

ST. JAMES INVESTMENT COMPANY

INDIVIDUAL PORTFOLIO MANAGEMENT

INVESTMENT ADVISER'S LETTER

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THIRD QUARTER LETTER

MARKET COMMENTS

"We will learn an enormous amount in a very short time, quite a bit in the medium term, and absolutely nothing in the long term."

--JEREMY GRANTHAM, DECEMBER 2008

In late 2008 Lehman Brothers had just collapsed, AIG needed help from the US government and markets around the world were in a tailspin. Today, five short years later, we find it strange how the strength of the stock market defies a climate of declining earnings. With another quarter of corporate results behind us, equities continue to rally despite corporate earnings offering no material support, with many companies actually talking down their future growth prospects. According to Société Générale, S&P 500 companies are expected to increase earnings by 3.6% year-on-year for the quarter, yet will decline by 1.3% excluding financials. In contrast, the S&P 500 has gained 18% over the past year while the financials have gained 33%. Stocks typically react to changes in future expectations, but looking ahead we fail to see any sustained positive earnings momentum.

Perhaps the real reason for the market's strength has to do with cash—companies are generating only meager revenue growth but are returning record amounts of cash to their investors in the form of dividends or share repurchases. While company efforts to return capital to investors are admirable, we see an admission that companies have few opportunities to invest for growth. In an environment where investors are desperate for yield, markets bid prices higher seeking cash dividends. Still, this is not a strategy that can last forever; at some point companies must generate more revenues and profits from which to make these cash payouts and justify current valuation levels.

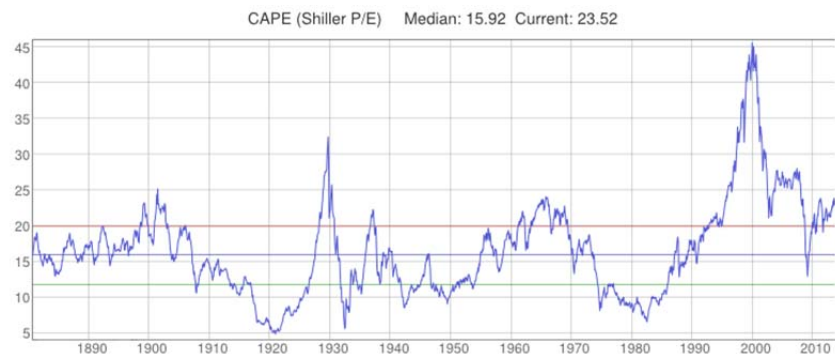
Somewhat depressingly, the current U.S. economic recovery is on the same path as it was before the recession: an economy driven by consumption and cheap imports. In our opinion, these are the first steps toward a future crisis. The US economy is not really recovering, but merely picking up its old bad habits – in which people spend more money on more stuff they don't need and can't afford. Can stocks rise further? Yes, of course—we have no idea what the future holds, but at current valuations we have our doubts about this market.

We base our market valuation judgments on a measurement developed by Robert Shiller, a Yale economist, who articulated a metric known as "CAPE" in his book *Irrational Exuberance*, published in 2000. CAPE, which stands for cyclically adjusted price-to-earnings multiple, incorporates earnings data back to 1871. The premise behind CAPE is simple—taking a multiple of one year's earnings is misleading as stock markets naturally adjust when profits are cyclically high or cyclically low. In contrast, CAPE compares prices to the average of inflation-adjusted earnings over the past ten years. By smoothing out the cyclical volatility associated with reported earnings, an investor can clearly see whether stock markets are overvalued or undervalued. According to Professor Shiller's metric the US stock market is 62% overvalued, and currently more expensive than any other major stock market in the world.

Recently several academic arguments disputing the relevance of the Shiller's CAPE P/E have recently appeared, suggesting that the accounting treatment of write-offs in recent decades has now made CAPE obsolete. Of note, well-known Wharton School economist Jeremy Siegel contends that CAPE is based on faulty data. Professor Siegel has produced a new version of the CAPE which he contends corrects

Professors Shiller's mistakes and suggests that US equities are cheap. Not surprisingly, Siegel's arguments have gained favor with many on Wall Street. Ordinarily, we would chalk this disagreement up to little more than an academic argument if it were not happening at such a pivotal moment of uncertainty within the equity markets. Given our pessimistic disposition to current market valuations, we find it interesting how the more optimistic crowd on Wall Street tends to move the goal posts when it suits their needs. We recall when analysts began talking about new valuation metrics such as "price-to-eyeballs" multiples for valuing internet stocks and price-to-EBITDA multiples for telecommunication and media companies in 1999.

