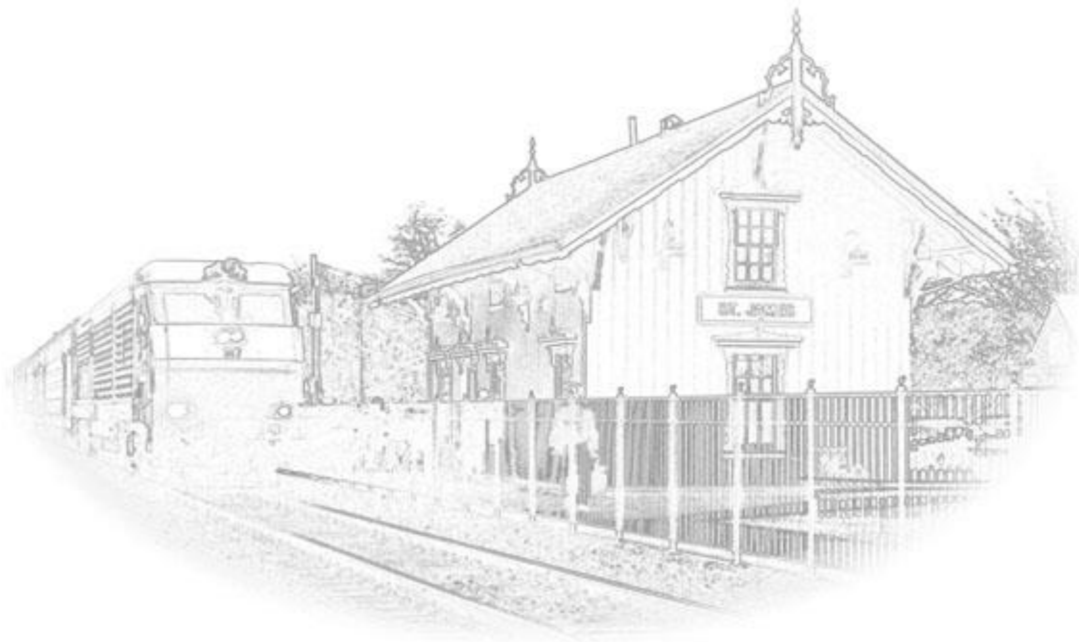

ST. JAMES INVESTMENT COMPANY

INDIVIDUAL PORTFOLIO MANAGEMENT

INVESTMENT ADVISER'S LETTER

OCTOBER 2017

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"Stability leads to instability. The more stable things become and the longer things are stable, the more unstable they will be when the crisis hits." Hyman Minsky

"Success breeds a disregard of the possibility of failure." Hyman Minsky

Academics teach that investors are rational decision makers who calculate optimal outcomes. The real world begs to differ, as investors do not always know why they make a decision. Professor Max Bazerman teaches a class at the Harvard Business School. Every year, on the first day of class, he holds up a U.S. twenty-dollar bill and announces that he is putting the bill up for auction.[1] One can buy this twenty-dollar bill for whatever they want. Bidding starts at $1 and moves in $1 increments; however, other participants can also bid on this $20 bill. If someone outbids you and you fold, you still must pay your final bid even though you receive nothing in return. Therefore, one must carefully consider how much they are willing to pay for a $20 bill.

Although psychologists have been conducting this experiment for years, the outcome is almost always the same. At first bidders are excited at the prospect of paying only $1, or $5, or even $10, for a $20 bill. However, when the auction level approaches about $18, a bidding war erupts between two players who realize they could end up paying a lot of money and receive nothing in return. Not wanting to lose, they each take the current bid higher. Eventually, someone bids $21 for a $20 bill -- which is surprisingly a rationale decision at that moment, because at this price the winner loses only $1 while the loser must pay $20. But, at this point, the train goes off the tracks as the bidding is now a fight to lose the least vs. winning the most.

In economics and decision theory, *loss aversion* refers to people's tendency to prefer avoiding losses rather than acquiring equivalent gains. For example, for most it is better to not lose $5 than to find $5. Some studies suggest that losses are twice as powerful, psychologically, as gains.[2] Loss aversion pushes bids for a $20 bill to absurd heights. From a rational perspective, the obvious decision would be for a bidder to accept their loss and back down. Unfortunately, that rationale decision is easier said than done. The bidders are now locked to their commitment, driven by loss aversion and fear, so they continue to bid the price higher. Professor Max Bazerman noted that, in one instance, the bidding finally reached $204.

