

# ST. JAMES INVESTMENT COMPANY

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INDIVIDUAL PORTFOLIO MANAGEMENT

## INVESTMENT ADVISER'S LETTER

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# FOURTH QUARTER LETTER

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## MARKET COMMENTS

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The U.S. stock market just completed its worst calendar decade in history, with the S&P 500 losing an average of 0.5% a year. Such dismal performance leaves the 2000s below decades remembered by major financial panics, such as in 1893, 1907 and the 1930s<sup>1</sup>.

In contrast, the performance of the 1990s proved to be the best calendar decade -- the Standard & Poor's 500 stock index produced a 17.6% average annual gain. However, the returns of the 1990s made stock valuations too expensive. As a result, investors would have been better off owning cash, bonds with annual gains of roughly 5.6% or gold--the best-performing asset, up 15% a year this decade after losing 3% annually during the 1990s.

On an inflation-adjusted basis, the returns are worse. Since the end of 1999, the Standard & Poor's 500 stock index has lost an average of 3.3% a year adjusting for inflation. Even the inflation-linked bear market of the 1970s outperformed, as the S&P 500 *only* lost 1.4% annually after adjusting for inflation. Considering a commonly-held goal of investing is to increase wealth faster than inflation, the indexes of the 2000's have not been kind.

Coupling the best decade (1990s) and the worst decade (2000s) produces a challenge, as many investors assume and expect a 10% annual return for stocks over the long term. In contrast the S&P 500 generated 8.2% annual gains over the last 20 years. Should stocks average 10% a year for the next decade, the 30-year average return would rise to 8.8%. It is worse for those who began investing in the S&P 500 in 2000; as a 10% annual return this upcoming decade would only produce a 4.4% annualized return. The market does not appear to be behaving as the academics expect.

So what has gone wrong for the U.S. stock market? It turns out that valuations matter, as stocks came into this decade overvalued. In late 1999, the S&P 500 was trading at roughly 44 times 10-year trailing earnings adjusted for inflation. Compared with a long-run average of about 16, the index proved extraordinarily expensive. Buying at such elevated valuations, the best one could hope for is mediocre returns.

Despite the poor returns of this decade, stocks still are not cheap. The S&P is trading at a price-to-earnings ratio of about 20 times 10-year trailing earnings.

As U.S. large-cap stocks are about 30% overpriced, returns should be about 30% less than their long-term average for the next several years. This suggests that stocks may be good for only about 7% a year this coming decade.

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<sup>1</sup> The stock market lost .05% annualized 1930-1939- S&P 500

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## UNDERSTANDING RISK

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"Risk comes from not knowing what you're doing." -- Warren Buffet

Many investors neglect the importance of time in producing wealth. In comparing two investment accounts, one which generates a 3% annual return and the other 4%, there is little difference in performance in the short term. But after fifty years, the wealth attained at a 4% annual return is about 65% greater than that attained at 3%. Small differences in return become quite important over long periods of time.

Berkshire Hathaway provides a great example, as Warren Buffet compounded the company's book value annually at a rate 11.4% greater than the overall market. Over a period of 43 years, time and prudent risk enabled Berkshire to outperform the S&P 500 by 358,043%.

The popular perception today is that one must bear more risk in order to generate greater returns and enjoy superior compounding. However, too much risk can actually reduce the effect of compounding returns over long periods, even as it increases the expected return for a single period.

A trained statistician will argue with this last assertion. The expected, or average, result of a compound return is the same as the compounding of the expected result for a single period. Therefore, once you know the expected return for each period, risk plays no further role in determining expected wealth.

However, the average compound result in a risky process will be distorted upwards from

what most investors receive. A better indicator of what an investor is likely to attain is the median compounded return--and this quantity is very much influenced by volatility of returns.

Consider an example where returns are volatile but known. You start with a dollar. The first period you receive a 100% return, so that your wealth becomes two dollars. The second period, you receive a 50% loss, and your wealth shrinks back to a single dollar. This sequence can be repeated indefinitely, and your money will not grow although your average return is 25%. The losses reduce the capital base from which the gains must grow.

