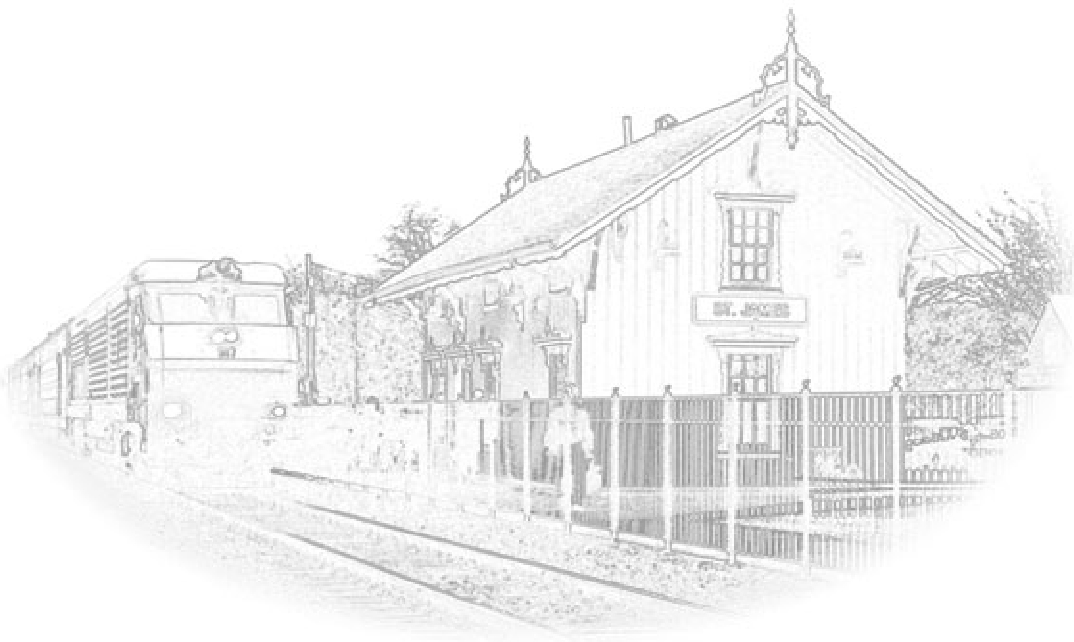

ST. JAMES INVESTMENT COMPANY

INDIVIDUAL PORTFOLIO MANAGEMENT

INVESTMENT ADVISER'S LETTER

JANUARY 2020

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"The whole problem with the world is that fools and fanatics are so certain of themselves and wiser people so full of doubts." -Bertrand Russell

On September 8, 1900, a hurricane hit the coastal city of Galveston, Texas. The Galveston Hurricane remains the deadliest natural disaster in modern U.S. history, leaving behind an estimated death toll of six to twelve thousand people. The first sign of trouble appeared on August 27 when a ship traveling one thousand miles off the coast of the West Indies reported troubling weather, but nothing to cause alarm. Antigua endured thunderstorms and Cuba received heavy rain in the following days, but the tropical storm that hit the Straits of Florida only hinted at what the storm would become. Conditions were perfect for a dangerous hurricane. Unfortunately, nobody had the foresight to evacuate. Galveston had experienced ocean floodwaters from storms before, but necessary preparations were typically minimal. This lack of preparation cost them dearly.

U.S. meteorologists ignored the warnings from Cuba. They understood the danger created by the warm gulf waters, but the meteorologists were convinced that the storm would head northeast, up the East Coast and into the cooler Atlantic waters. Cuban meteorologists warned the United States about the storm's track, but they could not convince the U.S. meteorologists otherwise as tensions were still high after the Spanish-American War.[1] The first surprise came on September 6, when Captain Halsey of the Louisiana reported that his ship encountered a hurricane shortly after they set sail from New Orleans. The news startled everyone because few other sources reported the severe weather. With telegraph lines knocked down or destroyed, towns and cities along the Louisiana and Mississippi coasts could not relay the news of the heavy damage suffered. Galveston residents had no idea of the danger and did not evacuate.