To paraphrase Sir Issac Newton's third law of physics, for every action there is an equal and opposite reaction. Greed is the opposite action to loss aversion. Greed has driven investment mania for centuries, from the tulip mania in 17th century Holland to the dotcom bubble in the year 2000. Investment greed leads individuals to rationalize buying investments at irrational prices. Speculation in cryptocurrencies is perhaps the latest example of greed. Although we do not yet possess an opinion on cryptocurrencies, we remain fascinated that something is being created by almost anyone in infinite amounts at effectively zero cost and, yet, being valued so highly.

Bitcoin originally stated that its maximum supply was limited by computer code to twenty-one million bitcoins. However, for reasons beyond our level of comprehension, bitcoin recently "*forked*" and the

[1] Brafman, O. and Brafman, R. (2016). *Sway: The Irresistible Pull of Irrational Behavior*

[2] Kahneman, D. & Tversky, A. (1992). "Advances in prospect theory: Cumulative representation of uncertainty". *Journal of Risk and Uncertainty*.

potential supply of bitcoins effectively doubled instantaneously. The new coins created by the fork now reside within a different blockchain and are called "bitcoin cash" rather than just bitcoin; otherwise, they are identical. The initial bullish investment thesis stated that the maximum supply of the original bitcoin was mathematically fixed. This proved false. We have seen a surge in cryptocurrency supply—there are now about 1,000 cryptocurrencies and new ones are coming into existence at the average rate of more than two per week. Oddly enough, bitcoin's price benefited from the growth in the supply of alternative cryptocurrencies because, in many cases, the initial purchase of the newly-created cryptocurrency could only be made using bitcoin.

Bitcoin and the other cryptocurrencies do not exhibit the stability necessary to act as a store of value. Their current use appears, at least in our eyes, as vehicles for speculation driven by investment greed. Or as *Financial Times* editor Robin Wigglesworth explained in a recent column[3], "*Its primary attraction has been its rocketing price, but that has turned what might have had a kernel of value into a 'trading sardine'*." The term 'trading sardines' means a can of sardines that is unfit for consumption but still traded between speculators placing bets on its future price. Seth Klarman in his book *Margin of Safety* tells the old story about the market craze in sardine trading when the sardines disappeared from their traditional waters in Monterey, California. Commodity traders bid sardine prices up and the price of a can of sardines soared. One day a buyer decided to treat himself to an expensive meal and actually opened a can and started eating. He immediately became ill and told the seller the sardines were no good. The seller responded, "*You don't understand. These are not eating sardines, they are trading sardines*."

Like sardine traders, many market participants prefer speculation rather than eating the sardines they trade. Speculation offers the prospect of instant gratification and involves going along with the crowd. There is comfort in consensus, as those in the majority gain confidence from their very number. Today many financial-market participants, knowingly or unknowingly, have become speculators. They are playing the game to see who the greater-fool is by buying overvalued securities and expecting to find someone (the greater fool) to buy from them at a still higher price. There is great allure to treating stocks as pieces of paper that you trade. Viewing stocks this way requires neither rigorous analysis nor knowledge of the underlying businesses. Speculating is fun and exciting as long as the market is rising. Importantly, speculating is not investing.

Nassim Taleb, author of *Fooled by Randomness*, uses the term "alternative histories" in an interesting manner. Taleb suggests that a market occurrence is never the only thing that could have happened at that time, as alternative histories describe what could have happened but did not. One of these alternative histories may have been very likely, but for some reason it did not occur. If one accepts that what happened in a market over a certain timeframe is not the only thing that could have happened, then one must also accept that being on the right side of any market move always involves some degree of luck. Naturally, the individual who ends up on the right side of a market move is not quick to credit luck. Nassim Taleb provides an example of an alternative history:

> *Imagine you are offered $10 million to play Russian roulette, i.e., to put a revolver containing one bullet in the six available chambers to your head and pull the trigger. Each realization would count as one history, for a total of six possible histories of equal probabilities. Five out of these six histories would lead to enrichment; one would lead to a statistic, that is, an obituary with an embarrassing cause of death.*

[3] Wigglesworth, R. (September 18, 2017). https://tinyletter.com/RobinWigglesworth/letters

Although this example of Russian roulette is a hypothetical situation, it highlights how society perceives reality.

> *The problem is that only one of the histories is observed in reality; and the winner of $10 million would elicit the admiration and praise…the public observes the external signs of wealth without even having a glimpse at the source.*

In general, we believe that if the outcome is good, the process and decisions made to arrive at that outcome must have been sound. Unfortunately, investing does not follow such straight patterns.

