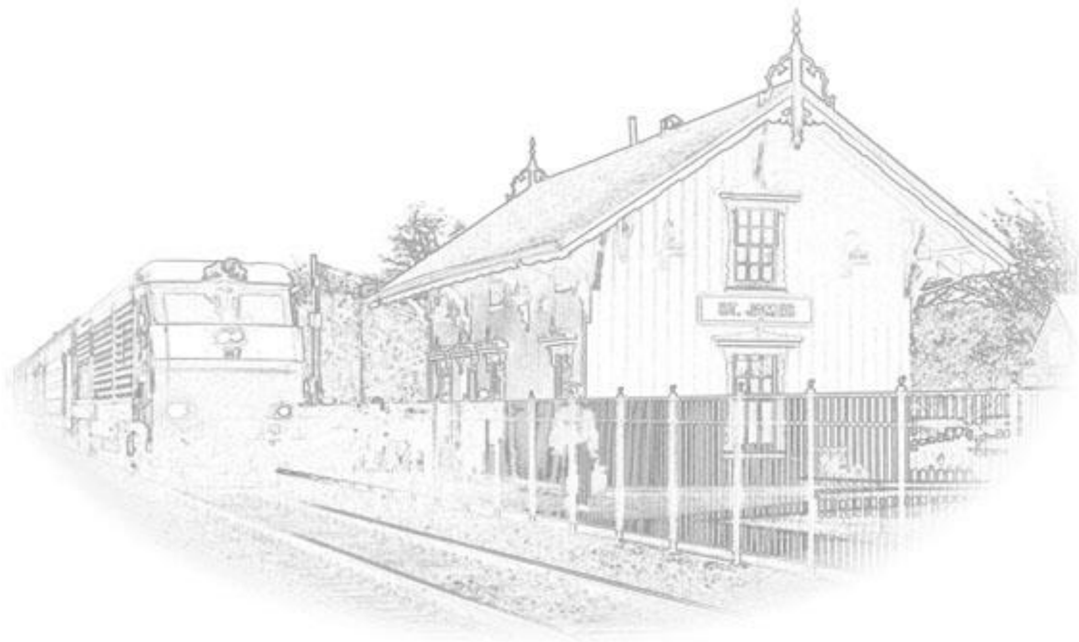

ST. JAMES INVESTMENT COMPANY

INDIVIDUAL PORTFOLIO MANAGEMENT

INVESTMENT ADVISER'S LETTER

JANUARY 2018

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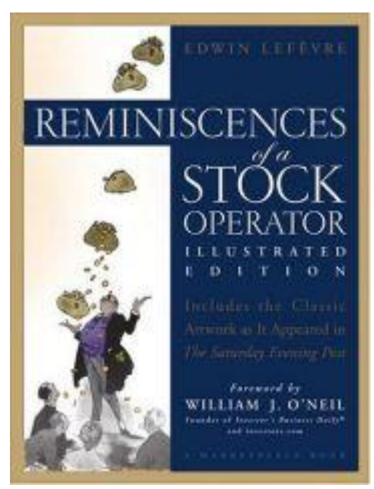
"After spending many years in Wall Street and after making and losing millions of dollars, I want to tell you this: It never was my thinking that made big money for me. It was always my sitting." Jesse Livermore

One of the more fascinating stories on Wall Street is how Jesse Livermore rose from office boy to Wall Street legend. Livermore was a self-made man who traded with his own money. In 1922, during a series of interviews in *Reminiscences of a Stock Operator* with "Lawrence Livingstone", a pseudonym for Jesse Livermore, financial journalist Edwin Lefèvre discussed the strategy and psychology of a master stock market trader. Starting with a few dollars, Jesse became one of the world's richest men by trading, or speculation as he called it. To be clear, Livermore bought stocks intending only to sell them for a capital profit—he had no intention of holding on to stocks for the long term.

