ST. JAMES INVESTMENT COMPANY

INDIVIDUAL PORTFOLIO MANAGEMENT

INVESTMENT ADVISER'S LETTER

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"The more you know, the more you realize you don't know." —Aristotle

"The more I learn, the more I realize how much I don't know." —Albert Einstein

The Dunning-Kruger effect is caused when confidence is so highly prized that one would rather pretend to be smart or skilled than risk looking inadequate and losing face. Described in a 1999 paper by Cornell University psychologists David Dunning and Justin Kruger, the pair tested participants on their logic, grammar, and sense of humor, and found that those who performed in the bottom quartile rated their skills far above average.[1] For example, those in the 12th percentile self-rated their expertise to be, on average, in the 62nd percentile. The researchers attributed the trend to a problem of metacognition—the ability to analyze one's own thoughts or performance. "*Those with limited knowledge in a domain suffer a dual burden: Not only do they reach mistaken conclusions and make regrettable errors, but their incompetence robs them of the ability to realize it*," Dunning and Kruger wrote.

Even smart people can be affected by the Dunning-Kruger effect, as having intelligence is not the same thing as learning and developing a specific skill. Individuals often mistakenly believe that their experience and skills in one specific area are transferable to another expertise. Many people describe themselves as above average in intelligence, humor, and a variety of skills. They cannot accurately judge their own competence because they lack metacognition, or the ability to step back and examine oneself objectively. In fact, those who are the least skilled are also the most likely to overestimate their abilities.

The meteoric rise in the S&P 500 index has attracted a large and diverse following of new market participants. Total returns of 31% in 2019, 18% in 2020, and 19% year-to-date are substantial. When stocks are appreciating violently everyone looks like an investment genius. Nothing personifies this confidence more than the popularity of meme stocks, defined as a stock that has seen an increase in trading activity not because of how well the company performs, but rather due to hype on social media. Confidence in one's investment ability grows—no one questions their investment process when the results speak for themselves. However, it befits long-term investors to be aware of the risks. After all, a big run-up followed by a big drop on a roller coaster may be exciting but may ultimately prove painful for one's hard-earned investment capital.

"Trading options was addictive, like cocaine. It was instant gratification," warned a Reddit user who goes by the name Krurd on the social media site.[2] Krurd was really a thirty-five-year-old Chicago psychiatrist who had lost his entire life savings in call options on Pershing Square Tontine Holdings, a special-purpose acquisition company (SPAC). SPACs are publicly traded boxes of cash, known as blank-check companies, that exist to take a private company public via a merger. Until a merger, investors in a SPAC have no idea what they are buying, but the mania provided enough incentive for retail investors rush in to purchase a myriad of newly-issued SPACs.

Raised in California as the son of Indian immigrants, the medically trained and licensed psychiatrist had no expertise in finance but started trading the market with extra money he earned moonlighting as a resident doctor. In two years, he had saved more than $300,000. With his student loan payments on

[1] Kruger, J., & Dunning, D. (1999). Unskilled and unaware of it: How difficulties in recognizing one's own incompetence led to inflated self-assessments. Journal of Personality and Social Psychology, 77(6), 1121–1134. https://doi.org/10.1037/0022-3514.77.6.1121.

[2] Michelle Celarier, "How Millennial Investors Lost Millions on Bill Ackman's SPAC," Institutional Investor, August 11, 2021.

hold during the Covid-19 pandemic and his working hours spent in either hospitals or nursing homes, he turned to the stock market. In the fall of 2020, he started hearing about the boom in SPACs, and Bill Ackman's Tontine caught his attention. Ackman, a well-known hedge fund manager, was the sponsor behind the SPAC and claimed it was the most investor-friendly SPAC ever. In early February 2021, Ackman retweeted a rap video about SPACs minting money.[3] The Reddit crowed loved it. Krurd, the psychiatrist noted "*That video literally single-handedly caused the stock to rise ten percent. It was like, okay, this is coming very soon. If you don't get in now, you're going to miss it. There's just that frenzy of wanting to get in on the ground floor. It's like getting in an IPO at the ground level*."

