

# ST. JAMES INVESTMENT COMPANY

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INDIVIDUAL PORTFOLIO MANAGEMENT

## INVESTMENT ADVISER'S LETTER

JANUARY 2016

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# FOURTH QUARTER LETTER

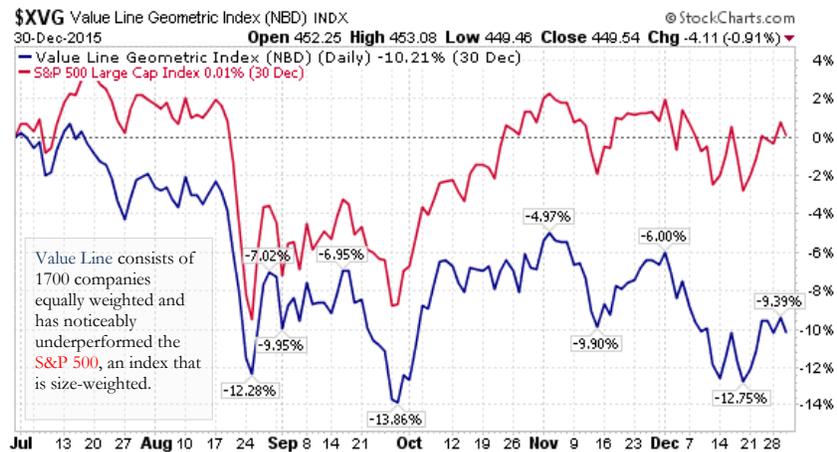
## MARKET COMMENTS

*"If you're not confused, you don't know what's going on."* -an old Haitian proverb

Confusion once again leads the herd of stock market participants back to the mistakes of 1999 and 2008, as the easiest course of action remains to buy stocks with rising prices while selling "losers", thereby ignoring valuations. This momentum chasing behavior buoyed the overall stock market in 2015 after the summer sell-off, as the S&P 500 Index closed flat and the technology-dominated Nasdaq Index gained about four percent. However, trouble lurks just below the surface as much of the stock market's gains in 2015 came from just four stocks: Facebook, Amazon.com, Netflix and Google. In fact, this group has become so popular with investors that it is now known by the acronym FANG (Facebook, Amazon, Netflix and Google).

Investors have been aggressively buying FANG stocks and pushing their valuations to levels reminiscent of the dotcom bubble of the 1990s. The problem is not only extreme valuations but also market breadth, as the number of companies going up in price is small relative to the number of companies going down. A characteristic of a healthy bull market is that a broad range of stocks and sectors move higher together. That is not the case today—the four FANG stocks now support both the S&P 500 and Nasdaq.

This narrowing of market breadth hides the underlying deterioration in the broader market. Price appreciation from one large cap stock can offset losses from dozens of smaller stocks. Currently, 30% of the stocks in the S&P 500 index and 46% of the stocks in the S&P 600 Smallcap index are in bear market territory. Historically, large companies are the last stocks to fall as investors perceive safety in large companies.



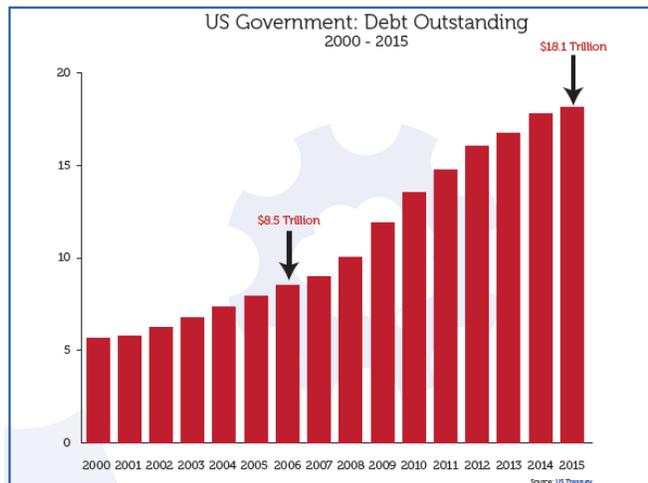
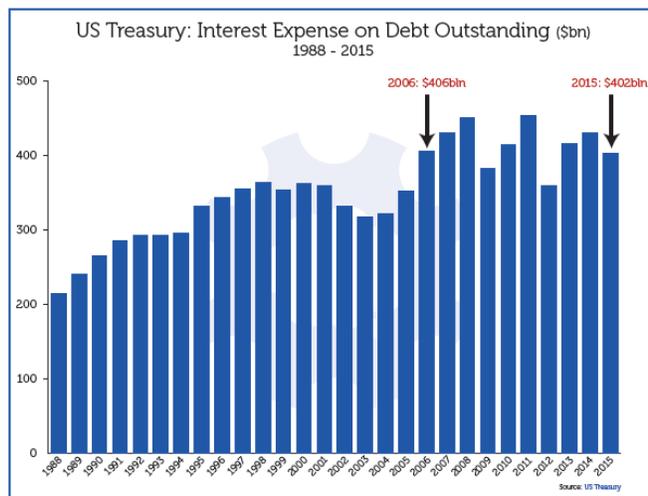
We do not understand why people buy these stocks at these valuations, just as we remain confused about why investors are willing to lend at negative interest rates. At the very root of economics are two very basic questions: Why do we pay interest when we borrow money? Why do we expect interest payments when we lend money? The obvious answer is that we exchange interest payments to compensate for an uncertain future. If so, then the lower the current rate of interest, the less incentive one has to lend and the more one is inclined to consume today. As a result, lower interest rates tend to pull future consumption forward to the present. Therefore, reducing interest rates should logically lead to a higher level of economic activity today with the understanding that we will pay for today's consumption with a lower level of economic activity at some point in the future.

