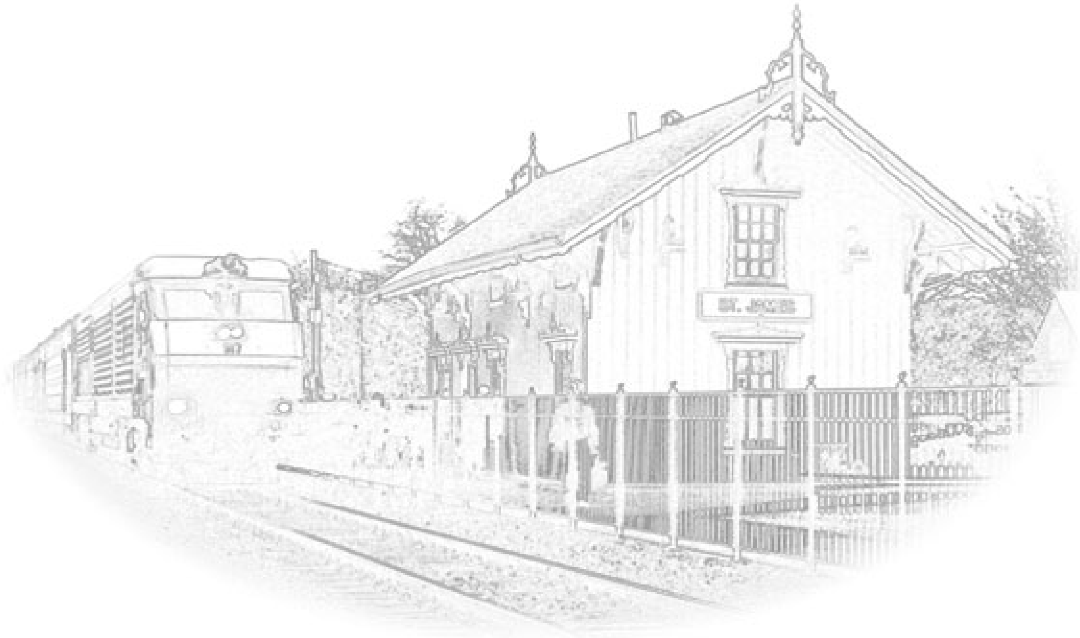

ST. JAMES INVESTMENT COMPANY

INDIVIDUAL PORTFOLIO MANAGEMENT

INVESTMENT ADVISER'S LETTER

OCTOBER 2015

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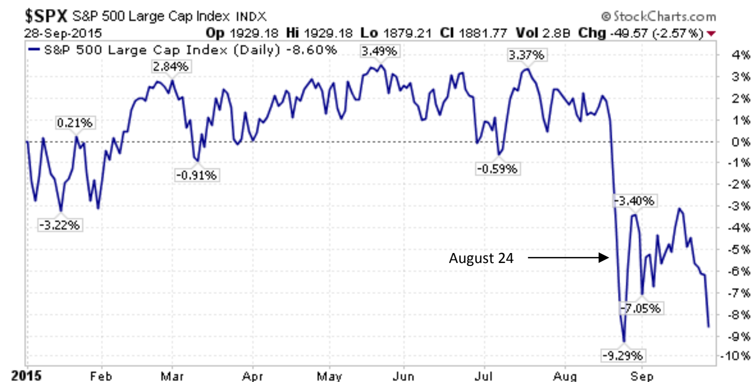
THIRD QUARTER LETTER

MARKET COMMENTS

"In a time of universal deceit, telling the truth is a revolutionary act." -George Orwell

The S&P 500 fell 6% from August 17 to August 31 - dropping as much as 11% during this period. August 24th proved to be the real shock to global markets. The Dow Jones Industrial Average fell more than 1,000 points at the open, rallied back and then declined 587 points, or about 3.6%. The S&P 500 ended the day off nearly 4%, while the NASDAQ dropped nearly 9% at one point, as popular momentum stocks rolled over. The disarray was global as Japan's Nikkei fell 4.6% and Germany's DAX was down 7%. The CBOE Volatility Index (VIX), Wall Street's fear gauge, spiked to levels not seen since December 2008.