Jesse Livermore began his working life in 1890 at the age of fourteen as a quotation board boy in a stockbroker's office. Updating the board using chalk was once an entry point for many young traders getting into the financial markets. The quotation boys updating the boards would wear fur sleeves so they would not accidentally erase prices. As the story goes, one day another office boy told Livermore that he had been given a tip to buy shares in Burlington and asked if Livermore had any money to join him, predicting they would quickly double their money. Livermore, at fifteen years old and after careful examination of the prices he had recorded for Burlington stock, decided to invest his entire savings in Burlington. Although the trade was just a few dollars, two days later he sold his position with $3.12 profit. Encouraged by his success, in the following months Jesse Livermore went on to make his first $1,000 – a large sum in 1891 – and his career as a trader took hold. He ultimately experienced his greatest moment as a trader at 52 years old, as he shorted the stock market before the great crash of 1929 and made a profit of roughly $100 million.

Back in Livermore's day, everyone considered themselves a trader. By contrast, everyone today considers themselves an investor. And while the difference between a trader and an investor appears stark, timeless psychological traits overlap the pedigrees of both. One particular passage from *Reminiscences of a Stock Operator* sums up Livermore's investment psychology:

"The game of speculation is the most uniformly fascinating game in the world. But it is not a game for the stupid, the mentally lazy, the man of inferior emotional balance, or for the get-rich-quick adventurer. They will die poor. The fruits of your success will be in direct ratio to the honesty and sincerity of your own effort in keeping your own records, doing your own thinking, and reaching your own conclusions. There is nothing new in Wall Street. There can't be because speculation is as old as the hills. Whatever happens in the stock market today has happened before and will happen again. There are times when money can be made investing and speculating in stocks, but money cannot consistently be made trading every day or every week during the year. Only the foolhardy will try it. It just is not in the cards and cannot be done. The point is not so much to buy as cheap as possible or go short at top price, but to buy or sell at the right time."

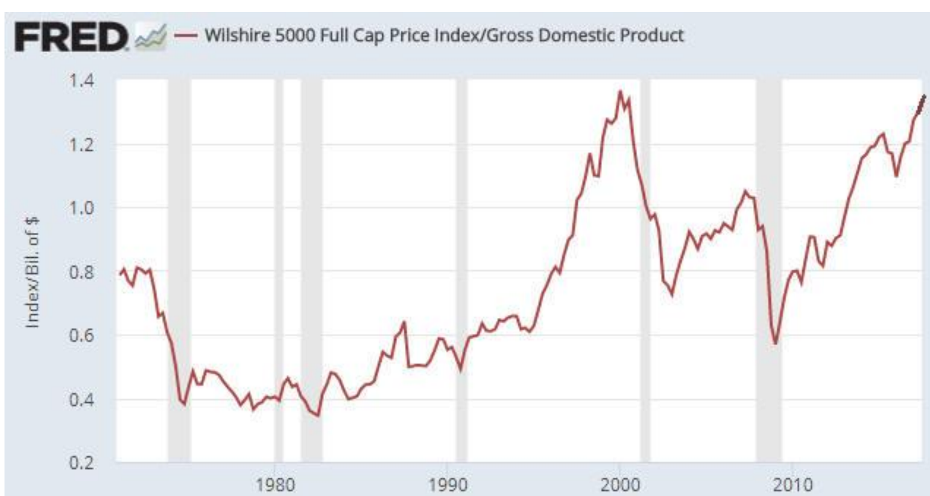


In contrast to Livermore's advice of doing one's own thinking and reaching one's own conclusions, nothing seemingly matters in today's stock market except the narrative. In general, investors remain attracted to assets with interesting stories regardless of valuation. Examples are easy to find within all sectors of the stock market, including the Canopy Growth Corporation that goes by the symbol WEED. Capturing market enthusiasm for pot legalization, Canopy Growth is an emerging Canadian medical marijuana company, with little revenue, that boasts a $6.5 billion market cap. A greater absurdity, publicly traded Long Island Iced Tea Corporation (which, as the name implies, is based on Long Island and makes iced tea) changed its name to Long Blockchain Corporation with the intent of acquiring companies in the cryptocurrency business. The stock surged 200% on the news. In cases such as these, the market value of a "story stock" will be based on dreams of what the underlying business could be worth in the distant future if many things go right - but bear no resemblance to what the underlying business is worth in the present.