By March 2021, the psychiatrist was speculating with his entire pool of savings in call options on Tontine. At one point, his stake in Tontine was worth over $1 million on paper. Sadly, he lost it all when his calls expired worthless. Krurd and the rest of the Reddit gang had convinced themselves that Tontine's success was imminent, largely because Ackman joked about "marrying a unicorn" when he first launched his SPAC. Unfortunately, there would be no deal. In an unusual move, Tontine tried to buy a ten percent stake in the upcoming spinoff of Universal Music Group from French conglomerate Vivendi. The structure was too complicated for investors and soon the Securities and Exchange Commission killed the deal by telling Ackman's lawyers that it did not meet the New York Stock Exchange's requirements for a SPAC. With his savings gone, the psychiatrist is now struggling to make quarterly tax payments to the IRS, while owing $350,000 in student loans. In the end, Krurd mistakenly believed that a set of skills in one specific area transferred to expertise in speculating with derivatives.

Given the miraculous performance of the S&P 500 Index in recent years, it's not surprising to see the euphoria of stock bulls. By contrast, the value investor cites concerns about measures of valuation, but acknowledges that valuations don't count for much in an era of zero-percent interest rates. Even so, one wonders where the market is going when the price-to-sales ratio for the S&P 500 index is now at more than 3.1 times, 32.3% higher than the March 2000 dot-com peak. Hypothetically, if the pandemic never happened would the S&P 500 be 30% above its peak in February 2020? All else equal, without Covid, would U.S. ten-year treasury real yields be negative…..and without negative real interest rates, would the stock market trade at multiples never sustained outside of the 1990s technology bubble?

A deeper understanding of the price-to-sales ratio of the S&P 500 is a useful reminder of the challenging arithmetic that passive index investors face at current market valuation extremes. Assume that over the next five years, S&P 500 revenues grow at the same 4% annual rate as in the two decades leading up to the pre-pandemic market highs. Additionally, assume that over this five-year period, the S&P 500 price-to-sales ratio drops from its current multiple of 3.1 down to the same level as the 2000 dotcom technology bubble extreme of 2.2. With the S&P 500's current dividend yield of just 1.3%, the market would generate a -1.6% annualized return over the next five years: Revenue growth rate x (ending valuation / beginning valuation)^(1/period) – 1 + dividend yield, or [1.04*(2.2/3.1)^(1/5)-1+.013].

This simple scenario assumes that valuations do not break below their 2000 bubble peak, hardly a stretch of the imagination. One can easily make assumptions that are reasonable and backed by historical evidence that end with a price-to-sales ratio far lower. However, one cannot change the basic math that links valuations, fundamentals, and subsequent investment returns. Applying the same arithmetic to today's current extreme valuations, investors should reasonably expect average annual total returns of about 5.3% over the next five years—the best-case scenario. Importantly, this scenario requires valuations to remain at record highs indefinitely.

[3] https://www.youtube.com/watch?v=9rHkXfaIRTM&t=181s

A new theory about market behavior identifies some of today's market risks and has important implications for investors. While it is easy to relish the strong stock returns of the last few years, it is healthy to maintain some perspective. In the September 3, 2021, edition of Grant's Interest Rate Observer, analyst Trey Reik notes that "*After achieving 2019 total return of 31.48% on the back of meager 5% earnings growth, the S&P 500 proceeded to alchemize its 33% earnings collapse in 2020 into additional gains of 18.39%. Now, with Q2 2021 warnings largely in the bag, S&P trailing twelve-month reported earnings ($150.20 estimate) are finally poised to exceed the low $130s level they first reached back in calendar 2018 ($132.39), a feat so far rewarded in 2021 with additional gains of 20.01%* (08/13)."

In other words, the market's impressive performance derives from earnings that have done absolutely nothing over the last three years. One should instinctively sense that something is wrong with this picture but is at a loss to describe the stock market's behavior. A recent paper by Xavier Gabaix and Ralph Koijen entitled "In Search of the Origins of Financial Fluctuations: The Inelastic Markets Hypothesis" provides a possible explanation for the market's relentless climb higher.[4] By analyzing the fluctuations of the stock market in aggregate, the authors isolate flows into stocks that appear unexplained by GDP growth over the period from 1993 to 2019. They determined that markets respond in a manner contrary to that established by the academic community: markets magnify, rather than dampen, the impact of stock flows. A dollar of inflows into equities increases the aggregate value of the market by $3 to $8. Markets are not elastic, as academic textbooks state; therefore, the authors call their idea the *inelastic* markets hypothesis.

