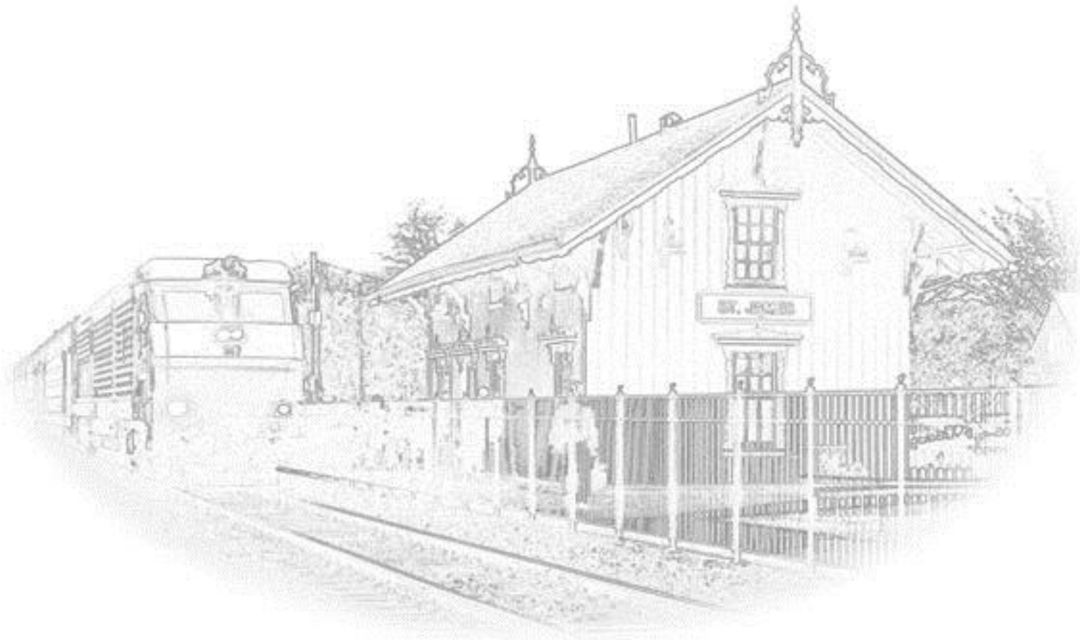

ST. JAMES INVESTMENT COMPANY

INDIVIDUAL PORTFOLIO MANAGEMENT

INVESTMENT ADVISER'S LETTER

APRIL 2015

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FIRST QUARTER LETTER

MARKET COMMENTS

"A thing long expected takes the form of the unexpected when at last it comes." --MARK TWAIN

The bull market in stocks turned six years old this past quarter. The S&P 500 index bottomed on March 9, 2009 at 676 and the index now sits near 2,100, a gain of 210%. According to data from research service Bespoke Investment Group, the current bull market – defined as a rally of at least 20% following a decline of at least 20% – is the fourth-longest bull market in history. Likewise, the Dow Jones Industrial Average is back over 18,000, the Nasdaq Composite is above 5,000 and the Russell 2000 is hitting new record highs almost on a daily basis. Overseas, Japan's Nikkei 225 Composite is approaching 20,000—a level that it has not seen since 2000. Germany's DAX index traded above 12,000 for the first time ever and is up nearly 30% from its recent lows. Money follows price action and TrimTabs, the investment research company, recently reported that investors added $47 billion to equity mutual funds and exchange-traded funds in March, the most for any month since October 2013.

Seven years after the financial crisis, global central banks remain the common theme behind these new market highs. While the U.S. Federal Reserve intends to move slowly when increasing interest rates later this year, other major central banks are just ramping up their stimulus programs. The efforts range from a new sovereign bond-buying program by the European Central Bank, to serious discussions that the Bank of Japan may start buying individual stocks, to rate cuts by the People's Bank of China. Overall, there have been 25 interest rate cuts, so far, this year, instituted by various central banks around the world, in response to diminishing global economic growth. Unfortunately, we are certain that central banks will only succeed in creating inflation, not economic expansion.

