"Bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria."
—Sir John Templeton

Fear is a critical factor in how individuals behave and how ecosystems function. Liana Zanette, a researcher at Western University in Canada, studied the behavior and diet of coastal raccoons in an experiment in which the sounds of barking dogs reintroduced the fear of predators back into their habitat. In short, scared prey eat less. Behaviorally, animals immediately change their activity and attend to the potential threat, a response that comes at the expense of other activities such as feeding.

Zanette conducted her study in the Gulf Islands of Vancouver, an ideal location as raccoons share the west side of Vancouver Island with cougars, bears, and wolves. These apex predators have a taste preference for raccoons, a major prey item. By contrast, on the east side in the Gulf Islands, humans exterminated all three predators a century ago. In their place raccoons ascended to the ecological apex and the only animal these island-based raccoons fear now is the domestic dog. In the absence of threats Gulf Island raccoons have radically changed their habits. Usually nocturnal, these raccoons have become bold daytime hunters. “They like to eat songbirds,” explains Zanette, but they also like to feast from the intertidal zone, “and you’ll see them kilometers out, where there are no trees and no places to hide,” she adds. As a result, Gulf Island raccoons have been decimating bird populations and devouring everything from worms to crabs and snails.

Zanette decided to see what would happen to raccoon behavior if she restored the element of fear. The research team broadcast dog barks from some beaches and the benign sounds of barking seals from other beaches. They discovered that on barking-dog beaches raccoons spent less time eating seafood and more energy on vigilance. Notably, this fear-based behavior carries across other ecosystems as well. Elk numbers were high when biologists restored wolves to Yellowstone National Park in 1995. The plentiful elk provided an abundance of food that allowed the wolf population to grow rapidly. As wolf numbers grew elk numbers declined. Eventually, the elk in Yellowstone changed their habits to now feed in safer areas, where wolf ambushes are less likely.

Ongoing central bank policies of quantitative easing, coupled with historically low-interest rates and the market’s obsession with passive index investing, have apparently removed the fear of loss for most market participants. Research firm Lohman Econometrics documents how

financial assets respond when central banks remove fear from the market—assets levitate higher with little or no downside volatility.

Although the first quarter’s economic numbers show that U.S. corporate after-tax profits of $1.9 trillion are no higher today than they were at the end of 2018, the S&P 500 Index is up more than 60%. The market is dramatically overvalued. David Rosenberg of Rosenberg Research notes that the ratio of corporate after-tax profits to corporate equity value now exceeds a multiple of fourteen for just the second time in history...only surpassed by the technology bubble in 2000. These distortions may continue, but investors should understand that this is an environment without a healthy balance of fear.

There is a striking resemblance between the speculative boom-to-bust of late 1999 to what has happened over the past year in the trendy areas of clean energy, electric cars, cannabis stocks, meme stocks, special-purpose acquisition companies (SPACs) and bitcoin. This price action reminds one of MicroStrategy, a business intelligence software provider that has reinvented itself as a bitcoin speculation vehicle. During the 2000 technology bubble, MicroStrategy shares rose 3,000% over ten months through March 2000, before collapsing 94% over the following two months. Following its stock implosion, CEO Michael Saylor paid a $350,000 civil fine and returned $8.3 million to settle SEC allegations that the company “materially overstated” revenues and earnings since going public in 1997.

Last year MicroStrategy purchased $425 million worth of bitcoin between August and October, when the cryptocurrency traded between $11,000 and $14,000. That action ignited a virtuous cycle, as the subsequent crypto-mania pushed MicroStrategy’s equity market capitalization to $12 billion in February, nearly ten times higher than six months earlier. The company financed subsequent bitcoin purchases with $1.7 billion in convertible bonds in December and February followed most recently by a June offering of $500 million in senior secured notes maturing in 2028, euphemistically known as “junk bonds.” With these bond proceeds the company purchased an additional 13,005 bitcoins at an average price of $37,617, bringing their combined total holding to 105,585 bitcoins at an average price of $26,080 for a total $2.8 billion investment outlay. MicroStrategy’s new direction leaves limited room for error when one considers that a 2% drop in the company’s bitcoin holdings is greater than the company’s aggregate net income of $67.6 million over the past three years combined.

An absence of caution, coupled with great expectations, underpins the euphoric state of today’s financials markets. A global survey of 8,550 individual investors conducted by Natixis2, a French investment bank, found that respondents anticipate an inflation-adjusted annualized return of 14.5% over the long term, while small investors in the U.S. expect to earn a shocking 17.5% annualized return over the long term, after inflation. The reality is that over the past fifty years the S&P 500 Index generated a 6.8% annualized real return. While the gap between expectations and reality continues, a strange calm reigns over the financial markets. The Wall Street Journal notes that the S&P 500 has not

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2 2021 Natixis Global Survey of Individual Investors
suffered a single 5% drawdown in the last nine months, marking the longest period since 2017. For context, the stock market in 1999 endured nine such 5% pullbacks, including a 13% drop from July to October of that year. Regardless, money is pouring into the stock markets. Equity funds have received $189 billion since February, the fastest pace in six years. Humans chasing performance at sky-high valuations is no different than Vancouver Island raccoons feasting on snails and crabs, miles offshore at low tide with no place to hide.