	Berkshire Hathaway	S&P 500	Berkshire Hathaway	S&P 500
1964	Book Value		\$ 100	\$ 100
1965	23.8	10.0	\$ 124	\$ 110
1966	20.3	(11.7)	\$ 149	\$ 97
1967	11.0	30.9	\$ 165	\$ 127
1968	19.0	11.0	\$ 197	\$ 141
1969	16.2	(8.4)	\$ 229	\$ 129
1970	12.0	3.9	\$ 256	\$ 134
1971	16.4	14.6	\$ 298	\$ 154
1972	21.7	18.9	\$ 363	\$ 183
1973	4.7	(14.8)	\$ 380	\$ 156
1974	5.5	(26.4)	\$ 401	\$ 115
1975	21.9	37.2	\$ 488	\$ 157
1976	59.3	23.6	\$ 778	\$ 195
1977	31.9	(7.4)	\$ 1,026	\$ 180
1978	24.0	6.4	\$ 1,272	\$ 192
1979	35.7	18.2	\$ 1,727	\$ 227
1980	19.3	32.3	\$ 2,060	\$ 300
1981	31.4	(5.0)	\$ 2,707	\$ 285
1982	40.0	21.4	\$ 3,789	\$ 346
1983	32.3	22.4	\$ 5,013	\$ 423
1984	13.6	6.1	\$ 5,695	\$ 449
1985	48.2	31.6	\$ 8,440	\$ 591
1986	26.1	18.6	\$ 10,643	\$ 701
1987	19.5	5.1	\$ 12,718	\$ 737
1988	20.1	16.6	\$ 15,274	\$ 859
1989	44.4	31.7	\$ 22,056	\$ 1,131
1990	7.4	(3.1)	\$ 23,688	\$ 1,096
1991	39.6	30.5	\$ 33,069	\$ 1,431
1992	20.3	7.6	\$ 39,782	\$ 1,539
1993	14.3	10.1	\$ 45,471	\$ 1,695
1994	13.9	1.3	\$ 51,791	\$ 1,717
1995	43.1	37.6	\$ 74,113	\$ 2,362
1996	31.8	23.0	\$ 97,682	\$ 2,906
1997	34.1	33.4	\$ 130,991	\$ 3,876
1998	48.3	28.6	\$ 194,260	\$ 4,985
1999	0.5	21.0	\$ 195,231	\$ 6,032
2000	6.5	(9.1)	\$ 207,921	\$ 5,483
2001	(6.2)	(11.9)	\$ 195,030	\$ 4,830
2002	10.0	(22.1)	\$ 214,533	\$ 3,763
2003	21.0	28.7	\$ 259,585	\$ 4,843
2004	10.5	10.9	\$ 286,841	\$ 5,371
2005	6.4	4.9	\$ 305,199	\$ 5,634
2006	18.4	15.8	\$ 361,356	\$ 6,524
2007	11.0	5.5	\$ 401,105	\$ 6,883
2008	(9.6)	(37.0)	\$ 362,599	\$ 4,336

Another example, a coin is flipped. If it comes up heads, your stake doubles. If it comes up tails, your stake is cut in half. Your average or expected return in a single period is 25%. What happens if you compound this process by flipping the coin 10 times? The median result will be an equal number of heads and tails, putting you right back where you started. That is, your median result will be 0%, even though for a single period the expected return is 25%. However, there is also a large probability that you will lose money. The expected or average wealth is far higher than the median, because it includes the approximately one-in-a-thousand chance of getting ten heads in a row. As a result, we believe investors should be skeptical of assertions that higher returns demand more risk.

Investors interpret the concept of risk differently. Warren Buffett prefers to define risk, using dictionary terms, as the possibility of loss or injury. Academics define investment risk as the relative volatility of a stock or portfolio compared to the market. For example, under beta-based modern portfolio theory, a stock that has dropped in price very sharply compared to the market becomes riskier at the lower price than it was at the higher price. This makes no sense to us. If the market offers the entire company at a sharply reduced price, and the underlying fundamentals remain intact, we grow increasingly excited about the investment opportunity.

Our goal at St. James is to practice the intelligent bearing of risk for profit. Investing deals with the future and dealing with the future means dealing with risk. Peter Bernstein once said that “risk means more things can happen than will happen.” Meaning, risk is essentially considering a range of possible outcomes or probabilities. In contrast, forecasters state their beliefs in an expected outcome and then establish investment positions that could do them a great deal of harm if they are incorrect. For example, on its outlook call for 2010, Morgan Stanley’s analyst, Greg Peters told listeners: “We like the junkiest of the junk for next year.” There is certainly reward to be had if Peters is correct, but the unexpected will likely be punitive – after all, it is “junk”.