The economist Irving Fisher wrote the book *The Money Illusion* in 1928, highlighting the deception performed by central banks which distorts the economy and destroys wealth. Individuals are susceptible to this "money illusion" as they confuse real and nominal prices - - ignoring the reality of inflation when deciding if they are better off. In the opening pages of *The Money Illusion*, Irving Fisher recounts a conversation with a German shopkeeper following the rapid depreciation of the German Mark after World War I:

> When I talked with her [the shopkeeper] inflation had gone on until the mark had depreciated by more than ninety-eight percent, so that it was only a fiftieth of its original value (that is, the price level had risen about fifty fold), and yet she had not been aware of what had really happened. Fearing to be thought a profiteer, she said: "That shirt I sold you will cost me just as much to replace as I am charging you." Before I could ask her why, then, she sold it at so low a price, she continued: "But I have made a profit on that shirt because I bought it for less."
>
> She had made no profit; she had made a loss. She thought she had made a profit only because she was deceived by the "Money Illusion." She had assumed that the marks she had paid for the shirt a year ago were the same sort of marks as the marks I was paying her, just as, in America, we assume that the dollar is the same at one time as another. She had kept her accounts in what was in reality a fluctuating unit, the mark. In terms of this changing unit her accounts did indeed show a profit; but if she had translated her accounts into dollars, they would have shown a large loss, and if she had translated them into units of commodities in general she would have shown a still larger loss – because the dollar, too, had fallen.

Examples of the money illusion today are everywhere. Assume an engineer making $100,000 per year receives a 2% raise and is now making $102,000 per year. Most people believe the engineer is better off. However, if inflation is 3%, the $102,000 salary is worth only $98,940 in purchasing power relative to where the engineer started ($100K x 1.02 x 97%). The engineer received a $2,000 raise in nominal terms but suffered a $1,060 pay cut in real terms. This financial difference between perception and reality is the money illusion. The money illusion is not limited to wages and prices but rather to any stream of cash, including dividends and interest, as well as asset prices, including stocks and bonds. Any nominal increase has to be adjusted for inflation in order to see past the money illusion.

Many economists suggest that the money illusion does not exist, arguing that individuals make decisions based upon "rational expectations." Meaning, we expect inflation, therefore we naturally discount the value of our money and invest or spend it according to its expected intrinsic value. Like much of modern economics, theory works better in the classroom than in the real world. Experiments by behaviorists show that people think a 2% cut in wages with no change in the price level is "unfair", but a 2% raise with 4% inflation is "fair." In reality, the two outcomes are economically identical in terms of purchasing power; however, people prefer a raise over a pay cut while ignoring inflation—the essence of money illusion. Perhaps the easiest way to think about the money illusion is with a quote from Warren Buffett: *"It isn't how many dollars you have, but how many cheeseburgers you can buy. In other words, if stocks double but so does the price of milk, gas and cornflakes, you haven't actually gained anything in real net worth."*

The money illusion is critically important because it gives central bankers the ability to transfer wealth from savers to debtors. Too much debt eventually suffocates an economy, as central bankers use inflation to reduce the real value of the debt in order to give debtors relief in the hope that they will spend more and help reinvigorate the economy. Of course, this form of relief comes at the expense of savers and investors who see the real value of their assets decline.

Assume an individual with no debt and $100,000 savings earning zero interest under the U.S. Federal Reserve's current zero interest rate policy. Suppose the government proposed that it would confiscate $15,000 from the saver and hand it over to a debtor with a $100,000 debt obligation. The saver now has only $85,000 in the bank, but the debtor has $15,000 less debt. The saver is worse off and the debtor is better off, each because of the $15,000 transfer payment. Investors will instinctively realize that this kind of confiscation is grossly unfair. Now assume the same scenario except the Federal Reserve engineers 3% inflation for five years, for a total of 15% inflation. The saver still has $100,000 in the bank, but it is worth only $85,000 in real purchasing power due to inflation. The borrower still owes $100,000 but the debt burden is only $85,000 in real terms after inflation.

At present, cash is despised by investors—it generates no yield; in some countries cash now earns a negative interest rate. That is to say, some banks now charge investors to hold their cash. As a result, investors who prudently avoided debt and risky assets since 2009 have seen their cash lose value when adjusted for inflation. By contrast, those who maximized their leverage, and borrowed as much as banks would lend, and purchased the riskiest assets (i.e., biotechnology stocks with zero earnings), now enjoy enormous gains.

Central banks incentivize speculators to borrow money and buy risky assets. But, oddly enough, in our modern economy based on fractional-reserve banking, when we talk about "money" what we really mean is credit. Banks create this credit out of nothing when they make a loan, existing as a digital record entry on a computer. Because credit is digital in nature, one cannot put it in a safe. Credit also depends

