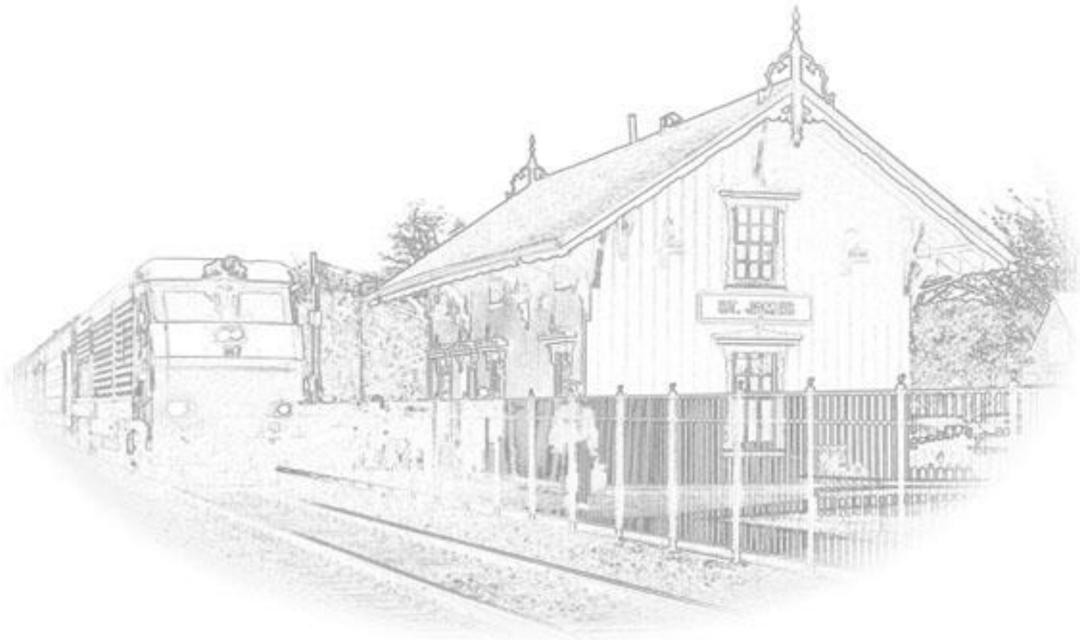

ST. JAMES INVESTMENT COMPANY

INDIVIDUAL PORTFOLIO MANAGEMENT

INVESTMENT ADVISER'S LETTER

APRIL 2017

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FIRST QUARTER LETTER

MARKET COMMENTS

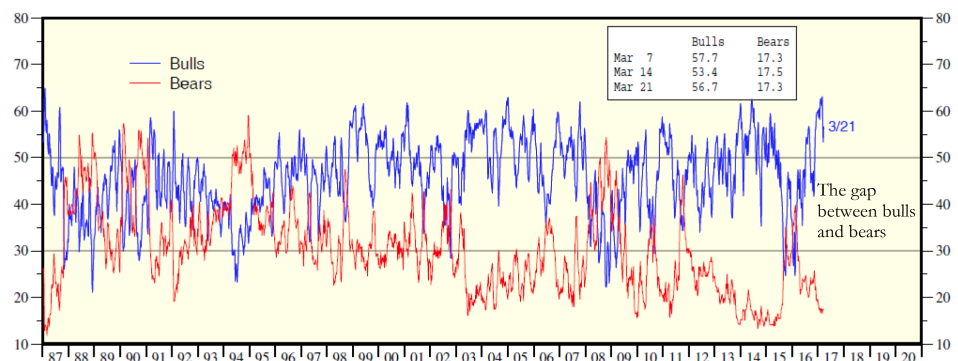
"Forecasts create the mirage that the future is knowable." –Peter Bernstein