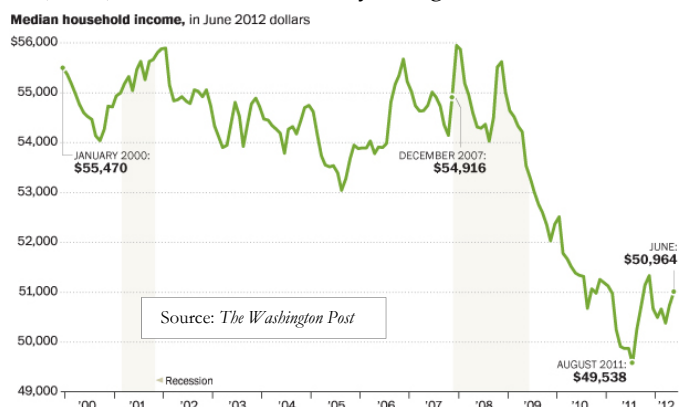
As the chart shows, extremes in the Shiller CAPE P/E have coincided with favorable times to overweight or underweight equity allocations. By staying far above its long-term average during the rebound that followed the technology collapse from 2003 to 2007, CAPE provided fair warning that the rally was misleading



ahead of the far worse credit crisis of 2007 to 2009. Professor Siegel previously called the CAPE "the single best forecaster of long-term future stock returns", but now he says that the data on which it is based is unreliable, thereby sending out a false signal that stocks are expensive.

Personally, we might have found Professor Siegel's argument more compelling if not for the fact that other valuation measures such as price-to-revenue, price-to-dividend, price-to-book value, and market capitalization-to-GDP did not all currently point to the same overvaluation the Shiller P/E indicates. On the subject of economy-wide measures, the present ratio of equity market value to GDP is consistent with an expected 10-year nominal S&P 500 total return of about 3%, which is about the same figure one obtains using Shiller's CAPE P/E and other historically reliable measures. Nearly all of this total return can be expected to come from dividend income, suggesting that the S&P 500 index could be little changed from present levels a decade from now.

Unlike unemployment or gross domestic product (GDP) statistics released by the government, median household income is a number that is difficult to manipulate. Regrettably, median household income is now worse than during the "official" recession from 2007 to 2009. We have an economy that is materially weaker than the 'recovery' proclaimed by politicians and Wall Street, but clearly the market is not discounting this weakness. The stock market has pushed higher this year—putting in all-time highs—even though earnings growth has clearly slowed.



Five years ago the average price of the Ford F-150 pickup truck was \$18,000. Today, the average price is \$24,000. While the average workers' wages stagnate, cars grow more expensive, because we are

effectively destroying the value of the dollar with inflation. The net result is prices go up in nominal terms and wages go down in real terms. Although the Federal Reserve's policy of quantitative easing can generate commerce, it cannot create wealth for an economy. You simply drive people out of the dollar and into other assets.

A glance at the housing market confirms that home prices are moving higher. Residential homes sales volumes are up, although primarily at the lower end of the housing market. Nevertheless, housing demand has increased, as has lending. Although the Federal Reserve's low-interest-rate policy has made it easier for people to buy homes, the most significant change is the nature of purchasers. We now have private equity funds and real estate groups buying hundreds of thousands of homes. In a normal functioning housing market, two-thirds of real estate activity is organic, meaning people buy homes to live in them. Today, that ratio is reversed: more than two-thirds of all real estate activity in the country today is driven by investors. Is that a housing recovery, or a speculative wager on higher asset prices driven by artificially low interest rates?

Slowing profit growth and a rising market mean valuations grow more expensive. Bloomberg reports that *'Valuations last climbed this fast in the final year of the 1990s technology bubble, just before the index began a 49% tumble.'* We believe that this is the time for the honest investor to keep their powder dry and remain cautious simply due to the relative scarcity of cheap stocks.

According to John Williams at Shadow Government Statistics, the Federal Reserve purchased 110% of the U.S. Treasury's net debt issuance this year. Meaning the Federal Reserve Bank bought every new dollar of debt issued, and then some. By the end of October, Williams calculates that the Federal Reserve's purchases should be approaching 140%. This clearly cannot continue indefinitely, otherwise the Federal Reserve will eventually own the entire federal debt market. As it stands now, it owns about 1/3 of the entire federal debt market. When it ends interest rates will likely rise, ending the easy-money party.

"Correlation does not imply causation" is a phrase often used in science and statistics to emphasize that a correlation between two variables does not necessarily imply causes. However, one quick glance at the graph below and it appears obvious that the Federal Reserve's expanding balance sheet via quantitative easing is the primary driver of today's ever-rising (and more expensive) stock market.