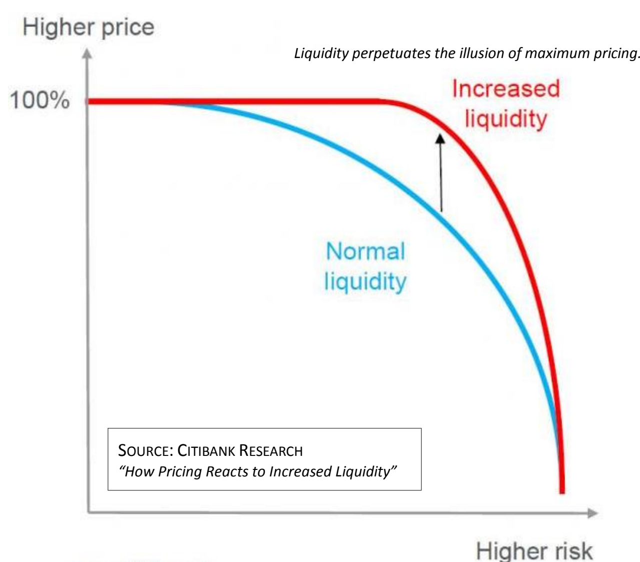
on trust. When the financial system stumbles, as it did in 2008, the banking functions of borrowing and lending stop. As a result, liquidity vanishes and credit simply disappears.

When liquidity disappears, cash will once again be in great demand, for the simple reason there will be so little of it. Howard Marks, co-chairman of Oaktree Capital and a brilliant value investor, just released his latest memo[1]. His focus was on liquidity, which most investors would define as how easy it is to sell an asset. "*The key criterion isn't 'can you sell it?' It's 'can you sell it at a price equal or close to the last price?'*"

Counterintuitively, liquidity can cause an investor to lower the bar for investments. When considering an investment that cannot be exited for many years, an investor will thoroughly conduct due diligence and employ conservative valuation assumptions. However, market participants often buy very liquid assets casually, with minimal analysis, assuming that they can readily exit the investment if wrong. While an investor may think that an investment is liquid today, the situation can quickly change. He notes:

> *Usually, just as a holder's desire to sell an asset increases (because he has become afraid to hold it), his ability to sell it decreases (because everyone else has also become afraid to hold it). Thus (a) things tend to be liquid when you don't need liquidity, and (b) just when you need liquidity most, it tends not to be there. The truth is, things often seem more liquid when you buy than when you go to sell.*

The impact of liquidity on price and risk can be sudden and painful. Liquidity provided by central banks simply perpetuates the illusion of maximum pricing and stability for stocks and bonds while shifting the risk curve to the point where any deviation from "perfection" - or loss of faith in the liquidity or its providers - will ultimately lead to a waterfall in price. When this moment materializes, there is essentially no market because an investor cannot sell.



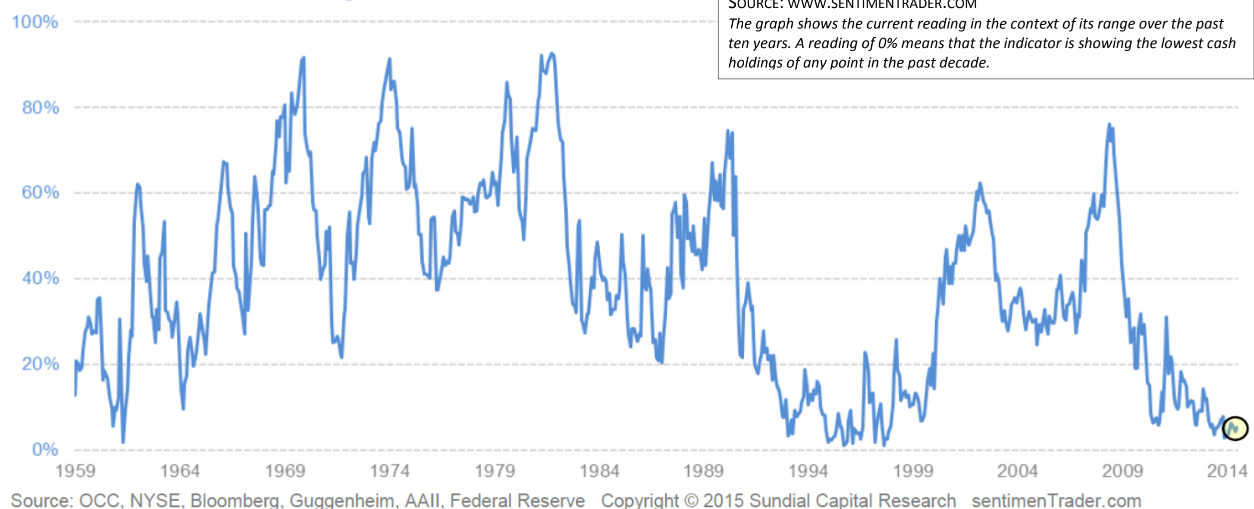
Despite zero percent interest rates nearly everywhere and continuous programs of central bank quantitative easing, world economic activity remains anemic. In the United States we have had six years of zero percent interest rates and three rounds of quantitative easing totaling north of $3 trillion producing only a couple of percent of GDP growth, and a large pool of misallocated capital chasing the fringes of technology and biotechnology. Combined with lopsided sentiment, expensive stock market valuations, and an end of quantitative easing in the United States, it is not difficult to envision the conditions for a sudden change in asset prices.