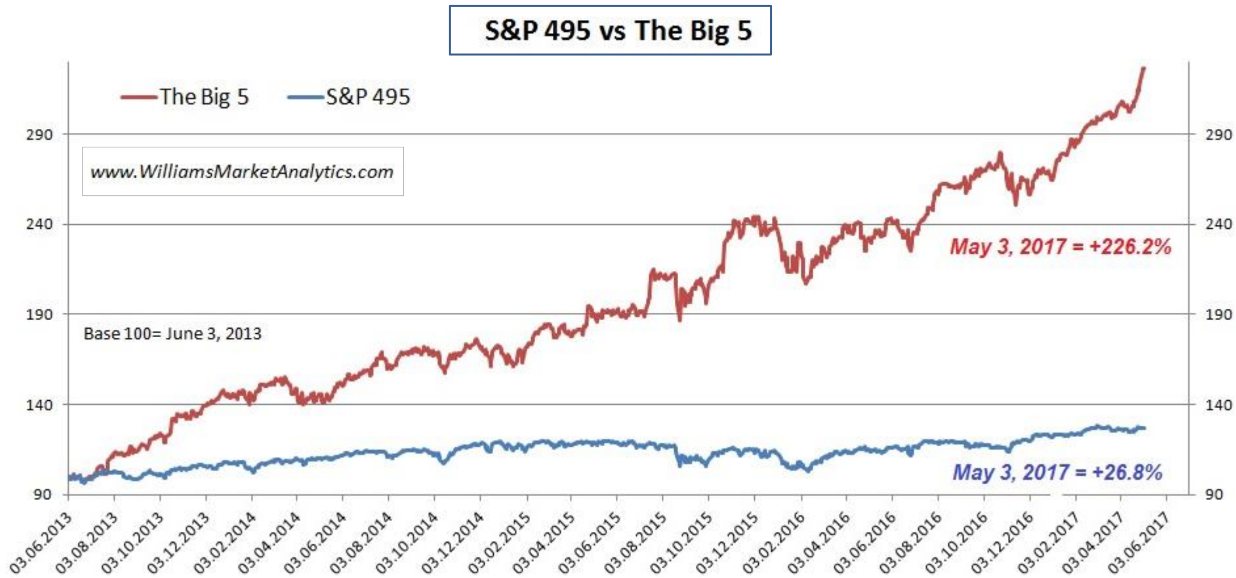
> *Reality is far more vicious than Russian roulette. First, it delivers the fatal bullet rather infrequently, like a revolver that would have hundreds, even thousands, of chambers instead of six. After a few dozen tries, one forgets about the existence of a bullet. One is thus capable of unwittingly playing Russian roulette and calling it by some alternative low risk name. We see the wealth being generated. People lose sight of their risks. The game seems terribly easy and we play along carelessly.*

One could have purchased bitcoin in September 2011 at roughly $4.50. Today, one bitcoin trades around $4,500. As a result, the person who purchased bitcoin six years ago clearly possesses insight that most lack. This sought-after individual today opines about the merits of bitcoin's simple architecture as a basis for a future payment system, or how transaction costs are lower with bitcoin, or maybe even that bitcoin was "born global" and belongs to no nation, yet works seamlessly across borders and markets. This person also likely cites some vague and unsubstantiated statistic that there is a 50% probability that one bitcoin is worth more than one million dollars within ten years. Who are we to argue otherwise? After all, this bitcoin "investor" has already generated a one-thousand-fold return on their original bitcoin investment.

Energy companies account for about 5% of the S&P 500 Index today. Back in 2014, the energy sector comprised over 10% of the index and Exxon Mobil was the largest company by market capitalization. The collapse in oil prices from $108 per barrel in 2014 to $50 per barrel today has dramatically impacted the energy sector weighting within the S&P 500 Index, as Exxon today is only the seventh largest company by market capitalization. The information technology sector replaced this void left by the energy companies. Owen Williams, of Williams Market Analytics LLC, noted several months ago that now the top five names in the S&P 500 Index are all technology companies: Apple, Microsoft, Google, Amazon, and Facebook, or as he refers to them, the "Big 5."