INVESTMENT PHILOSOPHY

Boston Red Sox outfielder Ted Williams was the last baseball player to have a batting average of .400. In 1941, Williams batted .406, and since only four players have hit as high as .380. Many baseball historians say that Williams' record will never be broken.

Importantly, Williams had an analytical mind and was a disciplined hitter. He estimated his batting average in each area of the strike zone and would swing only when the ball was in the area where he had the highest probability of getting a hit. He calculated that if the ball were thrown right down the middle, he would have a .400 batting average. If he swung at pitches in the lower-right or left-hand corner of the strike zone, he assumed his batting average would drop. The differential is extreme. In his best zone he hit .400, and in his worst zones he hit just .230, for a difference of .170. Understanding his strengths and limitations, Williams refused to expand his strike zone. He would rather walk than swing at a pitch that could lower his average.

Similar to Williams' approach to hitting, successful value investing necessitates patience and discipline. We swing only at the pitches down the middle—seeking financially sound companies that can be purchased at attractive prices. Simple enough, but over the past several quarters this methodology has become increasingly difficult to execute. The inexhaustible rise of the stock market fueled by quantitative easing has left very few stocks in bargain price territory, as the low-hanging fruit has already been picked. Howard Marks of Oaktree Capital said, *"The greatest risk doesn't come from low quality or high volatility. It comes from paying prices that are too high. This isn't a theoretical risk; it's very real."* In other words, the stock market is currently throwing few, if any, pitches right down the middle.

Published in the late 1950s, Philip Fisher laid out his *"Fifteen Points to Look for in a Common Stock"* in the conclusion of his famous book *"Common Stocks and Uncommon Profits,"* where he cataloged his most important concepts from over half a century of investing. Perhaps second only to Benjamin Graham, Philip Fisher's influence is seen with Warren Buffett who repeatedly made investment selections that combined a truly great company with the appropriate investment time horizon – an approach that ideally suited Berkshire Hathaway's opportunity set as the company grew in size. Naturally, several of Fisher's points resonate strongly with our investment approach at St. James:

- Buy into companies that have disciplined plans for achieving dramatic long-range growth in profits and that have inherent qualities making it difficult for newcomers to share in that growth.
- Focus on buying these companies when they are out of favor; that is, when, either because of general market conditions or because the financial community at the moment has misconceptions of its true worth, the stock is selling at prices well under what it will be when its true merit is better understood.
- There are a relatively small number of truly outstanding companies. Their shares frequently can't be bought at attractive prices. Therefore, when favorable prices exist, full advantage should be taken of the situation. Funds should be concentrated in the most desirable opportunities.
- A basic ingredient of outstanding common stock management is the ability to neither accept blindly whatever may be the dominant opinion in the financial community at the moment, nor to reject the prevailing view just to be contrary for the sake of being contrary. Rather, it is to have more knowledge and to apply better judgment, in thorough evaluation of specific situations, and the moral courage to act "in opposition to the crowd" when your judgment tells you you're right.

In 1975, Warren Buffett became the business "coach" and confidant of the Washington Post's Katharine Graham. Graham became chairman and CEO of the newspaper company unexpectedly

when her husband committed suicide. She relied deeply on Buffett's judgment. In a letter to Katherine Graham (<http://ify.valuewalk.com/wp-content/uploads/2013/08/160301289-Warren-Buffett-Katharine-Graham-Letter.pdf>), Buffett addressed a number of critical issues regarding the company's pension plan. Reading Buffett's letter, one can see Philip Fisher's investment influence. Beginning on page 15 of Buffett's letter:

Negotiated prices for such purchases of entire businesses often are dramatically higher than stock market valuations attributable to well-managed similar operations. Longer term, rewards to owners in both cases will flow from such investments proportional to the economic results of the business. By buying small pieces of businesses through the stock market rather than entire businesses through negotiation, several disadvantages occur: a) the right to manage, or select managers, is forfeited; b) the right to determine dividend policy or direct the areas of internal reinvestment is absent; c) ability to borrow long-term against the business assets is greatly reduced; and d) the opportunity to sell the businesses on a full-value, private-owner basis is forfeited.

These disadvantages are offset by the periodic tendency of stock markets to experience excesses, which cause businesses – when changing hands in small pieces through stock transactions – to sell at prices significantly above privately determined negotiated values. At such times, holdings may be liquidated at better prices than if the whole business were owned – and, due to the impersonal nature of securities markets, no moral stigma need be attached to dealing with such unwitting buyers.

Stock market prices may bounce wildly and irrationally, but if decisions regarding internal rates of return of the business are reasonably correct – and a small portion of the business is bought at a fraction of its private-owner value – a good return for the fund should be assured over the time span against which pension fund results should be measured.