There is no way a value investor can own the stocks of such companies in good conscious. Before the stock market crash of 1929, investing was a disordered and muddled activity, full of traders. Benjamin Graham and David Dodd's *Security Analysis*, first published in 1934, created an intellectual framework for a sound investment philosophy, bringing structure and logic to the concept of investing.

Graham mostly operated in a business environment conditioned by the extreme economic collapse of the 1930s. Indeed, the majority of investors during that period remained shell-shocked long after market conditions improved. However, when investing, like in life, one must adapt to the conditions at hand. In today's market, the "mentally lazy" and the "get-rich-quick adventurer" completely disregard Livermore's philosophy and chase rising prices that exhibit little, if any, volatility.

Valuation matters to the extent that it creates long-term downside risk or upside potential. Currently, by all historically reliable measures, the US stock market's valuation is at the top of its historic range. The chart below shows that the capitalization of the US stock market, as indicated by the Wilshire 5000 Index, now resides within 3% of its 2000 peak, relative to the country's gross domestic product (GDP), a statistic that measures the nation's economic output. Anyone who now buys a fund, that mimics the performance of a broad-based US stock index, will more than likely suffer a flat, or even negative, return if they manage to hold on to it for ten years.



Importantly, GDP is a somewhat suspect statistic. Politicians promote GDP to reinforce a narrative that everything is improving every day, in every way. However, there is a critical flaw in GDP—it only reflects the country's income statement and does not reflect changes in the country's balance sheet. If a country borrows money to pay people to dig holes and then refill those holes with the excavated dirt, GDP rises. The debt incurred to dig the holes is never accounted for in the GDP statistic. Therefore, the chart above likely overstates the denominator and understates the stock market's current overvaluation.

"*The world is full of bubbles*," warns former fund manager Richard Breslow. Breslow's warning reinforces what many value investors clearly believe in principle but have abandoned in practice, "*You don't have to like equities to buy them. And that will remain true until it isn't. For now, beauty is in the eyes of the holder*." Breslow explains that an investor cannot simply look at the current valuations and then reread Graham and Dodd's *Security Analysis* in hopes of a simple explanation, as the simplest explanation is also the least satisfying. The market keeps pushing higher and quantitative models and passive index funds simply do not care why, because they must keep participating. Models simply translate the definition of a trend and are not burdened by valuation measures. However, the behavior of the today's financial markets is not normal. Just consider a few of the remarkable events witnessed this year, presented by Michael Lewitt, publisher of *The Credit Strategist*:

- Global debt soared to $225 trillion, which now represents a record 324% of global GDP, while global stock market capitalization soared to more than $85 trillion, a new record 113% of global GDP.
- The central banks of Europe and Japan purchased more than $2 trillion of assets.
- European high-yield bonds, otherwise known as junk bonds, traded at yields below 2%, and yielded less than U.S. Treasury debt for the first time in history.
- U.S. corporations sold a record $1.75 trillion in bonds.
- Electric carmaker Tesla has never earned a profit but sold $1.8 billion of the junk bonds yielding just 5%.
- Volatility on the benchmark S&P 500 Index plunged to the lowest levels on record.
- The market capitalization of the popular "FANG" stocks grew by more than $1 trillion.
- A painting by Leonardo da Vinci sold for a massive $450.3 million, setting a new all-time record for any work of art several times over.
- And of course, we cannot forget about cryptocurrencies...

Bitcoin surged from less than $1,000 at the beginning of 2017 to around $19,000 by mid-December. At the same time, the broader cryptocurrency market, which has grown to include more than 1,300 different digital assets, has increased from a total valuation of $20 billion a year ago, to nearly $450 billion today. Many said the price of bitcoin looked like a bubble at $5,000, $10,000, and again when it briefly surged past $19,000, but who really knows how to price the cryptocurrencies? Ned Davis Research Group's technical strategist, Will Geisdorf, noted that the only historical event that rivals the price movement of bitcoin was the spike in silver during 1980. When the silver bubble popped, it had a ripple effect -- speculative money ran from commodities and the stock market sharply dropped. Bitcoin dances to the beat of its own drum. It is apparently not correlated to stocks, bonds, commodities, or volatility. One wonders what will be the impact should bitcoin implode.