The chart below illustrates the Big 5 company stock prices in an equally-weighted composite index that Williams created. Williams compares the Big 5 to the S&P 495, or rather the S&P 500 with the performance of the five technology companies removed[4]. Since the middle of 2013, the S&P 495 has generated an annualized return of +6.1%. By contrast, the Big 5 have appreciated at +57.3% per annum over the same period. Since 2014, these five technology companies have increased to the point that the Big 5 have eclipsed the performance of the entire S&P 500. Over the past four years [05/2013 - 05/2017] the S&P 500 Index compounded at an annualized rate of +9.9%; however, without the Big 5, the S&P 500 Index generated only a +6.1% annualized gain – an annualized return lower by 38%.

[4] Williams, O. (May 5, 2017). Seeking Alpha. Article No. 4069736



At what point does this alternate history involving financial markets distort the reality in the U.S. economy today? Exxon Mobil serves the enormous energy needs of our economy but is worth $148 billion less than Facebook, a company which generates most of its revenue running mobile ads targeting social media users. General Electric produces everything from air plane engines to medical devices yet is worth $252 billion less than Amazon, a company which serves as a middle man in online retail transactions. Investors should consider that alternative histories may have been very likely, but for whatever reason did not occur.

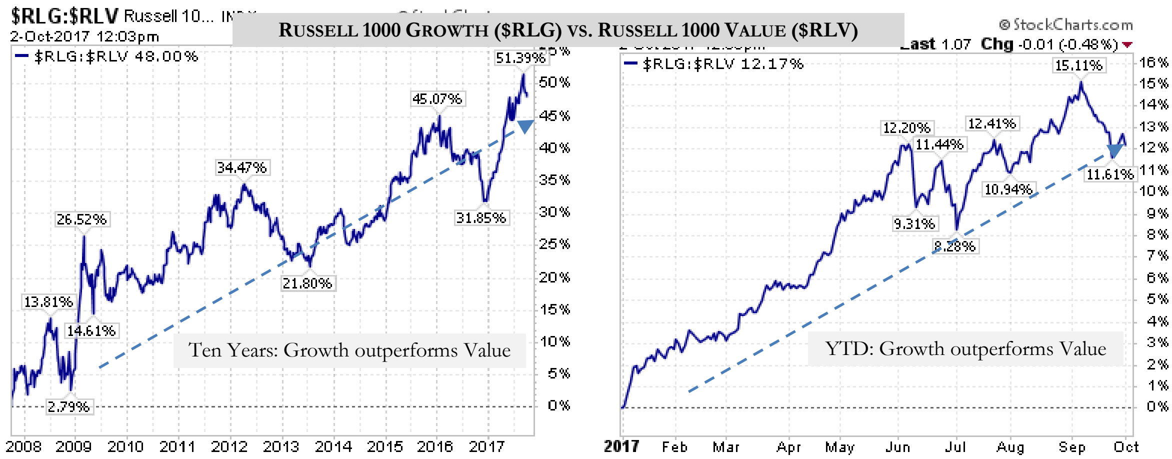
A recent survey by Bank of America reported that 71% of active fund managers hold an overweight portfolio position in the Big 5 stocks relative to the rest of the market. Naturally, these fund managers sit on the correct side of the market and are not quick to credit luck to their recent success. We wonder if these fund managers consider themselves investors or speculators? Benjamin Graham and David Dodd defined the difference between investing and speculation in their book *Security Analysis* as such: "*An investment operation is one which, upon thorough analysis, promises safety of principal and a satisfactory return. Operations not meeting these requirements are speculative*." When one believes that they are investing when in fact they are speculating, then any sudden drop in prices will leave one seriously doubting their "investment."

The Swiss National Bank, Switzerland's central bank, began buying equities in 2014. Because Switzerland's domestic economy is so small, the Swiss National Bank decided to invest globally. Today, the Swiss central bank owns more than $84 billion worth of U.S. stocks with the Big 5 accounting for five of the bank's largest seven portfolio positions[5]. The Swiss central bank continues to expand its balance sheet at almost $100 billion a year and has now grown to around $740 billion, or $90,000 in stocks per Swiss citizen. The bank's balance sheet grows every year just by printing more Swiss francs due to its ongoing interventions to depress the Swiss currency. As a result, the bank "invests" these funds created out of thin air in stocks and bonds. James Grant, of newsletter *Grant's Interest Rate Observer*, told the Swiss economic journal *Finanz und Wirtschaft*, this buying spree consists of Swiss francs created from "*the thin alpine air where the Swiss money grows. All this is done with a tab of a computer*

5 https://www.holdingschannel.com/13f/swiss-national-bank-top-holdings/

key. And then the SNB calls its friendly broker – I guess UBS – and buys the ears off the US stock exchange. All of it with money that didn't exist. That too, is something a little bit new."