On Friday, September 7, the central office of the Weather Bureau issued a storm warning for Galveston. The following morning a headline that read "Storm in the Gulf" appeared in the newspaper, but the news did little to cause the citizens much concern. Residents were similarly complacent when Galveston's Weather Bureau raised its hurricane flags. Isaac Cline, a Weather Bureau official, would later say that he drove his horse-drawn buggy through Galveston's neighborhoods urging people to seek shelter. Yet even Cline did not believe that there was cause for serious concern. He had previously written that "*it would be impossible for any cyclone to create a storm wave which could materially injure the city*." After all, everyone knew that Galveston had survived storms before, and it would survive them again. Nothing indicated that the Galveston Hurricane would be a different kind of storm.

On September 8 at 8:00 p.m. a Category 4 hurricane made landfall in Galveston. The highest point in the low, flat city was less than nine feet above sea level; the storm surge exceeded fifteen feet, leaving Galveston entirely submerged. The hurricane's winds destroyed the Weather Bureau's measurement device, leaving the job of estimating wind speeds to modern scientists who believe the storm may have reached maximum sustained winds of 145 miles per hour. When it was all over, the storm damaged every single house in the city. Eighty percent of the population of Galveston was now homeless, while one in five residents were dead. The Galveston Hurricane changed the city's stance on hurricane preparation and it later built a seventeen-foot sea wall to break future storm swells. Galveston should have overcome its complacency earlier and prepared before the storm, not after the fact.

[1] Joel Stice, *All That's Interesting*, August 16, 2017

The Weather Bureau is not alone in failed predictions. Experts with credentials following their last name continue to poorly anticipate future outcomes. At the beginning of the 20th century an essay in The Atlantic predicted that by the year 2000 society will have abolished war, and the poor would be living in high-rise "abodes of happiness and health." Around the same time a Ladies' Home Journal essayist wrote that society will eliminate all mice and rats, as well as the letters C, X, and Q (we have no idea why). Lewis Strauss, as chairman of the U.S. Atomic Energy Commission, told the National Association of Science Writers in September 1954 that nuclear power would produce energy "too cheap to meter." Stanford biologist Paul R. Ehrlich famously insisted in his 1968 best seller, The Population Bomb, that it was too late to prevent a doomsday apocalypse resulting from overpopulation. In 2006, David Pogue wrote in The New York Times, "*Everyone's always asking me when Apple will come out with a cell phone. My answer is, Probably never*." Apple introduced the iPhone on June 29, 2007. The track record of expert forecasters in science, economics, markets and politics is consistently poor.

In finance, highly compensated forecasters are routinely wrong with their predictions. Research shows human brains are fundamentally unreliable,[2] as most make decisions based primarily on emotions. The human mind exhibits a funny quirk, where one cannot distinguish between what one knows and what one feels. Humans often use memories of the emotions they had at one point in time as a basis for decisions made at another point in time, possibly months or years later. Unfortunately, memories of events fade, and interpretations grow susceptible to false information as time passes. Our memories are not storing binary data and are not nearly as reliable as we believe. Memories help humans learn from past events, which theoretically allows for better decisions in the future. Therefore, humans find it easier to use fuzzy memories and fill in the details on the go to fit the current situation.

When asked what people would learn from the financial crisis in 2008, investor Jeremy Grantham replied that "*In the short term a lot, in the medium term a little, in the long term, nothing at all. That would be historical precedent*." Judging by today's market exuberance, our fuzzy memories have forgotten about the critical relationship between the price one pays for an asset and the value one receives for the asset at this price. Given the historical importance of this relationship, the virtue of patience is central to the investment choices one makes. In classical economics, patience generates savings by households which, through financial intermediaries, finances investment by companies. Capital accumulation by the same companies drives future output. To the extent that financial intermediation is efficient, it also encourages thrift and promotes growth, reinforcing a patient approach to both private and public investment decisions. Adam Smith, the author of The Wealth of Nations, advocated for the virtue of patience in the Theory of Moral Sentiments (1759):

The qualities most useful to ourselves are, first of all, superior reasons and understanding, by which we are capable of discerning the remote consequences of all our actions; and, secondly, self-command, by which we are enabled to abstain from present pleasure or to endure present pain in order to obtain a greater pleasure in some future time.