First came bitcoin, then came initial coin offerings (ICO's), now comes Cryptokitties, an ethereum-based game in which users spend real money to "buy, sell, and breed cartoon kittens." Recently launched, the game already represents 20% of all computations on the ethereum network. To date, the top-selling cryptokitty garnered 247 ethereum tokens, worth $117,712 at the time of purchase. Zac Bissonnette, author of *The Great Beanie Baby Bubble,* noted that cryptocurrencies have more in common with collectibles than with investments. Collectibles possess no utilitarian value, they do not generate cash flows, and their value is entirely dependent on artificial scarcity—like baseball cards, paintings, comic books, etc.—all of which are categories with exceptionally poor long-term track records. Cryptokitties demonstrate the similarity between cryptocurrencies and collectibles. When people link cryptocurrencies to pictures of cute animals, one cannot help but remember the Beanie Baby craze.

The late 1990s brought together the creation of internet auction site eBay, a stock market boom, and many people who wanted to participate but could not afford to leverage a stock portfolio. One could argue that it was just dumb luck that made Beanie Babies the target of the inevitable bubble that ensued.

Or, maybe there was really something unique and special about those little bean bag animals. Beanie Baby mania paralleled the dot-com craze: parabolic prices and then a bursting of the bubble. In many ways, the Beanie Baby mania was the precursor to the dot-com stock bubble. Both were creatures of a strong economy with low unemployment topped by a large dose of consumer confidence. Both were assisted by the advent of online trading and the explosive growth of the Internet. Both gave rise to a handful of analysts who would publicly decode the mysteries of the market. Both created fraud. And, finally, both ignored all classical notions of investment value. That is, until they did not and reality painfully reasserted itself.

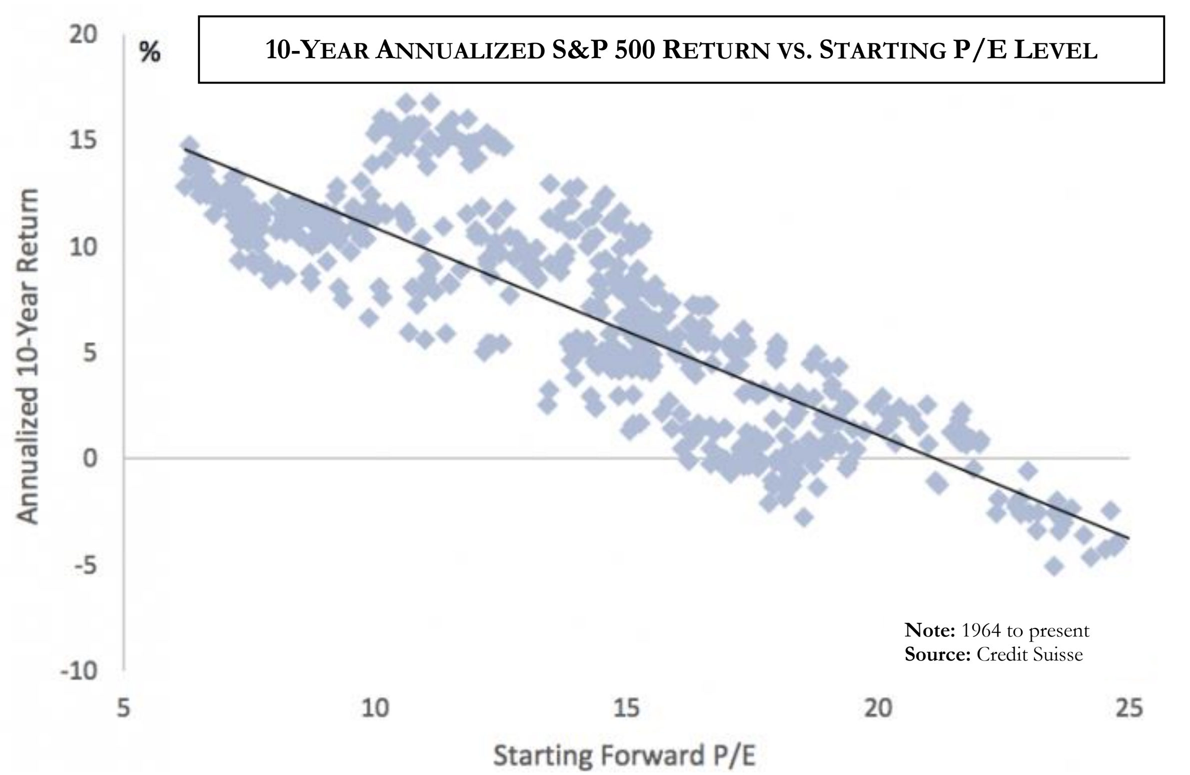
Investors in the S&P 500 end the year 2017 more than twenty percent wealthier, if one includes dividends. The market's advance was relentless, without a single day when it rose or fell by two percent. In fact, there were only eight days in 2017 when the index moved as much as one percent, according to S&P Dow Jones Indices. One has to go back to 1964 to find a year with fewer days of such minimal volatility. Counterintuitively, collective profit expectations fell as the market rose. A year ago, Wall Street forecast a collective $131 of earnings per share from S&P 500 companies in 2017. The estimate is now $125. Equivalent estimates for 2018 have also moved lower, from $146 to $144. The implication is that the stock market has been pushed higher simply by demand for stocks, which has, in turn, pushed valuations higher. While investor enthusiasm appears broad, and possibly sustainable at the current moment, it is important to recognize how much the stock market owes to just five companies. A quarter of the S&P 500's gains this year can be attributed to a surge in the share prices of Apple, Microsoft, Amazon, Facebook and Alphabet.