One wonders what would happen to the stock market if the Federal Reserve suddenly decided to permit savers to earn a real yield on their savings. We do not know, and neither does anyone else at the Federal Reserve. What we do know is that the market has become very comfortable in an environment with zero interest rates and ample liquidity. Richard Fisher, recently retired President and CEO of the Federal Reserve Bank of Dallas, said in a television interview, "*What worries me is how totally lazy investors have gotten, totally dependent on the Federal Reserve and I find this to be a precarious situation. Are we vulnerable in*

[1] http://www.oaktreecapital.com/memo.aspx

my personal opinion to a significant equity market correction? I believe we are... What worries me is that the people that watch this show are completely dependent on the Fed — look at the volatility. I could see a correction taking place of substantial magnitude."

The stock market today is not about investing; it is all about central banks. Over the past several years, in his monthly memos, Howard Marks has repeatedly noted that (a) investors—driven by central bank-mandated interest rates near zero—have been moving into riskier investments in pursuit of higher returns and (b) in taking this step they have often ignored the need for caution or have been ignorant as to how to achieve it. Investors have extrapolated the high level of liquidity they have witnessed in the last five years, failing to understand its transitory nature. In other words, investors have drawn the obvious conclusion: central bank liquidity lifts stock markets and fighting central banks determined to implement quantitative easing is futile.



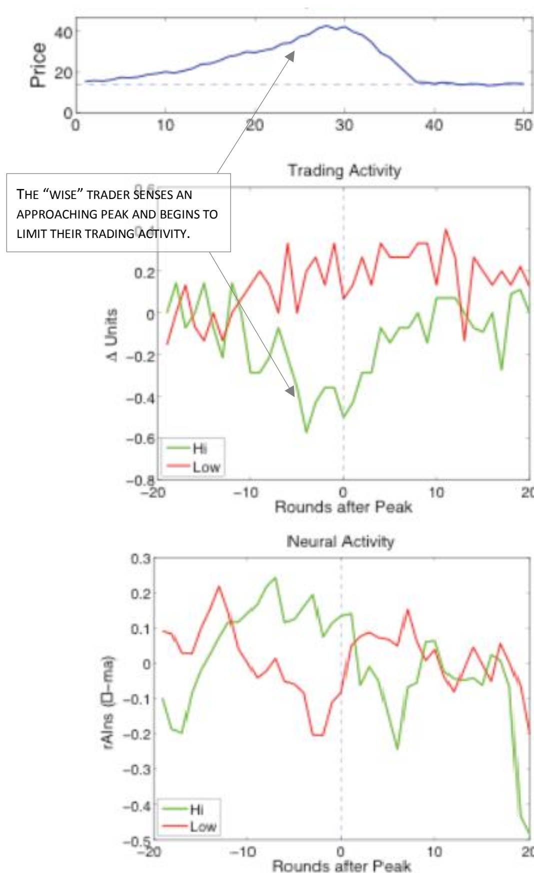
The reasons that investors hold little cash is well understood. In a period of zero interest rates, the incentive to hold cash is negligible, which is the whole point of central bank policy. There is no question that central bankers have succeeded in this regard. Among the cash-based indicators followed by Sundial Capital Research (www.sentimentrader.com), every indicator sits at or near 10-year lows. Sentiment, as measured by the Investors Intelligence data, shows that the stock market is overwhelmingly bullish, and cash is clearly not in demand.

The best preparation for a serious downturn in the market and the sudden evaporation of market liquidity remains the very principle's that back a value investment philosophy—buy solid income-producing assets at prices meaningfully below one's conservative estimate of fair value and maintain a long investment horizon. The simple alternative is cash.

"Only when you combine sound intellect with emotional discipline do you get rational behavior."

–WARREN BUFFETT

Investors need both sound intellect and emotional discipline to be successful. An investor can always build a sound intellect—it comes from doing one's homework. One can learn to research and conduct analysis of a company's business and value. Discipline on the other hand, refers to an investor's ability to wait for the proper price when entering or exiting an investment. Warren Buffett also suggested that investors should try to "*be fearful when others are greedy and be greedy only when others are fearful*" but according to a study[2] by behavioral economist Colin Camerer at Caltech, only certain people are capable of acting on this advice. The researchers looked at the brain activity and behavior of people trading in experimental markets where price bubbles formed, using a functional MRI scanner to track responses—functional magnetic resonance imaging (fMRI) measures brain activity by detecting changes in blood flow. The researchers found that only "wise" traders received an early "warning signal" from their brains, causing them to feel uncomfortable and urging them to sell.



