

ST. JAMES INVESTMENT COMPANY

INDIVIDUAL PORTFOLIO MANAGEMENT

INVESTMENT ADVISER'S LETTER

JULY 15, 2010

WWW.STJIC.COM
2716 FAIRMOUNT STREET
DALLAS, TX 75201

SECOND QUARTER LETTER

MARKET COMMENTS

Barry Switzer, the former head coach at the University of Oklahoma, once said "Some people are born on third base, and go through life thinking they've hit a triple." We could apply Switzer's comments to the current economic "recovery" as well, as many investors fail to understand that this recovery does not include the private sector. Every bit of growth observed over the past year can be traced to government deficit spending, with zero private sector expansion when deficits are factored out.

To invest profitably one has to look ahead of the crowd, or at least for the view that few, if any, anticipate. Until the first week of May, discussing a double-dip recession and a retest of the March 2009 lows was unthinkable. In fact, many investors assigned such a low probability to a recurrence of recession that many choose to completely ignore the possibility. Now stocks just registered their worst quarter since Q4 2008 and suddenly the crowd is assigning a higher probability to this event.

To better invest with today's level of market volatility, we believe an investor must appreciate the historical macroeconomic backdrop supporting today's market. To rescue the economy and financial system in 2008 from a total meltdown, the government created an unprecedented package of bailouts, stimulus, free money and massive fiscal deficits. The government succeeded and the US markets avoided a 1930s style debt deflation and depression. Liquidity, on a huge scale, was pushed into the financial system. We confess that we underestimated the power of such flows to drive up the prices of stocks, commodities and other risky assets. However, although the system was saved, it was not fixed.

We believe that we have been experiencing a multi-decade period of money and credit inflation that started back in the 1960s when the post-World War II global monetary system organized under Bretton Woods began to break down. As a result, from the late-1960s until 1982 our markets experienced price inflation. Since 1982 our markets have experienced a series of asset bubbles and mini-crashes, leading up to the market's crash in 2008-2009. The underlying problem still remains in effect today--we live in an age of money and credit inflation powered by a monetary system that is unanchored with no self-imposed discipline. Therefore, until this underlying problem is resolved, monetary inflation and instability will be a way of life for investors.

The current market dynamic is a continuation of the last 28 years with two main differences. The first is the sheer magnitude of the government's efforts at reflation this time around—by far the biggest in peacetime US history. The second distinction is the governments of the US and other countries have had to socialize private debt into unsustainable levels of public debt, sending projected government debt-to-GDP ratios to previously unthought-of levels. The

governments' efforts to re-inflate the system are on a scale at least as big as the bubble itself. It is an experiment never before attempted in the United States and we are certain that it will have consequences many investors will not anticipate.

Inflation remains the most dangerous enemy for long term investors. However, in the short term, inflation in its early stages is often looked upon favorably. Early stage inflation lubricates the economy and causes riskier assets like stocks, commodities and corporate bonds to rise. Everyone is happy.

We cannot over-emphasize that our definition of inflation is and will always remain an undue expansion of money and credit. Inflation's effect can either raise the prices of things we consume or the prices of assets we own or want to buy. Clearly the government's CPI statistic guides investors to focus on the effects of inflation: the things we consume. Regardless, if it is rising prices for things we consume or things we own, both effects are symptoms of inflation that, if extreme, tell us that a bust is coming. In the case of rising consumer prices, the central bank ultimately has to raise interest rates and restrict credit. Recession follows. Or, if asset prices rise on the back of credit expansion, interest for debt service ultimately becomes insupportable and asset prices—the collateral behind the debt—start to fall. Unfortunately, debt levels are fixed in the short term. When people cannot service or repay debt, panics and crashes follow, and the risk of a debt deflation and depression rises dramatically.

Too much debt and falling asset prices caused the depression of the 1930s and the near-depression in 2008-2009. Since August of 1971, the world has operated under a floating dollar standard, with most countries holding mainly dollars in their currency reserves. As a result, the US can and does inflate at will and foreign countries must buy the excess dollars on the foreign exchange market if they want to prevent their respective currency from rising. In a world of low and falling price inflation, as is the case since 1982, almost all countries want a cheap currency.

This is the critical flaw, as today's monetary system has a built-in inflationary bias. Countries that buy dollars to keep their currency depressed experience money and credit inflation. Bubbles result. When those countries re-invest their dollars back into the US, the US financial markets remain highly expansionary. Lenders keep lending and borrowers keep spending beyond their means. In the current system, the US can inflate and run huge balance of payments deficits with no immediate pain and no mechanism to stop it, other than a financial panic.