Wall Street conducts an annual exercise every December; analysts examine the stock market and declare that stocks will rise next year. The forecasts for 2017 demonstrate that, once again, strategists are bullish. Since 2000, the Wall Street consensus has been perpetually bullish, forecasting an annual market rise of 9.5% a year, according to Bespoke Investment Group. In contrast, the market rose only 3.9% a year during this era. Wall Street's predictions are often wrong but it really does not matter—the stock market rises most of the time. However, sometimes the stock market does indeed fall. Since 2000, the Standard & Poor's 500 stock index posted negative results in five calendar years (2000, 2001, 2002, 2008 and 2015) and was flat once (2011). Regardless, the Wall Street consensus every single year since 2000 predicted a rising market. Notably, Wall Street consensus forecasted a market increase of 11% in 2008, missing this target by 49 percentage points.

One should assume that Wall Street's annual forecasts are worthless, the equivalent of flipping a coin. Salil Mehta, an independent statistician and faculty member of Georgetown University, would argue that forecasters actually perform worse than flipping a coin[1]. If one predicted a market increase of 5% each calendar year, this simple forecast would consistently outperform Wall Street.

Individual strategists comprise the consensus and their forecasts can swing widely. For example, in December 2015, Federated Investors predicted that the S&P 500 would rise 18.2% in 2016. By February, when the stock market dropped, Federated sharply revised their 2016 forecast lower to predict a loss of 10.5%. In September, Federated reacted to a rising market and turned bullish again, predicting a 2.7% gain in 2016. As the stock market was up 12% on a total return basis for the calendar year, the static forecast of 5% would have outperformed Wall Street's counsel.

The difficulty with forecasting is that calendar years are arbitrary periods and are difficult, if not impossible, to predict. Will the market rise this year? No one knows. However, since the presidential election in November, stocks have appreciated by approximately $2.5 trillion based on the *hope* for lower taxes, corporate tax reform, less regulation and infrastructure spending along with a large dose of animal spirits. With the S&P 500 now trading at 24.8x trailing reported earnings, 31% above the long-term average, one knows that stocks are trading at expensive valuations. The problem is that valuations are now supported more by hope rather than economic fundamentals or

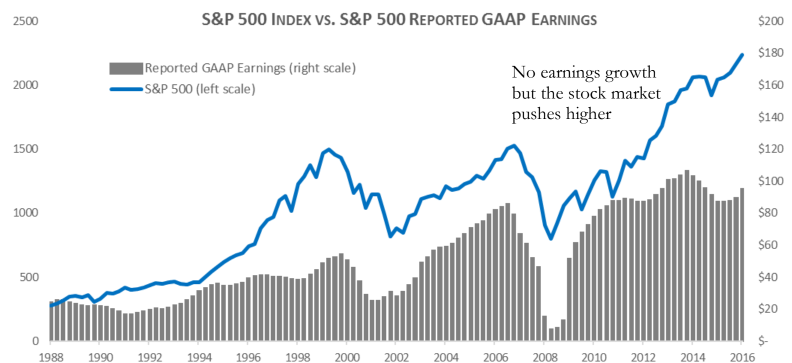


[1] *Mind the Gap: Wall Street Forecasts and YTD Returns*, Salil Mehta, 23 March 2016

