

# ST. JAMES INVESTMENT COMPANY

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INDIVIDUAL PORTFOLIO MANAGEMENT

## INVESTMENT ADVISER'S LETTER

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## FIRST QUARTER LETTER

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*"The definition of insanity is doing the same thing over and over again but expecting different results."*

--Albert Einstein

Most attribute this quote to Einstein, but if not Einstein, the meaning of insanity is still doing the same thing again and again and expecting a different result. Charles Schulz's Peanuts comic strip offered its version of insanity illustrated in the infamous football gag. The characters involved in the gag are Charlie Brown and Lucy van Pelt. Lucy tells Charlie Brown that she will hold a football while he runs up and kicks it. Charlie Brown usually refuses to kick the football because he (rightly) doesn't trust Lucy. Lucy then offers a reason to persuade Charlie Brown to trust her. A coerced Charlie Brown runs up to kick the ball, but at the very last second Lucy removes the ball and Charlie Brown flies into the air, falling and hurting himself. The gag typically ends with Lucy pointing out to Charlie Brown that he should not have trusted her.

The first appearance of the football gag was in the strip from November 14, 1951. In that strip Violet, not Lucy, is holding the ball and she only pulls it away because she is afraid Charlie Brown will kick her hand. Lucy was first shown playing the prank on Charlie Brown on November 16, 1952; the concluding part of the comic strip shows Charlie Brown running towards the ball and then tripping over it. Every year afterwards for the remainder of the strip's run, in the early autumn Lucy would continue to fool Charlie Brown. In the 1983 strip, when she tries to dare him, he wisely walks away only to see Sally, Peppermint Patty, Marcie, Snoopy and Woodstock all holding footballs and daring Charlie Brown to take his best shot.

Charlie Brown comes close to kicking the football in a 1979 storyline that begins when he is ill in the hospital. Lucy promises that she will never pull the football away again if Charlie Brown recovers. When Charlie Brown finds out about her promise, Lucy realizes she has no other choice but to let him kick the football. Lucy keeps her promise not to pull the ball away that year, but Charlie Brown misses the ball and accidentally kicks her hand. Later, when he apologizes for the accident, the following frame shows her bandaged hand and her angrily telling him that next time he goes to the hospital he should stay there.



Value investors can empathize with Charlie Brown. Just when valuations appear attractive on an absolute basis, Lucy, otherwise known as the U.S. Federal Reserve Bank (or any other central bank for that matter), repeatedly yanks away the opportunity to truly invest with a margin of safety. The S&P 500 Index now sits at five-month highs, putting the benchmark index on track for its strongest first quarter performance since 1998. The stock market continues to move straight up following the December lows and have been risk free since Federal Reserve Chairman Jay Powell (aka "Lucy") caved on January 4<sup>th</sup> and signaled flexibility on the reduction of the central bank's balance sheet. Bulls

continue to buy every dip in the stock market and bears increasingly look like Charlie Brown yelling “AAUGH!” in Schulz’s football gag.

Central bank jawboning has gone global. In just a few short weeks the U.S. Federal Reserve has completely reversed its positions: no more interest rate increases, flexible on balance sheet reduction (and consideration for even stopping balance sheet reductions altogether) while simultaneously discussing bond purchases as a regular policy tool rather than just for emergency measures. Some members of the U.S. Federal Reserve Board also hinted that quantitative easing is once again open to consideration. The European Central Bank is now discussing the return of LTRO (long term financing operation) which would once again inject liquidity into the banking system.....even though the bank just ended its policy of quantitative easing a few short months ago. The Bank of Japan never stopped its market manipulation and now owns more than 75% of the Japanese ETF market, while the Chinese central bank continues to create new liquidity measures on a weekly basis to resurrect its lending markets.

This renewed global central bank capitulation succeeded in once again ramping asset prices from December’s abyss. Too bad Charlie Brown—greed is back, with daily headlines hinting at a successful China trade deal and the President of the United States tweeting “up, up,



up” to ensure a continuation of the buying panic. Fundamentals and valuation do not matter—just buy stocks. Wall Street believes that the bear market ended on the evening of Christmas with the S&P 500 index bottoming out at 2346. The S&P 500 index had peaked just three months earlier in September at the record high closing level of 2931. Currently the index sits just 3% away from its all-time high. It was as if the October to December stock market plunge never happened. Fear has left Wall Street and Lucy once again pulled the football away from Charlie Brown.

