Miller CAPITAL

Investment Advisor

CONVERSATIONS ON INVESTMENT MANAGEMENT

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CONTENTS

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

"WHAT'S THE WORLD COMING TO? A ROBOCOP TICKETING A DRIVERLESS CAR."

Despite many concerning events in the news, global stock markets continue to push higher. Reconciling these two aspects is a frequent topic of conversation, as many wonder "What's the world coming to?" This issue of Investment Advisor begins with various investment issues we have been addressing for clients. Next, we highlight some investment and business wisdom from various people, followed by investment insights from the great investors John Templeton and Warren Buffett. We end with a look at demographic implications for the economy and investments in light of recent strength in the global economy, while touching on the critical issue of investment strategy. We hope you find something of value in these articles. As always, if you would like information about Miller Capital and the services we provide, please feel welcome to call, or e-mail us at info@millercapital.com.

Investment Issues of the Day

Here are some important investment issues at the forefront of our work for clients:

- With S&P 500 Index funds having over 25% of assets invested in technology stocks [including 6 of the top 10 holdings], is this risk appropriate and properly diversified with other portfolio holdings?
- Given the appreciation in most stock index funds and their overweight to large technology stocks, are other alternatives available that have better risk/return attributes? Can individual stock portfolios or other mutual/index funds be utilized to offset a large technology exposure?
- For companies that don't face competition from Amazon, and are unlikely to, are they valued appropriately to reflect this protection against Amazon or other companies? On the flip side, do companies exposed to the "Amazon risk" have this risk properly reflected in their stock price, or in our estimate of valuation? [see *"Porter's Five Forces: More Relevant than Ever"* in our 2nd Quarter 2017 issue available under Insights on our website www.millercapital.com]
- How large will mutual fund capital gain distributions be for 2017, and can they be mitigated ahead of time, or offset after the distributions occur?
- Can gifts of appreciated stock be made to charity or family prior to a sale, or prior to year-end, to gain tax advantages while also accomplishing client goals?
- For client deposits of cash, what is the appropriate approach for investing the cash in equities given the strong performance of most stock index funds, mutual funds, and many individual stocks? Is there a "meeting of the minds" with the client on the timing for investing new cash in equities?
- Where in the investment markets or economy are there excesses or irrational expectations that should be guarded against?
- If risk should be reduced in portfolios, are clients willing to accept lower performance if the sold investments continue to outperform despite their excessive risk?
- Are investment accounts and other investment assets owned in the most effective manner?
- Is a family meeting appropriate for a client's adult children to educate them on certain financial and investment concepts, and should certain client financial matters be discussed [depending on the client's desire and willingness to share such information]?

From the File – Investment Wisdom

To avoid making emotional investment decisions overly rooted in fear or greed, it's helpful to reflect on investment wisdom from highly respected investors. Here are some of our favorite investment insights [not including John Templeton and Warren Buffett, who are discussed in a later article]:

CHARLIE MUNGER, VICE CHAIRMAN - BERKSHIRE HATHAWAY:

- Opportunity comes to the prepared mind.
- Organized common [or uncommon] sense - very basic knowledge - is an enormously powerful tool.
- There are huge dangers with computers. People calculate too much and think too little.

PETER LYNCH, RETIRED PORTFOLIO MANAGER - FIDELITY INVESTMENTS:

- Never invest in an idea you can't illustrate with a crayon.
- This is one of the keys to successful investing; focus on the companies, not on the stocks.

ROBERT "TAD" JEFFERY, FORMER PRESIDENT - JEFFREY COMPANY
[MINING EQUIPMENT MANUFACTURER/FAMILY OFFICE]:

- The real risk in holding a portfolio is that it might not provide its owner, either during the interim or at some end date or both, with the cash he or she requires to make essential outlays.
- Conventional wisdom isn't necessarily correct [e.g., the longstanding universal belief that the world was flat], but, by definition, it is the accepted view, and thus any challenge thereto necessarily requires not only good logic, but good logic well-presented.
- Two important points occur to me:
  - > one, that major progress, in whatever the field may be, is usually made only when conventional wisdom is somehow being challenged: and,
  - > two, that successful challenges to conventional wisdom…almost always require the support and encouragement of smart and well respected people.

SAM EISENSTADT, RETIRED RESEARCH DIRECTOR - VALUE LINE INVESTMENT SURVEY:

- Subject all beliefs about investing to mathematical verification. Unfortunately, most advisers fail to live up to that standard.
- A successful strategy typically weakens as more and more investors start following it.

