad once, his research and writing [assisted by others in their family office], and our discussions, helped us greatly in advising our clients over the last two decades. Tad wrote one of the finest investment books for affluent families and trusts titled, “The Long Search for a Better Way”. He was a wise investor, and based on his reputation, a truly wise person.

# INSIGHTS ON TRENDS FROM INDUSTRY LEADERS

In addition to using index funds, active mutual funds, and outside investment managers for client portfolios, we also monitor and manage individual stocks for certain clients. Some clients bring in individual stocks when they hire us and we keep or sell them, depending on a host of factors including the amount of unrealized gain. We also use individual stocks for some clients, as part of a diversified portfolios that we design, when appropriate. As a result, we read many company annual reports as part of our research, including those from companies not owned in client portfolios. Here are some insights from current annual shareholder letters of companies we may or may not own in client portfolios [not a recommendation per our Cautionary Disclosure on the last page]:

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## **DEERE & CO. [Agriculture and Construction Machinery], CEO Sam Allen:**

"During the first half of this century, global demand for food and other kinds of agricultural production is expected to nearly double. What's more, with the world population growing by more than 200,000 people a day, this trend shows little signs of easing."

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## **BOEING [Aerospace and Defense Systems], CEO Dennis Muilenburg:**

"Passenger [air] traffic continues to outpace expectations and demand for new airplanes remains high. We estimate customers will buy more than 41,000 airplanes over the next 20 years, including approximately 9,100 widebodies, as more people travel by air, particularly in the rapidly growing Asia region."

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## **PRUDENTIAL, PLC [London-based Life Insurer/Investment Manager], CEO Mike Wells:**

"In Asia, the working-age population in the region is growing by a million people a month, and by 2030 is expected to reach 2.5 Billion. This means that between 2015 and 2030 some 178 Million people will reach working age, roughly the equivalent to the combined populations of the UK, France and Italy. Gross Domestic Product [GDP] in Asia is predicted to increase significantly. The implications on wealth creation are profound, with private financial wealth increasing by some US \$4 Trillion per annum from 2016 to reach US \$78 Trillion by 2021."

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## **ALPHABET [Parent Company of Google], Co-Founder/President Sergey Brin:**

"The new spring in artificial intelligence is the most significant development in computing in my lifetime."

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## **SOFTBANK GROUP CORP., Chairman/CEO Masayoshi Son:**

"Within this century, Artificial Intelligence [AI] will overtake human intelligence at a point that is referred to as the "Singularity". This will be the greatest paradigm shift in the history of humankind. The coming of the Singularity will redefine every industry, opening up new business opportunities for existing industries while also creating new industries."

# DEFINING RISK: TWO COMMON SENSE VIEWS

At Miller Capital, we require each client to have a written Investment Strategy. In particular, when we serve as investment advisor for trusts, the fiduciary standard of care often requires an Investment Strategy per the state trust statute, which often incorporates a version of the Prudent Investor Rule. While a state law standard of care can usually be altered or overridden by the underlying trust document, a central requirement of an Investment Strategy in most states is to have risk and return objectives reasonably suited to the fiduciary trust or estate. Various state and federal agencies, including those that regulate and examine bank trust departments and trust companies, have similar guidance. Professional organizations, such as the CFA Institute [among others], also use “risk and return” language in Investment Strategy guidance documents and professional standards of care.

**A LARGE FAMILY OFFICE FOUNDER DEFINES RISK.** Risk can be defined many ways. Certain academic theories which are foundational to the Prudent Investor Rule have risk definitions that some great investors find void of common sense. One common sense approach to risk comes from the late Robert “Tad” Jeffrey, founder and long-time president of the Jeffrey Co., a family office based in Columbus, Ohio. Tad was responsible for managing very large sums of money for family members and trust beneficiaries who depended on his investment acumen. Tad thought deeply about the concepts of risk and return. He was a prolific writer on the topic, and some of our individual clients and trust clients have benefitted through his research and writings which have influenced our thinking on risk and return.