The astonishing year-to-date rally is solely due to multiple expansion in the price-to-earnings (P/E) ratio, or the multiple that investors are willing to pay for one dollar of corporate profit. In fact, the year-to-date rally is the best start to any year since 1991 despite declining corporate profit forecasts. Since late 2018, the trailing P/E multiple on the S&P 500 Index has expanded from 15.5x to 18.7x. A three point expansion in P/E multiples in a such a short period of time is rare and last occurred in 2009 when the market exited the credit crisis. Before the credit crisis, rapid multiple expansion in the face of declining profit forecasts happened once more in 2002 following the technology implosion. Animal spirits are alive and well, and the stock market is once again at levels that look very expensive.<sup>1</sup>

<sup>1</sup> Animal spirits is the term John Maynard Keynes used in his 1936 book *The General Theory of Employment, Interest and Money* to describe the instincts and emotions that influence and guide human behavior, and which we can measure in terms of consumer confidence.

One unanswered question is that if everything is so wonderful, then why does the U.S. Federal Reserve and every other global central bank see the need to immediately reverse course upon any weakness in the stock market? Why did the Federal Reserve chairman Jay Powell in his recent congressional testimony announce: "We're going to be in a position to stop Federal Reserve balance sheet runoff later this year." In 2009, after then Federal Reserve chairman Ben Bernanke started the first quantitative easing program, he told Congress that it was temporary. Bernanke stated that "Clearly this is a temporary measure which is intended to provide support for the economy in this extraordinary period of crisis and when the economy is back on the road to recovery, we will no longer need to have those measures." But now these monetization actions are permanent. One recalls the Rick Santelli moment on television in 2013, when the trader bluntly asked Chairman Bernanke, "What's the Fed afraid of?"

It's likely central banks realize just how brittle the markets really are. The Federal Reserve was willing to disregard some market instability, hoping to begin the process of the markets standing on their own—they just did not appreciate the degree of market fragility that had been accumulating over the years. Federal Reserve policy makers decided that when in doubt, do no harm, which is now the new normal. Perhaps the U.S. central bank simply caved to Wall Street pressure. The rate hikes and quantitative tightening slammed asset prices and liquidity, much to the pain of Wall Street.

With equity markets once again surging, the "unicorns" sense an opportunity. A unicorn is a privately held startup company valued at over one billion dollars. A venture capitalist created the term in 2013, choosing the mythical animal to represent the rarity of such successful private ventures. The unicorns now want to access the public markets, as stock markets are rising but business activity is cooling. Consider that before a car rolls off an assembly line or a manufacturer assembles a refrigerator, the company must buy resins, pigments and other chemical inputs. The American Chemistry Council tracks these statistics with its Chemical Activity Barometer (CAB).<sup>2</sup> The year-over-year change in the CAB dropped sharply to -0.3% in March from 4.1% in March of last year. Unicorns see a resurgent stock market but slowing economic growth. Sensing that their window of opportunity is closing, the unicorns are getting restless.

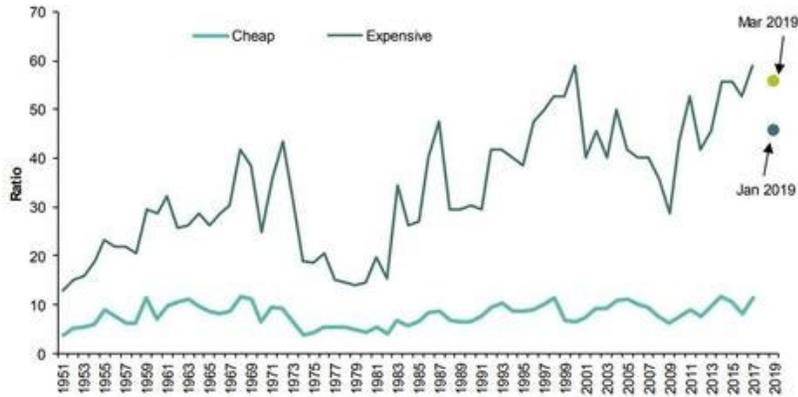
Lyft kicked off the unicorn parade on the last trading day of the first quarter in a highly anticipated initiated public offering. Lyft's IPO came before its better-funded rival, Uber Technologies, and leads the way for a procession of technology unicorns. Lyft's stock surge on its first day of trading valued the company at \$23 billion. Lyft's revenue in 2018 was \$2.2 billion but the company also lost \$911 million in 2018. IPO investors do not appear to be very particular about fundamentals and valuations. IPO investors just want to hear stories of rapid growth and remain more interested in accessing a much-hyped deal. With Lyft now public, Uber should not be too far behind, along with the ranks of other highly valued private companies such as Palantir Technologies, Slack Technologies and Airbnb. Uber has even named its IPO plans "Project Liberty," according to *The Wall Street Journal*, a reference to the thousands of employees and investors who have waited years to sell their full stake in the company for a profit. Not that we expect eager IPO investors to mind that Uber lost one billion dollars in the fourth quarter of 2018 and will not show any profit before its public debut in 2019. As the Wall Street adage goes, "When the ducks quack, feed them."

