

ST. JAMES INVESTMENT COMPANY

INDIVIDUAL PORTFOLIO MANAGEMENT

INVESTMENT ADVISER'S LETTER

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SECOND QUARTER LETTER

MARKET COMMENTS

The equity markets hit new all-time highs again this past quarter. However, one should temper enthusiasm, as this rally is largely due to Ben Bernanke's policy of Quantitative Easing (QE) which presently equates to the purchase of \$85 billion in U.S. government debt every month. Through the Federal Reserve's policies our government has effectively printed trillions of dollars since the financial crisis began, arguably inflating a host of asset prices including the stock market. Given the extraordinary magnitude of QE and the possibility of unintended consequences, we acknowledge that this rally could go on for some time, or end tomorrow.

We recently read a story (5/8/13) in the Wall Street Journal about pension funds investing in new-construction, high-end commercial real estate projects. These pension funds are investing alongside private-equity firms in projects like the Baccarat Hotel & Residences in Midtown Manhattan across from the Museum of Modern Art. The development will cost \$400 million and the developers are planning on selling condominiums for up to \$60 million apiece. Every unit will have a Baccarat crystal chandelier. One suspects how this might end.....but as Bob Jacksha, chief investment officer of the New Mexico Educational Retirement Board was quoted as saying in the article, "Pension funds have to take more risk to get double-digit returns." When markets approach peaks, investors grow complacent and turn a blind eye to potential risks. They see only opportunity and fear missing out on the expected future gains.

We beg to differ. We see a growing set of risks.

In his most recent letter to investors, Seth Klarman, founder of hedge fund Baupost Group, discussed today's complacent market environment. Klarman is recognized as one of the best value investors in the world – and he understands risk. Over two decades, Baupost Group regularly achieved double-digit returns for its investors while keeping half the fund in cash. From Klarman's letter to investors:

Most U.S. investors today have a clear opinion about what everyone else has no choice but to do. Which is to say, with bonds yielding next to nothing, the only way investors have a chance of earning a return is to buy stocks. Everyone knows this, and is counting on it to remain the case.

While economist David Rosenberg, at Gluskin Sheff, believes government actions could be directly or indirectly responsible for as many as 500 points in the S&P 500, or 30% of its current valuation, traders have confidence in Ben Bernanke because betting that his policies will drive equities higher has been a profitable wager.

Bernanke, likewise, is undoubtedly pleased with these speculators for abetting his goal of asset price inflation, though we all know that he will not call them first when he decides to reverse direction on QE. Then, the rush for the exits will be madness, as today's "clarity" will have dissolved, leaving only great uncertainty and probably significant losses.

Investing, when it looks the easiest, is at its hardest. When just about everyone heavily invested is doing well, it is hard for others to resist jumping in. But a market relentlessly rising in the face of challenging fundamentals – recession in Europe and Japan, slowdown in China, fiscal stalemate and high unemployment in the U.S. – is the riskiest environment of all.

We agree – “investing, when it looks the easiest, is at its hardest.” Berkshire Hathaway CEO Warren Buffett is often quoted as saying: “Be fearful when others are greedy and greedy when others are fearful.” People are greedy today --- they are ignoring risk. Paradoxically, the more one tries to de-risk a system, the more accident-prone it becomes, and the more damaging the accidents that eventually materialize. The economist Hyman Minsky described this very aspect of the financial system by saying that stability breeds instability. By using interest rates and monetary policy to prevent recessions, we believe that central bankers are making the world less safe and more likely to have an accident.

In Nassim Taleb’s new book, Antifragile: Things That Gain From Disorder, Taleb argues that the central banks are making the financial system more fragile. In essence, the world becomes more dangerous precisely because they are trying to make it safer. If antifragility is the property of all natural complex systems that have survived, then depriving them of volatility, randomness, and stressors will harm them. Financial markets are extremely complex systems but central banks are making every effort to suppress their natural volatility by manipulating interest rates and monetary policy.

If investors are led to believe that markets are safer, they will naturally be less vigilant about risk. The problem is that understanding risk is a highly useful advantage in evolutionary terms. Risk communicates signals as to when something important is at stake and the quality of one’s actions and decisions matter. Despite good intentions, if central banks try to systematically eliminate risk from the markets, they are not helping investors. In fact, they are obscuring investors of a basic instinct that promotes their ability to manage their capital.

