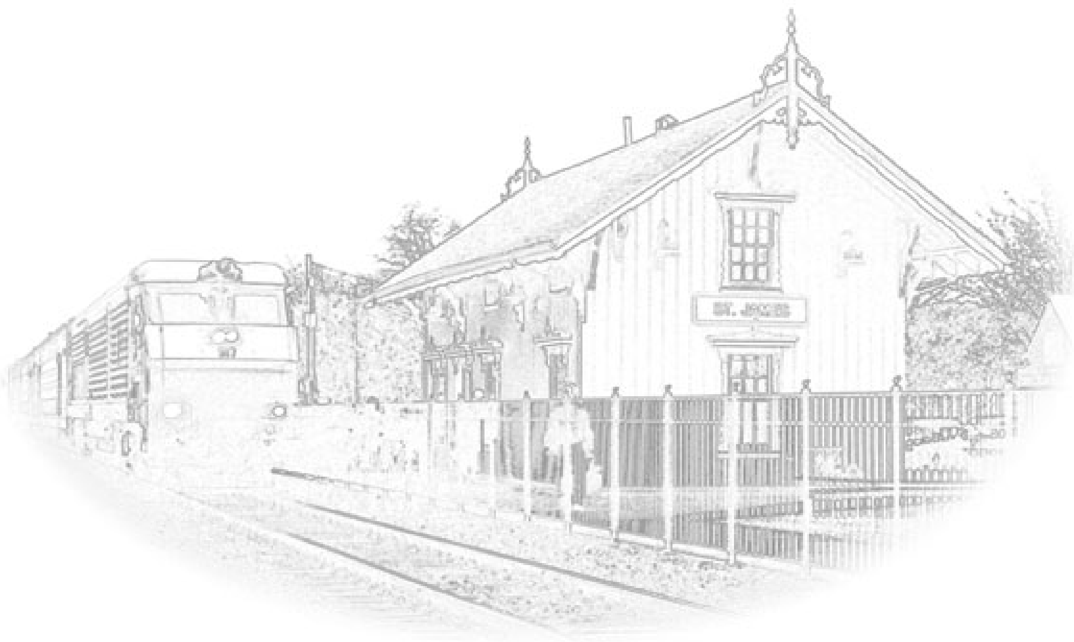

ST. JAMES INVESTMENT COMPANY

INDIVIDUAL PORTFOLIO MANAGEMENT

INVESTMENT ADVISER'S LETTER

JANUARY 2021

WWW.STJIC.COM
3838 OAK LAWN AVENUE, SUITE 1414
DALLAS, TEXAS 75219

"Where ignorance is bliss, Tis folly to be wise." – Thomas Gray

The notion that our 21st-century world is one of accelerating advances is so dominant, it seems pointless to challenge the notion of dramatic innovation. Twenty-five years-ago the internet was an oddity. Now we cannot imagine life without it. Almost every week one reads about potential breakthroughs for cancer patients, talk of space tourism and jets that can fly around the world in a few hours.

According to Michael Hanlon, a science journalist, today's unparalleled dream of innovation is hype, as most of the world's greatest technological achievements took place between 1945 and 1971.[1] Fifty years-ago hype matched reality. Most of what has happened since has been merely incremental improvements upon the foundation of the true age of innovation. Just about everything that defines the modern world arose during this era: Electronics. Computers and the birth of the internet. Nuclear power. Television. Antibiotics. Space travel. The Green Revolution in agriculture. Popular music. Mass aviation. Cheap, reliable, and safe automobiles. High-speed trains. This was truly a unique period, spanning less than a single human generation, when innovation dominated.