The logic behind the hypothesis focuses on the dynamics between supply and demand for stocks. Individuals allocate capital to institutions, but those institutions invest under constrained mandates. Most investment institutions have minimal room for variation in response to changing market conditions. As a result, the price elasticity of demand of the aggregate stock market is small and flows in and out of the stock market have large impacts on prices. For example, if a fund wants to buy $1 worth of stock, the reality is that many funds cannot supply the incremental $1 worth of stock. Consider a stock index fund cannot suddenly sell stocks and replace them with bonds—the index fund must always remain fully invested in equities.

Today's stock prices do not necessarily reflect discounted cash flows, the underlying economic value that determines the actions of fundamentally-based investment strategies. Instead, prices represent the supply and demand for stocks at a given point in time. Stocks do not need earnings to rise; they only need a regular source of inflows. Typically, a well-functioning market includes a relatively large number of diverse participants who act independently. Unfortunately, the market has lost diversity over the last

[4] Gabaix, X, & Koijen, R. "In Search of the Origins of Financial Fluctuations: The Inelastic Markets Hypothesis," June 11, 2021.

decade with the proliferation of passive index funds and target-date funds. BlackRock and Vanguard, the two dominant purveyors of such funds, claim passive funds do not yet dominate market share and therefore have little effect on markets. But this misses a significant point: Increasingly funds move in lockstep and there is too little active capital to offset the passive mechanism.

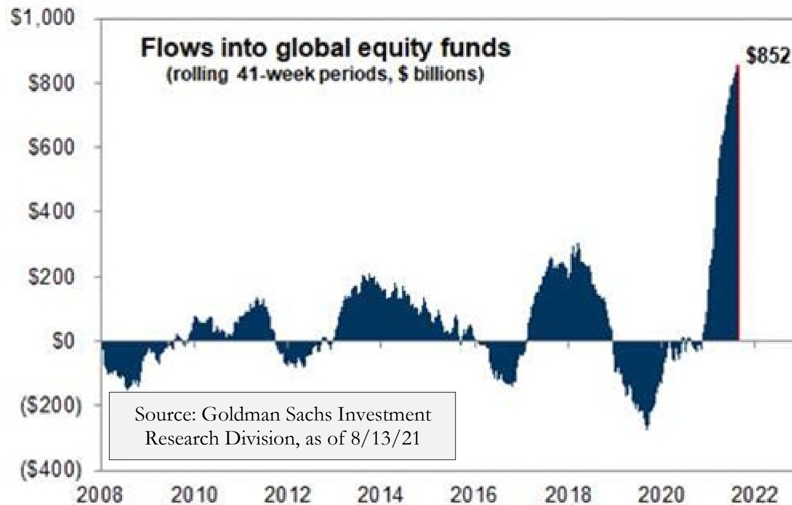
Inelastic markets, combined with regular inflows to stocks, have enabled stock prices to levitate far beyond what is justified in any economic sense. The pricing algorithm has become quite simple: if net flows are positive, prices go up. A simple and sobering reality. One implication is that there is very little information content in today's stock prices other than a reflection of flows. As a result, investors should no longer associate rising stocks with improving economic performance, individual company performance, or any other metric of economic value creation. Stock prices are no longer a good representation of underlying value in this environment.

While many academics still adhere to the efficient market hypothesis, that asset prices reflect all known information, the reality today is a perverse market structure now drives stock prices. In the framework of an inelastic market, fund flows become a critical market indicator. Corporate stock buybacks have been a significant fund flow factor and continues to exert influence. Labor force size and automatic contributions to retirement funds plays another important ingredient to fund flows. Given the current market structure, one should consider the impact of Baby Boomers taking mandatory withdrawals from retirement funds and reducing risk as they age; a scenario that could significantly impact stock flows. If commensurate demand volumes do not balance selling volumes, the marginal buyer is unlikely to be insensitive to the price. When this happens valuation will matter, possibly a lot.

The inelastic markets hypothesis at least provides a plausible explanation for why markets have been so strong despite weak underlying financial performance. The hypothesis also provides a serious challenge to the academic model of efficient markets—stock prices do not provide investors with much information content. Finally, the hypothesis highlights fund flows as a critical variable for setting prices. If flows to stocks become persistently negative, stock prices are likely to adjust based on an entirely different paradigm, one that ironically creates a significant opportunity for active value investors.