PETER L. BERNSTEIN, PROFESSOR, INVESTMENT HISTORIAN, ECONOMIST AND AUTHOR:

- We tend to believe that information is a necessary ingredient to rational decision making and that the more information we have, the better we can manage the risks we face. Yet too much information gets in the way and distorts decisions, because each incremental piece of information also has less utility because it can lead to second-guessing of major themes.
- The computer only answers questions, it does not ask them. Whenever we ignore critical thinking, the computer supports us in our conceptual errors. At the same time, we must avoid rejecting numbers when they show more promise of accuracy than our gut.

BILL MILLER, CFA, CHAIRMAN - MILLER VALUE FUNDS:

- Recency refers to the very human proclivity to overweight the most-recent events when making decisions, rather than basing our action on the full data available.
- To the extent that the future looks like the past, then the past is a good guide to the future; to the extent that it doesn't, then the past is a very bad guide to the future.

For this article and the articles that follow, sources are available upon request. Some sources were not previously documented, but we are confident they are properly attributed.

From the File – Business Wisdom

The following quote from Ben Graham, mentor to Warren Buffett, aptly links investing and business.

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

Success in investing and business, comes down to three basic things in our view; people, business and price.

- People [the experience, character, skill, and incentives of management and directors]
- Business [the competitive positioning and profit/cash flow potential of business operations]
- Price [how much you pay for, and receive from, an investment in a company, asset, or person]

Whether investing in private or public assets, the following business insights are a few of our favorites, and can assist with both investment strategy and discipline:

DAVE COTE, EXECUTIVE CHAIRMAN - HONEYWELL:

- It's your job to be right at the end of the meeting, not at the beginning of the meeting.

JOHN WHITEHEAD, FORMER CHAIRMAN - GOLDMAN SACHS:

- The client's objective is more important than yours.
- The respect of one person is worth more than acquaintance with one hundred.

RALPH WALDO EMERSON:

- Nothing great was ever achieved without enthusiasm.

GENERAL DOUGLAS MacARTHUR:

- The history of failure in war can almost be summed up in two words - "Too late":
  - > Too late in comprehending the deadly purpose of a potential enemy.
  - > Too late in realizing the mortal danger.
  - > Too late in preparedness.
  - > Too late in uniting all possible forces for resistance.
  - > Too late in standing with one's friends.

JOHN D. ROCKEFELLER, FOUNDER – STANDARD OIL:

- If you want to succeed you should strike out on new paths, rather than travel the worn paths of accepted success.

ANDREW CARNEGIE, FOUNDER - CARNEGIE STEEL COMPANY [LATER U.S. STEEL]:

- Here is the prime condition for success:
  - > Concentrate your energy, thought and capital exclusively upon the business in which you are engaged.
  - > Having begun on one line, resolve to fight it out on that line, to lead in it, adopt every improvement, have the best machinery, and know the most about it.

JACK WELCH, RETIRED CEO - GENERAL ELECTRIC:

- An organization's ability to learn, and translate that learning into action rapidly, is the ultimate competitive advantage.
- Face reality as it is, not as it was or as you wish it to be.
- Change before you have to.
- If you don't have a competitive advantage, don't compete.
- If you pick the right people and give them the opportunity to spread their wings and put compensation as a carrier behind it you almost don't have to manage them.
- I've learned that mistakes can often be as good a teacher as success.

STEVE WYNN, CEO - WYNN RESORTS:

- In tough times, capital structure [your balance sheet] is your salvation. You have to do the basics better, with the support of your balance sheet. Therefore, your balance sheet affects everything in tough times, your marketing, your customer services, etc...
- Consistency is probably the most important word in politics and business and human relations. Consistency allows for a better future and a better life for people. Inconsistency is destabilizing and frightening and creates uncertainty. We live with a certain amount of it on a daily basis.
- The question becomes if the only constant is change and uncertainty, then how agile is the company; how agile is it financially; how agile is it in terms of its human resources. It's very important for CEOs and senior management in all companies to recognize that flexibility, agility, is everything to survival in the modern world and I think that's probably almost a universal truth these days.

JOHN WOODEN, HALL OF FAME COLLEGE BASKETBALL COACH:

- Never mistake activity for achievement.
- Failure is not fatal, but failure to change might be.
- Do not let what you cannot do interfere with what you can do.
- It's the little details that are vital. Little things make big things happen.
- Success is never final; failure is never fatal. It's courage that counts.