Today, progress is defined almost entirely by consumer-driven, often commonplace improvements in information technology. Economist Tyler Cowen, in his essay *The Great Stagnation*, argues that a technological plateau has been reached. True, our mobile handheld phones are great, but that differs from the extraordinary novelty of flying across the Atlantic in eight hours or eliminating smallpox. As technologist Peter Thiel once said, "*We wanted flying cars, we got 140 characters*." Theil's comment about Twitter's technological impact resonates with Charlie Munger, the 96-year-old right-hand man to Warren Buffett and Berkshire Hathaway's vice-chairman. Munger spoke about a "frenzy" in technology stocks during a recent interview conducted by the California Institute of Technology. "*Nobody knows when bubbles are going to blow up. But just because it's Nasdaq doesn't mean it'll have another run like this one very quickly again. This has been unbelievable. There's never been anything quite like it*."

Although today's investment craze revolves around the FAANG stocks and related companies, one should recall Schlumberger's incredible odyssey from 1962 to 1980 as told by Goehring & Rozencwajg in their natural resource market commentary.[2] From its initial public offering on the NYSE in 1962 to its peak in 1980, Schlumberger appreciated fifty-fold. Schlumberger was the only member of the 'nifty fifty' growth stock craze of the late 1960s and early 1970s to emerge untouched by the 1974-1975 bear market. Unlike its peers, Schlumberger surfaced from the carnage with a stock price five times higher. By the end of the 1970s, Schlumberger's revenue and earning's growth were accelerating. An investor who bought the stock in 1971 compounded money at 37% over the next nine years, while the Dow Jones Industrial Average produced a compounded annual return of only 3%. By 1980 Schlumberger's market capitalization of $25 billion in 1980 placed it only behind AT&T, IBM, and Exxon, each worth approximately $40 billion.

Schlumberger provided the most advanced exploration, drilling, and production services to the rapidly expanding global oil and gas industry. Oil prices began the 1970s at $3.50 per barrel but by 1980 had rallied more than ten-fold to surpass $35. Oil and gas producers found themselves drowning in cash that needed to be reinvested, while investors believed the world's oil supply faced continued

[1] Michael Hanlon, "The Golden Quarter," Aeon, December 3, 2014.

[2] https://blog.gorozen.com/blog/the-40-year-odyssey-of-schlumberger

disruptions and production disappointments. Prices were high and were expected to move much higher. Energy company budgets exploded in response to ever-rising oil prices and this explosion in upstream capital spending directly lifted Schlumberger's revenue and profits. Between 1970 and 1980, Schlumberger compounded its revenues by 28% per annum while its earnings grew by 36% annually.

Given its popularity, Schlumberger traded at an expensive valuation. At its peak in late 1980, the market priced Schlumberger at twenty-five times its earnings and nearly eight times its book value, while its enterprise value was five times greater than its sales. Although these multiples seem quaint by today's standards, it is important to appreciate how cheap the rest of the market was in 1980. With the Dow Jones Industrial average at 900, the market traded right at book value and only seven times its earnings with a dividend yield over 6%. Today, the market trades at over four times its book value and over thirty times earnings while yielding just 1.7%. Schlumberger was the fourth largest company in 1980 with a market capitalization of $25 billion. The fourth largest company today is Google, with a market capitalization of $1 trillion – forty times larger than Schlumberger in 1980.

Schlumberger is a study of how an investment becomes universally accepted, the "must own" stock, when valuations become radically stretched. Imperceptibly, unexpected shifts in the economic and business landscape emerge. The universally accepted investment belief is gradually, then completely, undermined and a stock's price and valuation may eventually collapse. The economic and financial backdrop in 1980 could not be more different from today. Inflation was a problem, commodities were in short supply, oil was running out, and precious metals were by far the most popular asset class. Well-known business magazines were calling for the death of equities, arguing financial assets would never again offer strong returns. Stocks and bonds were extremely unpopular asset classes.

The only exceptions were those companies that possessed pricing power from the underlying inflation—commodity stocks. Of the ten largest companies by market capitalization in 1980, six were oil stocks. In total, one third of the S&P 500's market value was energy related and Schlumberger was the most popular company of the energy group. Just when investors became universally convinced that oil prices could only move higher, exactly the opposite happened. The bull market of the 1970s spurred a massive upstream investment boom and supply subsequently surged. Instead of running out of oil, the world developed the largest new oil fields in a generation. Oil prices peaked in the first quarter of 1981 before entering a crushing bear market that would last twenty years.