Success in large part is a matter of attitude, whereby the results of the business become the standard against which measurements are made rather than quarterly stock prices. It embodies a long time span for judgment confirmation, just as does an investment by a corporation in a major new division, plant, or product. It treats stock ownership as business ownership with corresponding adjustment in mental set. And it demands an excess of value of price paid, not merely a favorable short-term earnings or stock market outlook. General stock market considerations simply don't enter into the purchase decisions.

Finally, success rests on a belief, which both seems logical and which has been borne out historically in securities markets, that intrinsic value is the eventual prime determinant of stock prices. In the words of my former boss: 'In the short run the market is a voting machine, but in the long run it is a weighing machine.'

Buffett's recommends purchasing individual stocks in the same way one would buy whole business operations and to ignore prevailing market sentiment. In doing so, the investor achieves both the most profitable way to invest - because of the focus on long-term results and appropriate purchase price - and the safest. We know that buying financially sound companies trading at attractive prices works – all it requires is discipline and patience; attributes increasingly in short supply with today's headline obsessed market.

Aforementioned Jeremy Siegel published in his book *"The Future for Investors"* the returns of 50 of the largest companies in existence in the year 1950. Of these 50 companies, the ones with the highest investment returns by the end of 2003 were Kraft Foods, R.J. Reynolds Tobacco, ExxonMobil, and Coca-Cola. If you had invested \$1,000 in each of these companies in 1950, reinvested your dividends, and did not touch the portfolio until 2003, you ended up with:

- \$2,042,605 in Kraft Foods
- \$1,774,384 in R.J. Reynolds Tobacco
- \$1,263,065 in ExxonMobil
- \$1,211,456 in Coca-Cola

Hypothetically, that means that a \$4,000 investment compounded into \$6,291,510 by buying four stocks and doing nothing for 57 years. The same \$4,000 in a broad stock market index fund produced \$1,118,936 at the end of 2003. From Siegel's study, we also learn that investors needlessly fixate on growth and too often fall into what he calls the "growth trap." The growth trap occurs when an investor ignores prices and focuses solely on buying companies with what appear to possess the fastest-growing earnings. The trap is that higher prices paid already discount higher earnings from growth. Siegel concluded that

investors who chase after fast-growing companies actually suffer worse returns than those who buy slower-growing companies at reasonable prices.

Siegel provided an interesting example by examining two stocks, old industry Standard Oil of New Jersey (ExxonMobil) against technology darling IBM. He examined and compared these two companies in 1950, right before the digital and computer revolution boom in the United States made IBM a household name. From an investor's perspective, most would naturally assume that IBM proved the better investment. IBM outpaced Standard Oil on every growth metric that Wall Street fixates on—earnings-per-share growth, market value growth, and sales. However, Standard Oil was the better investment in terms of return for investors. There were two reasons for Standard Oil's outperformance: IBM sold at more than twice the price-earnings ratio (P/E) of Standard Oil and had less than half the dividend rate. When one adds these two factors together, over the next 53 years, Standard Oil of New Jersey outperformed IBM even though IBM was indeed actually one of the fastest-growing companies in the world during that time period.

Although IBM was correctly positioned in 1950 just before the beginning of a huge wave in technological innovation and growth, the company was selling at 35 times earnings – that prospect of growth was already embedded in the 1950 stock price. By contrast, from 1957, when the Standard & Poor's index was founded, through 2005, the best-performing company was Philip Morris, now known as Altria Group. Philip Morris produced a compounded annual investment return 3% greater than the next best-performing stock and almost doubled the S&P over the last half century. The simple explanation is that no one wanted to buy the company's stock; therefore, the valuation remained attractive and the price low. The combination of moral objection, fear of government regulation and the threat of constant litigation hung over the company's stock price. Even though the company had already paid \$150 billion in litigation and liability, the company continued to generate cash and pay a growing dividend to its shareholders. If an investor had reinvested the dividends, the investment returns on that company soared above every other stock in the index.

An investment philosophy dictates how one should consistently make decisions, but even an intelligent investment philosophy is of little value if the investor cannot exercise discipline and patience. Historically, successful investment philosophies focus on the decision-making process rather than short-term outcomes. Naturally, this is easier said than done, as results are objective while processes are subjective. However, we remain steadfast in our belief that a quality process derived from a fundamentally-driven investment philosophy is the best long-term approach to success. Given our negative assessment of current market valuations and the lack of individual investment opportunities, we continue to exercise discipline and patience in the deployment of our clients' capital.

Kind regards,



Robert J. Mark
Portfolio Manager



Larry J. Redell



William R. Sachs



Brian C. Mark

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 over a decade 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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