While there are numerous catalysts potentially accounting for the market's sudden turn, we believe this plunge was attributable to a loss of faith in cheap money. The sudden drop illustrates the market's heavy addiction to the flow of central bank stimulus and a misplaced faith that cheap money remains the path to economic deliverance. Unfortunately, both are at risk.



A recent working paper[1] by the vice president of the St. Louis Federal Reserve Bank finds that after six years of quantitative easing which increased the Federal Reserve's balance sheet to $4.5 trillion, "*casual evidence suggests that QE* [quantitative easing] *has been ineffective in increasing inflation*" and only seems to have boosted stock prices. In a note to clients, Deutsche Bank warned that "*the fragility of this artificially manipulated financial system was exposed*" and that "*the only thing preventing another financial crisis has been extraordinary central bank liquidity and general interventions from the global authorities*." Barclays Capital economists admitted that Federal Reserve policymakers are "*market dependent*" and will not tighten policy during a stock correction. Finally, Alberto Gallo, head of credit research at RBS, was the most direct with his assessment: "*Policymakers responded to the financial crisis with easy monetary policy and low interest rates. The critics — including us — argued against 'solving a debt crisis with more debt.' Put differently, we said that QE was necessary, but not sufficient for a recovery. We are now coming to the moment of reckoning: central bankers look naked, and markets have nothing else to believe in*."

The stock market's overreliance on excess liquidity has actually hindered capital markets—companies are focused on debt-funded share buybacks and dividends rather than long-term capital investment. Now, concerns about China, lower commodity prices, lower demand, and foreign currency exchange volatility reveal the market's structural vulnerabilities. More monetary stimulus, inevitable at some point given the current mentality of central bankers, will once again prove ineffective.

[1] https://research.stlouisfed.org/wp/2015/2015-015.pdf

The 1,000-point drop on the Dow Jones Industrial Average was a 6.6% decline, a dramatic fall for a trading session but not a meaningful adjustment to overall market valuation. The best tool, we believe, to value the stock market remains the 10-year average "cyclically adjusted price/earnings ratio" or CAPE, popularized by Yale University economist Robert Shiller. Shiller's cyclically adjusted P/E ratio is simply a 10-year smoothed average of P/E ratios which removes the noise generated when using a current price-to-earnings ratio. According to Shiller's CAPE, U.S. stocks are still well above their historical average.

On August 4th stocks were selling at a CAPE of 26.4, 50% higher than the long-term average dating back to 1871. At the depth of Monday's August 24th drop, the CAPE was 23.6 — not exactly a bargain. In fact, stocks have only been more expensive twice before: once in 1929 and again in 1999. Given the reliability of this tool over 130 years of market history, we believe the U.S. stock market remains expensive and buying broad market exposure today will likely confine an investor to a future of low returns.

John Hussman of Hussman Strategic Advisers also projects muted market results, forecasting average annual returns for the S&P 500 of about 0.5% over the next 10 years[2]. On a broad range of historically reliable valuation measures, Hussman's analysis concludes the stock market peak in May reached valuations roughly 114% above historical norms. Such elevated levels stand in stark contrast to the 10% annualized returns many investors expect over the long-term. After the recent market pullback, Hussman's valuation measures now sit 92% above historical norms—better but not meaningful.

Unfortunately, almost all financial assets are expensive. Deutsche Bank studied the prices of equities, bonds and residential property in 15 countries going as far back as 1800. The average valuation of the three asset classes is above the level reached in 2007 and close to an all-time high. Of these three assets, bonds are the most expensive—nominal yields are near record lows; real yields (i.e., accounting for inflation, using a five-year average) have been lower only 17% of the time. For equities, Deutsche Bank compared stock market prices with nominal gross domestic product (GDP), a measure of the economy's output. Using this metric, equity market values have been higher only 23% of the time. For residential homes, Deutsche Bank could only generate reliable data beginning in 1970 and calculates that inflation-adjusted home prices peaked in 2007 and now sit at average valuation levels.