Unlike the Bank of Japan, which at least limits its central bank distortions to its local capital markets, the Swiss National Bank is causing substantial price distortions in the financial markets of the United States. In other words, the Swiss National Bank is actively playing a role in creating an alternative history that most would never have previously expected. One side effect is that value investing is currently stuck in one of its worst stretches on record. Wall Street defines value stocks as those that are cheaper than their peers relative to earnings or reported net worth, and are typically purchased by investors anticipating long-term appreciation. Value stocks have significantly lagged growth stocks this year, compounding a gap that has persisted since the end of the financial crisis almost ten years ago.



Market participants continue to shun value and gravitate towards companies exhibiting rapid earnings or price growth (when no earnings exist), such as Netflix, Nvidia, Tesla, the Big 5 and so forth. This appetite for risk has pushed the market's valuation, by almost any metric, to levels that cannot continue indefinitely. The infatuation with growth at any price makes many wonder whether the markets are witnessing the death of value investing. The struggle for value stocks over such a prolonged period contradicts the investment approach espoused by Benjamin Graham, who was confident that value investing would never go out of style. The notion that a new paradigm will replace value investing repeatedly occurs, but those predictions always prove incorrect.

Market participants often rediscover the virtues of value-style investing during market downturns. The market's attraction to highflying stocks punished value investors in a similar fashion in the late 1990s during the dot-com bubble. Growth outperformed value during the two major bull markets that peaked in 2000 and 2007, before large market selloffs reversed the trend. Howard Marks, the co-founder of Oaktree Capital Management who correctly predicted in January 2000 that technology and internet stocks were overheated and about to fall—two months before the dot-com bubble burst, perhaps best sums up the market today. "*The super-stocks that lead a bull market inevitably become priced for perfection. And in many cases, the companies' perfection turns out eventually to be either illusory or ephemeral.*"

Investment Philosophy

One added to one, by any rules of vulgar arithmetic, will never make three and a half; consequently, all the fictitious value must be at a loss to some persons or other, first or last. The only way to prevent it to oneself must be to sell out betimes, and so let the Devil take the hindmost.

–Edward Chancellor in *Devil Take the Hindmost*

If one is a speculator, the only way to protect and prepare oneself is to sell out early ("*betimes*"), and let the Devil take the hindmost fool left in the market when it finally falls, as it always does, eventually, when markets grow dangerously overvalued. Poet Alexander Pope once wrote that, *"Most people thought the crash would come, but no man prepared for it; no man considered it would come like a Thief in the night, exactly as it happens in the case of death."*

Though we believe that stocks are extremely overvalued, it is impossible to predict a market correction happening within any period. Such an endeavor would be considered speculating rather than investing. Fortunately, if you are a fundamental value investor, it is unnecessary to predict anything. Lou Simpson managed the investment portfolio for GEICO, an insurance company, from 1979 to 2010. His performance was quite extraordinary: 20% compound annual returns as compared with 13.5% for the S&P 500 Index. One can distill Simpson's investment strategy down to five important principles: 1) Think independently, 2) Invest in high-return businesses run for the benefit of shareholders, 3) Only pay a reasonable price, even for an excellent business, 4) Invest for the long term, and 5) Do not diversify excessively.

In Simpson's own words: "*Companies that meet our criteria are difficult to find. When we think we have found one, we make a large commitment*." Simpson's focus increased over time. In 1982, he had 33 stocks in a $280 million portfolio. He kept cutting back the number of stocks he owned, even as the size of his portfolio grew. By 1995, he owned just ten stocks in a $1.1 billion portfolio. However, Simpson did not just buy and hold. Simpson would add to a holding if it fell and thus became more attractive (the margin of safety increased). He would trim a portfolio position if it grew expensive (the margin of safety decreased). Simpson based his buy and sell decisions strictly on valuation—not emotions, not news headlines and not chart patterns.

We note one other important aspect of Simpson's record: <u>He traded very infrequently</u>. There was very little turnover within his portfolio. Simpson emphasized that an investor only needs one, two, or possibly three good ideas each year. "*We do a lot of thinking and not a lot of acting. A lot of investors do a lot of acting and not a lot of thinking*." Therefore, an investor is best served when they focus their portfolio on a small group of select stocks.

With kind regards,

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 over eighteen 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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