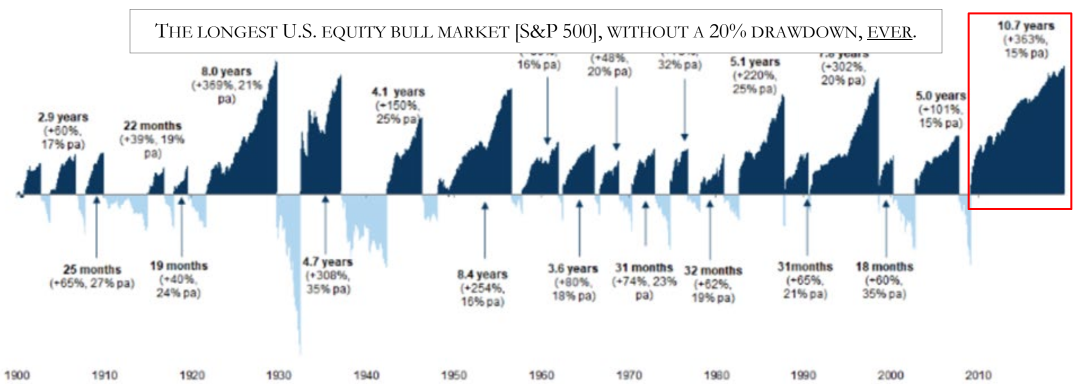
The compulsion for immediate gratification overrides the virtues of patience as well as the consideration of long-term consequences. In financial systems, debt at all levels—consumer, corporate, and government—pulls forward tomorrow's spending, leaving the future deprived of adequate resources. The Institute of International Finance (IIF) recently announced that global debt topped $250 trillion – 320% of the world's economic output. The IIF also estimated that global debt would end the year at $255 trillion – "*nearly $32,500 for each of the 7.7 billion people on the planet*" according to Reuters. Since the

[2] Aamodt, S. Biased brains, messy memories. Nature 452, 938–939 (2008)

2008 credit crisis, governments have borrowed $30 trillion, companies have taken on $25 trillion, households $9 trillion and banks $2 trillion.

The impulses behind credit binges differ little from individual drug addictions. Today, investors face their own dilemma—whether to take the patient or impatient path. Liquidity makes buying and selling easier with the added benefit of trading commissions now at zero. Few investors remember the days when physical certificates held in bank safety-deposit boxes represented share ownership, a clear barrier to frequently trading. Despite the conveniences afforded today, liquidity leads investors toward the path of least resistance: the excess of trading and the ability to easily access credit. This growing impatience further separates price from value. Over the last century, U.S. stock prices exhibited three times more volatility than fundamentals. Stock prices today fluctuate six to ten times more than the rate of change in an asset's underlying fundamentals.

Technology affects financial markets because it amplifies the actions of human investors. High-frequency algorithmic trading simply creates greater deviations between price and value than historically normal. To the extent that today's investors have practiced impatience in their daily lives, the markets they trade mirror those inclinations. Governments and companies assume too much debt to jumpstart slowing growth. Speculators leverage their capital to increase returns. Market participants chase the latest trends to avoid missing potential gains. All are practicing a form of impatience. The cautious should continue to avoid the playground of impatience. In financial markets, impatience invariably leads to unfortunate outcomes.



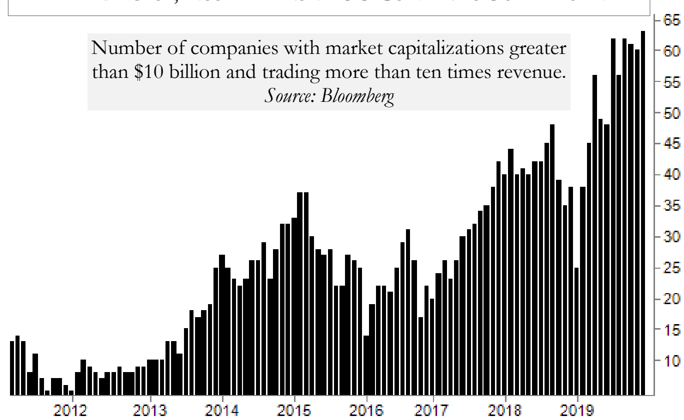
Source: GFD, Datastream, Goldman Sachs Global Investment Research

