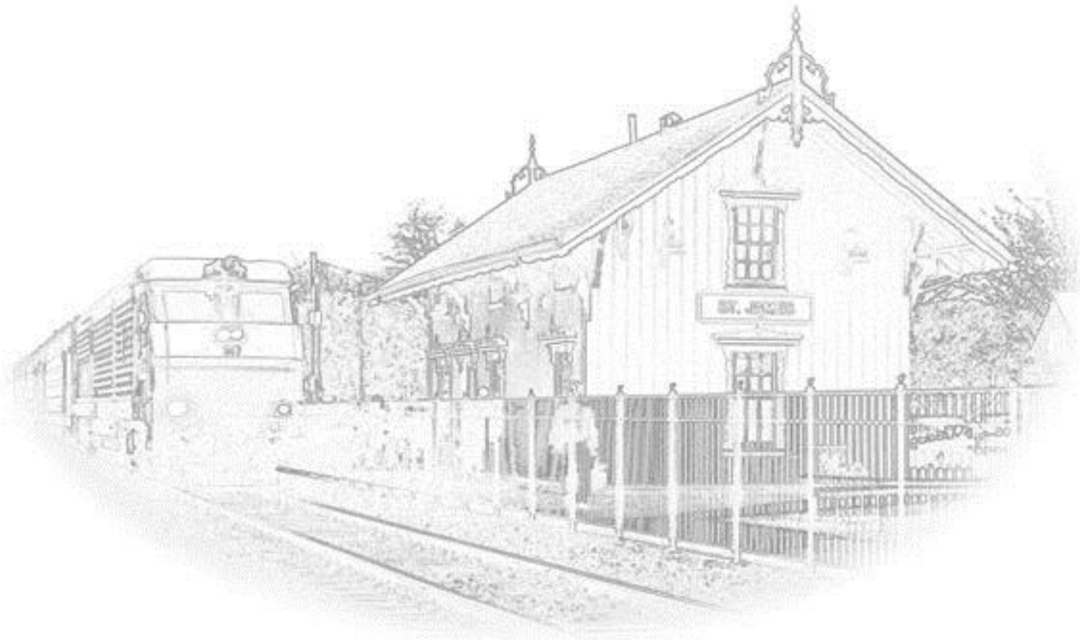

ST. JAMES INVESTMENT COMPANY

INDIVIDUAL PORTFOLIO MANAGEMENT

INVESTMENT ADVISER'S LETTER

OCTOBER 2014

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THIRD QUARTER LETTER

MARKET COMMENTS

"Explain to me how increases in paper pieces can possibly make a society richer. If that were the case, explain to me why there is still poverty in the world. Isn't every central bank in the world capable of printing as much paper as they want? And do you then think that society as a whole would be richer?" -- Hans-Hermann Hoppe

Hoppe, a retired academic and Distinguished Fellow at the Ludwig von Mises Institute, accurately captures the dilemma central bankers' face today in a world saturated with quantitative easing (QE). Common sense dictates that QE cannot possibly solve our problems, but rather, only create a different set of problems. Still, many accept the premise that today's challenges can be cured by money printing. Unfortunately for value investors, QE has made investing in today's markets the equivalent of shopping at Neiman Marcus: everything looks expensive. That is the intelligent investor's current dilemma; finding something that is of decent quality yet still cheap.

Because the entire market appears expensive, we fear any purchase could decline in value. Before the bursting of the 2000 stock bubble, the mania centered on the telecommunication and technology stocks. Prior to the financial crisis in 2008, housing and subprime loans captivated investors. What we presently find astonishing is the breadth of today's investment gains—the rising monetary tide has lifted every boat. Just as all assets have risen together, we fear that all assets will retreat together.

When central banks suppress interest rates, they create incentives for investors to speculate. At first the central bank's strategy appears valid, as increased speculating and investing temporarily boost economic activity. However, artificially low interest rates motivate the misallocation of capital into questionable investments. As a result, the use of monetary stimulus to combat the effects of the 2000-2002 collapse led to a more serious collapse during 2007-2009—the credit crisis simply became the justification for even more aggressive monetary stimulus.