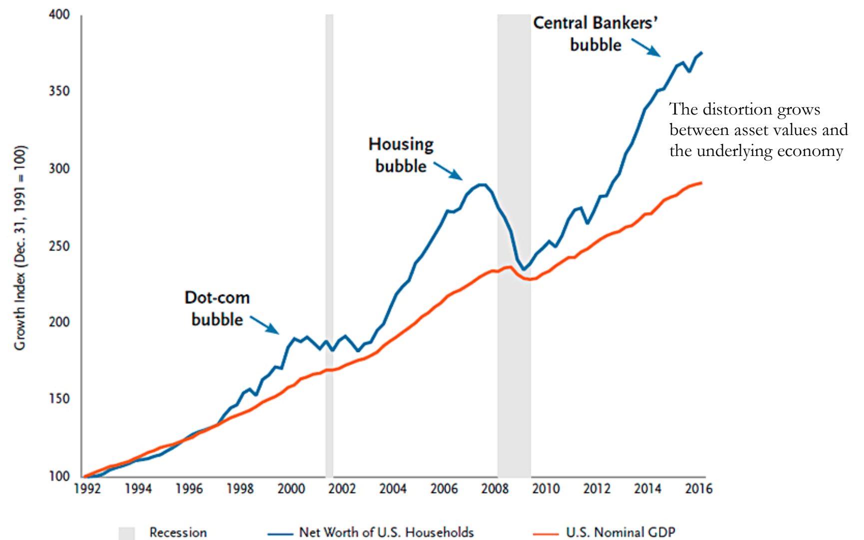
earnings. The Investors Intelligence (II) poll of advisors shows that the spread between bulls and bears (an indicator of investor sentiment) resides at an extremely optimistic 40%. Simultaneously, margin debt, the amount investors borrow against their brokerage accounts, reached a new high of $528 billion. Of course none of these data points implies any immediate prediction about the market's future, but they do serve as indicators to help with one's investment allocation.

As no one knows what the immediate future holds, investors should, at least, acknowledge that stocks are trading at the upper end of their historical valuation range. History confirms that investments made at such elevated levels deliver lower investment returns than investments made at lower entry points. The S&P 500 rose 9.5% in 2016 (price only), but revenue failed to rise for the second year in a row. The S&P 500 closed 2016 at 2,238 and reported GAAP earnings of $95; therefore, the market's price-to-earnings ratio closed 2016 at 23.6. On a GAAP basis, the traditional way companies *used to* report profits, there has been very little earnings growth over the past five years. Despite minimal earnings growth, the S&P 500 Index has doubled in price.

One can attribute the market's price gains to an expansion of the price-to-earnings multiple—a sign of investor confidence, if not animal spirits. Valuations are not only detached from economic and cororate fundamentals but dependent on the greater fool theory of investing; meaning, that market participants are buying stocks today based on the expectation that they will be able to sell their merchandise to someone even more bullish in the future.



The chart to the right is from the TCW Group and captures the last three financial distortions that have driven household asset values (in blue) far above nominal GDP (red) only to eventually recouple in a recession (grey bars). Interestingly, one should notice that these financial distortions coincide with the same periods of time when S&P 500 price growth greatly exceeds earnings growth (chart above). In other words, animal spirits and financial distortions go hand-in-hand.



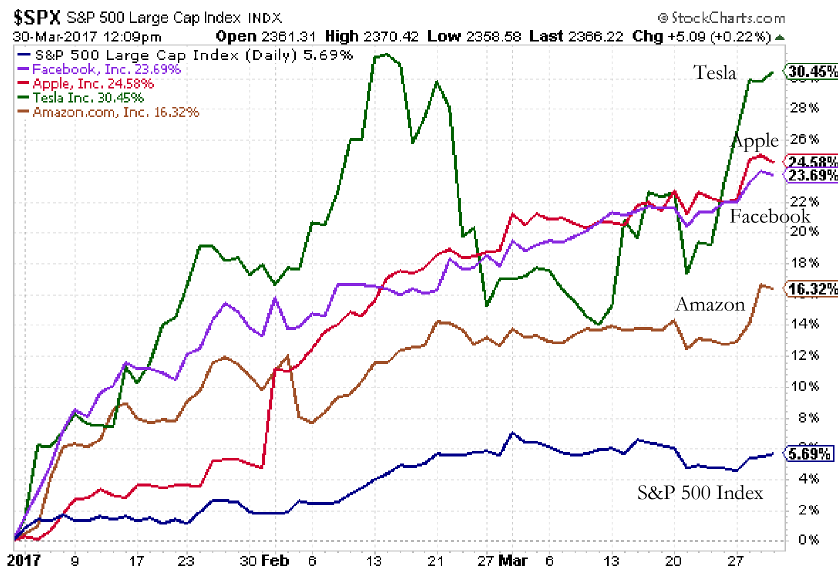
The three distortions start with the dot-com bubble, followed by the housing bubble and finally the current bubble in central bank confidence. Interestingly, as one can see from the first two distortions in the chart, unlike 2000 when any impact to the economy barely registered, the housing bubble was different. After the housing bubble burst in 2008, the markets experienced the biggest meltdown since the Great Depression.