Jeffrey’s definition of risk is stated below:

*“The real risk in holding a portfolio is that it might not provide its owner, either during the interim or at some terminal date or both, with the cash he requires to make essential outlays.”*

The definition above and the excerpt below come from a 2001 article authored by Jeffrey in the *Journal of Investing*, titled “Reflections on Portfolio Management After 25 Years”:

*“In 1984 I wrote an article in the Journal of Portfolio Management entitled “A New Paradigm for Portfolio Risk”. The thesis was basically that portfolio risk had been misspecified. I said there that “the problem with equating portfolio risk solely to the volatility of portfolio returns is simply that the proposition says nothing about what is being risked as a result of the volatility.” By way of example, the risk consequences of weather volatility are very different for a winter backpacker in the mountains than for a New York commuter who might have to walk a few blocks in the rain.*

*Presumably because I seemed to be implicitly defaming [academics], the editor Peter Bernstein, got a lot of flack from his academic readers, but he loyally defended my article. And years later in his “Against the Gods: The Remarkable Story of Risk”, Bernstein cited the article to support his point that “for true long-term investors...volatility represents opportunity rather than risk... to the extent that volatile securities tend to provide higher returns”:*

Jeffrey returns to the key aspect of risk which is the inability to meet future cash flow needs, and not whether the portfolio values or returns, go up or down in the short-term. Below is another quote from his 2001 article:

*"Over fifteen years have gone by since I wrote that [1984] article, but I still believe that too many investors—including sometimes large and sophisticated ones—worry too much about volatility and about finding elegant covariances to minimize it. At the risk of precipitating another wave of argument from my academic friends, I still believe that this worrying time might be better spent thinking through one's future needs for cash, i.e., for spending."*

**WARREN BUFFETT DEFINES RISK.** Before honing in on Buffett's definition of risk, we lead with a few related quotes from Buffett's latest annual letter to Berkshire Hathaway shareholders. It's worth noting that Buffett is not focused on serving individual clients, as was the case with Tad Jeffrey, or Sir John Templeton in his early years, but many of his general investment views are so helpful:

- "Our aversion to leverage has dampened our returns over the year. But Charlie and I sleep well. Both of us believe it is insane to risk what you have and need in order to obtain what you don't need."
- "We will stick with our simple guideline: The less the prudence with which others conduct their affairs, the greater the prudence with which we must conduct our own."
- "Charlie and I will never operate Berkshire in a manner that depends on the kindness of strangers—or even that of friends who may be facing liquidity problems of their own."

Buffett's definition of risk, also from his latest annual letter, differs from most academic definitions that focus on price volatility or volatility of portfolio returns.

- "Investing is an activity in which consumption today is foregone in an attempt to allow greater consumption at a later date. 'Risk' is the possibility that this objective won't be attained."
- "I want to quickly acknowledge that in any upcoming day, week or even year, stocks will be riskier—far riskier—than short-term U.S. bonds. As an investor's investment horizon lengthens, however, a diversified portfolio of U.S. equities becomes progressively less risky than bonds, assuming that the stocks are purchased at a sensible multiple of earnings relative to then-prevailing interest rates."

Over the past twenty years, we've seen how each client has their own view of risk after discussing the various risk definitions and practical implications. This is why many of our clients have tailored investment strategies and portfolios that fit their unique risk and reward preferences. For trust clients falling under the Prudent Investor Rule or other trust investment law, we must be mindful of applicable risk definitions and to what extent such definitions of risk are controlling or can be modified in their application for trust clients.

# IMPACT OF HIGHER OIL PRICES ON TEXAS PERMIAN OIL AND U.S. REFINERS

We have clients with low-cost basis holdings in the energy industry, including sub-sectors like oil exploration/production and refining. As a result, it is necessary for us to research various energy industry and company developments. In previous newsletters, we've reviewed the Permian oil field in west Texas, which is one of the largest oil fields in the world. We've also written about select U.S. refiners that have complex refineries in attractive areas which are able to distribute refined products [diesel, gas, jet fuel, marine fuel etc...] to high value end markets/users.