The US economy is like a fast car with no brakes, a scenario that is unlikely to have a pretty ending. In contrast, if we operated under a fixed exchange rate system in which countries do not hold dollar reserves, US international payment deficits would result and thereby drain domestic liquidity until the deficit was corrected.

With this macroeconomic backdrop, let us focus on the more specific cause and effect and the associated ramifications for investors facing today's volatile markets (aside from the clearly

obvious fact that investors may finally be refocusing their attention on quaint concepts like valuation and risk):

- When governments and central banks manufacture an economic recovery driven by liquidity and deficit spending, the faith in the sustainability of the recovery is weak. After two crashes in the space of a decade, the retail investor is now wise to the ways of institutional investors.
- Poor accounting quality still necessitates a huge leap of faith to invest in most financial stocks. Meaning, everyone owning financial stocks is well aware earnings depend on credit losses being stretched into the future. As a result, market participants will sell if conviction begins to waiver, and increased market volatility will cause convictions to waiver.
- The market has too many impatient, trend-following traders who sell when “support” levels get hit. An investor must accept the simple fact that many market participants are not buying stocks with the view that stocks represent fractional ownership in businesses – they are “renters”.
- The corollary to the last bullet point is that the market does not have enough patient, skeptical investors. Our opinion only, but we believe that a lack of skeptical value-oriented investors or fundamental short sellers creates conditions where bubbles and crashes are more likely. Fortunately for us, this creates buying opportunities.
- Computerized trading clearly has the unexpected ability to intensify market swings. Rather than supply cash to the market during panics like the “flash crash”, it appears that these funds do the opposite. “Quants” clearly know the price of every tradable security with each passing second—but the value of nothing. When possible, our goal remains to take advantage of mispricing caused by quantitative trading by maintaining a far longer time horizon, measuring investment opportunities in years, not nanoseconds. We believe the less one trades, the more time one has to think.
- Extreme market volatility causes market participants to have a “deer in the headlights” reaction. However, if we are confident in the value and fundamentals of company stocks we research and own, we should have the courage of our convictions to add to existing positions. Obviously, day to day, stocks are worth whatever the prospective buyer is willing to pay. In panics, sellers overwhelm buyers. But over time, in normally functioning markets, a stock’s price will reflect a company’s intrinsic value measured by the company’s ability to deliver free cash flow to shareholders. As anyone who has ever created a discounted cash flow model knows, the next two or three years of earnings are only a small fraction of any stock’s long term intrinsic value.
- As Jeremy Grantham at GMO has often written, the sad but true fact is that the vast majority of institutional fund managers do not stay in business if they think too independently. If money managers decide to not participate in a rally because they

judge the fundamentals as weak, they often get fired. A few decades of this investing culture has resulted in institutional groupthink. The less that fund managers can think and act independently, according to their best judgment, the less efficient the market becomes. Career risk forced otherwise rational investment managers to buy into March and April's expensive, rising market. Our hope is that increased market volatility tilts the market back to a market driven by human judgments of value and risk rather than momentum and technical analysis.

As for the problems in Europe, we believe the announced rescue package for Greece simply buys more time rather than addresses the problem directly. The political will to perform the necessary adjustments does not exist, at least not yet. The fundamental problem is that the EU locks together countries with vastly different economic models. The foreign trade-based economic strategy of current account surplus nations like Germany and the Netherlands is managed under the same policies of consumption driven economics of current account deficit nations like Greece and Spain. Germany pursues rising employment through exports while restraining domestic consumption through wage and fiscal policy discipline. In contrast, countries like Greece must run fiscal deficits in order to increase employment.

The challenge is that not every country can have a current account surplus. If Germany plans to create its jobs by being more competitive, then less-competitive countries in Europe will have little choice but to create jobs by either building up leverage in the private sector or in the government sector. A trade deficit nation, by definition, spends more than it is earns. To do so, it must either run down existing assets or issue new liabilities. If other countries in Europe decided to replicate Germany's approach, Germany would soon find its growth reduced, since other countries would be stealing global market share from Germany. Germany eventually would need larger government deficits or smaller private-sector net saving in order to return to its prior growth path if it lost global market share and its trade surplus shrank. In other words, if one country successfully targets an export-led growth strategy, another country will become less competitive and will need either larger government deficits or smaller domestic private-sector net saving in order to return to its historical long-run growth path. Unfortunately, the economic relationship between the US and China is eerily similar.

We believe that the likely outcome over the next year is that the euro will trade at par with the US dollar—a 25% depreciation for the euro. The European Central Bank will not intentionally pursue such a policy—the market will force parity. More specifically, it will be the rapid and volatile movement of capital out of Europe that will impose this depreciation on the euro. European equity investors will realize that government budget cuts will generate unattractive earnings growth while European bond investors will suffer, as restructuring defaults become the new accepted policy.

