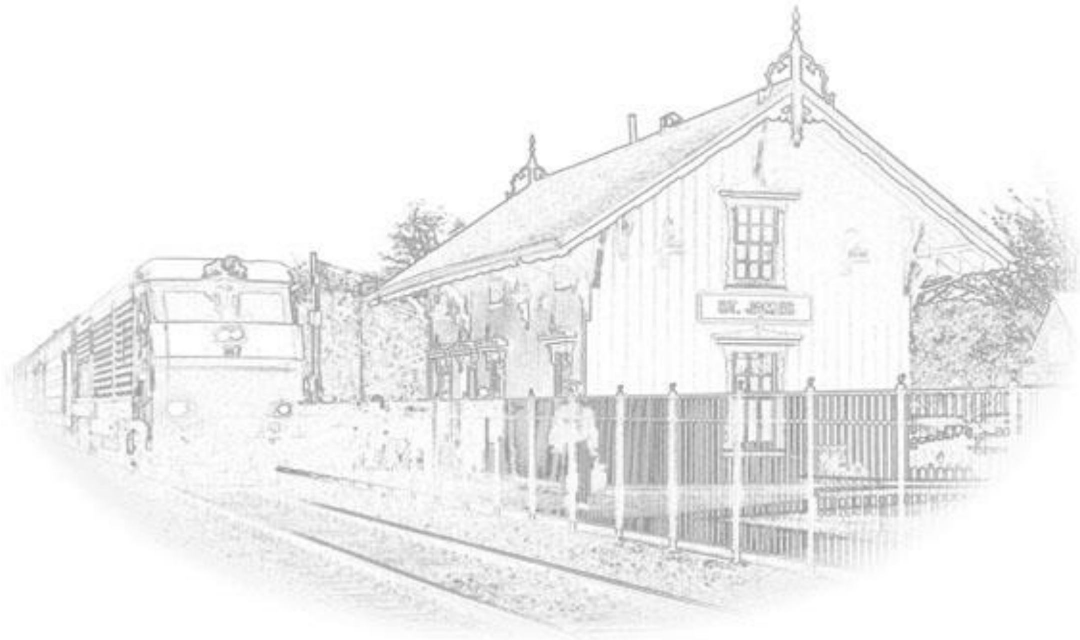


ST. JAMES INVESTMENT COMPANY

INDIVIDUAL PORTFOLIO MANAGEMENT

INVESTMENT ADVISER'S LETTER

JANUARY 2022

WWW.STJIC.COM
3838 OAK LAWN AVENUE, SUITE 1414
DALLAS, TEXAS 75219

"You can avoid reality, but you cannot avoid the consequences of avoiding reality." —Ayn Rand

IBM was not the first company to build computers. The distinction belongs to Sperry-Rand's subsidiary UNIVAC, which introduced the first commercially successful computers in the early 1950s. In this era, IBM did possess the largest research and development department of the business machines industry and quickly caught up, introducing cost-competitive computers a few years after UNIVAC. By the late 1950s, IBM held the dominant market share in computers. IBM also touted a vastly superior sales organization, which used a sales tactic called "paper machines" (the equivalent of today's "vaporware"). If a competitor's product was selling well in a market segment that IBM had yet to penetrate, the company would announce a competing product and start taking orders for the "paper machine" long before it was available.

One cannot overstate how powerful IBM was in the computer industry in the 1950s and 1960s. Every competitor rightly worried that if their product worked too well for too long, it was only a matter of time before an army of IBM salesforce representatives mobilized. In their easily recognizable uniforms of starched white shirts, red ties and blue suits, IBM marketers marched on their customers and offered a more expensive, but much more defensible, choice. "*Nobody gets fired for buying IBM*" was a common phrase. Even competitors acknowledged that the company excelled at sales. As a UNIVAC executive once complained, "*It doesn't do much good to build a better mousetrap if the other guy selling mousetraps has five times as many salesmen*."