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<sup>2</sup> <https://www.americanchemistry.com/CAB-vs-Industrial-Production>

The market's infatuation with unicorn IPOs simply reinforces a trend where the markets bid up the lowest quality growth names while they punish value stocks. This discrepancy recently touched historic proportions. According to Inigo Fraser-Jenkins, the head of global quantitative equity strategy at AllianceBernstein, the valuation divergence between the cheapest and priciest companies has reached a rare level. According to Inigo Fraser-Jenkins, "Valuation spreads in the United States are close to all-time wide levels compared to the past seventy years... This provides a support for value within the market contrasted with traditional asset classes which are mostly fully valued." Value lagging both the broader market and growth stocks for the past decade is hardly news to the Charlie Brown value investor. With the world's central banks backstopping the capital markets, investors continue to dutifully seek companies that claim high growth.

EXHIBIT 15: Record valuation dispersion: All of the multiple expansion is in the most expensive part of the market



Source: Ken French Data Library with analysis by AllianceBernstein. The dots show the median trailing price-to-earnings ratio (P/E) of the expensive quintile of the MSCI US constituents.

Although losses come with the territory of investing, the anxiety that accompanies normal stock market turbulence is disproportionate to the level of volatility. A 10% drop in the S&P 500 Index reliably induces media hyperventilation. Stocks drop 20% and the media screams "bear market" even though a drop of 20% tells one nothing about where stock prices are going, only where they have been. When stocks rise 13.6% in a single quarter, as they did in the first quarter, the world is once again back to normal. When one invests in stocks, one must expect to occasionally lose money. In the United States, those losses have always been temporary—so far.

It's important to consider that once every generation the market drops by fifty percent. As a result, the preparation for financial volatility is psychological. To borrow a quote from Yogi Berra: "Ninety percent of the game is half mental." Investing is an operation that transfers wealth to those who have a process and can execute this process from those who do not maintain a process. The average investor's strategy consists of glee when prices rise and panic when they fall. Staying the course when the sky turns dark requires a disciplined approach to investing and being able to execute this disciplined process depends on one's frame of mind.

Back in the fourth quarter of last year we were hopeful that a value-based investment process would begin to yield outsized returns. We were wrong. The cheaper stocks, what one would consider as "value" stocks, fell less than the overall market. However, value's outperformance lasted little more than a week at the start of October. This year began once again with the pattern of growth outperforming value. As faithful believers in buying stocks cheaply, growth's continued outperformance remains a source of frustration. After a dozen poor years for value, should one accept Einstein's definition of insanity, surrender and join the herd buying into the glamour of Facebook, Amazon, Netflix and Google? Of course not.

Professor Kenneth French at Dartmouth's Tuck School defined value stocks as those with a low price-to-book ratio.<sup>3</sup> If so, a strategy of owning value stocks and selling short expensive stocks has lost money for the past twelve years. This hedged value strategy has lost as much once before, during the dotcom bubble, but never have value investors underperformed for so long. Indeed, the previous longest period of underperformance was in the latter half of the Great Depression, not necessarily a comforting thought. Even though value stocks have seldom been this cheap relative to the wider market, at least when measured on Professor French's price-to-book ratio, they are not particularly cheap on an absolute basis. At 2.3 times book value, the MSCI USA Value index stands at the same multiple as the overall market just before the Black Monday crash in 1987.

Back in 2007 value was coming off one of its best runs in history. From its underperformance prior to the dotcom implosion, value generated seven straight years of outperformance—the first time since the U.S. joined World War II. In contrast to cheaply-valued stocks, expensive stocks trade at a premium because of their growth potential – and investors have historically overpaid for this expected growth. Although the earnings of growth stocks do indeed grow faster than the overall market, this growth seldom justifies paying a rich price. However, the past decade has been different, as growth stocks have beaten earnings expectations. Trendy big companies such as Apple, Facebook and Google are obvious examples, but in every sector the strong companies have grown stronger.