Persistently negative fund flows seem a long way off. Goldman Sachs strategist Scott Rubner notes that there have been more fund inflows in the last forty-one weeks (+$852 billion) than he has seen in his eighteen years tracking fund flows, *combined*. The average yearly inflow for the past twenty-five years is about $29 billion per year or $115 million per day. Year-to-date, 2021 is averaging +$3.9 billion per day. Furthermore, 82% of year-to-date fund flows have gone into passive funds, while only 18% of flows have gone into active management. Passive funds operate under a very simple mandate: "*You give me $1, and I buy $1 of stocks, regardless of price or valuation*." No fund outflows equal no selloff, regardless of current valuations. For the last eighteen years, every Thursday night, Rubner examines the weekly flow data. Since November 2020, Rubner notes that these fund inflows are completely U.S. focused, all passive, all large capitalization stocks, and buying every market dip. The biggest incremental buyer is the retail investor, who may or may not realize how passive funds operate, and merely looks at recent performance as validation of their investment acumen.

The original idea behind indexing is that active traders and actively managed funds dictate how the market behaves, and a small number of passive investors in index funds tag along. This relationship is the original assumption behind passive investing; the active majority dictated market behavior and the passive minority enjoyed a free ride. Today, active strategies and passive investing are the same size. Therefore, the fundamental assumption no longer holds true. Millions of individual investors use index funds to invest huge portions of their income and savings, which is how many 401(k)s operate. Index fund inflows are now the single largest transactors in the market and these inflows influence the market.



Price discovery is the process of determining the price of an asset in the marketplace through the interactions of buyers and sellers. Without active price discovery, markets grow fragile. Typically, stock market price discovery involves many buyers and sellers conducting detailed analyses of a company's assets, profits, and cash flows–all fundamental business metrics. Passive investing disregards these fundamental considerations and just follows along. It assumes 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, stock prices are now dangerously skewed from what traditional price discovery suggests. One must assume that this cannot go on forever; eventually, prices revert to fundamentals.

Charlie Munger, one of the great minds of the 20th century, once shared some insight to how he lives his life: "*Spend each day trying to be a little wiser than you were when you woke up. Discharge your duties faithfully and well. Systematically you get ahead, but not necessarily in fast spurts. Nevertheless, you build discipline by preparing for fast spurts. Slug it out one inch at a time, day by day. At the end of the day – if you live long enough – most people get what they deserve*."

Munger is perhaps best known as the Vice Chairman of Berkshire Hathaway. In the time of his and Warren Buffett's reign as the leaders of Berkshire, the company has returned roughly 2,000,000% on its initial value, or said otherwise, each $1 invested in now worth $20,000. This was accomplished in the adult lifetime of two men, simply by investing the capital of the company in an increasing number of prosperous enterprises and without dangerous amounts of borrowing. It is a story for the investment ages that all investors should learn. Charlie is known as a "sidekick" but is actually a fiercely independent intellectual who, in the words of his partner Buffett, "*Marches to the beat of his own music, and it's music like virtually no one else is listening to*."

Trained as a meteorologist during World War II and as a lawyer at Harvard before devoting himself to business, Munger's ability to critically think draws heavily from the study of psychology, economics, physics, biology, and history. Munger developed his critical thinking by constructing a system of "multiple mental models" that cut through difficult problems in complex social systems. Speeches and writings made long ago stand up in their logic and validity today as much as when they were written,

given their basis in the deeply fundamental wisdom of the world. When asked his secret to success, Munger once answered simply "*I'm rational*."

The simplest definition of critical thinking is it is space for thinking. A pause or a delay in decision-making to consider additional possibilities. This contemplative process is not natural. Humans are wired for survival and have a hard time shifting away from their instincts that protect them and towards a slower and deliberative thought process. Part of the reason for this is many of our instincts and learned reactions are the right ones. Our most basic instinct is survival, which involves basic behaviors that help one preserve their health by eating, seeking shelter, and avoiding danger. Doing what is normal and fashionable among peers is good enough in almost every domain, but one wonders if that holds true in financial markets.

As a rational investor, one implicitly understands the critical importance in protecting accumulated life savings. But, if fund inflows are at record levels and completely dominated by U.S. focused, large capitalization and growth-oriented stocks in passive index funds, with retail investors buying every market dip... And the price discovery mechanism no longer reflects economic value and has been supplanted by fund flows… And U.S. ten-year treasury bonds yield 1.5% but the consumer price index (CPI) measures inflation at 4.5%... Then perhaps the rational investor should give pause to their natural instincts of following the crowd. The critical thinker appreciates markets are priced at valuation levels that assure stiff headwinds for any investor, particularly those who only allocate to U.S. focused passive indexes. Only by intelligently allocating one's capital to limited pockets of value do we see a path forward over the next decade.

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.

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