As for the United States, we can envision a situation in which the flight to safety to the dollar and US Treasuries further increases our country's external deficits but carries the benefit of lower US Treasury yields. Therefore, the initial effects from capital leaving the euro zone and

moving to the United States may appear positive. With lower yields and stronger relative economic and earnings growth, the United States will look like a safe haven once again.

However, we believe US exports to Europe will eventually suffer as a depreciating euro makes US exports too expensive and euro zone consumer end demand falls under the weight of wage and salary cuts, along with other economic austerity measures imposed by euro zone governments. Eventually, under this scenario, US equity markets will begin to discount lower 2011 earnings expectations due to unfavorable currency translation gains on foreign sales, loss of export sales and market share, and increased imports as the dollar strengthens. To summarize, US asset markets should be initial beneficiaries of a euro zone contraction, but we remain concerned this will eventually catch up with the United States as our trade balance deteriorates under a much stronger dollar.

We take this analysis down to the individual security level with the understanding that after an asset bubble pops, private-sector spending collapses. According to the Austrian theory of economics, to which we subscribe, this is a necessary purge of “malinvestment”. Under the influence of distorted financial asset prices, capital cycles to economic activities do not reflect true demand. In the last cycle, it was housing, and in the prior one, it was technology and telecommunications equipment. Many legitimate businesses — ones that otherwise were correctly positioned to meet expected underlying demand conditions over the medium term — will fail. Only those companies that are the least leveraged and maintain balance sheets with large cash (or near cash) hoards, while also selling the least discretionary items, will manage to endure. Cash acts as a buffer during the debt deflation process following a burst asset bubble. Cash also acts as a store of value that can be deployed to purchase assets on the cheap in the depths of the subsequent economic meltdown. Companies like ExxonMobil, Microsoft, and Johnson & Johnson come immediately to mind.

In fact, given our outlook, we contend that an investor’s best wealth preservation strategy is the ownership of high-quality stocks. Fundamentally strong companies are well-prepared to handle economic downturns and global instability. Yes, during market sell-off such as the one we’re experiencing now, the respective stock prices may grow cheaper - but the value remains as the enterprises are sound.

Despite neither the never ending cycles of contracting and expanding market volatility nor the macroeconomic concerns that always serve as the backdrop to investing in the equity markets, in the end, the beauty of value investing is its logical simplicity. Our value investment philosophy is based on two principles: what is a company worth and what am I, the investor, willing to pay for that company. These concepts were introduced by Benjamin Graham in 1934 and they are as relevant today as they were then.

INVESTMENT PHILOSOPHY

Richard Russell, who began publishing Dow Theory Letters in 1958, once wrote an article titled "Rich Man, Poor Man". Essentially, Russell lays down a set of rules that any and every investor should follow if they are serious about protecting and growing their wealth. First, all investors must understand the simple truth that compounding is, as Russell would say, "the royal road to riches." Compounding is safe, assured, and fortunately, available to every investor. However, in order to successfully compound one's capital, an investor needs patience, perseverance and time--time to allow the power of compounding to work. Unfortunately, compounding is boring.

Above all else, an investor must not lose money or, more realistically, never lose big money. A catastrophic loss immediately stops the process of compounding and recuperation can often take years.

To avoid the catastrophic loss, an investor should always focus on valuations. And if no outstanding values exist, the investor waits.....and the patient investor can afford to wait. The patient investor does not mind waiting months or even years for the next investment, in contrast to most market participants who always feel pressured to "make money." And, in return, market participants are always hoping for the market to "do something". Because the typical participant tries to force the market to do something, losing is almost guaranteed. The participant who does not understand values will constantly overpay.

Russell judges an investment to be a great value when it offers (a) safety; (b) an attractive return; and (c) a good chance of appreciating in price. To us, Russell means buying companies that are cheap and safe. In the current market environment, we believe that investing in companies that are boring, cheap and safe holds a lot of appeal. In fact, these conditions hold a lot of appeal when investing in any market.

Warm 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.



IMPORTANT DISCLAIMER

Information contained herein has been obtained from sources believed reliable but is not necessarily complete and accuracy is not guaranteed. Any securities that are mentioned in this issue are not to be construed as investment or trading recommendations specifically for you. You must consult your advisor for investment or trading advice. The publisher of this newsletter and one or more of its affiliated persons and entities may have positions in the securities or sectors recommended in this newsletter and may therefore have a conflict of interest in making the recommendation herein.

2010Q2

4836-7675-9302, v. 1