



# ST. JAMES INVESTMENT COMPANY

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INDIVIDUAL PORTFOLIO MANAGEMENT

## INVESTMENT ADVISER'S LETTER

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## FOURTH QUARTER LETTER

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*Smart is when you believe only half of what you hear. Brilliant is when you know which half to believe.*

--Robert Orben, comedian and speechwriter

In the 1970's, Ellen Langer, a researcher from UCLA, demonstrated a phenomenon she termed the illusion of control.<sup>1</sup> Langer asked a group of subjects to predict the outcome of thirty coin tosses, rigging the feedback so that each subject was correct exactly half the time. However, the groups differed in where their "hits" occurred in the order of the flips. Langer told some that their early guesses were correct while others had their successes distributed evenly throughout the thirty tosses. Afterwards, Langer surveyed the participants about their performance. Subjects with early "hits" overestimated their total successes and had higher expectations of how they would perform on future guessing games. Forty percent of these subjects believed their performance would improve with practice and twenty-five percent said that distractions would impair their performance.

The subjects believed they could improve their ability to predict the outcome of thirty coin tosses. Even though the results were completely random, and there was absolutely no correlation between their skills and the results, they still thought they could influence the outcomes. What made the subjects think that they could control a random process? This human mechanism has long been known, yet Ellen Langer was the first to describe it in detail and named it *the illusion of control*.

The human mind is a powerful machine but has limits. In a single day, the brain processes thirty-four gigabytes of new information, the equivalent of 6,800 copies of the *King James Bible*.<sup>2</sup> New data inundates our minds daily - around 2.5 quintillion bytes, a number so large that it is impossible to conceptualize. To cope, the brain creates shortcuts called cognitive biases. The illusion of control, for example, encourages us to impose order over a chaotic and unpredictable world. The downside is that cognitive biases can disrupt rational thought, often without one realizing.

Biases can prove problematic when making important decisions, such as investing for one's financial future. Ellen Langer argued that humans overestimate their abilities in successes and underestimate their contribution to failures by ignoring the role of chance. How readily one ignores the effect of chance, Langer argues, depends on certain conditions: *"This illusion of control may be induced by introducing competition, choice, stimulus, or response familiarity, or passive or active involvement into a chance situation. When these factors are present, people are more confident and are more likely to take risks."*

Optimism is a healthy trait but believing in the impossible, like predicting coin tosses, can lead to severe financial losses. Back in October investors expected technology stocks to grow regardless of conditions, yet the sector sold off. Even after October's decline, Wall Street's optimism persisted. Predicting anything is difficult and going out several years relies heavily on guesswork - and the best use of Wall Street forecasts is as an indicator of Wall Street optimism. Even after the recent selloff, Wall Street is still as optimistic as ever. This past July the market reached a peak number in earnings growth forecasts not seen since the dot-com bubble.

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<sup>1</sup> Ellen J. Langer, "Heads I win, tails it's chance: The illusion of control as a function of the sequence of outcomes in a purely chance task," *The Journal of Personality and Social Psychology*, 1975, Vol. 32, No. 6: 951-955.

<sup>2</sup> Daniel J. Levitin, *"The Organized Mind,"* Random House, 2014.

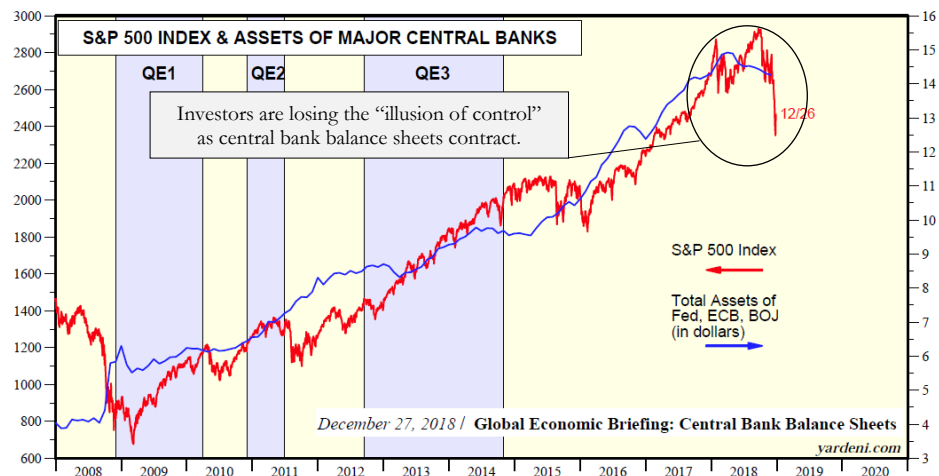
Market declines historically follow peaks in optimism. Analysts polled by S&P Global Market Intelligence still believe earnings for stocks in the S&P 500 Index will grow 13.3% a year for the next three to five years. Under any realistic calculation, achieving 13.3% growth is impossible. Importantly, belief in future earnings growth is a major factor supporting the stock market's record high valuations and is even more important for the most speculative stocks.

