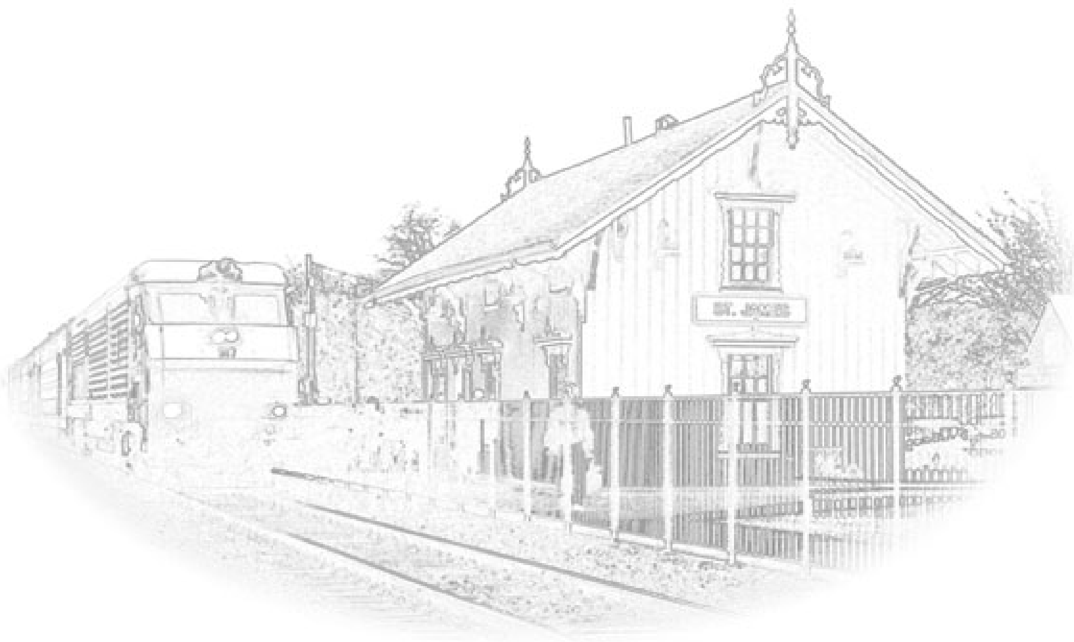

ST. JAMES INVESTMENT COMPANY

INDIVIDUAL PORTFOLIO MANAGEMENT

INVESTMENT ADVISER'S LETTER

OCTOBER 2020

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"We don't have to be smarter than the rest. We have to be more disciplined that the rest." -Warren Buffet

In 1910 a series of devastating forest fires swept through Idaho, Montana, and Washington, culminating on August 20–21 in what is known as the "Big Blowup." The first fire of the season broke out in the Blackfeet National Forest in northwestern Montana on April 29. Fires continued throughout the ensuing summer months and, by August, the region was experiencing drought conditions. On August 10 reports began coming into district headquarters in Missoula, Montana, that fires had broken out and were quickly spreading to the surrounding Clearwater, Lolo, Cabinet, Flathead, and Kaniksu National Forests. With supplies and manpower lacking and the number of fires growing, the Forest Service convinced President William Howard Taft to deploy troops to supplement the civilian firefighting force. As the fires spread to the Idaho panhandle and western Montana, as well as in Washington and Oregon, the federal government's resources reached their breaking point.[1]

On August 20 hurricane-force winds swept through the region and there was no longer any chance of containing the fire; one could only hope to avoid it. Trains raced to evacuate towns just ahead of the flames which now reached several hundred feet high. One forester described the scene:

> On the afternoon of that day a hurricane, strong enough in many localities to uproot whole hillsides of timber and force men out of their saddles, swept over the forests adjoining the Montana-Idaho state line. The gale continued for fully twenty-four hours and fanned every smoldering fire in its path into uncontrollable fury. The flames roared into the crowns of trees and spread through the adjoining timber… At many points, these fires jumped rivers a quarter or half a mile wide and, in several instances, leaped across canyons a mile or more in width, from ridge to ridge, leaving solid strips of green timber untouched. Cinders, ashes, and burning embers carried many miles. The nearest fire to Missoula, Montana, was about twelve miles, yet cinders as large as robins' eggs fell in the streets, and the clouds of smoke and ashes were so thick that the electric lights were lit at 3 o'clock in the afternoon.[2]

Official reports after the Big Blowup estimated that 1,736 total fires burned more than three million acres of private and federal land, consuming an estimated 7.5 billion board feet of timber. The fire killed at least eighty-five people and destroyed numerous small towns. Smoke from the fires reached New England and soot travelled all the way to Greenland.