Politicians, academics, and Wall Street executives all claimed that something had to be done in reaction to the housing bubble. Unfortunately, the only demographic large enough to address the problem was the general public—essentially the unlimited balance sheet of the U.S. Federal Reserve. Author and analyst Grant Williams refers to this current distortion as the '*The Confidence Bubble*.' The confidence in question being that central bankers try to control outcomes – namely the stock market. To date, and a value investor's frustration, the central bankers have proven quite successful in their efforts.

The confidence bubble continues to manifest itself once again with another forecasted recovery in corporate earnings, something one hears every year from Wall Street analysts. The Wall Street consensus forecast is for earnings to grow to $127 and the market to increase to 2,310 or 6.5%[2]. One should take these forecasts with a grain of salt—in order to achieve their annual argument that earnings will increase by double digits, analysts rely on suspect non-GAAP (Generally Accepted Accounting Principles) earnings, which are at least $20 higher than reported GAAP earnings. These forecasts are inherently volatile and unreliable. Nevertheless, investors welcome these forecasts with open arms as they chase the market higher.

One consequence of the confidence bubble is that indexing investment company Vanguard has gained over $4 trillion in assets while market participants have withdrawn $40 billion from Jeremy Grantham[3], legendary value investor and co-founder and chief investment strategist of Grantham, Mayo, & van Otterloo (GMO). Investors are punishing GMO for the crime of holding cash in the late stages of a bull market. Unfortunately, that is what retail clients always do as a bull market grows long in the tooth—they buy what they wish they would have owned and sell what they are going to need.

Investors have a habit of doing the opposite of what makes sense, and these days they are buying stocks they should consider selling. Amazon missed revenue forecasts by a billion dollars last quarter, Google missed analysts' earnings forecasts by $0.31 per share (second big miss in 2016), and Facebook's management warned last month that the company's advertising revenue growth will slow this year, while it plans to aggressively increase expenditures in 2017. Apple's revenues declined 8% year-over-year and operating income dropped 16%, but anticipation of the upcoming Apple iPhone dominate the market's attention. The confidence bubble continued to propel this group of stocks higher during the first quarter.



According to Fred Hickey of the *The High-Tech Strategist*, the poster child of the current bull market is Tesla, a company that captures the imaginations of all the early technology enthusiasts but almost never meets any of its targeted financial or production goals. To survive, Tesla needs constant cash injections—the company raised $1.4 billion in the fourth quarter of last year but quickly burned through all that cash. Tesla's market value is $48 billion, ten times the profitless

2 *Outlook 2017: This Bull Market Has Legs*, Barron's, 17 December 2016

3 *Magic Eludes Bubble-Caller Jeremy Grantham*, The Wall Street Journal, 8 January 2017

company's current revenue. By comparison, Ford Motor Company carries the same market value as Tesla; however, Ford generates $152 in revenue and is profitable[4]. Of course, none of this currently matters. Collectively, Amazon, Google, Facebook Apple and Telsa account for over $2 trillion in market value and have risen 23% year-to-date.

Which brings us to Snapchat, the latest popular social-media company to go public. The company raised $3.4 billion in its initial public offering, giving Snap an initial valuation of $20 billion. At this valuation, the market values Snap at more than 21 times this year's sales, twice as expensive as Facebook, and four times more expensive than Twitter. Of note, Facebook was profitable and reported earnings of $1 billion in 2011 (the year before going public) while Snap reported a net loss of $500 million last year.