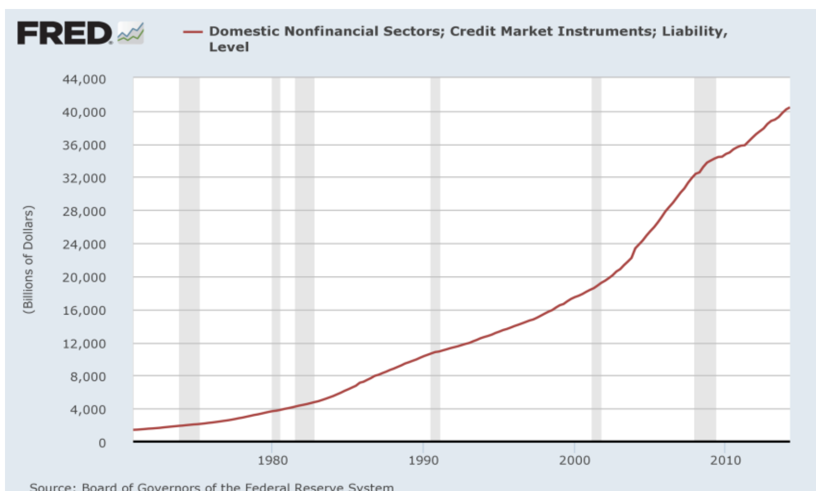
For example, cheap credit has incentivized private equity firms to buy more than 200,000 residential houses. Sadly, many people who lost their homes during the previous Federal Reserve monetary crash now rent these very houses. This artificial increase in housing demand boosts home prices and creates the false impression that the residential real estate market is undergoing a sustainable recovery. Likewise, the current strength in automobile sales correlates to the return of subprime credit lending. As a result, we wonder if the shale oil-and-gas industry's current success is not somehow related to the access to cheap credit. As in the past, the current malinvestment sets the stage for the next down cycle.

Artificially suppressed interest rates have also ignited a dash for yield, which has pushed high-risk bonds down to once unthinkably low yields. Consider that the bonds issued by the governments of Spain and Italy now yield less than US Treasury Notes. Central bank monetary accommodation continues to increase the appetite for risky, higher yielding investments. One of the biggest beneficiaries of this trend has been public companies, which have been buying back equity at a record pace despite rich equity valuations. Although equity valuations are expensive, debt is priced even more expensively. Regardless how expensive a company's stock is, from a financial-engineering perspective, a company can justify borrowing money to repurchase its own stock. While buying back stock increases a company's earnings-per-share, it does nothing to expand or improve the underlying business.

Despite the Federal Reserve's easy money policies, the real economy still appears far less dynamic than normal. Perhaps this explains corporate America's hesitation to allocate money to capital investments, as companies today continue to focus on financial engineering designed to boost earnings-per-share growth. Since 2004, IBM has generated $131 billion of net income, spent $124 billion repurchasing its own stock but dedicated only $45 billion to capital investments. Meaning, IBM allocated almost all of its earnings into stock repurchases—almost $3 towards its own stock for every $1 of capital investment. Furthermore, 90% of IBM's capital investment simply covered depreciation and amortization of its current asset base. And, while IBM was repurchasing company stock on the open market, not a single corporate executive at IBM purchased any stock over the past six months; however, company insiders did sell almost a quarter million shares of stock. IBM recently reported declining year-over-year revenue for the ninth consecutive quarter. If interest rates were at more realistic levels, there would be less incentive to financially engineer earnings growth and more incentive to invest, increase productivity and grow revenue rather than engineer reported earnings-per-share.

IBM management is not alone, as U.S. companies are buying their own stock back at the strongest pace since the credit crisis. Corporations repurchased $338.3 billion of stock in the first half of 2014, the most for any six-month period since 2007. Unfortunately, the same cannot be said for company executives: 7,181 insiders bought their own company stock this year through September, while 23,323 company executives sold stock. The ratio of buys to sells is the lowest since 2000.[1] To summarize, U.S. companies are issuing record levels of debt to conduct share repurchase programs, at valuations that we consider seriously expensive. Simultaneously, companies continue to shortchange their capital investment outlays while executives sell their personal company stock at a pace not seen since just prior to the technology bubble of 2000.