Although the United States had established the U.S. Forest Service five years earlier, the Big Blowup profoundly influenced the agency's fire protection policy for the next century. Forest Service administrators emerged from the incident convinced that only total fire suppression could prevent such an event from occurring again, and that the Forest Service was the only department capable of carrying out that mission. This policy had two goals: preventing fires and suppressing a fire as quickly as possible once one started. To prevent fires, the Forest Service came out in opposition to the practice of light burning, even though many ranchers, farmers, and timbermen believed it improved land conditions. Forest Service leaders argued that all fires were bad because they destroyed standing timber. Educating the public about the need for fire prevention became an important part of this goal and in 1944, the Forest Service introduced Smokey Bear to help deliver its fire prevention message.

[1] "The 1910 Fires," Forest History Society, https://foresthistory.org/.

[2] P.A. Silcox, "How the Fires Were Fought," American Forestry, vol. 16, (November 1910): 631-639.

During the 1960s, scientific research increasingly demonstrated the positive role fire played in forest ecology. Some researchers, as well as some timber companies and private citizens, understood that fire was a natural state in many ecosystems. Fire would periodically clean out the understory and dead plant matter, allowing economically important tree species to grow with less competition for nutrients. Scientists believe that between 4.4 million and 11.8 million acres burned each year in prehistoric California.[3] Native Americans would often burn woodlands to reduce overgrowth and increase grasslands for large prey animals such as bison and elk. As early as 1528, Spanish explorers noted that in the area that is now Texas, "The Indians of the interior go with brands in the hand, firing the plains and forests within their reach...".[4] This new research led to a radical change in Forest Service policy in the early 1970s—to let fires burn when and where appropriate. From this policy evolved prescribed burns based on the idea that, historically, forests burned often. These fires cleaned up the forest floor, so when new fires appeared, they burned cooler, smaller, and caused less damage.

The devastation caused by forest fires often yields healthy change, just as economies must undergo similar transformations. Joseph Schumpeter popularized the expression "creative destruction" in his book Capitalism, Socialism and Democracy, first published in 1942. Schumpeter believed that technological innovation drove sometimes painful yet positive evolution. He described the disruptive process of transformation that accompanies such innovation. "*Capitalism is by nature a form or method of economic change and not only never is but never can be stationary. The fundamental impulse that sets and keeps the capitalist engine in motion comes from the new consumers' goods, the new methods of production or transportation, the new markets, the new forms of industrial organization that capitalist enterprise creates*." In Schumpeter's vision of capitalism, innovative entry by entrepreneurs was the disruptive force that sustained economic growth, even as it destroyed the value of established companies and laborers that enjoyed some degree of monopoly power. Schumpeter understood that the very nature of capitalism requires the turmoil of creative destruction.

While government bureaucracies can impede the creative destruction process within forests, so too can bureaucracies within the private sector impede the creative destruction of capitalism. Recently a gentleman applied for a loan to remodel his house, believing it sensical to borrow money at negative real interest rates.[5] This individual had money in the bank and maintained an investment portfolio and other savings at the same institution. However, the bank denied the loan request on the basis that he had a blemish on his credit report. The blemish was in fact a mistake made by the telephone company which incorrectly reported an unpaid bill of $85. The telephone company acknowledged the mistake and apologized. However, the company said that legally they could not undo the damage to this gentleman's credit score—the law requires that the mark remain on his credit report for two years. The bank refused to reconsider their loan decision and the telephone company will not correct their mistake. Although a small (yet all too common) example, this frustration evidences the bureaucracy within large, near-monopolistic companies, stifling innovation and market disruption. In a pure capitalistic market, these companies typically fail, yet today they continue to exist and even thrive.

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[3] Weil, Elizabeth. "They Know How to Prevent Megafires." ProPublica. August 28, 2020.

[4] MacCleery, Doug. "The Role of American Indians in Shaping the Landscape." Forest History Society. November 2, 2004.