If the average expected outcome is poor, in terms of fundamentals and valuation, we work to avoid the possibility of permanently destroying our investment capital. Such discipline in our investment process can be difficult during periods when speculative risk is temporarily working. Long-term returns are based on repeated discipline, not single hits or misses. In contrast, speculators are investors who take excessive risks that can wipe them out.

"Consciously paying more for a stock than its calculated value—in the hope that it can be sold for a still-higher price—should be labeled speculation which is neither illegal, immoral, nor—in our view—financially fattening." -- Warren Buffet

What produces strong risk-adjusted returns over a complete market cycle is to accept more risk, on average, when the return per unit of risk is likely to be strong, and avoid risk, on average, when the return per unit of risk is likely to be weak. Translation – purchase companies with superior business models at valuations that afford one a comfortable margin of safety. Otherwise, remain patient and keep your powder dry by maintaining cash.

When do we accept more risk? Simple – when the expected return from accepting risk increases. Valuation coupled with the concept of margin of safety accomplishes this goal.

From our perspective, most investors focus more on the return side of the equation than on risk. Sun Tzu said if you sit by the river long enough, you will see the bodies of your enemies float by. The key is “long enough.” If you invest long enough, you have to be the survivor. The first requirement for long term success is survival. And the best way to ensure one’s survival is to put an emphasis on risk – not on achieving high returns.

Notably, investors quickly forget about risk control and risk aversion when the market’s emphasis shifts to return maximization. Return maximization and ensuring investment survival are mutually exclusive. Being a high-risk, high return investor is akin to operating without a safety net. One can do it spectacularly . . . for a little while. As the old adage goes – “There are old investors, and there are bold investors, but there are no old, bold investors.”

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## OUTLOOK

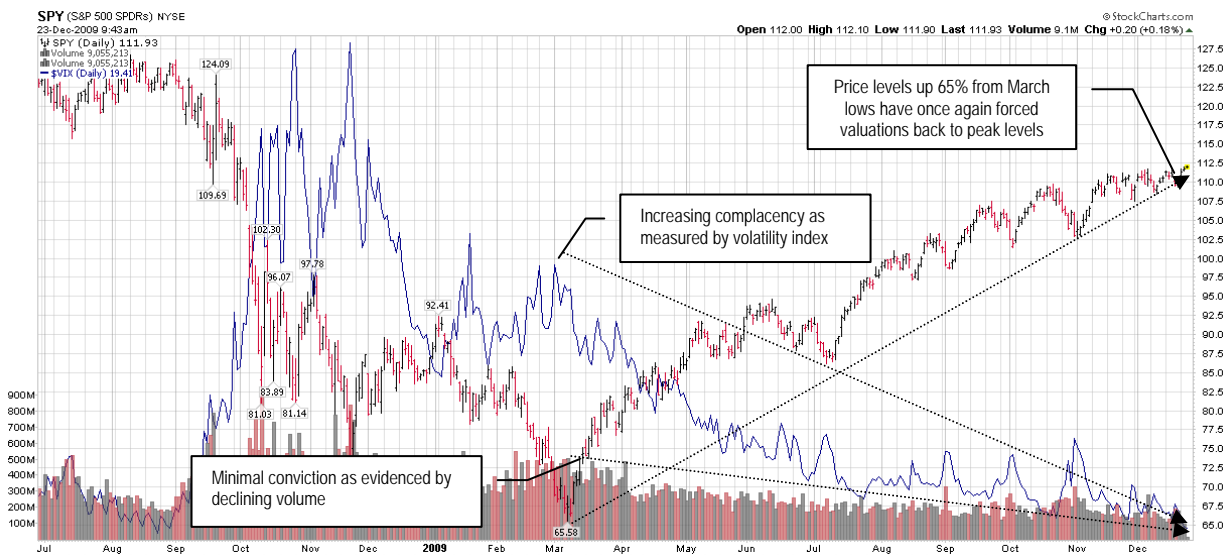
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Fear and greed are the two prevailing emotions of Wall Street. The credit crisis which erupted in the middle of 2007 was the product of greed and unsustainably optimistic valuations. By the end of the first quarter in 2009, fear prevailed and valuations reflected extreme pessimism. Now we enter 2010 with valuations that once again reflect greed and prosperity. The investment consensus is comfortable assuming that there will be an economic recovery and it will be a vigorous, normal recovery. When the expectations that are factored into prices are overwhelmingly complacent, as they are today, then the risk resides in over-paying for an investment.