Snap's valuation is not the only reason investors should be wary—Snap investors hold no shareholder voting rights. As one commentator wrly noted, "calling them *shares* is an insult to, well, sharing." This total control of a publicly-traded company is without precedent, one that serves as another example of the complacency that often precedes bubbles in confidence. This complacency recalls the way bondholders behaved before the 2008 financial crisis. Pre-2008 bondholders consented to all manner of twisted repayment conventions. For instance, bondholders agreed to be paid in more debt from already risky borrowers if they could not pay the current coupon in cash. As one might imagine, the crisis ensured that these debt holders were ultimately punished for their leniency.

One month after Snap's initial public offering, several Wall Street banks bestowed bullish ratings on the company's new shares. Investment bank Jefferies published their milquetoast analysis, "*We believe Snap has all the ingredients to build a robust advertising business. Snap has a large audience of 158 million daily active users, deep engagement, and robust data about its users. Snap should scale its business without significant capex investment. We forecast the company will achieve GAAP profitability by 2019*." Of course, all of the banks bestowing Snap with a favorable rating were underwriters of Snapchat's offering. As Morgan Stanley and Goldman Sachs received the highest number of shares in the offering, Goldman Sachs issued a "buy" rating with a $27 price target while Morgan Stanley issued an "overweight" rating with a $28 price target.

Conflicts of interest naturally exist in the relationship between Wall Street analysts who write research and make recommendations, the clients who pay for that research, and the companies that are the subjects of the research. Warren Buffett often writes about a concept that he calls the "*institutional imperative*". The institutional imperative describes any institution's inherent propensity to do dumb things simply for the sake of doing them. In his 1989 shareholder letter to investors, Buffett described his mistakes during the first twenty-five years managing Berkshire Hathaway:

> *"My most surprising discovery: the overwhelming importance in business of an unseen force that we might call "the institutional imperative." In business school, I was given no hint of the imperative's existence and I did not intuitively understand it when I entered the business world. I thought then that decent, intelligent, and experienced managers would automatically make rational business decisions. But I learned over time that isn't so. Instead, rationality frequently wilts when the institutional imperative comes into play.*
>
> *"Institutional dynamics, not venality or stupidity, set businesses on these courses, which are too often misguided. After making some expensive mistakes because I ignored the power of the imperative, I have tried to organize and*

[4] *The High-Tech Strategist*, Issue #350, 6 March 2017

manage Berkshire in ways that minimize its influence. Furthermore, Charlie and I have attempted to concentrate our investments in companies that appear alert to the problem."

The institutional imperative in Snap's case is the reflexive response by underwriters to initiate freshly-minted initial public offerings with a "buy" rating despite the company's lack of profitability and immense future competition. Similarly, publicly traded companies who overly focus on the current stock price, often pressuring Wall Street analysts about their investment rating, are all part of the institutional imperative. Focusing on the stock price or caring about Wall Street's investment rating is counterproductive. This behavior creates a major distraction for company management from focusing on what is important—running the business.

The institutional imperative can take many forms. "Window dressing" is a term used to describe the practice of a mutual fund making cosmetic changes to its portfolio just before the end of each calendar quarter. Mutual funds publish their exact holdings of securities four times a year based on what they own at the end of each quarter. The basic concept is that managers are either hiding their mistakes or adding winners to look smarter. The S&P 500 finished flat in the last week of the first quarter of 2017; yet, Amazon, Google, Apple, Tesla and Facebook all closed noticeably higher during that same week. This behavior is not an anomaly but rather the institutional imperative at work. Investors should think about the Latin expression *caveat emptor*: let the buyer beware.

INVESTMENT PHILOSOPHY

A stock-market rally inspired by confidence in central banks presents a difficult choice for many individual investors: Miss out or risk investing at the top of the market. The scars of the 2008 financial crisis have left many investors wary, even as the second-longest bull run in S&P 500 history has added more than $14 trillion in value to the index since it bottomed in March 2009. Overall, investor sentiment remains strong for the U.S. stock market.