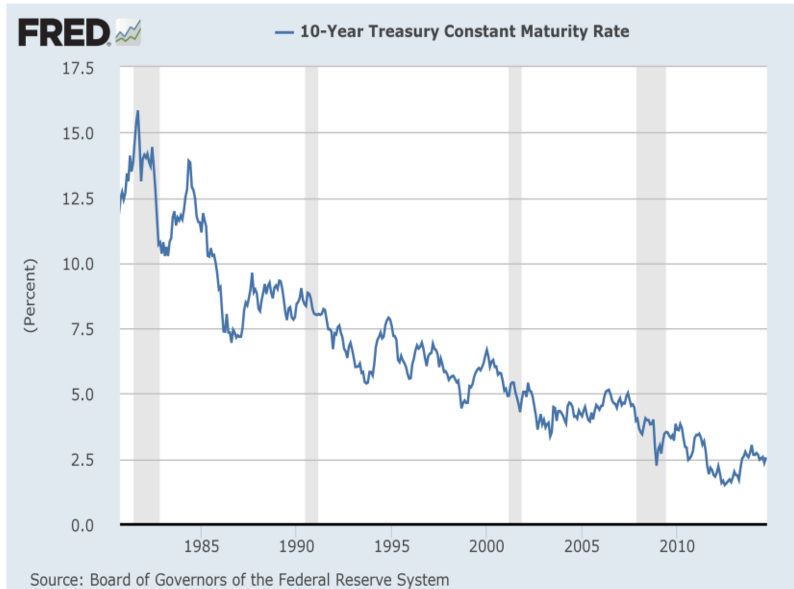
Despite claims to the contrary, there has been no deleveraging in the United States. Instead, the Federal Reserve's promotion of leveraged speculation and the government's deficit-spending reinforces the upward trend in credit. Consequently, in terms of total debt, the U.S. economy is more levered today than it was in 2007. Therefore, we fail to see how it will be possible for interest rates to normalize without creating an economic contraction.



Exactly 33 years ago U.S. Treasury yields peaked at 15.8%. Currently sitting at 2.5%, U.S. Treasury yields can still go lower—German yields are at 1.0% and Japanese bonds yield 0.5%. However, at some point, if we actually operate in a functioning market, interest rates must normalize. As a result, no amount of QE and financial repression by the Federal Reserve can keep yields on the current $12 trillion of publicly held U.S. Treasury debt at negative (inflation-adjusted) rates indefinitely. Our central bank must realize this looming problem.

[1] http://www.bloomberg.com/news/2014-09-22/insider-buying-dries-up-defying-275-billion-of-buybacks.html

In 2007, U.S. debt totaled $9 trillion, incurring interest payments of $430 billion on an average annual rate of 4.9%. In 2013, U.S. interest payments cost taxpayers $416 billion on $16.7 trillion in debt due to the artificially low average rate of 2% engineered by the Fed. Unfortunately, the Congressional Budget Office (CBO) calculates that, if interest rates normalize by 2020 — meaning 10-year notes at 5% (versus 2.5% today) and three-month T-bills at 3.7% (versus 0.1% today) —annual interest payments will jump to $840 billion, or double what taxpayers currently pay.



Low interest rates not only support greater levels of government debt, but also underpin Wall Street's bullish argument for capitalizing corporate earnings at rates well below historical averages. Wall Street somewhat simplistically assumes that low interest rates justify higher valuation multiples on company earnings. To understand this perspective, one needs only two inputs: 1) company earnings, and 2) interest rates. When considering just these two data points, bulls unsurprisingly still see substantial upside in U.S. stocks. These pundits argue that over the past fifty years the stock market's P/E ratio averages 18.9 [current price ÷ trailing twelve month reported earnings]; however, the P/E level depends significantly on interest rates. When rates are low, like today, stocks trade at higher valuation levels. Conversely, when interest rates are high, think early 1980s, stocks trade at lower P/E levels.

As the table shows, interest rates can significantly impact stock prices. When interest rates are high, bonds appear attractive relative to stocks. When interest rates are low, Wall Street believes that there is no alternative—investors find bonds unattractive, and so they must buy stocks regardless of prevailing price.