The range of potential market outcomes remain extremely wide – but in our analysis, tilted toward the downside. As we learned from the various bubbles of the past decade, discounting a risk means more than simply paying lip service to it. Risks are discounted when it is taken for granted that the current environment will get worse. Positives are discounted when it is taken for granted that conditions will continue to improve. It appears today that markets are much closer to having fully discounted the positives than even scratching the surface of the potential second wave of negatives.

From current valuations, sustainable market returns appear unlikely, as whatever merit there might be in stock index investing at current levels is speculative. From the March lows, the market has advanced steadily and relentlessly on declining volume. Complacency as measured by the volatility indices are back to levels last seen prior to the markets complete meltdown in September of 2009. Valuations are once again priced with little to no margin of safety. Market gains from these levels will likely be given back, possibly abruptly.

"Some people seem to think there's no trouble just because it hasn't happened yet. If you jump out the window at the 42nd floor and you're still doing fine as you pass the 27th floor, that doesn't mean you don't have a serious problem. I would want to address the problem right now." – Charlie Munger



Although stocks continue to rise, virtually all the recent growth in profits comes from one sector – finance. Indeed, quarter over quarter, at the end of the third quarter, financial sector profits were up 36%, while those of non financial firms rose only 2%, and most of the profits in the financial sector came from the banks. During the fourth quarter of 2008, most financial institutions existed largely at the pleasure of the government. The firms that the government decided to support survived and are now doing better. The financial institutions that the government decided not to support went bankrupt or were bought out at low prices.

We remain allergic to financials as they are difficult to analyze. During the last weekend of Lehman Brothers' existence, Bank of America and Barclays were the two primary candidates to buy the company. Both firms took a look at Lehman Brothers and saw that there were two million interest rate swaps. One can only imagine how long it would take to figure out the net exposure of two million interest rate swaps, never mind all of the other derivative positions on the books. That is an incredible task if you are inside and have access to the data. If you are on the outside, you have no chance to decipher net exposure. Regarding Lehman Brothers, this is just one example from one part of the Lehman balance sheet.

We generally consider the analysis of financials incompatible with our approach to investing, as a financial institution is almost purposely opaque. It borrows short in order to lend long yet is always subject to a run on the bank. A financial is in the risk assumption business, meaning it puts out money and assumes risk anticipating that its returns exceed its cost of capital. They borrow at low risk and lend at high risk. That model always works great... until it doesn't.

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## INVESTMENT PHILOSOPHY

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The holy grail of investing is a strategy that works all the time. But it does not exist. The nature of markets is highly probabilistic. Uncertainty is central to the act of investing, as nothing works continuously.

Not only can value strategies go wrong but they can take long periods of time to work. When a value opportunity is uncovered and analyzed, there are two ways for it to pay off. For instance, if we purchase the stock of a company we believe to be significantly undervalued, it is possible that everyone else might soon realize that this is indeed a cheap stock and the price might correct accordingly and rapidly. However, it is also quite possible that the stock remains undervalued for years, yet generates its anticipated higher long term rate of return by continuing to pay an above average dividend yield while the valuation discount slowly collapses. When one makes an investment via value analysis, it is impossible to know which mechanism will deliver the returns.

As a result, value investors must have long time horizons—ideally an average holding period of 5 years. Unfortunately, 5 years seems like an eternity when compared to the average holding period for a stock on the NYSE... 11 months!



As the evidence suggests, long time horizons do not come naturally to humans. When faced with the possibility of a reward, our brains release dopamine. Dopamine makes us feel good about ourselves and confident, sometimes too confident. Investors have a tendency to behave impatiently today *but* plan to act patiently in the future. Perhaps Keynes was right when he wrote, “Investment based on genuine long-term expectation is so difficult today as to be scarcely practicable”.

Patience really is a virtue. When one invests, loss aversion and time horizon are not independent issues. The more frequently an investor checks their portfolio, the more likely it is that he will witness a loss. We learned long ago that it is too hard to make hundreds of smart decisions. Therefore, our strategy remains focused on patience, discipline and *modest* intelligence. Ideally, we would be quite satisfied if we found only two or three truly compelling new investment ideas each year. Through our experience, we believe that a concentrated portfolio of carefully considered investments decreases risk as it raises both the intensity of our analysis and the comfort level we demand prior to investment.

Warm regards,

Robert J. Mark  
*Portfolio Manager*

Larry J. Redell

William R. Sachs

Brian C. Mark

# 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 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 personal portfolio management to individuals, retirement plans and private companies.



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