October marked the thirty-year anniversary from the stock market crash of 1987. The leading features of that event are well known, from the strong increase in stocks through spring and summer, to the downward reversal that cascaded into a 22.6% crash in the Dow Jones Industrial average on "Black Monday," to the role of portfolio insurance, a popular hedging strategy at the time that led to indiscriminate selling in equity futures and aggravated the market's price drop. Perhaps less well known was the state of the bond market during that period of time. The bond bull market began in 1981 with the 10-year Treasury yield reaching a shocking 15.8% on September 30, 1981. A strong bond rally (higher prices and lower yields) in 1985 and early 1986 stalled by the end of that year, and by the summer of 1987 interest rates were again rising sharply. The 10-year yield for the US Treasury reached 10.2% on October 15, four days before the crash.

A ten percent yield presented a compelling opportunity to own the debts of the United States, particularly at a time when the country carried far less debt on its national balance sheet. The down side of 10% is clear to anyone who has recently purchased bonds at historically attractive yields of 8% or 9%. Financial perspective can be difficult to maintain, particularly during a runaway stock market. However, at yields of 10%, one may lose 10% of one's principal over the next twelve months while still breaking even from the bond's coupon payment. The same cannot be said today for an S&P 500 Index fund that yields 1.9%. It was easy in that demoralized 1987 market, to hate bonds, but a 10% coupon should have been welcomed rather than feared. Fast forward to present day and we see that 10-year US Treasuries yield only 2.4%. Where once upon a time the bond market offered an attractive alternative to the stock market, today's situation presents a far more difficult decision.