Source: Ibbotson Associates

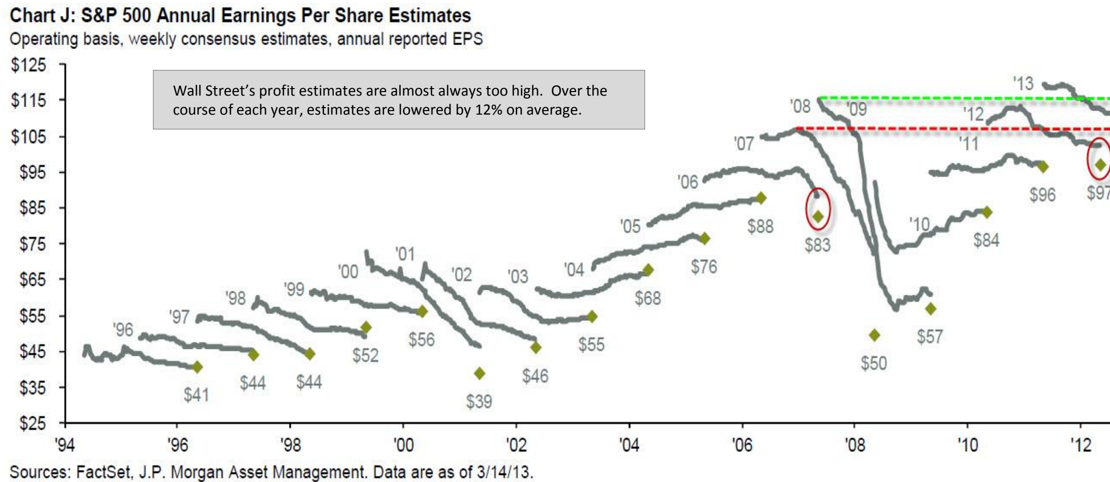
Time Period: 1964 to 2014	Average Interest Rate	Average P/E Ratio
Average during lowest-third of interest rates	3.8	24.8
Average during middle-third of interest rates	6.4	15.9
Average during highest-third of interest rates	9.7	11.9
Today	2.6	19.7
Potential S&P 500 gain if P/E ratio at 24x		25.8%

Year	Estimated Earnings	If P/E ratio equals 24x, Potential S&P 500 Gain
2014	119.7	49%
2015	133.4	66%

Source: Factset

The Wall Street argument states that the S&P 500 currently trades for a P/E ratio of 19.7 [=1990÷101], above the historical average, but only if one ignores interest rates. Therefore, as current interest rates are low, stock market P/E ratios should continue climbing to much higher levels. If the market's P/E ratio moved to its historical average, based on current interest rates, and earnings continued to grow as analysts expect, stocks could potentially return 66% by the end of 2015. When interest rates are this low, Wall Street bulls conclude that stocks are the only game in town.

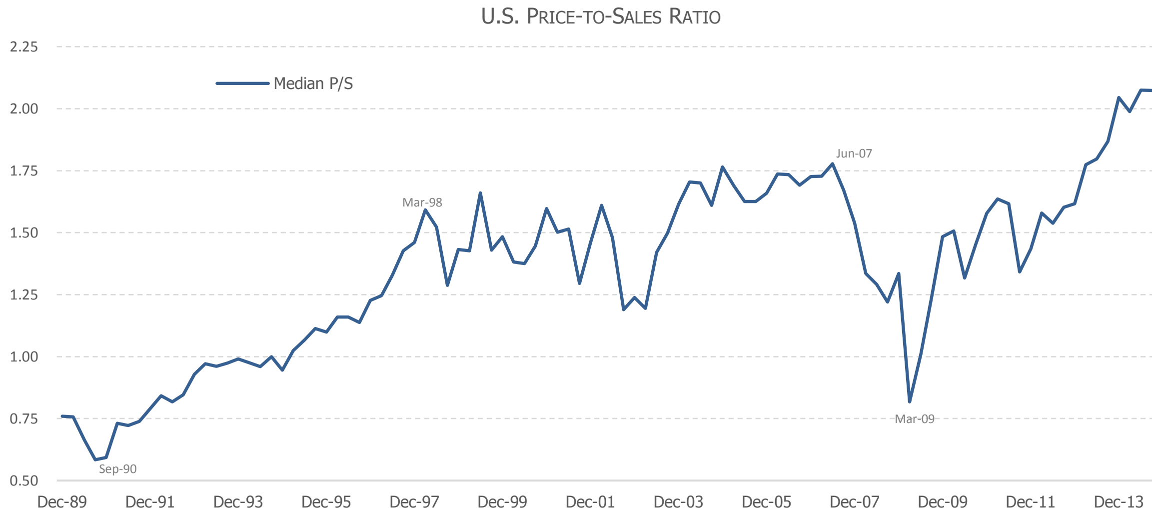
While we wish investing were so simple, we believe John Wayne summed it up best when he said that "*Tomorrow hopes we have learned something from yesterday*." Unfortunately on Wall Street tomorrow has never learned anything from yesterday. A quick glance at the chart below clearly illustrates that Wall Street analysts are persistently overoptimistic when estimating future company profits.