Certainly natural gas and techniques such as distributed power will impact the energy industry in major ways. But while many see the oil industry as a dying, un-investable industry due to the growth of electric vehicles [EV] and new energy concepts, the outlook for oil for the next few years and decades is more nuanced. Crude oil prices are rising due to growing demand and the significant reduction in supply over the last two years. Here are some key points on the oil sector:

## THE OIL GLUT OF THE LAST FEW YEARS IS REVERSING QUICKLY

- By the 3rd Quarter of 2018, Goldman Sachs predicts that global oil demand will exceed 100 Million barrels per day for the first time in history. Unless OPEC and Russia increase oil production above the current output agreement, and factoring in increased oil production from the U.S. [primarily from the Texas Permian oil fields], the anticipated oil supply of 99 Million barrels per day will soon result in a supply deficit of 1 Million barrels per day. [Source: Goldman Sachs 5/17/18].
- Existing oil fields have an average production decline of 6% to 7% per year, with some estimates even higher. This amount of natural decline must be made up with new investment that leads to new production. [Source: IEA, World Energy Outlook]. In the last few years, oil exploration investment has declined significantly which should lead to lower production in the future.
- Any increase in oil production from OPEC, Russia, and the Permian may mute the increase in oil prices temporarily. Within a few years, and longer-term, this increased oil production may be insufficient to offset the decrease in oil exploration, and growing demand for oil.

## DESPITE ELECTRIC VEHICLE [EV] GROWTH, OIL DEMAND IS STILL INCREASING LONG-TERM

- Over the next decade, nearly 40% of the world's population is expected to enter the critical \$3,000 to \$10,000 per person annual gross domestic product threshold, where energy demand accelerates dramatically. India is about where China was nearly 15 years ago, just before China's oil demand nearly tripled from 2001 to 2017. [Source: Burggraben Holding AG, April 2018].
  - > All of the growth in energy consumption is in fast-growing developing economies, with China and India accounting for half of the growth in global energy demand.
  - > Oil demand continues to grow, primarily from industrial uses [non-transport], and from fuel demand [transport] in emerging economies.

- Asia uses more than 35% of global oil usage and its share is steadily rising. Asia accounts for less than 10% of oil output.
- China alone uses nearly 10% of global oil usage. China is by far Asia's—and the world's—biggest importer of oil, ordering 9.6 Million barrels per day in April 2018. At current prices, this amounts to a Chinese oil import bill of nearly \$800 Million per day, or just under \$300 Billion per year. A ramping up of U.S. oil purchases would be an easy way for China to reduce its trade surplus with the U.S.
- India is an example of the growing demand for oil and related products, despite the growth in EV vehicles. In April 2018, Indian oil and fuel demand grew as follows: [Source: Morgan Stanley, 5/15/18]
  - > Oil demand up 4.5% from a year ago.
  - > Gasoline demand up 9.3% from a year ago.
  - > Diesel demand up 2.7% from a year ago.
  - > Jet fuel and kerosene demand up 6.1% from a year ago.
- In developing economies such as India, Vietnam or the Philippines, fuel costs eat up around 8% to 9% of an average person's salary. That compares to just 1% to 2% in wealthy countries such as Japan or Australia. [Source: Inside Commodities, Reuters, May 18, 2018]. For this reason, higher oil prices should eventually cause demand to slow down in developing economies, which is why OPEC and Russia may begin to export more oil to keep prices at or below \$80 per barrel +/-.

## STRUCTURAL CHANGES WILL SLOW OIL DEMAND GROWTH, NOT REVERSE IT

The change in rules for marine fuel oil coming in 2020 is likely to have a material impact on the oil market. This change, known as IMO 2020, requires much less sulfur in marine fuel oil. Analyst Phil Verleger believes IMO 2020 will be a positive profit “game changer” for select, low-cost oil producers, and for refiners that are able to produce this ultra-low sulfur diesel for ships. Given that marine fuel oil makes up nearly 10% of total oil demand, and given the large reduction in sulfur required, companies are already making large changes in anticipation of this change in 2020.

While EVs, both hybrid plug-in and total battery vehicles, will reduce oil demand longer-term, the demand for oil and related products [primarily from industrial use and emerging markets with a rapidly increasing middle class] is still poised to grow while oil supply faces a material, natural decline which requires greater investment. Consider these projections from the BP Energy Outlook 2016:

- Only 20% of global oil demand is for car fuel [19 Million barrels per day out of nearly 100 Million barrels per day total usage], with another 24% for truck fuel, or 44% total for car/truck fuel. The remaining 56% is for other commercial usage, including jet fuel, marine fuel, fertilizer, chemicals, and household goods [including plastics and coatings].
- Even with growth in EVs, oil demand for transport will still grow slowly over the next 25 years, with most of the slower growth due to efficiency of combustible engines, not EVs.