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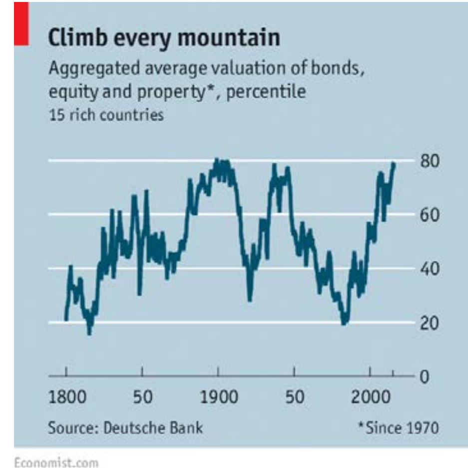
[2] http://hussmanfunds.com/wmc/wmc150907.htm

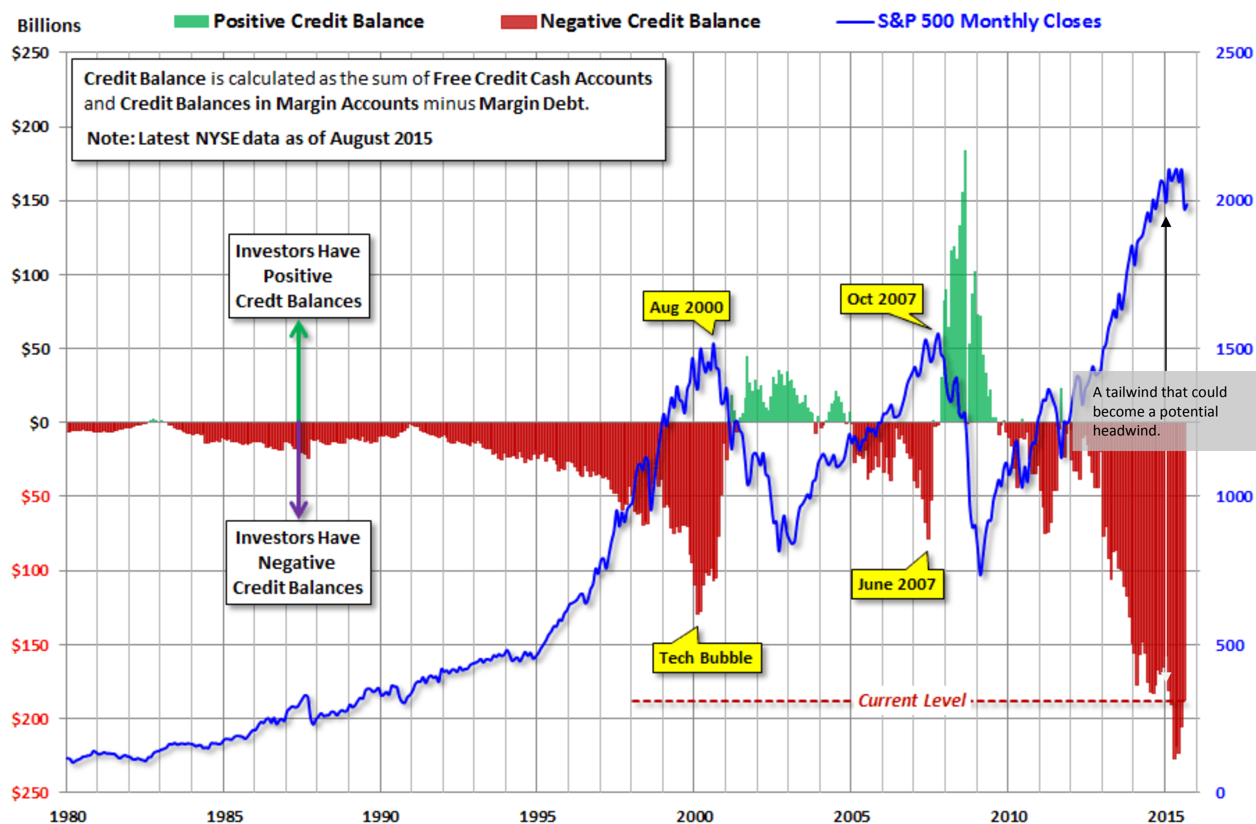
When it comes to equities, returns can continue to grow only if profits continue rising, or if valuations move even higher. Since profits at U.S. companies are already close to a record high, relative to GDP, rapid future growth is unlikely. And, hoping for higher valuations is not impossible but highly unlikely. Of course, there is always the chance that profits or valuations will drop to their historical norms. If this happens, Deutsche Bank calculates that the average real return from equities over the next ten years will be negative. The same is true for government bonds, corporate bonds and U.S. residential property.