From the File - Templeton and Buffett

John Templeton and Warren Buffett are two of the greatest investment minds in modern history. Templeton worked for individual clients before transitioning to managing mutual funds. Buffett's career has been devoted to managing limited partnership and company funds [Berkshire Hathaway], rather than individual client portfolios. Here are some of our favorite investment insights from Buffett and Templeton:

BUFFETT ON INVESTING:

- To others in the investment field, risk simply equaled price volatility. However, Buffett found volatility to be the opposite of risk because it creates the opportunity to buy companies [investments] at prices far less than what they are worth.
- We think the best way to minimize risk is to think.
- When you buy bonds, you know exactly what you are going to get, the coupon and maturity. When you buy a business, you are buying something with coupons on it too, except the only problem is that they do not print in the amount of the coupon. It is my job to print in [figure out] the amount of the coupon.
- Buffett's guide to finding attractive stock opportunities can be summarized as follows:
  - Pay no attention to predictions about future stock prices; focus on long-term business value or the size of the coupons down the road.
  - Stick to stocks within one's circle of competence. If you don't understand the business, you can't value the stock.
  - Look for managers who treat the shareholders capital with owner like care.
  - Study prospects and competitors in great detail; trust your own eyes. But exact valuation is not necessary.
- Buffett defined cash flow as reported earnings plus depreciation and amortization and other non-cash charges less the average annual capital expenditures required for the company to maintain its unit volume and competitive position.

- I cannot promise results to partners, but I can and do promise this:
  > Our investments will be chosen on the basis of value, not popularity,
  > Our patterns of operations will attempt to reduce permanent capital loss [not short-term quotational loss] to a minimum.
- Fortunately, the investment business is one where knowledge accumulates and builds into a knowledge base that's useful.
- Run your business like it's the only business your family will own for 100 years, and measure your business not by short-term profits etc…but by whether the moat around the business gets bigger or smaller.
- This is fertile soil you're working [in the U.S. economy], so there is no need to cut corners [ethically].

TEMPLETON ON INVESTING AND SERVING INDIVIDUAL CLIENTS:

- At Yale I was investigating what talents God gave me, and where I thought I could be most beneficial to people was to help them make fewer stupid mistakes in selecting their investments.
- At age 27, I formed my own investment firm, working with just five wealthy people. Eventually, when I sold out, we were helping over a million people with some part of their investments. And I felt that was a ministry, that I was doing a useful job, that I was not wasting the life God gave me.
- The key to long-term [investment] success is to keep an open mind. And by that I mean the willingness to adapt any approach, any technique suitable for the investment. And to explore any type of investment in any place in the world.
- The worldwide pursuit of profit demands study, patience, and always – common sense.
- Purchase an investment only when you can pay less for it than it is worth today, and only if you believe it will be worth more tomorrow.
- Bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria.
- My job was being paid by wealthy families to help them choose stocks and bonds. And my results were much better when I was working from here [Bahamas] than from Manhattan, Radio City and Rockefeller Center. I had good results in New York. But when I came here, I had better results. The secret, I think, is … you have to do the opposite of the crowd. When you're going to the same meetings with the other people in Manhattan, it's hard to be different.
- The investor wants to feel that their list of stocks is the best which could possibly be selected. If you explain in great detail why each stock is good and what methods we use in selecting stocks a client will be happy with their list. Clients like to know that each of their stocks is subject to continuous restudy and follow-up.
- The investor will be comfortable if they know that they are following a sensible program. In each interview [meeting] and often by letter it is often wise to describe the program [the client] is following. They want to feel that their program has been carefully prepared with regard to their own particular needs, and that improvements are made frequently. The client should understand the reasons why their program is likely to prove not only safer but also more profitable in the long run than any other possible program.
- Intimate knowledge of every detail of family affairs is a proper expectation of the client, because investment counsel does fit selections to the needs and wishes of the particular client. If the [investment advisor] remembers most of the details about the family, taxes and investment holdings of the client, this gives the client a feeling that they are getting close personal attention.
- Frequent mailing of reports and studies gives the client a better understanding of the [investment advisor's] work. This helps the client to learn how much research and thoughtful work in many fields is devoted to their financial welfare.
- When recommending switching from one [investment] to another [the investment advisor] should often give a tabulation of five or six reasons.

Demographics and Investment Strategy

One of our most important investment realizations of the last ten years has been that we are making investment decisions in a world that is structurally different than in the past:

- Interest rates have declined substantially and are staying low, despite the most expansive/simulative central bank monetary policies, on a global basis, in history.
- Core inflation rates are low and actually declining further in 2017, away from central bank goals, despite massive stimulus and even as we experience a broad global economic recovery.

THIS TIME IS DIFFERENT. Our consistent view over the last decade is that demographics are changing the world's economic future, overpowering the stimulus efforts of global central banks. The central banks are doing everything in their power to create inflation, increasing their combined balance sheets from about $7 Trillion in 2008 to nearly $25 Trillion as of July 31, 2017. [Source: Pimco/Haver]. But it's not working, because this time is different. Even though most developed and emerging countries are now experiencing economic growth, inflation and interest rates are still very low. In our opinion, we're not going back to the higher interest rates and higher inflation rates seen over the last fifty years, unless countries experience a crisis [such as Greece a few years ago before its EU bailout]. This has implications, both negative and positive, for nearly all asset classes and sectors.

