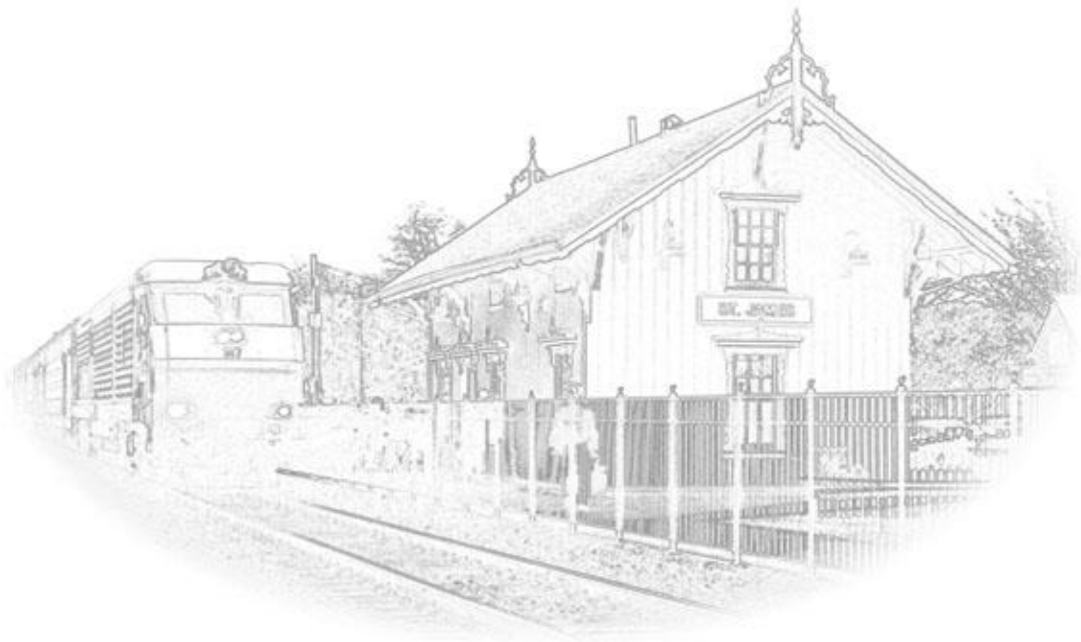

ST. JAMES INVESTMENT COMPANY

INDIVIDUAL PORTFOLIO MANAGEMENT

INVESTMENT ADVISER'S LETTER

JULY 2017

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SECOND QUARTER LETTER

"When the wall starts collapsing, 10,000 people rush to push it down." –Chinese proverb

Argentina began the 20th century as one of the wealthiest countries in the world, only to endure one of the most spectacular economic declines over the past one hundred years. Once again Argentina is generating international headlines, not with news of another default, but rather the successful issue of sovereign bonds that mature in one hundred years. According to Reuters news service, Argentina sold $2.75 billion of a "*hotly demanded*" 100-year bond in U.S. dollars. Investor appetite for yield resulted in the new bond being 3.5x oversubscribed, as the Argentine bond issue received $9.75 billion in orders. This surprising amount of investor demand subsequently lowered the bond's yield to 7.9% from initial expectations of 8.25%.

Investors seemingly are ignoring the simple fact that over the country's 194-year financial history Argentina has defaulted eight separate times on its debt obligations, most recently in 2014 during a dispute with creditors from its prior financial crisis in 2001. Given this historical track-record, these newly-issued bonds maturing in 2117 will likely default several times prior to the distant maturity date.

A little history puts this new bond issue in perspective. Before Europeans reached the Argentine area of South America, the region was only lightly inhabited. Spain colonized the country in the 16th century, instituting a strong central government and building a large railroad system. The efficiency of the new infrastructure helped transport the country's agricultural products to the coast for shipping, allowing for robust economic growth through exports. As the Spanish kingdom weakened due to constant wars, a military junta took control of Argentina, declaring independence from Spain in 1816.

Large farms powered the Argentine economic growth in the 19th century. The fertile land and availability of cheap labor allowed the country to produce and export large amounts of grain and meat products. Like the United States, Argentina was known as the "*land of opportunity*" and was a destination for many European immigrants. In fact, prior to World War I, Argentina was the 8th wealthiest country in the world (the seven wealthier countries were Belgium, Switzerland, Britain and four former English colonies including the United States[1]). Although the country was rich in natural resources, it failed to create an internationally competitive manufacturing base. Both WWI and the Great Depression severely weakened the country. As a result, rising unemployment and social unrest marked the beginning of a long period of political instability in the country.