The period when investors experience a market moving from a low valuation to a high valuation is pleasant; unfortunately, all good things come to an end. If equities move from trading on a dividend yield of 4% to a yield of 2%, then share prices will double (assuming dividends do not change). However, to repeat this performance, the dividend yield must subsequently fall to 1%. At some point, the revaluation stops and averages revert back to their mean.

The bond market is also concerning, as Barclays Capital issued a report outlining the risk to bonds in the current low rate environment. The graph below dates back to 1989 and highlights the divergence of yields to effective duration since 2009. At current levels of effective duration, or the sensitivity of bond prices to movements in interest rates, there continues to be the highest risk to rising rates than anytime over the past 26 years. Today's average duration of 5.5 means that bond prices will fall by 5.5% for every 1.0% rise in interest rates. Compare this elevated level with 4.2% in 2007 and 5.0% in 1999. In other words, today's risk of a decline of 5.5% for every 1.0% increase in interest rates means investors are exposed to potential bond losses 10% greater than their risk in 1999, and 23% higher than in 2007.

In addition to market valuation studies, background indicators provide additional metrics that describe current market conditions. For example, a background indicator signaling potential risk is the level of margin debt at the New York Stock Exchange (NYSE). Margin debt measures the amount of money borrowed for the purposes of leveraging a stock position. The higher the level of margin debt, the more leverage in the system and the greater the amount of potential risk. As of April, NYSE margin debt stood at an all-time high at more than $500 billion. After August's market decline, margin debt sits at $473 billion, down 6.7% from the highs.



Only in hindsight will one ever know if the stock market's recent drop indicates a normal pullback or signals the beginning of a larger trend. Considering the current elevated levels of margin debt, the resulting move in stocks could be meaningful. During periods of rising stock market prices and low volatility, excesses build. The buildups of these excesses, in metrics like margin debt, serve as a tailwind for the market as long as prices continue to rise. However, when markets decline, these tailwinds quickly become headwinds.

In a June 19 blog post[3], Dominique Dassault of Global Slant details a conversation with a "black box" equity trader from one of the world's largest hedge funds. The trader explained how he converted from an unsuccessful, discretionary technical trading style to a purely quantitative and scientific trading mode. The fund's black box modeling team had back-tested every conceivable variable from every perceived angle in order to gain an "*edge*" over the competition. The team's leader acknowledged that "black box" trading was somewhat delicate. The algorithms may work for a while but then, inexplicably, they will just completely "*blow-up*". To him, the most important component to quantitative trading was not the creation of a good trading model but rather the real challenge was to "*sniff out*" the degrading of the model prior to its inevitable implosion because, "*you know, eventually they ALL blow-up*."

[3] http://globalslant.com/2015/06/black-box-trading-why-they-all-blow-up/

This honest remark begs the question as to why do black box trading models all "blow-up". And if they eventually all "blow-up", then why even do this in the first place? His simple explanation to the second question is direct but very disturbing, "*We are all doing this because we can all make a lot of money before they blow-up and after they do blow-up nobody can take the money back from us*." As to the first question, "*Despite what we all want to believe about our own intellectual uniqueness, at its core, <u>we are all doing the same thing</u>. And when that occurs a lot of trades get too crowded, and when we all want to liquidate these similar trades at the same time, that's when it gets very ugly*."

Despite the blow-ups faced by several famous black-box trading firms utilizing risk-parity strategies, the market decline of recent weeks was not a crash. The reason that the word "crash" is used is because investors have lost all perspective of the losses that one historically associates with this term. Regardless of how we debate the definition of a word, a value investor should never be scared of the stock market but rather stand ready to exploit the opportunity when others act irrationally. When black-box hedge funds blow themselves up, opportunity is potentially at hand. Forced selling, unrelated to changes in the underlying fundamental value, is a gift for the patient investor, as August 24th provided a brief glimpse of this potential gift. No matter how much trading is done by computers, stocks are not lottery tickets.