This logic is the very crux of today's central bank monetary policies. Continuing with this thread, if interest rates drop to zero, then one's future consumption should be brought forward to the present and one's savings rate should theoretically fall to zero. However, if interest rates drop into negative territory we enter a new dimension. As interest rates compensate an investor for an uncertain future, then negative interest rates must mean that the future is more certain than the present... Which is complete nonsense. The future, by its very definition, can never be more certain than the present. And yet the European Central Bank's deposit rate now stands at -0.2% and the Swiss National Bank at -0.75%. In fact, the entire European monetary policy now sits on a completely illogical foundation. How intelligent people believe such illogic will lead to favorable results is confusing. Then again, maybe there is a correlation between the same people chasing FANG stocks higher and those who endorse today's central bank policies.

In a world of negative interest rates, the logical choice is to borrow money rather than save money. This works as long as there are savings within the system to borrow - - and eventually all savings will disappear under such conditions. Because savings funds investment, capital investment collapses when savings are exhausted—the point at which economic growth stops. Unfortunately, what's sauce for the goose is sauce for the gander, as U.S. Federal Reserve Chairwoman Janet Yellen recently opened the door to the possibility of negative interest rates when she testified before a House of Representatives committee in November: *"Potentially anything - including negative interest rates - would be on the table... This would happen if the economy were to deteriorate in a significant way."*

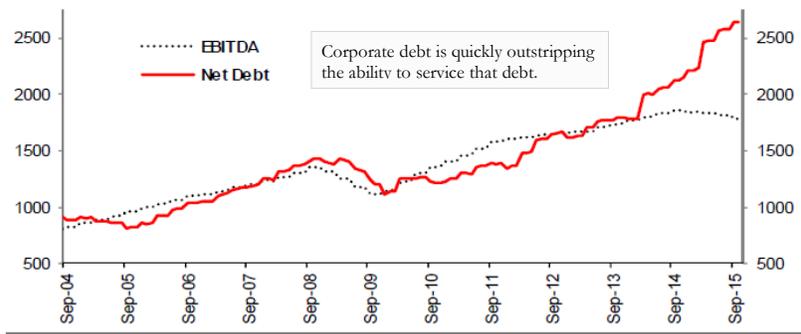
In terms of borrowing money, the U.S. government clearly distinguishes itself. Lower interest rates accelerated the accumulation of debt as illustrated on the charts on the right. The top chart shows the interest expense on the outstanding debt of the U.S. government. The current interest expense is slightly less than where it was in 2006, yet during that time the amount of U.S. government debt outstanding increased by \$10 trillion.

These two charts clearly illustrate that something is wrong. The average interest rate paid by the U.S. government on its outstanding interest-bearing debt has fallen from 5.03% in 2006 to just 2.32% in 2015. Debt increased but debt service costs remained the same. If the debt service rate was once again 5.03% today, the same rate as in 2006, the U.S. government's interest service costs would increase by roughly half-a-trillion dollars each year. To put that in perspective, it took the United States 176 years, beginning with its independence from England, to amass a total national debt of half a trillion dollars.



Numbers of this size begin to defy comprehension, as one trillion is a thousand billion, which in turn is added by many more trillions. These enormous figures suggest we are past the point where the country's accumulated debt will ever be paid off, leaving two options: inflation or default. The easiest way, and the path of least resistance, is for a country to inflate debt payments away. Perhaps the Federal Reserve recognizes this conundrum and is now floating the trial balloon of negative interest rates as a preferred way to inflate away our debt burden. If so, we're confused as to how policy makers envision a smooth outcome. Such extreme measures typically have severe unintended consequences.

The warning bells are also sounding off in the expanding U.S. corporate debt markets. The chart to the immediate right shows the size of corporate debt (net of cash) relative to profits. U.S. corporate net debt, beginning in 2013, now massively exceeds EBITDA, an approximate measure of cash profits.