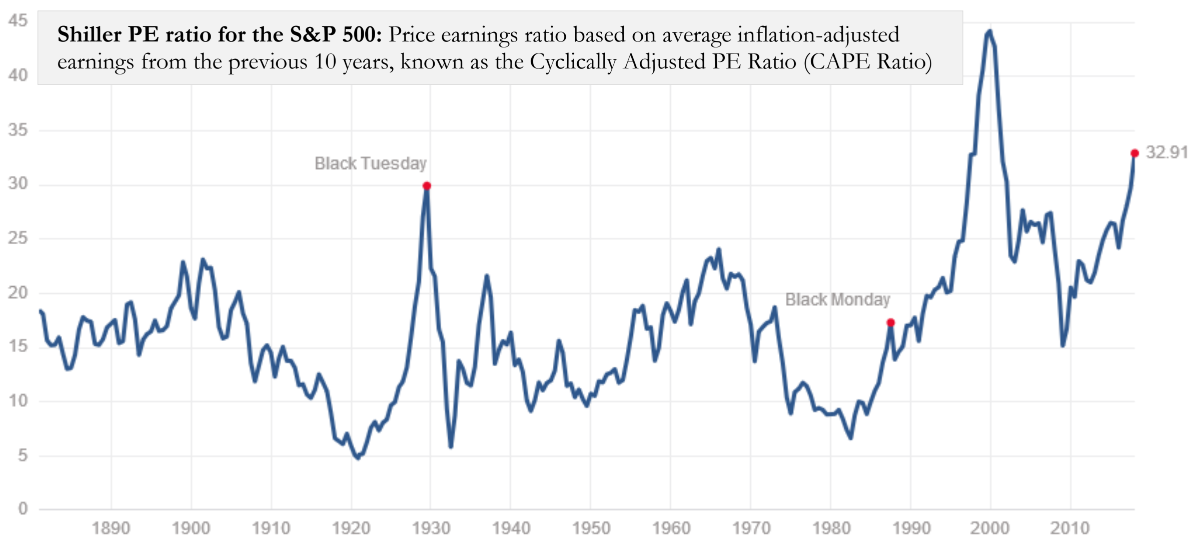
Although stock market valuations are at their highest levels in years, valuations are typically poor indicators of short-term returns. According to Goldman Sachs strategist David Kostin, the median S&P 500 stock trades in the 99th historical valuation percentile. Kostin immediately dismisses his own ominous warning about valuations and writes that he expects the S&P 500 to rally to 2,850 in 2018. Kostin bases his market forecast on the forward price-to-earnings (P/E) ratio, the most popular measure of value in the stock market. For the S&P 500, one calculates the P/E ratio by taking the price of the index and then dividing it by future expected earnings forecasted by Wall Street. If the P/E is above the long-run average, then one could simplistically argue that the market is expensive. If the ratio is below, then the market may be cheap. Importantly, prices do not necessarily have to fall for the P/E to fall — they just have to rise at a slower pace than earnings are growing.

Currently, the S&P 500 is trading at a forward P/E of around 18.2, significantly higher than the ten-year average of 14.2. In other words, the market looks expensive. But high valuations can be followed by both significant gains or losses in the next year. The P/E ratio works better over time. Specifically, the trend shows that, over time, high returns historically follow low valuations and vice versa. There is a very strong relationship between the level of the P/E ratio and subsequent ten-year returns. In fact, this relationship carries an 85% correlation. The chart below illustrates that a low P/E (left side of horizontal axis) is typically followed by higher longer-term returns. By contrast, a high P/E (right side of horizontal axis) is typically followed by low returns or losses over a long-term period.



Some of the greatest gains in the stock market historically occur just before bull markets turn to bear markets. For value investors, it really is darkest before the dawn. "*Equity returns in the last years of a bull market have historically been very strong, making it very painful to sell too early*," Bank of America Merrill

Lynch's Savita Subramanian said back in a May 2017 note to clients, a point she has been reiterating to clients for over a year. Therefore, value investors must remain incredibly patient as many of the market's major warning signs will flash red for months or even years before events turn towards a more conducive investment environment to deploy investment capital. The granddaddy of warning signs is Robert Shiller's cyclically-adjusted price-earnings (CAPE) ratio, which is at levels seen prior only to history's great stock market crashes. And though the CAPE ratio looks to be at worrisome levels, it is just another input to consider. In fact, even Shiller warns against abandoning the stock market while CAPE is at elevated levels. "*The S&P 500 could go up 50% from here. That's what it did around 2000. After it reached this level, it went up another 50%*."



At the end of bull markets, investors often pursue phantom opportunities in a relentless but futile pursuit of unrealistic gains. The apparitions of wealth that continually mesmerize, and beckon the unsuspecting, remind one of the Sirens in Greek mythology whose seductive songs lured sailors to their death. Wall Street suggestively sings that the end is the worst time to be out of the market. While it may be tempting to chase index investing all the way to the market's peak, history shows that long-term investment returns are negligible, starting at current valuation levels. Yes, sell too early and one misses out on potential returns. In a low-return world, investors believe that they cannot afford to miss potential returns. But as Jesse Livermore said, "*It never was my thinking that made big money for me. It was always my sitting*."

Now is the time for intense scrutiny in security selection, ignoring the Sirens of Wall Street for broad-based market participation.

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 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.