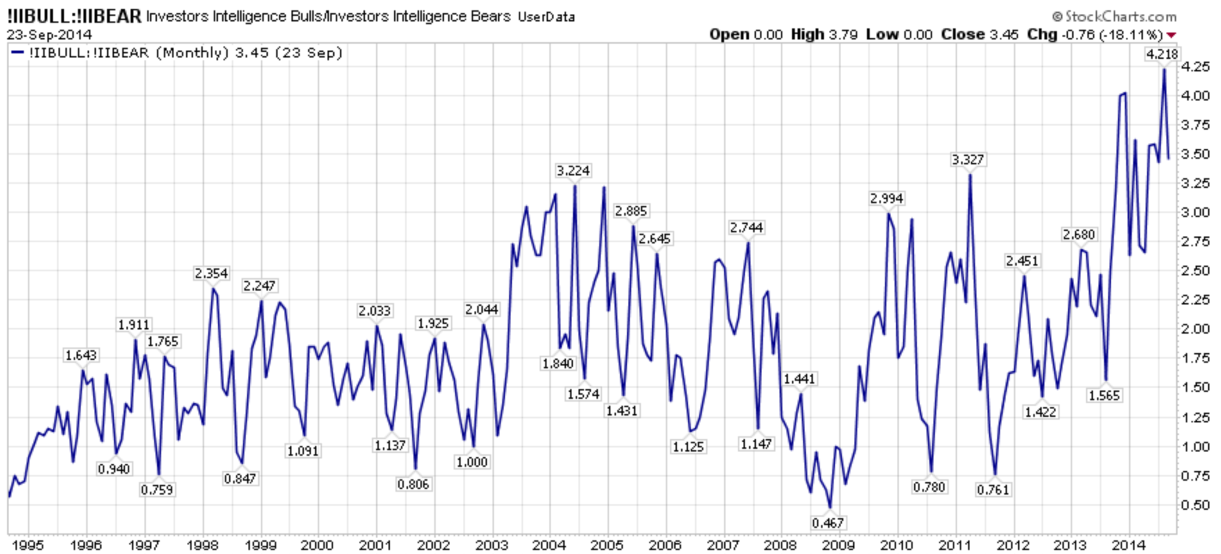
Fittingly, we are reminded of another John Wayne quote; "*I couldn't hit a wall with a six-gun, but I can twirl one. It looks good*." Indeed, Wall Street cannot come close to accurately projecting future interest rates or profit estimates, but they sure look good making those projections. The fact is that if an economic recession unfolds, the market's P/E ratio will serve as a poor measure of valuation. The denominator of the P/E ratio, earnings, grows too erratic during a profits recession. Although stock prices of publicly traded companies fluctuate widely, the values of the underlying businesses change far less—the exact reason Benjamin Graham used average earnings over a period of 7-10 years to value companies. Average earnings not only smooth the peaks and valleys of the business cycle, they also correctly adjust for late-stage peak earnings.