Source: Datastream

There is always a limit to how much excess debt bond investors are willing to tolerate, and it now appears we may have reached the tipping point. The widening of junk bond spreads is ultimately the result of money inappropriately priced. As illustrated by the poor performance of junk bond ETFs, the growing rot within the "high yield" sector is spreading as prices decoupled from equities in Q4.



Albert Edwards of French investment bank Societe Generale possesses a knack for succinctly summing up the situation. *"The party's over and bond investors, who always tend to be the more sober types, realize this and have headed for the exits, whereas equity investors are so intoxicated they haven't realized that the music has stopped. Equity investors are still gyrating around the dance floor—just as in 1999 and 2007."*

While we struggle to understand an investment environment with negative interest rates, we already feel the impact of an extended period of near-zero interest rates. Investors managing retirement assets have replaced allocations to low-yielding U.S. Treasury and investment-grade corporate bonds with equities and high-yield corporate bonds ("junk bonds") in order to generate investment returns they need to avoid outliving their nest egg. A recent report from Fidelity Investments found that 11% of its 401(k) account holders aged 50-54 allocated 100% of their retirement assets to stocks. Fidelity estimates that roughly \$1.3 trillion in retiree assets are currently misallocated into equities based on the historic average price-to-earnings ratio (P/E) for the S&P 500. This misallocation results in stock price inflation and props up equity valuations even as quarterly corporate revenue and profit results show signs of growing weakness.

On the basis of stock valuation measures that closely correlate with actual subsequent ten-year S&P 500 total returns in market cycles over more than a century, a ranking of the most overvalued stock market extremes in U.S. history, in order of severity, include: 2000, 2015, 1929, 2007, 1937, 1907, 1968, and 1972<sup>1</sup>. While the 1969-70 bear market reduced the S&P 500 by only one-third of its value, each other instance generated market losses of 50% or more over their entire respective market cycle. Given that the current stock market presents the second highest valuation extreme on record, a scenario where the market experiences a severe loss is not an outlier but a very real scenario that one should assign a meaningful probability. While large-capitalization stocks and the technology sector dominated the 2000 dotcom market peak, the current central bank-induced debt bubble actually pushes the valuation of the median stock above the 2000 extreme. The current investment environment distinguishes itself as the most overvalued in history for the broad market.

When making investment decisions, it is important to appreciate that everything is connected. As today's global economy is more fragile than it was on the eve of the 2008 credit crisis, then investment capital is potentially at greater risk than it was in 2007. Those who benefited by riding a wave of a central bank-induced speculation will be disappointed if they do not respect the environment we now operate within. For example, banks have an energy lending problem. Low interest rates created artificial demand for energy loans and now one in seven oil and gas loans is heading towards default. According to a review conducted by the Federal Reserve, the percentage of problem loans jumped from 2.5% to 12.5% over the past 12 months. According to the *Wall Street Journal*, CitiGroup, JP Morgan, Bank of America and Wells Fargo carry a combined \$105 billion in loans to the energy sector, or 15% of the combined tangible equity for these four megabanks. Banks will suffer losses from their energy loans which, in turn, will tighten credit conditions and negatively impact every other business that interacts with banks.

In today's confusing investment landscape, it is crucial to understand that valuations remain the primary driver of long-term market returns, not the mentality of herds. The most reliable valuation measures in market cycles across history are those that account for cyclical variation in profit margins (i.e., Shiller CAPE ratio). As the legendary value investor Benjamin Graham wrote, the worst investment losses normally result from the assumption that good business conditions can be priced into stocks as if they are permanent: *"purchasers view the good earnings as equivalent to 'earning power' and assume that prosperity is equal to safety."*

Unfortunately, over shorter time periods, the main driver of investment returns is not valuation, but rather the propensity for investors to speculate. An overvalued market populated with speculators who are chasing the same stocks when prices are rising is a recipe for disaster. History suggests that the current stock market is vulnerable to the risk of severe losses, particularly in those sectors where the herd mentality is most pervasive.

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<sup>1</sup> John P. Hussman, *Weekly Market Comment*, December 7, 2015

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## INVESTMENT PHILOSOPHY

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"I love money. I love everything about it. I bought some pretty good stuff. Got me a \$300 pair of socks. Got a fur sink. An electric dog polisher. A gasoline powered turtleneck sweater. And, of course, I bought some dumb stuff, too." --Steve Martin, comedian

In 1975 Charles Ellis wrote about investment being a loser's game. He was using the distinction Simon Ramo drew in his book "Extraordinary Tennis for the Ordinary Tennis Player" who observed that the game of tennis was in fact, two games. After extensive statistical analysis, Ellis concluded that professional players win points, while amateurs lose points. Professional players put the ball wherever they want, at whatever pace they like, with a precision and consistency which the overwhelming majority of players could never hope to replicate. The winner of a professional tennis match is the one who makes the most winning shots. For most tennis players the game is different. Each player tries to make those special shots. They try to win points but in doing so they double-fault, miss the baseline, hit the net. In other words, most tennis players lose points because they keep trying to hit winning points they are not capable of hitting. The winner of the loser's game is the one who loses the least points.