In 1903 the military took control of Argentina and instituted import restrictions in an attempt to achieve self-sufficiency. Their efforts failed spectacularly. During the rest of the 20th century, fourteen generals and eleven elected civilian presidents ran the country. Between 1930 and 1983, presidents averaged only two years in office. In 1952, during a period of social unrest, the people elected Juan Domingo Peron as president. Peron promised to redistribute wealth away from wealthy land owners and over to the large urban working class. Peron nationalized many private and foreign-owned companies, leading to large capital outflows as foreign investors became increasingly nervous. Capital flight, combined with falling commodity prices, caused severe economic turmoil. Following, labor and trade restrictions eventually pushed inflation to 40% annually. Peron managed the social unrest through increased social spending—the economic development path that Argentina has followed ever since.

[1] Historical Statistics of the World Economy: 1-2006 AD, Angus Madison

Fans of the 1979 musical "*Evita*" by Andrew Lloyd Webber may remember that the death of Peron's popular first lady, Eva "*Evita*" Peron, triggered extensive social unrest which in turn, once again, led to a military take over.

Argentines have sadly seen it all - lurching from one banking crisis to another, to political dysfunction, to depression-level economic contractions and hyperinflation. Argentine bond investors have participated in the chaos, ranging from the Baring Bank Crisis in 1890-91, which resulted in Argentina's largest private banks holding a cash-to-deposit ratio of just 22% (yes, read that number again), to the hyperinflationary period seen in the late 1970's and 1980's, where inflation jumped by 5% or higher in almost every quarterly period from 1975-1990. The country's 2002 default was perhaps the most spectacular of all, remaining one of the largest sovereign defaults in history at over $82 billion according to Moody's, the bond credit rating agency. Most creditors suffered a 70% loss, with some holdouts seeking and obtaining better terms from a U.S. court decision, which in turn pushed Argentina back into default in 2014.

Investors welcomed the 2015 election of business-friendly Mauricio Macri. The Argentina Merval Index has more than doubled since the Macri's election, while the Argentine ten-year bond yield has declined from 14.25% to around 6.15%. Markets typically precede fundamentals, yet the fundamental indicators have yet to confirm investor enthusiasm. Economic growth fell by 2.3% in 2016, the third annual decline in the past five years, and the Argentine peso trades at its 52-week low of 16.15 pesos per dollar. If one were a bond investor, the country's recent weakening fiscal position should be potentially concerning. For example, in the fourth quarter of 2016, the Argentine budget deficit exceeded 1.5% of GDP, a monetary measure of a country's economic output. In isolation, this number means little; however, this budget deficit number constitutes the biggest shortfall going back to 2002.

Investors constantly consider the tradeoff between risk and reward when allocating capital. If so, then how does one explain the rationale behind the decision to buy Argentine bonds maturing in 2117 yielding 7.9% in contrast to Argentine bonds maturing in 2027 yielding 6.2%? Is the additional 1.7% truly worth the added ninety years of time until maturity? The market has spoken – yes.

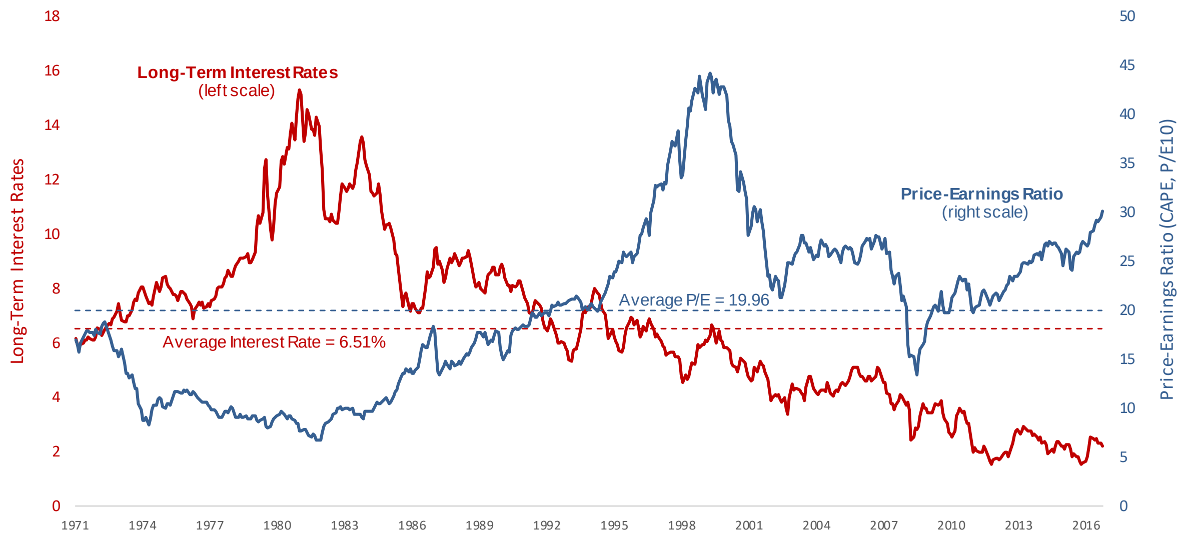
Investors apparently also believe the semiconductor sector offers an attractive risk and reward trade-off. The chart to the right shows the eight-year historical performance of the Philadelphia Semiconductor Index (the SOX). The SOX index is made up of thirty companies with the three largest components of the index being NVIDIA, Broadcom and Qualcomm. This highly volatile, brutally competitive sector is evidently compelling to investors, as the index has quadrupled off its 2009 lows with one half of the return gained in the past eighteen months.