**EVALUATING SPECIFIC OPPORTUNITIES.** As long as oil remains above \$60 per barrel, select producers in the Texas Permian oil fields [the highest producing and lowest cost U.S. oil field] and select U.S. refineries are well positioned to continue to harvest profits well above current forecasts. Stock index investors have some exposure to oil companies and refiners, depending on which index is utilized. The question is whether the index has the right focus within its energy component, or if a different weighting and different set of energy holdings better reflects the risks and opportunities presented.

**RISK VS. RETURN POTENTIAL.** Regardless of whether an investor focuses on index investing or also uses a more active/selective approach, the difference in oil company and refiner assets is substantial. Barriers to new industry entrants are nearly insurmountable, especially for the U.S. refiners that make complex, low sulfur jet and marine fuel from both sweet crude and sour [sulfur] crude, in addition to derivatives such as asphalt. While we realize certain oil alternatives are best for the environment and for cost per unit of energy, we are also realistic about near to medium-term oil supply/demand dynamics.

## STOCK BUYBACK PROGRAMS: WHEN AND WHY

Many U.S. public companies benefitting from the reduction in corporate tax rates are using some of the savings to buy back their own shares on the open market or in privately negotiated purchases. Some other uses of cash include debt repayment, dividend payments, investment in new or existing endeavors, holding cash for liquidity, or mergers and acquisitions. The financial analysis of buying back stock should compare:

- returns available on each alternative use of cash
- need for balance sheet liquidity
- intrinsic value of the company stock.

Public companies should buy back their own stock only when it trades at a price below a reasonable estimate of intrinsic value [defined below by Warren Buffett], if it represents the best and highest use of cash.

*"Intrinsic value is an all-important concept that offers the only logical approach to evaluating the relative attractiveness of investments and businesses. Intrinsic value can be defined simply: It is the discounted value of the cash that can be taken out of a business during its remaining life." [Source: Owner's Manual, Berkshire Hathaway].*

As with most investing, the focus should be on the long-term and partnering with management teams that repurchase stock at attractive prices. Recently, a company we monitor made the following sensible statement during its earnings conference call regarding its own stock buyback program:

*"You'll notice that we did start buying back shares. And generally, we think about long-term minded investors and the value it brings to long-term minded investors. So, you will see us buy back more shares when there is a larger gap between the intrinsic value of a short-term minded investor versus a longer-term minded investor."*



# OTHER ITEMS OF INTEREST

## INDEX FUNDS VS. ACTIVE/DIFFERENTIATED INVESTING

Whether to use index funds, and to what degree, is not an all or nothing decision; there is room for variation. Even famed investors and partners Warren Buffett and Charlie Munger disagree to some extent on index investing [Buffett's preference] vs. differentiating among investment choices [Munger's preference], as detailed in our Second Quarter 2017 Investment Advisor. The late, great investor and advisor, Sir John Templeton, who began his career serving high net worth clients with unique needs and tax situations, would also be in the Munger camp. Yet, all three agreed with these common themes:

- be careful to not overpay for an investment, and
- exercise discipline in adhering to a well-reasoned investment strategy.

## GROWING GLOBAL MIDDLE CLASS

- Chinese passport ownership has more than doubled in the last three years to 130 Million, translating into actual outbound travel demand.
- Bookings on commercial airlines for international travel by Chinese travelers grew 7.8% in the 1st Quarter 2018 compared to the year earlier, accelerating from the 7.3% growth rate in the 1st Quarter 2017 compared to the year earlier.
- Rising income levels are driving an increase in the spending power of China's expanding middle class, contributing to higher travel spending per Chinese traveler of 14% per year from 2012 to 2017.
- Source: Goldman Sachs, May 15, 2018.

## DEMOGRAPHICS

- The number of people age 60+ years is expected to grow to 2.1 Billion by 2050 [vs. 901 Million today].
- We are arriving at "peak youth" for the first time in history as the number of persons age 65+ years is expected to outnumber children under age 5 by the end of this decade.
- Aging has become a universal phenomenon. By 2050, 80% of older people will live in emerging countries, not in developed countries.
- Age related spending makes up 40% of government budgets in developed markets.
- Source: Merrill Lynch, May 11, 2016.

### 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

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