At times, market participants can be fearless. The late 1990s technology bubble was such an era. The average Robinhood customer was just ten years old, while the average baby boomer was in their prime earning years. Today, the average Robinhood customer has no recollection of the late 1990s while the baby boomers’ anguish has largely faded with the twelve-year bull market. Those memories were painful for a reason—an entire generation speculated on margin in some of the riskiest companies promoted by Wall Street. On February 29, 2000, about two weeks before the high of the NASDAQ Composite index, Jim Cramer, the perennial pied piper of Wall Street, delivered his “The Winners of the New World” speech, in which he recommended ten stocks and said, "I wouldn’t own any other stocks in the year 2000."

“You want my top ten stocks for who is going to make it in the New World? OK. Here it goes. Write them down -- no handouts here! 724 Solutions, Ariba, Digital Island, Exodus, InfoSpace.com, Inktomi, Mercury Interactive, Sonera, VeriSign, and Veritas Software. You have to throw out all the matrices and formulas and texts that existed before the Web... If we use any of what Graham and Dodd teach us, we wouldn’t have a dime under management.”

A few years later all ten companies were either out of business, were taken over by competitors or traded at fractions of their 2000 stock price. Today’s market carries a familiar feel. Technological revolutions are taking place, rewarding youth and daring, while punishing experience and caution. Similarly, star fund managers have emerged. In 2020, over two dozen funds reported triple digit returns, five of them from Cathie Wood’s Ark Investment Management. Assets under management at Ark have gone from $1.9 billion in 1998 to $50.2 billion today. In 1999, rock star fund manager Garrett Van Wagoner’s Emerging Growth Fund was up 291% and assets under management grew from $189 million to $1.5 billion as money poured in. Just as Cramer’s “Winners of the New World” companies imploded, Van Wagoner’s Emerging Growth Fund lost 89% in three years and assets dropped to $100 million. Cathie Wood, a baby boomer by age, seems oblivious to any parallels between today’s situation and Cramer’s ill-fated list of companies or Van Wagoner’s fund experience.

One stark difference between today’s market and the market of 2000 has been the incredible growth of indexing and the popularity of passive index funds. The original idea behind indexing is that active traders and investors will dictate how the market behaves, and that a small number of passive investors in an index fund can tag along. The active majority dictated market behavior and the passive minority enjoyed a free ride. Today, active investing and passive investing are similar in size. The past twenty years have seen index funds grow enormously, with millions of individual investors now using index funds to invest their savings. Index fund inflows are now the single largest transactors in the market and these inflows profoundly influence valuations.

Unfortunately, active investors no longer dictate market behavior. Price discovery is a term that describes how buyers and sellers interact to determine the price at which an asset may change owners. Stock market price discovery involves many buyers and sellers conducting detailed analyses of a company’s fundamental business metrics. By contrast, passive investing completely ignores fundamental metrics and simply follows prices. Passive investors assume that others in the market have already done the fundamental research, and that the current price of a stock is the correct price. Since
passive investing does not rely on price discovery, one can argue that prices are now dangerously skewed from what traditional price discovery would suggest. This logically cannot go on forever, but in the absence of fear one has no idea when prices will reconnect with fundamentals.

“Investors in stocks these days are expecting far too much, and I’m going to explain why. That will inevitably set me to talking about the general stock market, a subject I’m usually unwilling to discuss. But I want to make one thing clear going in: Though I will be talking about the level of the market, I will not be predicting its next moves. At Berkshire we focus almost exclusively on the valuations of individual companies, looking only to a very limited extent at the valuation of the overall market. Even then, valuing the market has nothing to do with where it’s going to go next week or next month or next year, a line of thought we never get into. The fact is that markets behave in ways, sometimes for a very long stretch, that are not linked to value. Sooner or later, though, value counts. So, what I am going to be saying—assuming it’s correct—will have implications for the long-term results to be realized by American stockholders.”

The quote above is from an interview Warren Buffett gave to Carol Loomis at Forbes magazine in November 1999. Buffett’s quote is applicable again today—investor expectations no longer sync with reality. The definition of investing is simple but often forgotten. Investing means laying out money now to get more money back in the future—more money in real terms, after taking inflation into account. On a macro basis, Buffett likewise believed that valuation does not need to be complicated—the market value of all publicly traded securities as a percentage of the country’s business output (GNP or GDP). The ratio has certain limitations, but Buffett believed that it was probably the best single measure of where valuations stand at any given moment. If Buffett’s indicator sounded the alarm over two decades ago, it positively screams a warning signal today.