Today's investment landscape represents the mirror image of what occurred forty years ago. Stocks and bonds are both extremely popular asset classes. Bonds are so in favor that $18 trillion of sovereign debt trades with negative yields – a first in 4,000 years of financial history. Instead of worrying about inflation, most investors see only deflation. When interest rates peaked in the summer of 1980, U.S. Treasury bonds were priced to yield 16% and energy stocks made up one third of the S&P 500 – both record highs. Today, U.S. Treasury bonds yield 0.91% and energy stocks account for only 2.5% of the S&P 500 – both record lows. The investment landscape has completely flipped in forty years. This holds true for inflation expectations, bond yields, energy prices, commodity stock valuations, and stock market prices. Four technology companies today each carry a market capitalization greater than $1 trillion and government bonds commonly trade with negative yields. One could argue that both stocks and bonds have never been more popular.

Few investors saw the market's seismic shift in 1980, and few will see today's seismic shifts that are currently nothing more than imperceptible tremors. When the prevailing wisdom pushes stocks like Amazon to twenty times book value and over one hundred times earnings, investors have collectively forgotten the fundamental events that undid Schlumberger's success four decades ago. Back in 1980, market participants could not possibly envision that Schlumberger would ever trade below its 1980 price in the years to come; however, forty years later Schlumberger does indeed trade at a lower price. The FAANG stocks today may be no different than Schlumberger in 1980. History could be ready to repeat itself, but few investors expect the change.

An additional concern for investors today is the reduced role government bonds serve in a balanced portfolio. Government bonds typically provide two basic functions for investment portfolios: bonds generate income and provide a hedge in the event of an exogenous event. Historically, government bonds provided higher income than stocks and generated positive capital gains at those times when risky assets fell. Over the last ten years these bond characteristics have diminished, as income from U.S. Treasury Notes roughly equals stock dividend yields. In the rest of the developed world, government bond yields have fallen well below stock dividend yields.

While the income side of the equation for bonds is clearly not what it once was, one can continue to assume that bonds will accomplish their other important tasks, such as providing capital gains in the event of an economic disaster. During the early stages of the Covid-19 crisis, U.S. Treasuries once again hedged a balanced portfolio, providing positive returns while riskier assets fell. Unfortunately, at today's yields, U.S. Treasuries not only fail to provide a useful amount of income to investors but also have lost most of their ability to hedge in the event of further economic trouble. GMO, an asset management firm, documented how fixed income helped investors weather the storm in five of the last six major drawdowns (see chart on next page). The average bond return was +10.9% while stocks dropped by 34.2%. For an investor allocated 60% to stocks and 40% to U.S. Treasury bonds, that balanced portfolio provided a level of comfort. In the next stock market drawdown bonds will likely provide minimal downside protection.

A paper published in May by Two Centuries Investments analyzed performance data back to 1825, finding that the value factor, defined as owning cheaply valued companies and short richly valued companies, tumbled 59% from its most recent peak through March—the worst drawdown on record.[3] While value's drought is spurring bouts of capitulation, growth-focused managers flourish, largely thanks to a handful of technology-focused mega-capitalization stocks which have ascended to an historic share of the indices. Bloomberg recently reported that, among 200 equity funds benchmarked to the S&P 500, those with at least 20% of assets allocated to Facebook, Amazon, Apple, Microsoft, and Alphabet have generated an average 17% year-to-date return, far surpassing the 2.6% advance for funds which have less than 10% invested in that quintet. For investment managers with 0% exposure to this small number of select technology stocks, the struggle has been long and frustrating.