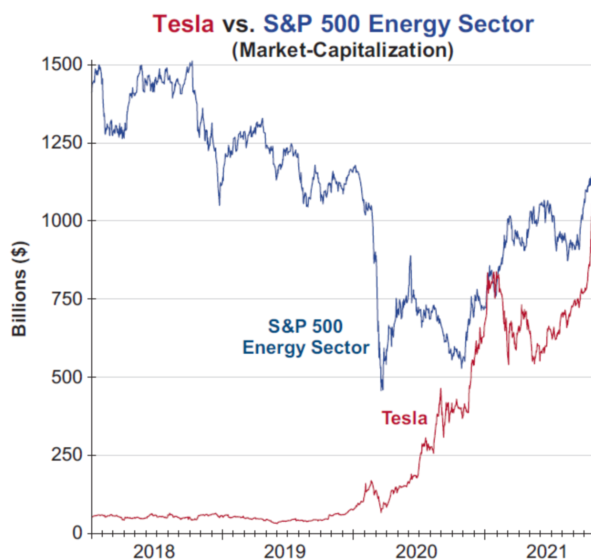
The IBM 360 product, introduced in 1964, was IBM's most intensive development project in history, costing twice as much as the Manhattan Project by some estimates. The 360 was a series of machines that had compatible code, allowing customers to easily upgrade from one computer machine to the next as they scaled without needing to rewrite their software. While the 360 represented a technological advance, it was also an organizational change—a way to give the company a strict hierarchy of products so it could enhance pricing power. The launch of the 360 represented IBM's apex in terms of influence and ability to shape markets, although their financial peak was still years ahead.

In his 1942 book *Capitalism, Socialism and Democracy*, Joseph Schumpeter described the dynamics of a market economy as a process of "*creative destruction*." In his view, innovation— "*the new consumers' goods, the new methods of production or transportation, the new markets, the new forms of industrial organization that capitalist enterprise creates*"—drives this process. A market economy provides the means for the mass of the population in developed countries to enjoy a standard of living that even the kings of past ages could scarcely have imagined. As a market based economy develops, it necessarily brings about an immense variety of changes in particular demands and supplies, which result in losses as well as profits. Creative destruction occurs when innovations, such as new technologies or new business models, demolish the capital structures of well-established industries that have lost the ability to satisfy the changing demands of consumers. This process can happen almost overnight, such as when the vinyl record industry collapsed with the introduction of digital music.

IBM was the most profitable company in America in 1985 and accounted for 6.4% of the S&P 500 Index. By 1992 IBM reported what was then a record annual loss for any U.S. corporation. The story of IBM's long-term collapse was not the result of any one decision. IBM's sales centric approach assumed a slower industry cadence than the one that developed in the 1980s. Rapid growth in low-end computers reduced the relevance of their competitive advantage in large-scale, long-term deals. As low-end computers grew

increasingly powerful, software began to proliferate. IBM found it increasingly difficult to operate within an industry it no longer dominated. IBM had an incredible stretch of nonstop growth, and the company's ability to keep growing while disrupting itself was astounding. The IBMs of today perhaps include companies like Facebook and Apple—each dominates their respective industry in a similar way that IBM once did. Change is inevitable and each of these companies may one day succumb to market forces at some point in time.

Today a small group of stocks dominate today's market to such a degree that Goldman Sachs created the acronym FAAMG to identify this select group of stocks: Facebook (Meta), Amazon, Apple, Microsoft, and Google (Alphabet). These five stocks account for 23.1% of the S&P 500 Index's market capitalization, a measure of value calculated by multiplying a company's total outstanding shares by its last traded stock price.[1] The sixth largest company in the S&P 500 Index is electric vehicle company Tesla with a weighting of 1.94% and supporting a market capitalization of $1 trillion. The market capitalization of Tesla now exceeds the entire value of the energy sector within the S&P 500 despite the energy sector's trailing twelve-month revenue of $897 billion, which dwarfs Tesla's revenue of $46 billion. In fact, the combined market value of the twenty-one energy stocks in the S&P 500 only equals the 2021 increase in Apple's market capitalization.