Value investors are often early, sometimes by years, which leads them to stay on the sidelines and miss out on spectacular gains. However, the discipline of not chasing the latest investment fad protects the value investor when bubbles eventually burst. Beyond Meat, a plant-based food company, priced its initial public offering (IPO) at $25 a share. At the end of the first day of trading the company's shares reached $65.75, or 163% above its IPO price, making it the best-performing first-day IPO in nearly two decades. Beyond Meat's stock hit an all-time high of $239.71 on July 26, over 820% since it went public on May 2. Beyond Meat's market capitalization reached $13.9 billion for a company that produced only $230 million in revenue over the trailing twelve months. At this price, its valuation was greater than 25% of the companies in the S&P 500 index. As of December 31, its shares trade at approximately $76 with a market capitalization of $4.6 billion, a valuation that still exceeds 20x trailing revenue and an operation that continues to lose money. For some perspective on what that revenue metric means in terms of valuation, one should revisit this 2002 quote from Sun Microsystems CEO Scott McNealy, who addressed it in an interview that served as an autopsy of the dot-com period:

'At 10 times revenues, to give you a 10-year payback, I have to pay you 100% of revenues for 10 straight years in dividends. That assumes I can get that by my shareholders. That assumes I have zero cost of goods sold, which is very hard for a computer company. That assumes zero expenses, which is really hard with 39,000 employees. That assumes I pay no taxes, which is very hard. And that assumes you pay no taxes on your dividends, which is kind of illegal. And that assumes with zero R&D for the next 10 years, I can maintain the current revenue run rate. Now, having done that, would any of you like to buy my stock at $64? Do you realize how ridiculous those basic assumptions are? You don't need any transparency. You don't need any footnotes. What were you thinking?'[3]

McNealy's quote shows the absurd valuation of SUN Microsystems at the height of the dot-com bubble. Today, there are sixty-three companies with equity market capitalizations greater than $10 billion that trade on U.S. exchanges and carry a valuation greater than ten times their sales—meaning, a company with a $10 billion market value would have sales of $1 billion or less. The chart to the right shows the trend. The average 2019 performance of those sixty-three companies was +60% or double the return of the S&P 500. Maybe one day investors will look back at 2019 and wonder "*What were we thinking?*"

THE LARGEST, MOST EXPENSIVE U.S. COMPANIES OUTPERFORM



If the largest most overvalued companies generated the greatest return in 2019, companies with negative tangible book value generated the best returns over the past decade. About 40% of public stocks quoted in the U.S. have negative tangible book value, meaning the value of a company's tangible assets cannot repay all their debt. Two decades ago, this was only true of 15% of companies, according to Vincent Deluard, head of global macro research at INTL FCStone. A "negative-value" fund, composed of the shares of companies with negative tangible book value, would have outperformed the U.S. stock market by 24% over the last twenty years. This outperformance happened almost entirely since the credit crisis in 2008.

If WeWork were a public company, the real estate coworking company masquerading as a technology company would trade above ten times sales and carry a negative book value. Fortunately for potential IPO investors, the company cut its valuation down to $8 billion from $47 billion, removed its CEO, and delayed its initial public offering indefinitely. The company's collapse was the direct result of an overexpansion powered by credit and arrogance. Miserable outcomes like WeWork are a twist on what economist John Kenneth Galbraith called the "bezzle." In his 1955 book on the 1929 Wall Street crash, Galbraith suggested that "*embezzlement is the most interesting of crimes*". It is the only one of the various forms of theft that comes with a time lag, where "*weeks, months, or years may elapse between the commission of the crime and its discovery*." During that lagging period, things are good, and investors are happy. They believe this new wealth is permanent. This happy period is the bezzle and all booms experience it. Markets grow relaxed and trusting when liquidity and credit run freely. WeWork represents the distortions created in an easy-money environment. Such market periods transfer wealth from ordinary savers to ridiculously overvalued companies, a modern version of the bezzle.

[3] Scott McNealy, "A Talk with Scott McNealy," Businessweek, (March 31, 2002).

The current investment environment is one that will eventually transfer wealth from leveraged speculators back to prudent investors. The S&P 500 index continues to rise despite flat national corporate profits since 2013, further widening the discrepancy between stock prices and value. Apple, the largest company in the U.S. market, exemplifies this discrepancy. The company has gained over 100% since the lows in January 2019, adding over $500 billion in equity market capitalization. Whether it was stock buybacks, central bank liquidity, passive indexing money inflows, the net result was the single largest equity market capitalization expansion in an individual stock in a single year in history. Due to its size the stock has also been the single largest contributor to stock market index gains. In fact, Apple's value now exceeds the entire value of the U.S. energy sector.

Perhaps the dynamics of the investment management industry explain these valuation discrepancies. The financial industry thrives on savers delegating control of their investments to Wall Street. In return, savers need a method to track performance. The system that has evolved involves benchmarking against a stock index. Funds that outperform see money flow in; those who underperform see money flow out.