Bear Market	*Start*	*End*	*MSCI World Return*	*Yield Change for 10-Year U.S. Treasury Note*	*Capital Gain/Loss of 10-Year U.S. Treasury Note*[4]
First Gulf War	7/16/90	9/28/90	-21.3%	0.4%	-2.4%
LTCM	7/20/98	10/5/98	-20.3%	-1.3%	10.7%
TMT	3/27/00	10/9/02	-49.8%	-2.6%	21.9%
GFC	10/31/07	3/9/09	-57.8%	-1.6%	13.6%
Euro Crisis	5/2/11	10/4/11	-22.0%	-1.5%	13.7%
Covid-19 Crisis	2/19/20	3/23/20	-34.0%	-0.8%	7.8%
		Average	-34.2%	-1.2%	10.9%

Source: Datastream, MSCI, GMO

The gains enjoyed by the high-growth technology sector has pushed valuations to extremes—the Nasdaq 100 Index currently trades at five times enterprise value to projected full-year revenues, up from less than three times enterprise value-to-sales in 2016. Over this four-year period, the broader based S&P 500 Index's enterprise value-to-sales ratio rose from a multiple of two to three times sales. According to Research Affiliates, the valuation spread between growth and value is wider than it was at the peak of the technology bubble. Not that valuations evidently matter—a portfolio manager at Fidelity summed up the market's mindset: "*Valuation, I find, is a useless tool. If you base your investment decisions on valuation, you are never going to make money*." But markets can turn on a dime; value lagged growth by 4,000 basis points over the fourteen years through 2000, before erasing this gap in only thirteen months.

Back in June, value investing legend Jeremy Grantham reduced his exposure to U.S. stocks to a net short position for his $7.5 billion portfolio. Grantham explained his thoughts: "W*e have never lived in a period where the future was so uncertain*" and yet "*the market is 10% below its previous high in January when, superficially at least, everything seemed fine in economics and finance. And if not "fine," well, good enough. The future paths include many that could change corporate profitability, growth, and many aspects of capitalism, society, and the global political scene*." In short, the veteran value investor known for calling several of the biggest market turns in recent decades admitted he had lost his faith for an optimistic outcome in a world of record uncertainty "*which in some ways seems the highest in my experience*" and as a result "*in terms of risk and return – particularly of the worst possible outcomes compared to the best – the current market seems lost in one-sided optimism when prudence and patience seem much more appropriate*." Grantham highlighted that the market and the economy have never been more disconnected: "T*he current P/E on the U.S. market is in the top 10% of its history... the U.S. economy in contrast is in its worst 10%, perhaps even the worst 1%.... This is apparently one of the most impressive mismatches in history*."

In a world where many institutional clients demand immediate returns, Grantham's dramatic underperformance has led to a tsunami of redemption requests. In the past ten months GMO clients

[3] Mikhail Samonov, "Value Crashes: Deep History," Quantitative Investing, May 4, 2020.

have pulled $2.2 billion from the fund with assets down by more than half since 2015, to $6.6 billion. GMO management noted that "*The cruel logic of being a value manager is that at the very time when your opportunities are at their best, your credibility with clients is at its lowest ebb*." Unfortunately, a few more quarters of billion-dollar redemptions and the value-focused fund will no longer have capital to allocate to its convictions—a terminal state which has befallen so many other experienced value investors.

Rather than step back from the market's exuberance, investors are increasing their appetite for risk by chasing a group of leveraged exchange-traded funds, which pulled in a record amount of funds in 2020, according to Morningstar. The funds use leverage to double or triple daily returns. The $8.6 billion ProShares UltraPro QQQ ETF, the biggest leveraged ETF by assets, triples the daily return of an index that tracks the top 100 Nasdaq stocks and has doubled in value over the past six months. "*If you're bullish about the S&P 500, then all the more reason you should be bullish about a leveraged S&P 500 fund*," said John Rossi, a 69-year-old retiree who says he favors triple-leveraged funds, saying the products have been reliable contributors to his portfolio's performance.[4] When the allure of leveraged ETFs is so great that retirees use them, one suspects that the stock market's run is getting long in the tooth.