For the U.S., we believe our economic potential remains strong because of our demographic and structural advantages compared to nearly every other country in the world. Of course, world events could change all of this quickly and we still have large debt and entitlement problems to address. But in the meantime, low and stable interest rates, low and stable inflation rates, and a modestly growing global economy have created a near perfect environment for most risk assets like equities.

DEMOGRAPHIC CAUSATION OF LOWER FOR LONGER. In several past issues of Investment Advisor, we have written about the downward pressure on interest rates and inflation caused by global demographic changes. More specifically, the dramatic decline in population growth and labor force growth, caused by much lower birth rates over the last several decades, is different from the past. The result is lower global inflation as the population base is aging and spending less, without adequate growth offsets from the younger generation [which does have large numbers in certain age categories]. Automation and technological advances are also reducing inflation at greater levels than in the past. Inflation and interest rates are likely to remain lower for longer, in our view.

Consider the following demographic facts:

- The global birth rate [developed and growing countries combined] has declined substantially over the last several decades to just above the 2.1 replacement rate [births per woman]. In most developed countries, the birth rate averages just 1.5, below the replacement level of 2.1.
- Global population should level off this century; a dramatic new development.
- Some countries, such as Japan, are experiencing population declines. This trend will soon spread to other rapidly aging countries in Europe and Asia. For example, the birth rate in Spain [similar to many other countries] has declined from nearly 3.0 in the 1970s to just 1.3 today. [Source: Asia Times Online].
- After adding nearly a billion workers in the past thirty years, China will lose over 400 million workers over the remainder of this century, as birth rates have collapsed and the population over age 65 has grown rapidly. China is the second fastest aging population behind Japan. [Source: BCA Research, United Nations Population Division]
- Even India's birth rate is collapsing [cut in half the last fifty years], although still growing at just above the 2.1 replacement rate.
- Despite declines in the U.S. birth rate, the U.S. population will still grow nicely over the next several decades, thanks to a higher than average birth rate and immigration. This is a powerful exception which will benefit the U.S. longer-term, compared to most countries.

- The Federal Reserve is finally admitting the demographic factor, as they wrote "We find the overall impact of population aging on U.S. interest rates has been negative and quantitatively relevant and is projected to be long-lasting." [Source: Economic Letter of the Federal Reserve Bank, 2017]

FOR THE FIRST TIME IN TEN YEARS ECONOMIC GROWTH HAS STRENGTHENED GLOBALLY.
For the first time since 2008, the demographic pressures pushing interest rates lower have been met by a counter force of improved economic growth. All 47 countries tracked by the Organization for Economic Co-operation and Development [OECD] are now growing. This is not surprising considering how depressed European economies had become. Future global growth may be more measured and settle back to normal ranges; normal being at lower growth rates than prior to the 2008-2009 Global Financial Crisis [hence the often used economic term, "the new normal"].

ARE ECONOMIC FORECASTS A FOOLS GAME? Warren Buffett has said that predicting future economic trends is not something he cares about in making investments. Yet he also talks about the dramatic impact lower interest rates can have on future equity performance. John Templeton often made investment decisions taking his economic forecasts into account. Buffett and Templeton's investment approaches varied, but both held to a disciplined approach of evaluating investments assuming economic conditions would change, for better or worse. Importantly, we agree that all investment decisions should assume economic forecasts and realities will change, perhaps dramatically, and therefore decisions should not be overly reliant on a particular forecast.

FOCUS ON INVESTMENT STRATEGY. Moving beyond debatable topics like demographics or stock valuations, overall investment strategy is the most important focus for client portfolios, including issues such as:

- What is the required return the portfolio must earn over time to meet the client's needs?
- Does the client have the ability [financially] and willingness [emotionally] to accept the risk level necessary to achieve the required return?
- How is risk defined?
- Are portfolio expenses as low as reasonably possible in pursuing the required return, or can they be reduced further without detrimental impact?
- Are taxes on portfolio income as low as reasonably possible?
- Is there sufficient flexibility in the investment strategy to meet unforeseen circumstances or unique client preferences?
- How can the client best understand what they own in the portfolio and why they own it, and do they receive this information on a timely basis [in their opinion]?
- Does the client have a high level of confidence in the overall approach adopted for their portfolio, and its customization to their particular needs and preferences?

The list above deserves much more attention than economic views and forecasts. Analysis of asset valuations, and associated risks, should always be high on the list as well, in the spirit of both Templeton and Buffett.

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