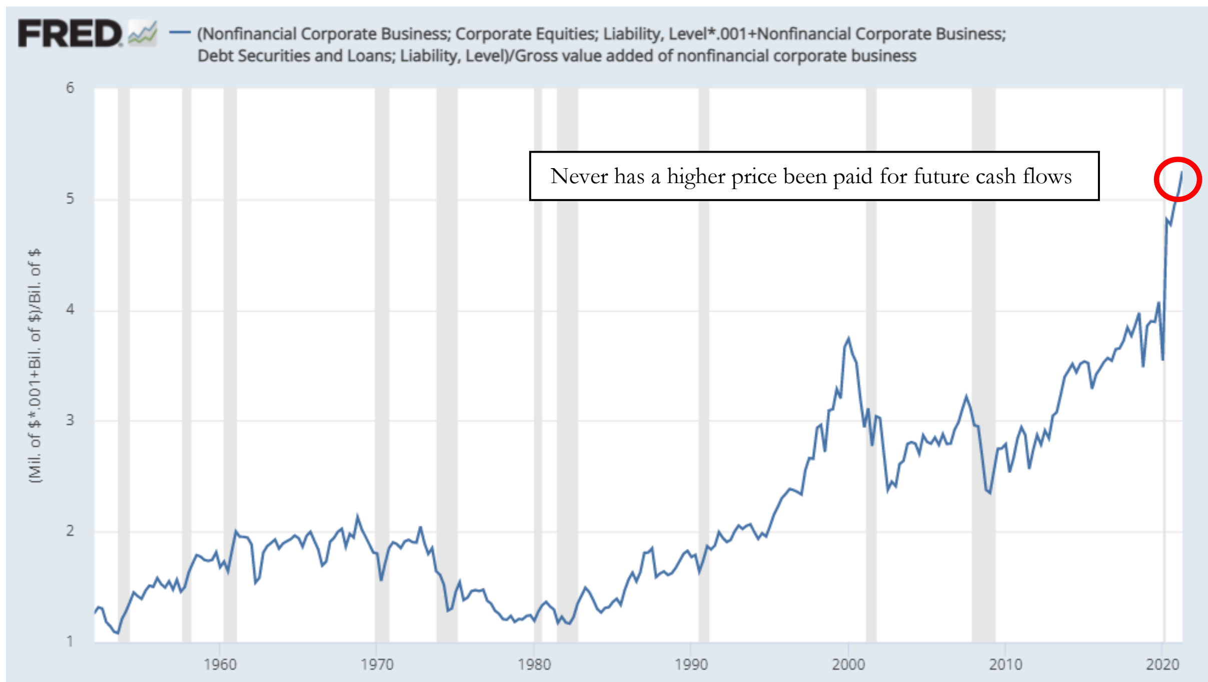
Many investors underappreciate the sheer intellectual horsepower typical of companies in the energy industry. The army of scientists and engineers at Schlumberger and Exxon Mobil are every bit as talented as their peers at Apple, Facebook, and Amazon. The technology sector could not exist without the energy sector. The FAAMG stocks, including Tesla, are amazing companies. However, at some point Wall Street's investment narrative separated price from value. A common problem with every business cycle as it advances to its later stages is that investors extrapolate the recent success of strong performing industries, which further drives momentum and speculation. Priced with unrealistic future growth assumptions, the valuations of underlying businesses detach from operating fundamentals.

During economic downturns, the creative destruction process purges the financial system of accumulated excesses. In the subsequent recovery, new market leadership arises from sectors and industries that differ from those of the prior expansion. Embedded in today's market darlings are valuations that assume sustained high liquidity and low inflation. If one believes that the business cycle remains intact, then too much liquidity creates inflation. Too much inflation requires the removal of excess liquidity, which catalyzes a subsequent economic downturn. After twenty-five years of declining inflation, coupled with suppressed cost of capital, technology related businesses have achieved complete dominance in the global equity markets. A secular shift in the inflation outlook may no longer support the powerful tailwinds the technology sector has enjoyed for so long.

[1] https://www.slickcharts.com/sp500

Among the illusions encouraged in every speculative bubble is the idea that the price of a security equals wealth, and that higher prices inherently represent greater wealth. Importantly, the value of every security is a claim to the future stream of cash flows that an investor expects to receive over time. The investor's wealth resides in those cash flows—not the price of the security. One obtains the market price of a security only by selling it to someone else. Ultimately, someone must own every security until it is retired, and the value of this security depends on only one thing: the cash flows the security will deliver over time. This is where wealth resides, not in the security price. Until a security is retired, every transaction is simply a transfer of wealth between buyers and sellers.

What investors view as wealth is just the current price of their future wealth. Except for individual investors who sell into the extreme valuations that are periodically offered by exuberant markets, stock prices are just flashing numbers on a computer screen. For long-term investors, the wealth is and will always remain in an asset's cash flows. According to economist John Hussman, when one divides the market's capitalization by the value-added production that generates the cash flows, one produces an insightful picture of future long-term investment returns. Hussman has long argued that valuation measures based on these comparisons are also the measures best correlated with actual subsequent market returns. At present, that picture has never been more extreme. Hussman's chart below shows the sum of equity market capitalization and debt for U.S. nonfinancial firms, divided by the gross value-added (essentially revenues) of those firms.