For the past two decades, corporate earnings for companies in the index have grown at an average of 7% a year while revenue has grown by 4%. Either of those numbers could rise, but even if revenue grew faster than 4%, and companies kept repurchasing stock (which increases earnings per share) at their current pace, the only way for earnings growth to achieve a 13.3% annual rate is for profit margins to increase. With profit margins at record levels, this scenario is unlikely. Companies face rising wages, increasing interest rates and more expensive imports affected by tariffs. Additionally, any recessionary conditions will further squeeze profit margins.

When investing, what matters is how expectations affect the stock market, as prices normally follow earnings forecasts. Over the past two decades, higher expectations led to lower actual earnings growth. Earnings optimism peaked at 19% in 2000 when it was timely to reduce exposure to stocks. By contrast, earnings optimism bottomed in January 2010 - in hindsight, an ideal time to have increased stock exposure. One reason for this inverse correlation is long-term earnings expectations function as a sentiment indicator. The more optimistic Wall Street is, the more good news already baked into current stock prices and the easier it is for disappointing news to adversely surprise market participants.

Over the past ten years central banks, led by the U.S. Federal Reserve, motivated increased market participation through zero level interest rates and quantitative easing. Quantitative easing is an expansionary monetary policy where central banks buy government bonds or other financial assets to stimulate the economy and increase liquidity. Artificially suppressed interest rates and an easy monetary policy all but guarantee that risk becomes mispriced. Austrian economic theory states that central bank monetary actions do not release more resources into the economy. However, what changes is the number of investments that appear profitable. The same pool of real resources must now suffice for the realization of many more investment projects, driving up prices. Central bank policies misdirect investors because the market no longer determines the natural interest rate, causing gross perversions. Suppressed interest rates drive up the prices of all assets.

Like Ellen Langer's experiment, central banks have rigged investment outcomes over the past ten years in favor of passive index investing and the stock prices of the most speculative companies. This illusion of investor control has created an atmosphere of



complacency. Complacency in turn affects market liquidity, defined as the ability to trade without creating adverse price movements. Central banks have conditioned Wall Street over the past decade to expect less financial volatility - the net result has been complacency and less liquidity. After the fourth quarter, investors now realize the reality of a world with less liquidity, a world where stock portfolios are vulnerable to dislocations and sudden changes in behavioral biases. The U.S. Federal Reserve's continued rate increases, the gradual contraction of its balance sheet and the lack of any comforting words are driving home this new reality for investors.

While some eternally optimistic market pundits readily dismiss this period of volatility as temporary, it is prudent to be concerned. The long period of central bank driven liquidity encouraged investors to become overexposed to speculative sectors such as technology, cryptocurrencies, leveraged loans, and junk bonds. The unwinding of these crowded trades has led to the recent underperformance of popular technology stocks, as well as market indices and sector exchange traded funds with heavy technology exposure. With no fundamental analysis or understanding of valuations, sudden drops in stock prices panic investors into selling further, as stock prices have little relationship to underlying value. Passive and other index-driven investing amplify this herd-like dynamic.

After the equivalent of ten years of correctly calling "heads" in an artificial monetary experiment, the public release of U.S. Federal Reserve Chairman Jerome Powell's November speech captures Wall Street's addiction to central bank liquidity. The Bloomberg headline read: *"Powell: No Preset Policy Path, Rates 'Just Below' Neutral Range."* When the Federal Reserve Chairman began his presentation to the New York Economic Club just minutes later, the Dow Jones Industrial Average had already surged 460 points. From Powell's prepared comments: *"Interest rates are still low by historical standards, and they remain just below the broad range of estimates of the level that would be neutral for the economy that is, neither speeding up nor slowing down growth."* When Powell read his speech, Wall Street reacted when he said "range" as opposed to "broad range" of estimates.

Powell reaffirmed Wall Street's illusion of control, as stocks responded to the Chairman's dovish transformation with joy. Powell's language was a far cry from his message in the beginning of October when he said, *"We may go past neutral, but we're a long way from neutral at this point, probably."* The Federal Reserve is three years into a tightening cycle - their first interest rate increase was in December 2015. With unemployment at a multi-decade low 3.7% and the consumer price index (CPI) up 2.3% year over year, there is certainly a reasonable case that higher interest rates are necessary for monetary policy to reach a "neutral rate." Unfortunately, higher interest rates and less liquidity will shatter any illusion of control that investors may possess.