Adding fuel to the market's exuberance, business intelligence software provider MicroStrategy announced in early December that it will issue $400 million worth of convertible senior notes for open market bitcoin purchases. "*Our investment in bitcoin is part of our new capital allocation strategy, which seeks to maximize long-term value for our shareholders*," CEO Michael Saylor explained in a press release. The company announced in August that it purchased $250 million worth of the bitcoin cryptocurrency, then another $175 million worth of bitcoin a month later. MicroStrategy shareholders have certainly enjoyed the company's new strategy—the stock has rallied 150% rally since August, leaving the stock at twenty-year highs and memories of the Y2K era when company shares rose 3,000% from May 1999 to March 2000, before collapsing 95% over the next two months to erase nearly all those gains. Enjoying the market's current kindness, MicroStrategy corporate insiders have decided to not wait around and see if their 'new capital allocation strategy' is successful—they sold 220,000 shares on the open market.

Tesla's recent inclusion in the S&P 500 Index is another indication that the stock market's run is reaching a crescendo. With a market capitalization of $630 billion the day it joined the index, Tesla generates profits from tax credits rather than selling cars. The 'story' behind the company remains a mystery to most value investors, other than the effects of liquidity and speculation. Tesla's inclusion in the S&P 500 made an incredibly concentrated market even more concentrated--$12 trillion of passive equity funds made room for the company's stock on December 21. Because of the company's size, 1.35% of the S&P 500, every ETF that indexes the S&P 500 purchased the stock. Upward pressure continued through December, until every index ETF purchased shares of TSLA stock. With Tesla's inclusion in the S&P 500 completed, the top six stocks in the stock market now equal in size the 388 smallest holdings in the index.[5] This is the challenging market environment where the intelligent investor must now operate.

The one investing reality that never changes is that a higher-priced asset will produce a lower return than the same asset at a lower price. As a security is a claim on a set of future cash flows that investors expect to receive over time, the higher the price an investor pays today for that amount of cash in the future, the lower the long-term return. By contrast, investor psychology – particularly the inclination either towards speculation or risk-aversion, drive short-term return prospects. The price one pays for having this market go ever higher is a lower return from today's peak valuations.

---

[4] Michael Wursthorn, "Investors Pile into Risky ETFs During Wild Market Rally," WSJ.com, November 29, 2020.

[5] https://www.liberatedstocktrader.com/sp-500-companies/

Investing is about putting money to work today in the hopes that it will be worth more in the future—simple in theory but difficult in practice. Many investors concentrate too closely on near-term results; they want to earn a profit immediately without giving enough consideration to risk and the long-term prospects of a business. Understanding this concept is not easy, but fund manager and academic Joel Greenblatt has a simple description he uses when teaching his Special Situation Investing Class at Columbia University Business School. Greenblatt tells his students the story about how he explained to his son what he did for a living. Jason, a student in his son's sixth grade class, sells gum. He buys several packages of chewing gum for twenty-five cents each, and he sells each stick of gum at school for twenty-five cents, earning a dollar profit on each pack. With six years left before he finishes high school, Jason expects to earn $3,000 in profits before graduation day. If someone wanted to invest in Jason's company, how would they value the business?

What would an investor pay for half of Jason's gum business? Not $1,500--a price would merely return one's money over six years with no gain. But why would Jason accept less since he can earn that amount from not selling half his business? There is no simple answer to how much Jason's chewing gum business is worth; it depends on the investor. In today's stock market, if Jason announced gum delivery by drone as well as a 'new capital allocation strategy' involving bitcoin, perhaps he could sell fifty percent of his company for $6,000. By contrast, the value investor may see $750 as suitable price to pay for fifty percent of Jason's gum business and double his investment over six years. However, a prudent investor wishing to maintain a margin of safety may only offer $600 for one half of Jason's business.

Charlie Munger once said, "*It is remarkable how much long-term advantage people like us have gotten by trying to be consistently not stupid instead of trying to be very intelligent*." Paying $6,000 for fifty percent of Jason's gum business would be a mistake. Rational investors who want to minimize 'stupid' mistakes understand that the higher the price an investor pays today for an amount of cash in the future, the lower the long-term return the investor can expect on an investment.

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 over 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.