For investors to gain wealth at a rate that exceeds the growth of U.S. business, the percentage relationship line on the chart must keep going up. If U.S. economic output is growing at 5% a year and

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one wants market values to go up 10%, then the line goes straight off the top of the chart (like today). For Buffett, the long-term interpretation of the chart is straightforward: If the percentage relationship falls to the 70% or 80% area, buying stocks in general is likely to work very well. However, if the ratio approaches 200%, as it did in March 2000, or 270% as it is today—one is playing with fire. Buffett’s rationale is simple: value is a function of price. Overpay today and one receives less value in the future.

John Train gained fame from his 1994 book *The Money Masters*, but his periodic columns in Fortune Magazine during the 1970s were just as insightful and entertaining. In an article published in 1978, Train shared a letter he received from a reader in Houston:

“Right after I was discharged from the Army at the close of World War II and went into the drilling-rig building business, on the side I began buying and selling stocks. At the end of each year, I always had a net loss. I tried every approach I would read or hear about; technical, fundamental and combinations of all these… but somehow, I always ended up with a loss.”

The irritated gentleman even claimed that a blind man could have made money in the rally of 1958, but he did not. His in-and out trading and strategy switches maintained his money losing streak. One day in 1961 when the gentleman visited the Merrill Lynch office in Houston, he was completely discouraged and frustrated. A senior account executive, having observed the frown on his face for so many years motioned him over to his desk.

“Would you like to see a man,” the broker asked, “who has never lost money in the stock market? Never had a loss on balance, and I have handled his account for near forty years.”

The broker pointed to a large man dressed in overalls who was sitting among the crowd of people watching the stock market ticker tape scroll along. The broker advised the gentleman to hurry because the man in overalls only visited the Merrill Lynch office once every few years except when he was buying stocks. He only had time to hang around a few minutes to look at the tape, because his full time occupation was rice farming and raising hogs over in Baytown.

The gentleman worked his way through the crowd to find a seat by the stranger in overalls. He introduced himself, talked about rice farming and duck hunting before gradually broaching the subject of stocks. The stranger, to his surprise was happy to talk about stocks. He pulled a sheet of paper from his pocket with his list of stocks scrawled in pencil that he had just finished selling. The gentleman looked at the list of companies and was dismayed. The farmer had gained over 50% in long-term profits on the entire group of stocks. Of the thirty-stock portfolio, one stock went bankrupt, but most had appreciated 100%, 200% and even 500%.

The farmer explained his simple technique. During a bear market, when he would read in the newspapers that the market was down to new lows and the experts were predicting further doom, the farmer would look through a Standard & Poor’s Stock Guide and select around thirty stocks that had fallen in price – solid, profitable, and somewhat boring dividend-paying companies (pecan growers, home furnishings, etc.). He would travel to Houston and buy a portfolio of these companies. And then two, three or four years later, when the stock market was once again euphoric and Wall Street talked incessantly about the market’s new highs, he would return to Houston and sell his entire portfolio.

During the subsequent years, as the gentleman cultivated his friendship with Mr. Womack, he better understood the farmer’s investment philosophy. Mr. Womack equated buying stocks with buying a truckload of pigs. The lower he could buy the pigs, when the pork market was depressed, the more
profit he would make when the next seller’s market would come along. He claimed that he would rather buy stocks under such conditions than pigs because pigs did not pay a dividend and one must feed pigs. Like Warren Buffett, Mr. Womack understood that value is a function of price.

Mr. Womack took a “farming” approach to the stock market. Just as there is a planting season and a harvest season when rice farming, stock purchases and sales should also follow a similar cycle of undervaluation and overvaluation. Mr. Womack never quite purchased a stock at its absolute bottom nor sold at its zenith. He was quite content to buy or sell in the bottom or top range of a stock market’s normal price fluctuations. Furthermore, he always maintained the courage of his convictions. When the bottom fell out of the market in 1970 the farmer added to his bargain-priced but fundamentally sound positions, eventually magnifying the portfolio’s total annualized return by lowering his cost basis. Mr. Womack instinctively recognized the difference between price volatility versus sound fundamentals.

Just as in farming, there is a time to plant and a time to harvest when investing. It is an enduring principle that reaches back to the Book of Ecclesiastes, “To every thing there is a season, and a time to every purpose under the heaven… a time to pluck up that which is planted.” In the absence of fear, many market participants fixate on price and price momentum. The market’s daily noise can be confusing unless one takes a step back to better understand the current environment—expensive valuations, unrealistic expectations, and an absence of fear. Sir John Templeton famously said, “Bull markets are born on pessimism, grown on skepticism, mature on optimism and die on euphoria.” There comes a point in time in every market cycle when euphoria takes hold, only to have a major shift back towards risk aversion suddenly open the trapdoor to lower stock prices. One never knows exactly where one is in a market cycle, but at times discretion is the better part of valor.

With kind regards,

[Signature]

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