There is an old market axiom that every bear market starts with a dip, but not every dip starts a bear market. How does one distinguish between a sell-off that they should buy and one they should sell? Japanese stocks dominated the late 1980s global bull market. Telecommunication and technology stocks dominated the late 1990s. Real estate dominated the mid-2000s. The technology FANG stocks dominated the most recent cycle. Each episode of excess started with a dip but ended badly.

Speculators navigate by short-term trading indicators such as sentiment, momentum, lines on a chart, or forward pricing-earnings ratios. By contrast, the prudent investor employs fundamental analysis and valuations as their guiding light. When investing, one should not try and squeeze the last returns out of an overvalued, ten-year bull market. Recall, smart is when one believes only half of what they hear, while brilliant is when one knows which half to believe.

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## INVESTMENT PHILOSOPHY

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*"The individual investor should act consistently as an investor and not as a speculator."* – Ben Graham

It is common to hear that fundamental analysis is irrelevant because valuations do not signal turning points in markets. Those who scorn valuation analysis are correct - there is no fundamental statistic, technical or sentiment indicator that supplies any certainty as to when market trends will change direction. Market gains over the past decade have humbled value investors, but the prudent investor stays resolute about the merits of a conservative investment posture. At some point current equity market valuations will succumb to financial gravity and the upward trend of the last decade will reverse. When the day arrives, it will not be because a valuation ratio hit a certain level or because the market formed a well-known technical pattern - it will simply be the day that selling pressure overcomes demand.

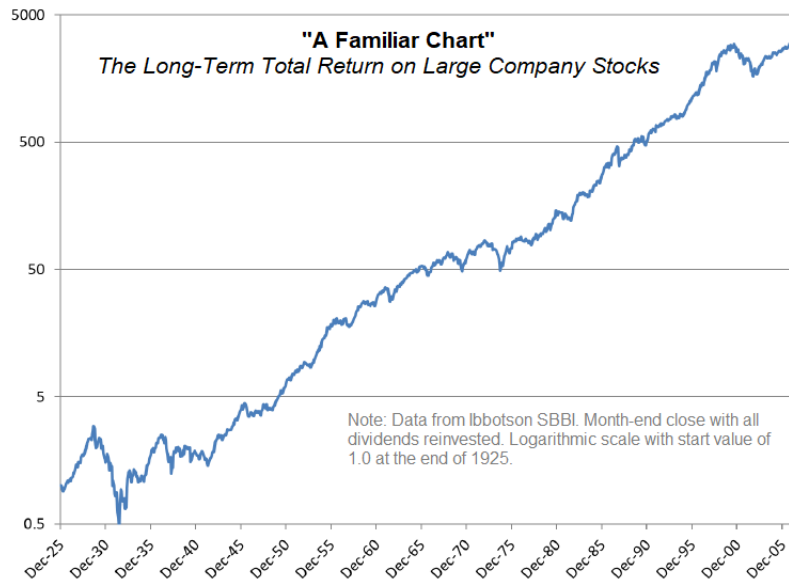
No rational investor seeks an investment opportunity that pays 0% over the next five years and, at some point over this period, the value of the investment drops by 30%. High volatility and a low return on investment does not attract the serious investor. At the beginning of the fourth quarter, the U.S. stock market offered this same probability, yet buyers aggressively accepted this offer based on money flows into passive index funds. Investor behavior is always perplexing and sometimes downright incoherent - basic ingredients that underpin any asset bubble.

Reliable measures of market valuation (CAPE, Buffett yardstick, Tobin's Q, etc.) evidence equity valuations at historical extremes only seen during speculative manias. When one adds in the enormous increase of corporate debt, index investors now operate in uncharted territory. Equally obvious is the popular misconception of passive investors driving the current stock market bubble. *'Put your money into the broad U.S. stock market and, regardless of the price you paid, you are guaranteed to make a good rate of return so long as you are willing to hold for at least a decade.'* Edward F. McQuarrie, professor of emeritus at Santa Clara University, proved this misconception in a paper published last year titled, *"Stock Market Charts You Never Saw."*<sup>3</sup> McQuarrie sums up the 'buy the index and forget' misconception as such:

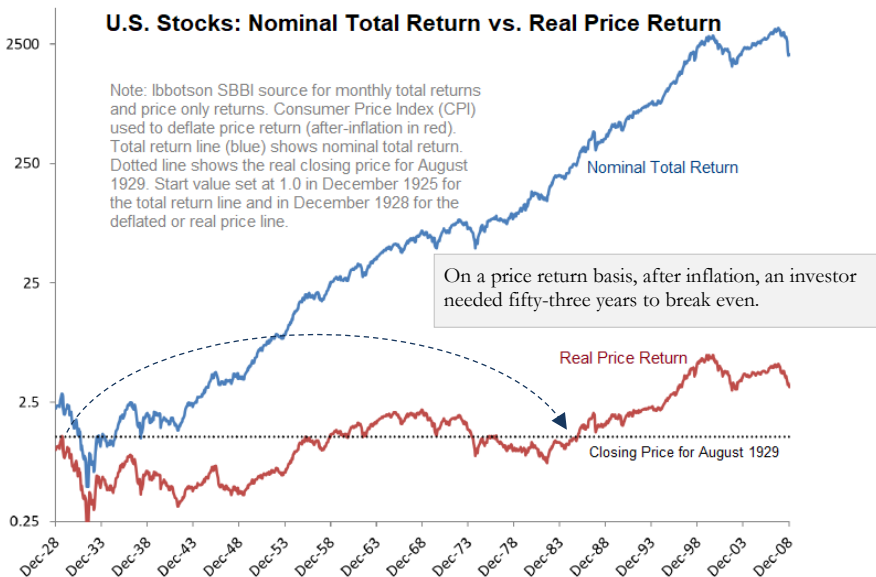
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<sup>3</sup> McQuarrie, Edward F., Stock Market Charts You Never Saw (September 10, 2017). Available at SSRN: <https://ssrn.com/abstract=3050736> or <http://dx.doi.org/10.2139/ssrn.3050736>

Today, charts like Figure 1 [A Familiar Chart] anchor investor expectations, which shows the total return offered by the S&P 500 Index from year-end 1925 through year-end 2006. The overall import of Figure 1 is unmistakable. Stocks go up. And up. And up, returning over \$3,000 for each \$1 initially invested. Yes, there were hiccups along the way; stocks didn't go up every year. But during this lengthy period, declines always proved temporary...a plausible interpretation of Figure 1 is that when it comes to stocks, investors should buy and hold...time heals all stock market wounds.



McQuarrie discusses the problems with this sort of thinking in great detail, but the single greatest data point McQuarrie uses to dispel the idea that "time heals all stock market wounds" is this: "Investors who bought in summer of 1929, and held only until the summer of 1982, spending dividends along the way, would have seen the real value of their portfolios drop by 40%." This is not the only period that questions the near religious faith in passive investing, but it is the most noteworthy.



Wall Street often dismisses this chart [Nominal Total Return vs. Real Price Return] as an anomaly. However, one must consider this scenario as a possibility because bear markets destroy the misconceptions behind the preceding bull markets. With stock valuations as expensive today as in 1929, index investing is fraught with risk.

In the final chapter of *"The Intelligent Investor,"* Benjamin Graham wanted to distill the lessons of his book into one phrase:

*"Confronted with a like challenge to distill the secret of sound investment into three words, we venture the motto, MARGIN OF SAFETY. This is the thread that runs through all the preceding discussion of investment policy—often explicitly, sometimes in a less direct fashion."*

Benjamin Graham refers to “margin of safety” as “the thread that runs through all the preceding discussion of investment policy.” If an investor could read only one chapter of any investment book, this is the chapter to read. The term “margin of safety” refers to the practice of ensuring that an investor leaves oneself enough of a gap between the price paid for an investment and an assessment of what the investment is worth. If the fair value assessment is wrong, the margin of safety minimizes the harm. For example, if an investor employs a 25% margin of safety, then he or she will pay no more than \$75 for a share for a stock estimated to be \$100 (\$75 is 25% less than \$100). Even if the investor later concludes that their \$100 fair value estimate was too high, the margin of safety minimizes the impact of the error.

This estimate of \$100 refers to what the investor believes the asset is worth, based on a careful analysis of company fundamentals. Importantly, this estimate refers to the investment’s intrinsic value, as opposed to its market value (which is simply determined by the last price traded). This estimate of intrinsic value often sits at odds with actual market prices. Consequently, value investors often wait months, even years, before making an investment at a price that is sufficiently below their estimate of intrinsic value. Because intrinsic values are often quite distant from market values, there is often not much point in paying close attention to what happens on a day-to-day basis.

While valuation is an effective and proven predictor of future returns, it requires patience. One of the biggest advantages of St. James is our willingness and ability to focus on the long term. In the short term, news and sentiment drive returns. As time horizons lengthen, valuations increasingly matter. We recognize that maintaining patience for such an extended period is incredibly difficult, but we also believe that a valuation-based investment approach, coupled with patience, is the best way to compound wealth. As Benjamin Graham concluded, speculating and investing are two vastly different endeavors. We prefer the proven practice of investing.

With kind regards,

A handwritten signature in black ink, consisting of a series of loops and a long horizontal stroke at the end.

ST. JAMES INVESTMENT COMPANY

# ST. JAMES INVESTMENT COMPANY

We founded 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 nearly twenty years, to invest alongside our own capital.

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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