A recent article[5] in the Wall Street Journal citied the story of an investment advisor in Charlotte, North Carolina. The story explained that one of the advisor's clients recently increased his stock allocation to 80% from 70% after cutting back on bonds based on frustration with low rates. The client, a 69-year-old retired neurosurgeon, said he is concerned about what the Trump administration may do as well as expensive U.S. stock valuations. But, he quickly rationalized the increase in his equity allocation, "*What do you do? If you take your investment out and stocks go up another 1,000 points, you're going to be pretty miffed. I'm slightly concerned that there might be a pullback, but I'm not losing sleep over it*."

Marrying the unprecedented level of confidence in central banks with the rising dominance of computerized trading strategies, one can make a plausible argument that the market is no longer an efficient discounting mechanism. The incessant push for short-term, data-driven trading gains stands in stark contrast to fundamental analysis and a focus on long-term investing profits. Stocks for the long-term now sounds like a quaint concept, as funds which trade on quantitative algorithms have grown rapidly over the past several decades. According to BarclayHedge, a hedge fund research consulting firm, assets managed by quantitative algorithms have grown to $250 billion—close to 10% of all hedge fund assets.

Given the improvement in data analysis via state of the art computers, what should be an increasingly efficient market actually shows signs of becoming less efficient. Oddly enough, this situation provides a

[5] *Individual Investors Wade in as Stocks Soar*, The Wall Street Journal, 10 March 2017

glimmer of hope for today's remaining active value investors who believe that fundamentals powerfully prevail over long time horizons. Today, a dramatic market inefficiency stems from the scarcity of capital devoted toward long-term, fundamentally-sound investing.

Surprisingly, some on Wall Street share the same belief. Bank of America's strategist Savita Subramanian published a research note where she noted "*The declining interest, assets and resources devoted to fundamental analysis suggests a significant opportunity in our view. Fundamental investing is not dead, far from it, but seems to require patience. Our analysis shows that fundamental signals see amplified performance as time periods are extended, but technical and positioning-based signals do reasonably well in the short term*." Subramanian's note emphasizes the point that over long periods of time, valuation is almost all that matters. She added that valuations have historically explained up to 90% of subsequent returns over a ten-year time horizon.

Value investors intuitively understand that as the investment time horizon lengthens, the probability of losing money in stocks generally decreases (historically dropping to 0% for the market over a twenty-year time horizon). Further, the ability to patiently hold stocks qualifies as a meaningful competitive advantage. To illustrate, consider the stark difference between a trader in the stock market and a business owner. The owner of a paint company does not wake up in the morning considering a sale to buy a pet store. The owner spends every waking moment thinking about making better paint, selling more paint, or doing something for customers that enhances competitiveness vs. other paint stores. The paint company owner operates with the intent to own the business for the long term, as equity is long-term capital with no expiration or maturity date. In contrast, obsessively watching share-price movements emphasizes short-term thinking. Value investors appreciate that time is far better spent analyzing the underlying businesses of a portfolio than trying to make sense of short-term stock price action.

The average holding period of a stock has fallen from eight years in the 1960s to around five days today[6]. A major consequence of such a short holding period is that investors fear short-term market events and volatility more than the economic factors driving long-term investment returns. Often, what makes investors successful is deceptively simple – easy to understand but hard to replicate. An investment process that focuses on finding wonderful businesses, buying them at cheap prices, and holding on long enough is simple but exceedingly difficult to execute. It is axiomatic that if an investor wants to beat the market, they cannot be the market, as the only way to outperform the market is to be different than the market. And time is the most powerful advantage an investor can have.

With kind regards,

St. James Investment Company

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[6] *Stock Market Investors Have Become Absurdly Impatient*, Business Insider, Sam Ro, 7 August 2012

ST. JAMES INVESTMENT COMPANY

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