[5] Blain, Bill. "New Reality Part 2." The Morning Porridge. September 11, 2020.

The policy of interest rate suppression by the U.S. Federal Reserve not only continues to sustain many companies with poor business models, but it has also produced an army of zombie companies. A decade of low interest rates sustains a rising number of companies which continue to borrow cheaply yet generate insufficient profits to service the interest expense needed to pay their lenders. In response to the pandemic, massive market intervention from the U.S. Federal Reserve lowered corporate borrowing costs to historic lows this summer. This drop in interest rates facilitated unprecedented debt issuance from companies desperate for cash to outlast the virus's economic impact. The Leuthold Group calculates that fifteen percent of companies in its index are zombies. Should access to the capital markets suddenly cease, zombies will no longer be able to refinance or pay down their debt. Zombies have been more numerous only once before—just after the technology dotcom bubble burst in September 2000.

*Companies where profits are less than the interest paid on their debts for at least 3 years / Data based on the Leuthold 3000 Universe (Russell 3000 equivalent)
Source: The Leuthold Group
© FT

The growth in the number of zombie companies comes at a cost to the economy by holding back productivity and growth. But it is not just zombie companies benefiting from interest rate suppression, but rather almost all companies. Suppressed bond yields misdirect investment and turn savers into speculators by stimulating greater risk taking. The Financial Times reported that investment grade bond issuance reached a record $210 billion in August, bringing the year-to-date total to $1.5 trillion. According to Bank of America, year-to-date bond issuance exceeds the prior full-year high water mark of $1.3 trillion set in 2017. Outstanding U.S. corporate debt with a maturity of 2035 or later now exceeds $2 trillion, a record figure. Normally, investors avoid riskier assets in a recession and migrate towards safer assets. That is no longer evident today—interest rate suppression is distorting the market's price signals and obscuring deteriorating corporate fundamentals.

Hyman Minsky, a professor of economics at Washington University, distinguished between three models of financing. The first model is hedge financing, or when households and companies rely on future cash flows to repay debt. Hedge financing works well if there is a manageable debt load and a steady income. The second financing strategy, speculative financing, is riskier. Households and companies rely on cash flow to repay interest but must roll over their principal debt into new loans. Minsky's third type of financing, called Ponzi financing, is the most dangerous. Cash flow covers neither principal nor interest—this is the zombie company's means of financing. These companies hope that the value of their assets will appreciate by enough to cover their liabilities.

Economies with strong cash flows and low debt levels are stable. By contrast, economies based on speculative Ponzi financing are vulnerable to sudden collapses. Years of interest rate suppression leave the U.S. economy extremely vulnerable. If asset values start to fall, overindebted households and companies must liquidate their positions. This burst of selling further undermines asset values, making things worse. Events spiral out of control, leading to a *Minsky* moment. The way to avoid Minsky moments is to operate with sustainable financing. But when the economy is buzzing, and interest rates are low, the temptation to take on debt is irresistible. Debt levels grow to speculative and Ponzi levels. Boom becomes bust. Minsky's conclusion was that economic stability breeds instability, as periods of prosperity create financial fragility. Everything is fine until it is not.

Modern-day philosopher Charles Smith notes that post Covid-19 everyone talks about the 'new normal,' as if there is a guarantee that life will return to normal.[6] But the 'new normal' is denormalization, which he defines as everything that was normal is gone and will not be replaced with some new normal. Denormalization is the complete dismantling of what we once accepted as normal and the loss of any future version of normal. Smith uses professional sports as an example of denormalization. The old normal involves enormous television advertisement contracts which produce expensive player contracts and professional franchises worth billions of dollars while ignoring the steady erosion in attendance at live games and in viewing audiences. Younger generations exhibit less interest in Boomer generation sports' habits and would rather watch a highlight video on their phones. Many fail to notice that the 'old normal' has become an expensive habit. Advertisers will eventually catch on that younger generations never acquired the same habit of worshipping sports.

Denormalization may eventually dismantle restaurants, air travel, cruise lines, movie theaters, healthcare, higher education, local government services and many other iterations of normal that have become unaffordable. The 'old normal' systems cannot restabilize at some modestly lower level of diminishing returns. None of these systems can operate at anything less than about 80% of full capacity and customers paying full retail price. Companies with high fixed cost structures and thin profit margins face extinction. By stark contrast, there has never been a better time to live at the top of the public company food chain in this age of denormalization, as evidenced by the performance of Microsoft, Apple, Amazon.com, Facebook and Alphabet. This small group of stocks now constitute 23% of the S&P 500's index weighting according to investment bank Goldman Sachs.