This simple mechanism comes with consequences. If a sector starts rising and a fund manager is underweight, regardless of the fundamentals, the fund cannot afford to underperform the benchmark. Career risk forces fund managers to buy the sector at the new higher prices. Funds already overweight this sector have no incentive to sell. Demand exceeds supply and prices squeeze higher. This "momentum" effect leads to herding, as active fund managers pile into the most expensive sectors. While quantitative funds actively seek to benefit from momentum, those tracking an index simply want to avoid tracking error, or the divergence from an index. Index managers robotically respond to money flows--they mindlessly eat what the market serves and further amplify the discrepancy between price and value.

Contrary to conventional finance theory taught by academics, the most expensively valued stocks now exhibit less volatility than more reasonably valued stocks. To survive, the investment management industry has morphed into a business model that favors price-based momentum investing. Quantitative and artificial intelligence-based strategies spot emerging spikes in prices and attack, sucking in conventional active fund managers, who are late to the party but must buy at higher prices to avoid risking their careers. This widespread mispricing of assets can result in undesirable social costs. For example, momentum investing encourages corporate boards to pursue strategies that increase its near-term stock price by issuing debt and repurchasing stock while reducing capital expenditures that will fund the company's future growth long-term.

Bob Farrell was a widely followed strategist at Merrill Lynch. Wall Street still speaks of him reverently, as many of the greatest traders and investors refer to his rules on a frequent basis. Farrell recognized the importance of investor psychology and contrary thinking to markets and was the first to use the term "sentiment" analysis to describe psychological indicators. Farrell believed that both euphoric and pessimistic markets can cloud people's heads. Many investors try to find the latest hot sector, and soon a fever builds that "this time it's different." Of course, it never really is. When the hot sector cools, individual shareholders are usually among the last to know and sell under duress at lower prices. Investors can be their own worst enemy, particularly when emotions take hold.

1. Markets tend to return to the mean over time
2. Excesses in one direction will lead to an opposite excess in the other direction
3. There are no new eras -- excesses are never permanent
4. Exponential rapidly rising or falling markets usually go further than you think, but they do not correct by going sideways
5. The public buys the most at the top and the least at the bottom
6. Fear and greed are stronger than long-term resolve
7. Markets are strongest when they are broad and weakest when they narrow to a handful of blue-chip names
8. Bear markets have three stages -- sharp down, reflexive rebound and a drawn-out fundamental downtrend
9. When all the experts and forecasts agree -- something else is going to happen
10. Bull markets are more fun than bear markets

Going against the herd, as Farrell repeatedly recommended, can be very profitable, especially for patient buyers who raise cash from bubbly markets and reinvest this cash when sentiment is darkest. Unfortunately, most investors find this simple process exceedingly difficult to execute. As John Maynard Keynes once noted, people will perceive the long-term investor as "*eccentric, unconventional and rash in the eyes of average opinion … and if in the short run he is unsuccessful, which is very likely, he will not receive much mercy*." During bull markets, market participants want to grab as much cash as they can in the near term even if they know it carries severe consequences at some point later.

During the Galveston Hurricane, the storm surge began flooding the city in the early morning hours of September 8. Water rose steadily from 3:00 p.m. until approximately 7:30 p.m., when eyewitness accounts indicated that water rose about <u>four feet in just four seconds</u>. An additional five feet of water flowed into portions of the city by 8:30 p.m. It can be incredibly difficult for the value investor to hold themselves to a higher standard, but if one does not prepare before the storm, they may not survive the storm. There is great deal of angst among those currently trying to do the right thing and a great deal of confidence among the rest. As Bertrand Russell fittingly observed, "*The whole problem with the world is that fools and fanatics are so certain of themselves and wiser people so full of doubts*." For the prudent investor who understands this, there is no choice but to do the right thing no matter how difficult.

With kind regards,

St. James Investment Company

ST. JAMES INVESTMENT COMPANY

We founded the St. James Investment Company in 1999, managing wealth from our family and friends in the hamlet of St. James. We are privileged that our neighbors and friends have trusted us for twenty years to invest alongside our own capital.

The St. James Investment Company is an independent, fee-only, SEC-Registered Investment Advisory firm, providing customized portfolio management to individuals, retirement plans and private companies.