Fred Hickey, author of *The High-Tech Strategist*, noted in his June publication that the SOX has experienced two periods of wild speculation. The first episode began in late-1998 and continued until its collapse in early 2000. The second period is the current one. Hickey notes that unlike the year 2000 when there was strong industry growth, today there is almost no growth. Hickey cites a study by Gartner, a leading research firm, where worldwide semiconductor revenues at the end of 2016 were $340 billion. By comparison, two years earlier, at the end of 2014, worldwide semiconductor revenues were $340 billion. In fact, from 2010 to 2016 industry revenue growth averaged only 1.97% per annum. Hickey argues that investors (if that is the correct word) are buying the appearance of growth, but this growth is actually accounting growth manufactured by company management from their financial statements. When the market's perception eventually meets reality, the unwind could be brutally quick.

Importantly, when investing in the financial markets, events often take longer than expected to unfold but then proceed faster than expected once underway. We attribute this trait to inertia. Once a large majority of investors embrace a particular view, investors then need overwhelming amounts of evidence over a long period of time in order to shift a critical mass to an opposing view. Once a critical mass has shifted its outlook, the dam breaks. Anticipating the breaking of the dam's wall is challenging. As long as the cracks in the dam remain small, any steps taken to protect one's investment capital from the dam's eventual rupture will result in an opportunity cost or even a loss. By contrast, a substantial investment allocation that bets on the cracks remaining manageable will result in disaster if the investment is maintained too long.

Extending the analogy, the key challenge is that while the dam's structural weaknesses can be determined with a fair degree of confidence, one never knows exactly when the cumulative effects of these weaknesses will cause the wall to collapse. Investors never know exactly when the market will shift its collective perception in a way that creates a tipping point. Determining this tipping point today is further complicated now that passive and quantitative investors account for about 60% of all equity assets, compared to 30% a decade ago, according to data from JP Morgan Chase.

Structural weaknesses taking longer than expected to reach a tipping point include the normalization of interest rates and a reversion to the mean in U.S. stock market valuations. Forty-six years ago, in 1971, President Nixon announced the end of the Gold Standard and the end of the Bretton Woods international monetary system, thereby ushering in the modern monetary system which influences our current investment markets. Since 1971, the cyclically-adjusted price-earnings ratio averaged 20x versus today's P/E ratio of 30x. Likewise, long-term interest rates have averaged 6.5%, far higher than today's 2.2% rate. Valuations are the market's structural weakness but until the market collectively reaches a tipping point, this fragility means little in the short-term.



In April, Jason Zweig, *Wall Street Journal* columnist, wrote investors believe the darndest things[2] when he cited a recent survey where individual investors expect their portfolios to earn a long-run average of 8.5%, annually, after inflation. Zweig noted that with bonds yielding roughly 2.5%, a typical stock-and-bond portfolio would need stocks to grow at 12.5% annually to hit that overall 8.5% target. Net of fees and inflation, this requires a rate of return that is almost double the 7% annual gain stocks have historically produced over the long term. Zweig resolved that although almost nothing is impossible in the financial markets, these expectations are so far-fetched they border on fantasy. "*The traditional explanations for believing in an investing tooth fairy who will leave money under your pillow are optimism and overconfidence: Hope springs eternal, and each of us thinks we're better than the other investors out there*." In particular, Zweig cited another reason so many investors believe in magic: *We can't handle the truth*.