A patient investor appreciates that stocks are ownership claims on a long-term stream of future cash flows. Paper gains create paper wealth, not aggregate wealth. Likewise, paper losses destroy paper wealth, not aggregate wealth. For example, suppose an investment security offers a $100 payment 10 years from now. If the investor pays $50 for that security, they will earn a 7.2% annual return on their money. However, if the investor overpays and offers $150 for that same security, they will generate a -4% annual loss on their money. In both scenarios the investment security represents $100 in 10 years—there is no change in aggregate wealth. Patient investors who continually buy stocks from others at depressed prices, and sell them to others at elevated prices, will accumulate a greater share of aggregate wealth. Speculators who do the opposite will surrender their share of aggregate wealth.

We conclude that, after all the drama of the past two months, stocks are a little cheaper than they were before but not meaningfully cheaper to alter our current course.

INVESTMENT PHILOSOPHY

"*Complexity is not intelligence*" -Michael Lewis

The oldest cockroach fossil is 350 million years old. By contrast, human beings have only been around for 200,000 years. Cockroaches survived the third, fourth and fifth global mass extinctions—the last extinction being the Cretaceous period event that ended the dinosaurs. Cockroaches can go without air for 45 minutes, survive submerged under water for half an hour and can survive freezing temperatures. They can even withstand 15 times more radiation than humans; meaning, they stand a better chance of surviving a nuclear war. How? Cockroaches operate according to one of the simplest algorithms in nature. Richard Bookstaber's book, <u>A Demon of Our Own Design</u>, describes the cockroaches' survival strategy as: "*singularly simple and seemingly suboptimal: it moves in the opposite direction of gusts of wind that might signal an approaching predator*." That's it—simple but incredibly robust. A value investor will intuitively understand that valuations represent that gust of wind—rich valuations are a warning to investors to move away from danger.

Richard Bookstaber's book tackles the question of "*why do our markets keep crashing?*" by using decades of observation to show that our so called efficient markets are actually "*built to crash*". Markets are clearly not fragile because of a lack of information. Bookstaber notes that we drape layers of complexity over our markets in the form of options, portfolio insurance, leverage, statistical arbitrage, and regulations. As a result, the financial system is now "*tightly coupled*" where stability depends on many components all working in harmony. Although the failure of any one component in isolation is unlikely and inconsequential, the same failure within the context of a larger, more complicated system can trigger a rapid collapse of the system. Making corrections becomes more difficult, as actions taken to stop the crisis actually end up accelerating the unwinding. For instance, in a flight to liquidity, mass selling of an asset in order to reduce margin debt creates even more selling.

By keeping the algorithm simple, the cockroach can respond to whatever environment it encounters. On the other hand, species that develop behaviors optimized for their current environment flourish while the ecosystem remains constant, but perish when confronted with a new ecosystem—not unlike black box trading systems highly optimized for the current complex trading environment. However, as a patient investor with an extended investment time horizon, what may prove suboptimal for any one investment market environment will always prove more than satisfactory for a wide range of unforeseeable market environments. In the long run, the best approach is to hedge against the unknown. Bookstaber cautions, "*Just because you can create a swap or forward contract to trade on some variable doesn't mean it makes sense to do so... Each innovation adds layers of increasing complexity and tight coupling*." The prescription to fix the system is easy—simplify.

For our long-term investment survival, we believe that an optimal equity portfolio should hold at least fifteen separate companies, ideally somewhere between fifteen and twenty-five. A lower number of underlying holdings might be unreasonably concentrated while a greater number simply amounts to "*diworsification*", a phrase created by Peter Lynch to describe a manager's lack of focus. For each portfolio holding, we seek a company that possesses a high quality business with a sustainable competitive advantage. We want quality management, who continually align their interests with those of their shareholders. We invest our capital only when shares are trading at an attractive discount to a reasonable assessment of the company's inherent value. We prefer that our companies have minimal debt and we ensure that our holdings are not dominated by any one industrial sector.

When in doubt, we do nothing. We believe that sitting on our hands is far better than creating complexity by overtrading. We admittedly adhere to a simple investment philosophy, but effective for all investment environments.

With kind regards,

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 almost fifteen 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.

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