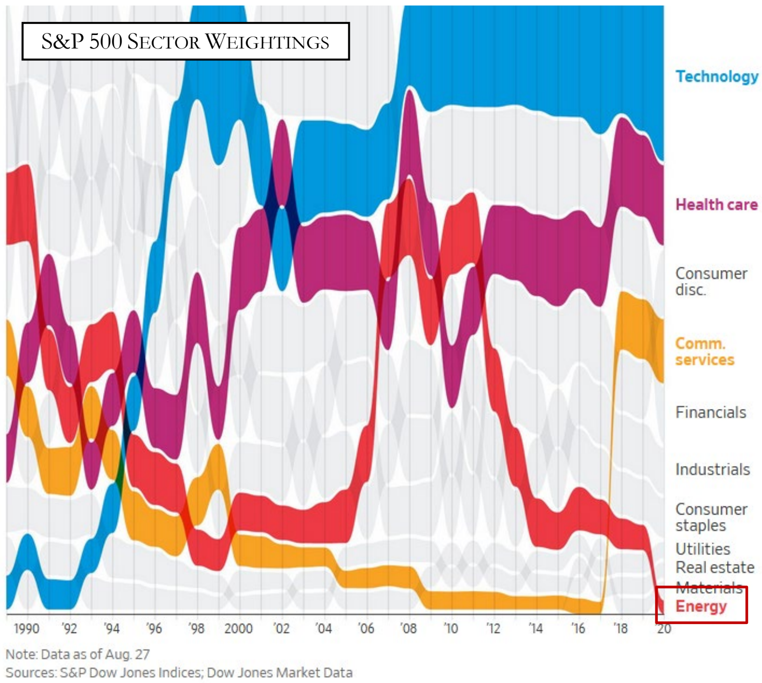
The valuation of the overall market sits at extreme levels, yet investors remain complacent. The S&P 500 Index, on a trailing basis, trades at a 27.4x price-to-earnings multiple—only 0.4% of the time in the past seventy years has the multiple been so expensive, according to David Rosenberg of Rosenberg Research. There is no margin of safety at the top of the market at these valuation levels. History repeatedly demonstrates that these elevated levels leave the market exposed to trouble. In the early 1970s, it was the 'nifty-fifty' must-own concept stocks. Everyone had to own a Polaroid camera back then, just as everyone must own the latest iPhone today. Five months after the pandemic, lockdown-induced market plunge, markets are back to all-time highs with speculation rampant in the very same areas prior to the market's spring plunge.

A handful of mega-capitalization sized stocks now dominate the stock market. Value investors study fundamentals, but the current stock market is a study of liquidity and passive indexed investing money flows. This small group of mega-capitalization sized stocks carry valuations not premised on past, or current performance but on extrapolations and assumptions for revenue and profit streams that may or may not matriculate at some distant point in the future. As Tesla has a market capitalization bigger than the rest of the auto industry, and Amazon commands more than 40% of the entire valuation of the consumer discretionary sector, the prudent investor takes pause. But the passive index fund never pauses-it buys and sells at the current price regardless of valuations. If money continues to flow into

[6] Smith, Charles Hughes. "The "New Normal" Is De-Normalization." Of Two Minds.com. August 13, 2020.

index funds, then these funds remain compelled to buy this very concentrated group of mega-capitalization sized stocks to mirror the index at whatever price the market offers.

In stark contrast to the must own technology behemoths, the Dow Jones index committee recently announced plans to remove energy company Exxon Mobil, the index's longest-serving member. The index is replacing Exxon with three companies with a heavier technology focus. One wonders if energy's current sector weighting of 2.3% in the S&P 500 Index compared with 12.1% ten years ago marks low tide for those who seek companies that operate tangible assets. Investors continue to allocate funds to those companies that they think will benefit from the accelerated digital shift brought about by the pandemic, while selling 'old normal' sectors such as energy.