While P/E ratios serve as a poor valuation tool during typical profit recessions, as much of the bad news is delivered over a short period of time, the ratio of price-to-sales per share (P/S) provides better insight during these instances. The P/S ratio avoids the confusing issue of which earnings measure to employ (estimated earnings, forward operating earnings, reported earnings, adjusted earnings, normalized earnings, etc.) by comparing the index price against total revenue generated by the companies in the index. Because revenue numbers are restated far less often than earnings, this metric provides a more stable value in the denominator of the P/S ratio.

The chart on the following page confirms our valuation assessment using P/E ratios that are based on multi-year averages of earnings, or earnings that take into account the entire economic cycle—the stock market is dangerously overvalued. Much like P/E ratios, markets have peaked and bottomed at different P/S levels. Since 1955, using weekly data, the median P/S ratio at market peaks has been 1.0. Correspondingly, markets bottomed at a median P/S ratio of 0.7. Beginning in 1996, the P/S ratio began to disconnect from its historical boundaries. Still, if we assume that a level of 1.0, which formerly marked bull market peaks, now represents market bottoms, a price-to-sales ratio of 1.0 is meaningful. A price-to-sales ratio of 1.0 also makes for simple math. The current revenue per share for the S&P 500 is $1142, and the S&P 500 closed the third quarter at 1975.



To date, there has been no evidence in the S&P 500 price action that any pullback is more than a minor setback, although valuation and sentiment levels remain at dangerous extremes. The chart below puts the current sentiment situation into perspective. Based on the Investors Intelligence survey, the ratio of bullish advisors to bearish advisors is at its highest level in twenty years. This does not mean that a large decline is about to begin; it means that sentiment is sufficiently extended into optimistic territory. Historically though, such complacency sets the scene for such a decline.



INVESTMENT PHILOSOPHY

In the financial markets, frustration usually results from being emotionally or financially committed to a specific short-term outcome which doesn't manifest itself. Accordingly, short-term speculators typically move to the sidelines when faced with any significant deviation from their intended plan. Conversely, long-term investors should remain focused on the fundamental considerations that drive their investment decisions, avoiding any expectations regarding how markets will perform in the near-term.

As long-term equity investors, we avoid frustration by understanding that we make money from stocks in three ways: 1) receiving dividends; 2) buying stocks at a discount to intrinsic value and waiting for the market to recognize the gap between price and value; 3) growth in intrinsic value. Ideally, we want to benefit from all three sources of return; however, in the current market, we suspect that most gains will come from growth in a company's intrinsic value. When managing a portfolio, we avoid frustration by selling stocks trading above our estimate of fair value and ideally replacing them with other stocks trading sufficiently below our estimate of fair value.

Intrinsic value should increase over time as companies generate free cash flows, grow their earnings, and raise their dividends. If future estimates of company cash flows are exactly correct (they never are exactly correct), one would expect a company's fair value estimate to increase in line with the assumed cost of equity embedded in a discounted cash flow model—generally 10% for our holdings. In other words, our fair value estimates already incorporate the expectation of 10% total returns. In order to continue improving our portfolios' intrinsic value, we must continuously sell overvalued stocks and replace them with undervalued stocks. Perhaps more importantly in today's elevated markets; we must focus on investing in companies that will compound their intrinsic value over time.

When asked about the secret of Berkshire Hathaway's success, Charlie Munger, Warren Buffett's business partner, responded: "*I think we have had a temperamental advantage: Warren and I know better than most people what we know and what we don't know. That's even better than having a lot of extra IQ points… People chronically misappraise the limits of their own knowledge… Knowing the edge of your circle of competence is one of the most difficult things for a human being to do. Knowing what you don't know is much more useful in life and business than being brilliant*."

Charlie Munger further noted that Buffett <u>sees nothing worth investing in right now and has not initiated a new investment in his personal account for at least two years.</u> Buffett is waiting for an irresistible bargain to appear. Successful investing, concluded Mr. Munger, requires "*this crazy combination of gumption and patience, and then being ready to pounce when the opportunity presents itself, because in this world opportunities just don't last very long… It's waiting that helps you as an investor, and a lot of people just can't stand to wait*." Likewise, we patiently remain waiting to buy good companies trading at cheap valuations.

With kind regards,

ST. JAMES INVESTMENT COMPANY

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We founded 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 almost fifteen 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.

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