Reading that sentence, one may recall the climatic courtroom scene in the movie *A Few Good Men* where Lt. Daniel Kaffee (Tom Cruise) confronts Col. Nathan Jessup (Jack Nicholson):

> Jessup: *You want answers?*
>
> Kaffee: *I think I'm entitled!*
>
> Jessup: *You want answers?!*
>
> Kaffee: *I want the truth!*
>
> Jessup: *You can't handle the truth!*

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[2] Zweig, Jason. "Whatever You Do, Don't Read This Column." *The Wall Street Journal*, April 28, 2017

Col. Jessup might concur – today's investors cannot handle the truth. Every stock market top throughout history has the same characteristic: fear of missing out ("FOMO"). The supporting logic changes from cycle to cycle, but the ending phase remains consistent as this time is never different. However, while valuation metrics prove reliable over long periods of time (7-10 years+), valuation is a poor timing tool in the short-term. As a result, overvalued markets grow more overvalued while undervalued markets grow more so before a bottom is in place.

Back in the 1990s there were many new age investment geniuses, hooked on anything dotcom related. Euphoria took hold of the market, as valuations were ignored and speculators chased the price action of the new-economy stocks. Alan Greenspan, then Federal Reserve Board chairman, warned of "irrational exuberance" in December of 1996, several years prior to when the market finally cracked and completed the down side of the cycle.

This time will be no different. Cautious, fundamentally-based value investors will sell too early based on valuation concerns while momentum players will ride the market all the way up to and over the top, and sell too late. For patient investors, who have the discipline to endure a bear market, a traditional buy-and-hold strategy will probably offer positive returns, over the long run, but periodically be interrupted with several agonizing down years. An investor might believe that they can remain indexed to the S&P 500 and ride out the ups and downs without ever being tempted to watch the daily, weekly, and monthly price movements. However, human nature will intervene, sucking in investors at a top and flushing them out near a bottom… *"When the wall starts collapsing, 10,000 people rush to push it down."*

A rationale investor understands that the stock market derives its returns from the collective equity of the companies within the market. Stocks are not a claim on next year's earnings - but rather a claim on a very long-term stream of cash flows delivered to investors at various points in the future. For example, an asset yielding 2% annually (the same as the current dividend yield on the S&P 500) derives nearly 70% of its present value from cash flows that are expected to be received more than twenty years out, or the year 2037. Therefore, why do investors keep allocating capital to stock index funds when valuations are now irrational? Perhaps economist John Kenneth Galbraith summed it up best in a passage from his 1994 book titled *A Short History of Financial Euphoria*:

> "*The euphoric episode is protected and sustained by the will of those who are involved in order to justify the circumstances that are making them rich. And it is equally protected by the will to ignore, exorcise, or condemn those who express doubts*."

From a fundamental standpoint, equity is the value from whatever cash remains after a company pays everybody else. Importantly, equity investors must consider they are the least senior and, therefore, the riskiest claim on a corporation's assets and earnings. When a company liquidates the assets on its balance sheet, equity holders stand last in line to receive payment. During a liquidation, after all secured creditors, the order of seniority drops down to unpaid wage earners, taxes, trade creditors, unsecured debt holders, subordinated unsecured debt holders and finally preferred stockholders. Importantly, even if a company never liquidates, all those claim holders must first be paid before equity holders ever receive a dividend. Equity only has value if there is something left over for investors after the company satisfies all other commitments. That remaining stub is the company's cash profit. Equity only has value if a company earns a profit. If one thinks "*this time is different*", ask Col. Jessup what he thinks.

INVESTMENT PHILOSOPHY

Rather than waste time predicting specific market outcomes, investors should prepare their portfolio for a range of potential outcomes by operating within a simple investment framework. Any investment strategy that offers one a higher probability of long-term success must begin with the correct mindset: The individual investor should act consistently as an investor and not as a speculator. Meaning, an investor must justify every purchase they make and each price they pay through impersonal, objective reasoning. In other words, the investor always seeks a margin of safety in order to protect their capital commitment. This simple, but timeless, principle provides an investment road map that all value-conscious investors should follow.

Because stocks are not merely pieces of paper or electronic quotations on a computer screen, but partial ownership interests in real businesses, valuations matter. As Benjamin Graham said, an investor must study "*the facts in light of established standards of safety and value*." Therefore, one should carefully consider what they believe the company could be worth at some point in the future. Unfortunately, valuing a business is not an exact science. Therefore, the investor should incorporate a sufficient margin of error. Although valuations will never be completely accurate, one remains better off being vaguely correct rather than absolutely wrong.

Lastly, investors must learn to control their emotions. If the investor cannot control their emotions, then they will find it difficult to separate price from value. Never overpay for a company's equity—a great business can be a terrible investment if one pays too much. Therefore, patience is mandatory—one must never fear holding cash until one finds value. "*Prepare, don't predict*" remains the most appropriate mindset for any long-term investor.

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 over 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.