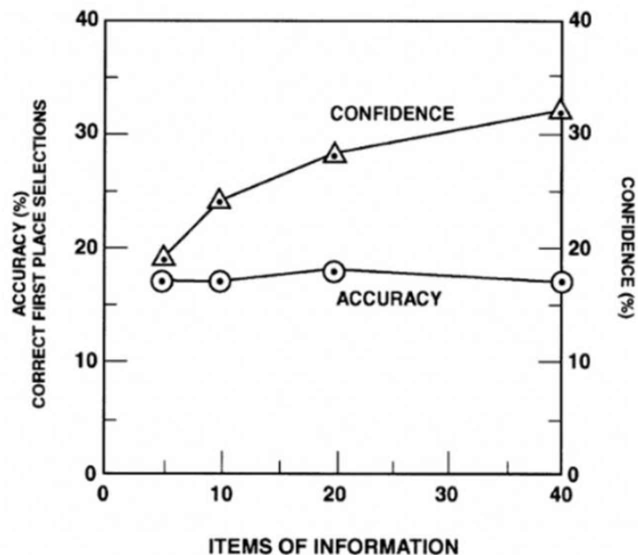
If one is an investor and not a speculator, the essential question an investor must always ask is, "*How much am I paying for the stream of cash flows that I expect to receive?*" If a security is nothing more than a claim on a very long-term stream of cash flows that an investor expects to receive over time, then the higher the price an investor pays today for those cash flows, the lower the long-term return the investor can expect. This is not conjecture, this is just simple math.

Not too long ago investors operated in a market with no Internet, no smartphones, no algorithms processing "Big Data," and no quarterly earnings conference calls. Today's instant and constant information floods market participants. One may argue that this phenomenon partially explains why

stocks defy simple math and trade at incredible valuation premiums to prior market cycles. More information can make investors overconfident, but more information does not necessarily translate to better results. On the contrary, too much information can artificially inflate one's confidence so that he or she accepts greater risk without any additional insight to predict the outcome of future events.

In 1973, psychologist Paul Slovic created an experiment with a group of professional horse handicappers—individuals that made their living on horse betting. The handicappers were given various amounts of information for purposes of making their bets. The researchers tracked the success and confidence of each handicapper as more information became available. Importantly, the study group consisted of professionals—they earned their living from wagering on horse betting and were not merely casual gamblers. The study followed a specific sequence. First, the handicappers had to predict the outcome of a set of races with no information about race participants. For the next race, the handicappers were given five requested pieces of information. Then ten data points. Then twenty. And finally, each bettor received forty pieces of information for the last set of races.

The researchers tracked (1) accuracy of prediction and (2) confidence with each race. The results demonstrated that while a small amount of information increased the accuracy of predictions by about 70%, the information above five pieces of data only served to increase confidence. Accuracy flatlines at 17%, but confidence jumped to 34% when forty pieces of information became available. With higher confidence, the handicappers increased their bets without any higher accuracy, ultimately producing worse overall results. The lesson is that beyond some small amount of useful information, additional information only feeds existing biases. Contrary information is ignored or often dismissed, while additional information feeds and reinforces a flawed view.



This practice is called confirmation bias. As more facts become available, one incorporates those facts that support their case for an opinion but ignore any facts that that support a contrary opinion. Likewise, one thinks that they understand the world, but even the most seasoned investors occasionally claim that a trend does not make sense. "*It doesn't make sense that interest rates are so low*" or "*it makes no sense that stocks keep going higher*." Investors may not understand the current trend because they see valid reasons why the trend should be moving in the opposite direction, yet it keeps moving in the current direction. They believe the trend makes no sense. The reality is that one must invest in the markets as they are, not as they want markets to behave. To believe otherwise ignores reality.

Today's value investor looks around the world and finds it hard to believe that since January 2020 (just prior to the Covid market crash) the stock market, as measured by the Wilshire 5000 Index, has increased in value equal to what the entire market was worth at the top of the dotcom technology bubble in 2000 (approximately $14.5 trillion). Many facts support concerns about market valuations, yet the current trend continues to power stock prices higher. One wonders what would precipitate a market decline, perhaps nothing more than an effort to take profits would be enough. To be clear, there are no limits to

market extremes that cannot become more extreme. The point is that there are certain features of valuation, investor psychology, and price behavior that emerge when the fear of missing out becomes extreme and the focus of speculation becomes narrowly focused on a small set of stocks.

While investing strictly "*by the method of valuation*", as Benjamin Graham called it, may be effective over the long run, it can prove painful over more limited periods. From the vantage point of record valuations, the current environment presents an opportune moment for an investor to obtain a "wealth transfer" from other investors….by selling. Logically, someone must always hold every share of stock outstanding—it is impossible for everyone to leave the market simultaneously. Market capitalization is only the price at which the most recent buyer and seller traded even a single share of stock, multiplied by the total number of shares of company stock outstanding. Currently, the market capitalization of U.S. equities stands at $68 trillion, about three times the $23 trillion level of the U.S. economy (GDP). At the 2000 technology dotcom market peak, U.S. market capitalization reached a record 1.9 times GDP, a quaint number in hindsight that sits 36% below the current multiple.