The euphoria in owning stocks today is very different than the sort of euphoria at the peak of the technology mania in 2000. During the 90's investors made outlandish assumptions about the prospects for growth in corporate sales and earnings. Today investors assume that rich corporate profit margins and stock valuations are the new normal. Jesse Felder, publisher of *The Felder Report*, notes that investors using earnings-based valuation measures like the price-to-earnings ratio are assuming profit margins will maintain their current record highs indefinitely.<sup>4</sup> As Felder notes, "*This issue of profit margins is so critical because if earnings-based valuations were to simply return to their historical averages it would mean a substantial decline in prices.*" Felder provides a simple example: trailing earnings for the S&P 500 are currently \$130. If a 15x multiple (the long-term historical average) is applied to this estimate, one calculates a price of 1,950 for the index, or 32% below the index's current level. However, if profit margins fall from today's record 13.5% to the historical 8%, earnings would fall from \$130 to just \$78. Apply a 15x multiple on this estimate and fair value for the S&P 500 is now 1,170—60% below its current level.

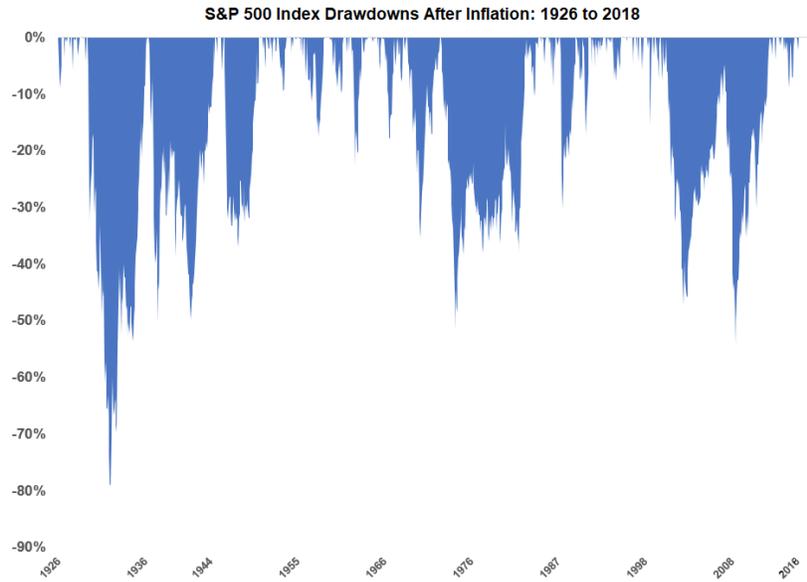
The risk all investors should most fear is the permanent loss of their investment capital, as long-term investors should care only about lasting price movements. Therefore, an investor should view the permanent loss of capital as a loss in value of one's investment capital that will not recover within the average time horizon one requires. Most investors operate under the assumption that wealth compounds continuously when in fact drawdowns, the peak-to-trough decline in price during a specific period for an investment, periodically interrupt the market. Drawdowns present a significant risk to investors when considering the change in price needed to overcome a drawdown. The 50% drawdown in the S&P 500 Index during the 2008 credit crises required a 100% increase to recover the prior price peak.

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<sup>3</sup> [http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data\\_library.html#Benchmarks](http://mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library.html#Benchmarks)

<sup>4</sup> Jesse Felder, "A Different Kind of Euphoria," *The Felder Report*, March 28, 2019

An investor can either view a generational drawdown as a cataclysmic event that permanently destroys their investment capital or a positive catalyst to deploy capital at extremely attractive valuations. To act, the investor needs only two things: cash and courage. Having only one is not enough. Courage is not just a matter of temperament but also a function of process. Our process is straightforward: we seek compelling values and, if we find little of interest, cash is the alternative. We remain humble and constantly reevaluate our investment thesis. In doing so, the result is a high degree of conviction when deploying capital.



One's psychology is critical to the investment process. If the investor loses confidence, has made too many mistakes, or is down too much, it becomes very easy to say, "I can't stand being down more than this." Therefore, by being conservative all the time—by being both a highly disciplined buyer and seller, one ensures a margin of safety in their investments and the right frame of mind to act. Avoiding short-term devastation enables survival for the long run. Charles Schulz noted that after he drew the final Peanuts strip, he realized to his sadness that Charlie Brown would never get to kick the football, although he also stated that having him succeed would be a disservice to the character. Fortunately, value investors will not suffer the same fate as Charlie Brown, but they will need the courage of their convictions to act when the time is appropriate.

With kind regards,

ST. JAMES INVESTMENT COMPANY

# ST. JAMES INVESTMENT COMPANY

We founded the 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 twenty 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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