The wise traders had more intense activity in the insular cortex, which is associated with risk aversion and is often activated when a person detects that something is amiss. The much more common brain pattern the researchers found was one that made traders behave in a greedy way, buying aggressively during a bubble and even after its peak. These traders produced greater activity in the nucleus accumbens (NAcc), which assists in the cognitive processing of motivation, pleasure, and reinforcement learning, and plays significant role in addiction.

In the brain activity charts to the right, one sees that the high earners, in green, saw significantly more insular activity as a peak approached. Meanwhile, the poorly performing traders' brains' regulation areas basically shut down. In the trading activity chart, one sees that the high earners reduced their trading activity significantly as they sensed the approach of peak pricing, and then bought into the dip once it passed. The bad traders kept buying throughout the peak.

Colin Camerer summarized the study's findings. "*The high-earning traders are the most interesting people to us. Emotionally, they have to do something really hard: sell into a rising market. We thought that something must be going on in their brains that give them an early warning signal. The prices were still going up at that time, so*

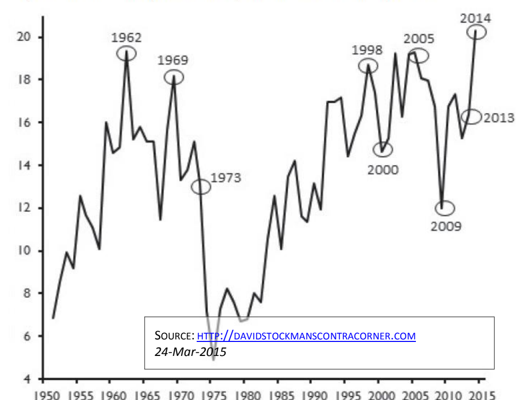
[2] http://inside.econ.ubc.ca/webfm_send/747

they couldn't be making pessimistic predictions just based on the recent price trend. We think this is a real warning signal."

Exactly fifteen years ago, on March 30, 2000, Tiger Management sent a letter[3] to its limited partners announcing the closing of its fund. Value investor Julian Robertson, definitely a "wise" trader, started the Tiger fund in May 1980 with total capital of $8.8 million. Eighteen years later, the $8.8 million had grown to $21 billion and compounded investor capital at a rate of return of 31.7% net of fees. Unfortunately, beginning in 1998, the Tiger funds began to badly underperform and investors withdrew $7.7 billion of the fund's capital. Robertson lamented about the demise of value investing and the stress of dealing with investor withdrawals. Because there was no indication that a quick end was in sight, Robertson decided to close his fund. In his letter, he wrote:

> *What is "end" the end of? End is the end of the bear market in value stocks. It is the recognition that equities with cash-on-cash returns of 15 to 25 percent, regardless of their short-term market performance, are great investments. "End" in this case means a beginning by investors overall to put aside momentum and potential short-term gain in highly speculative stocks to take the more assured, yet still historically high returns available in out-of-favor equities. I have great faith though that, "this, too, will pass." We have seen manic periods like this before and I remain confident that despite the current disfavor in which it is held, value investing remains the best course.*

Chart 2: Median price/earnings multiple for U.S. stocks*
*Based on all NYSE stocks with positive earnings for the last fiscal year calculated in June of each year since 1951 through 2014



Robertson poorly timed the closing of his fund. Fortune magazine reported in January 2008 that from the time Robertson shut down the Tiger fund on March 30, 2000, through December 2008, Robertson generated a total return for his own pool of capital of 403.7%. The bear market in value stocks had ended and Robertson capitalized on the opportunity with his personal fortune.

Regrettably, investors face an environment today where there are even fewer investment opportunities than in 2000 when Robertson thought he was facing the demise of value investing. U.S. stock valuations, as measured by the median price-to-earnings multiple, are materially more expensive today than during the period from 1998 to 2000. It is difficult if not impossible to predict when a change in investment sentiment will occur. In this regard, we have no advantage; however, we will continue to combine sound intellect with emotional discipline and behave in a rational manner.

With kind regards,

ST. JAMES INVESTMENT COMPANY

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[3] http://money.cnn.com/2000/03/30/mutualfunds/q_funds_tiger/sidebar.htm

ST. JAMES INVESTMENT COMPANY

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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