No investor ever wants to buy "dumb stuff", but on occasion it does happen. The goal is to buy the least amount of dumb stuff. Richard Russell, publisher and writer of the *Dow Theory Letters* newsletter for nearly six decades, died last month at the age of 91. Russell's longevity won him many fans over the years, including us. One theme that consistently prevailed in Russell's writings: *Don't Lose Money*. That idea may sound obvious --- but it is not simple to implement because humans, by nature, are optimistic. Human nature wants to hope. Ironically, hope does not work in the stock market. In the stock market hope is a hindrance, not a help. Once an investor takes a position in a stock, they obviously want that stock to advance. In contrast, if the stock the investor bought is of real value, and purchased at the right price with a margin of safety, the investor is not reliant on hope and takes comfort in the knowledge that over time the stock's value will eventually materialize. The investor has value on their side — and all they need is patience. In the end, patience pays off with a higher price for the stock.

Hope should not play any part in the investment process. Any time an investor finds themselves hoping in this business, the odds are that they are on the wrong path — or they acted imprudently and "bought some dumb stuff." Ultimately, hope is a money-losing strategy in the investment business.

Richard Russell also believed that hope was a dangerous emotion when investing. Russell understood that hope turns a small loss into a large loss. In the stock market, hope gets in the way of reality, and hope gets in the way of common sense. Richard Russell's most famous essay is titled "*Rich Man, Poor Man*", in which Russell details how one correctly approaches the investment process.

*In the investment world, the wealthy investor has one major advantage over the little guy, the stock market amateur and the neophyte trader. The advantage that the wealthy investor enjoys is that he doesn't need the markets... The wealthy investor doesn't need the markets because he already has all the income he needs... The wealthy investor tends to be an expert on values. When bonds are cheap and bond yields are irresistibly high, he buys bonds. When stocks are on the bargain table and stock yields are attractive, he buys stocks. When real estate is a great value, he buys real estate. When great art or fine jewelry or gold is on the "give away" table, he buys art or diamonds or gold. In other words, the wealthy investor puts his money where the great values are. And if no outstanding values are available, the wealthy investor waits. He can afford to wait. He has money coming*

*in daily, weekly, monthly. The wealthy investor knows what he is looking for, and he doesn't mind waiting months or even years for his next investment.*

*But what about the little guy? This fellow always feels pressured to "make money." And in return, he's always pressuring the market to "do something" for him. But sadly, the market isn't interested. When the little guy isn't buying stocks offering 1% or 2% yields, he's off to Las Vegas or Atlantic City trying to beat the house at roulette. Or he's spending 20 bucks a week on lottery tickets, or he's "investing" in some crackpot scheme that his neighbor told him about (in strictest confidence, of course). And because the little guy is trying to force the market to do something for him, he's a guaranteed loser. The little guy doesn't understand values, so he constantly overpays... The little guy is the typical American, and he's deeply in debt.*

Every investor must consider whether they invest like the poor man or the rich man. How much does the investor know about the value of what they purchased? How long did the investor wait for the right opportunity to buy the asset? Does the investor understand the potential downside risks? What is the investor expecting as an investment result? Is the investor prepared to hold this investment for a year? Five years? Ten years? If the average length of home ownership is roughly six years, while the average mutual fund holding period is slightly more than three years, then the average investor cannot even imagine a 10-year investment horizon. Nothing they buy lasts that long. However, if an investor really wants to grow their investment capital, almost every investment should last at least ten years. Compound returns increase investment capital, not quick trades, and certainly not investment strategies based on hope.

Investors spend so much time and energy trying to be clever: What will the Federal Reserve do next; where will oil prices go; where is the unemployment rate going? Perhaps one should simply focus on not being dumb rather than making predictions. As the late Yogi Berra said, *"It's tough to make predictions, especially about the future."*

As investors, we want to avoid the siren's song of hope but, instead, embrace the cold, clear reality of valuations. Despite the confusion one feels in the markets, we should accept that no one can predict the future accurately. Instead, we should focus on building an investment portfolio that thrives over time, no matter what happens. Today, stocks in general no longer offer great values and it is difficult to find attractive investment opportunities. Therefore, our goal remains to avoid doing anything dumb and protect our investment capital.

With kind regards,

A handwritten signature in black ink, appearing to be a stylized name with a large loop at the end.

ST. JAMES INVESTMENT COMPANY

# 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 more than 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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