The divergence between the 'old normal' and a handful of technology super companies grows starker. Nearly two-thirds of the companies in the S&P 500 are underperforming the index this year, while half of the companies in the market are still down 20% (Value Line Geometric Index). At more than $6 trillion, the market capitalization of Apple, Amazon, Microsoft, and Google is greater than the economic output of every country in the world except for the United States and China. This shift has been so pervasive that the five largest stocks in the S&P 500 have a combined market capitalization that equals the smallest 389 stocks in the index.[7] Markets can remain irrational longer than most can remain solvent, but investors should avoid the fear-of-missing-out (FOMO) by chasing the unbridled momentum in a handful of technology companies. A well-conceived investment strategy is critical to controlling one's emotions, because even the best investors can succumb to FOMO. Famed hedge fund trader Stanley Druckenmiller recounted how he succumbed to the technology dotcom bubble:

> "So, I'll never forget it. January of 2000, I go into Soros's office and I say I'm selling all the tech stocks, selling everything. This is crazy at 104 times earnings. This is nuts. Just kind of as I explained earlier, we're going to step aside, wait for the next fat pitch. I didn't fire the two gun slingers. They didn't have enough money to really hurt the fund, but they started making 3 percent a day and I'm out. It is driving me nuts. I mean their little account is like up 50 percent on the year. I think Quantum was up seven. It's just sitting there... So, like around March I could feel it coming. I just – I had to play. I couldn't help myself. And three times during the same week I pick up a phone – don't do it. Don't do it. Anyway, I pick up the phone finally. think I missed the top by an hour. I bought $6 billion worth of tech stocks... and in six weeks I had left Soros and I had lost $3 billion in that one play."

When asked what he learned from the experience, Druckenmiller was adamant that he learned nothing. He already knew that he should not have made those purchases, but he just could not help himself. If

[7] Pelletier, Martin. "The Dow Booting Exxon." Financial Post. September 1, 2020.

he learned anything, he learned not to do it again. But he already knew that. A prudent investor should know better. Unfortunately, investors today have no way of knowing when value investing will outperform. What has worked in the past is not predictive of what will work in the future. Historically, value investing referred to the practice of purchasing stocks at a price that is low relative to some fundamental measure such as earnings. By comparison, the term 'growth investing' typically involves purchasing stocks at relatively high ratios of earnings or revenue based on the expectation that the company's future growth potential would compensate for that starting rich valuation.

Over the past one hundred years, including the last decade, value investing has outperformed growth by over 3% annualized.[8] Value investing traditionally outperforms growth for several reasons. Investors tend to extrapolate recent company-specific problems into the future disproportionately to what a rational analysis of fundamentals would warrant. Institutional investors also exhibit a tendency to sell or avoid companies that are out of favor—too much career risk. Additionally, uncovering undervalued stocks can at times require significant manual effort—it is far easier to buy a company like Tesla and accept the popular growth narrative spun by Wall Street. Lastly, most investors are impatient, as few are willing to sit years with an investment. They want to see validation in their decisions sooner rather than later. Short-term investors therefore shift their attention to companies where the current fundamental trends are positive. Value investing, by its very nature, fully expects multi-year periods where it performs poorly, thus pushing away all but a few investors with a long time horizon.

The result has traditionally been that inexpensive stocks tend to outperform over long periods of time because their low starting valuation offsets their unexciting near-term prospects. Growth's current outperformance of value is now at unprecedented levels, as an extended period of interest rate suppression has turned savers into speculators. Zombie companies continue to access the capital markets, while denormalization accelerates the concentration of speculation into a small group of dominant technology companies. Furthering these conditions, monetary and fiscal policy makers remain terrified of the creative destructive nature of capitalism. A permanent policy of suppression thwarts the movement away from risky assets and towards safe assets.

Extended periods of prosperity create financial fragility—everything is fine until it is not. One can never anticipate the next 'Big Blowup' nor should one try to do so. One should simply manage their investments in a prudent manner that incorporates a range of outcomes, including the consequences of investing in an environment that has suppressed true price discovery for multiple years. Navigating such an environment simply means that "*We don't have to be smarter than the rest. We have to be more disciplined that the rest*." We remain adamant that a disciplined value investment strategy provides the most effective means to manage risk in the current environment and prosper over time.

With kind regards,

St. James Investment Company

[8] Michael Lebowitz and Jack Scott. "The Future Promise of Value Versus the Allure of Growth." Real Investment Advice. September 2020.

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.