Although market capitalization compared with economic output is a common valuation metric, one must remember that market capitalization is not wealth. Market capitalization is simply the last traded stock price, multiplied by the company's shares outstanding. If someone buys a single share of Apple at a price that is $0.05 higher than the previous trade, $820 million in market capitalization emerges from digital ether. If a single share of Apple stock trades $0.10 cents lower, $1.6 billion evaporates just as quickly. Ultimately, the wealth inherent in a security, or a market of securities, is the future stream of cash flows delivered to the stockholder over time. Price fluctuations do not change those underlying cash flows—they just provide opportunities for the transfer of savings between investors.

Because high valuations favor sellers, corporate insider selling can be insightful. Recently, Bloomberg reported that, "*Mark Zuckerberg sold Meta Platforms Inc. stock almost every weekday of this year. The founders of Google began to unload shares in May, which is also when two of the three Airbnb Inc. co-founders started diversifying their stakes. The transactions are part of a surge of selling by the very richest Americans*." Additionally, Elon Musk sold 10% of his Tesla stake in recent months and Jeff Bezos has sold a record amount of Amazon stock. As sellers, the insiders at these dominant companies are using high valuations to transfer wealth away from today's buyers.

A stock market bubble does not increase the level of wealth, just as a market collapse will not decrease the collective wealth for owners of securities. Only market capitalization changes: therefore, one need not forecast where prices will go, but rather only on the future cash flows and the appropriate valuation to apply to those future cash flows. Consequently, an investor's main consideration is to ensure that an investment allocation is aligned with their investment horizon and risk-tolerance. If one chooses to be heavily invested in stock index funds today, then it's important to understand there has never been a higher price paid for the future cash flows tied to the index.

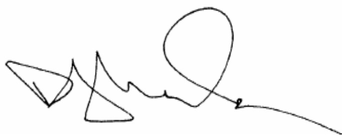
The 1940 edition of Benjamin Graham's *Security Analysis* is timely for today's value investor. The search for public securities priced at a discount from estimated intrinsic value over the past decade has been difficult and often frustrating. Eighty-one years ago, markets exaggerated price momentum both upwards and downwards—narrative and manias were just as popular back then as they are today. Similarly, market participants pay more lip service to the value investment approach in word than deed. "*The partialities of the market have tended to confound the conservative viewpoint*," Graham wrote with his co-author, David Dodd.

Risk aversion is at the heart of the investment approach employing a value philosophy. Graham and his generation understood that concept instinctively, having endured World War I, which gave way to the Spanish flu pandemic, followed by the 1920–21 depression. And while investors prospered in the 1920s, one was lucky to have survived the markets of the 1930s. Germany invaded Poland in 1939, and World War II was under way when Graham and Dodd published their second edition of *Security Analysis*. Graham somehow found the fortitude to write the first edition of *Security Analysis* as his own finances were collapsing—between 1929 and 1932. The value of Graham's investment partnership dropped by 70%.....his resilience was admirable.

Graham always took the world as it was, not how he wanted it. "*The notion that the desirability of a common stock was entirely independent of its price seems incredibly absurd*," he wrote. Determining the desirability of a security independent of its price defies the timeless principle that the price one pays determines the value one receives. This concept is just as pertinent today as it was back in 1929. Today, many market participants have once again forgotten that valuation is the ultimate mechanism of market returns. Graham noted that such behavior led to price-to-earnings ratios of fifty and more back in 1929. Today, Bloomberg counts 253 American companies with price-to-sales ratios of fifty and higher. No different between today and then is the relentless cycle of innovation in technology and industrial organization, and the creative destruction that typifies every business cycles.

Graham spoke of the paradox in market cycles: "*At the very period when the increasing instability of individual companies had made the purchase of common stocks far more precarious than before, the gospel of common stocks as safe and satisfactory investments was preached to and avidly accepted by the American public*." Today's low opinion of value investing is attributable to the narrative of the times. After a decade plus of unprecedented liquidity and costless capital, growth and technology dominate today's stock market. That was the reality of the past decade, and value investors who ignored this reality suffered the consequences. But as Graham-disciple Seth Klarman wrote, *"adhering to a value approach means standing apart from the crowd, challenging conventional wisdom, and opposing the prevailing investment winds."* Those who pay a rich premium for quality and safety gain neither. Instead, they expose their savings to potentially significant risks. One never knows what events will bring about the realization that today's winners are now priced for perfection, just as few could see how IBM's fortunes peaked in 1985.

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 over twenty 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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