From our perspective, the “Austrian school” of economics remains the best theory about the world economy. The Austrian mindset is suspicious of efforts to control the natural workings of an economy and acknowledges that stability breeds instability. As Austrian economist Ludwig Von Mises explained:

“This first stage of the inflationary process may last for many years. While it lasts, the prices of many goods and services are not yet adjusted to the altered money relation. There are still people in the country who have not yet become aware of the fact that they are confronted with a price revolution which will finally result in a considerable rise of all prices, although the extent of this rise will not be the same in the various commodities and services. These people still believe that prices one day will drop. Waiting for this day, they restrict their purchases and concomitantly increase their cash holdings. As long as such ideas are still held by public opinion, it is not yet too late for the government to abandon its inflationary policy.

“But then, finally, the masses wake up. They become suddenly aware of the fact that inflation is a deliberate policy and will go on endlessly. A breakdown occurs. The crack-up boom appears. Everybody is anxious to swap his money against ‘real’ goods, no matter whether he needs them or not, no matter how much money he has to pay for them. Within a very short time, within a few weeks or even days, the things which were used as money are no longer used as media of exchange. They become scrap paper. Nobody wants to give away anything against them.

“It was this that happened with the Continental currency in America in 1781, with the French mandats territoriaux in 1796, and with the German mark in 1923. It will happen again whenever the same conditions appear. If a thing has to be used as a medium of exchange, public opinion must not believe that the quantity of this thing will increase beyond all bounds. Inflation is a policy that cannot last.”

Mises is describing the lunatic phases of a classic inflationary cycle. At first, investors cannot tell the difference between a real dollar, one that is earned, saved, invested or spent, from a dollar that just came off the proverbial printing press. Investors assume that the new dollar is as good as the old dollar. At some point, prices rise and investors begin to question their assumptions. Eventually, investors understand, because if a country could get rich simply by having their central bank print money, then Zimbabwe under Robert Mugabe would be the financial equivalent of heaven on earth.

We find today's investment landscape interesting in that participants making money in the equity markets are attributing their results to skill rather than luck. Everyone knows the Federal Reserve's quantitative easing program buys \$85 billion worth of bonds and mortgage backed securities every month. The connection to market performance is clear. To put this figure in better perspective, \$85 billion equals the combined annual profits of Exxon Mobil and Apple. Further, the twenty largest companies by market capitalization in the S&P 500 index generate annual profits of \$323 billion, or a little less than four months of QE under the current program's pace of monetizing debt. Meaning, the combined annual profit output of millions of workers engaged at these twenty companies with billions of invested capital (which constitute 34% of the entire U.S. equity market's capitalization) are the equivalent of less than four months of Federal Reserve QE. With so much liquidity entering the market, we believe that stock market participants are confusing investment skill with luck. With few exceptions, fundamental analysis has been replaced by the daily headlines emanating from central bankers around the world. At some point in time this will change as investors will contemplate what will happen when liquidity is no longer entering the market. While it often appears that financial markets have short memories, markets will eventually correctly discount future events.

Company	Ticker	MarketCap	Net Income
		\$Billion	\$Million
Exxon Mobil Corp.	XOM	\$ 411.0	\$ 44,800
Apple Inc	AAPL	\$ 405.3	\$ 41,733
Google Inc	GOOG	\$ 298.8	\$ 10,737
Microsoft Corporation	MSFT	\$ 292.1	\$ 16,978
Berkshire Hathaway Inc.	BRK.A	\$ 284.2	\$ 14,824
General Electric Co	GE	\$ 251.6	\$ 13,641
Wal-Mart Stores, Inc.	WMT	\$ 248.1	\$ 16,999
Johnson & Johnson	JNJ	\$ 242.6	\$ 10,853
Chevron Corporation	CVX	\$ 235.6	\$ 26,179
International Business Machines Corp.	IBM	\$ 227.2	\$ 16,604
Procter & Gamble Co.	PG	\$ 216.6	\$ 10,756
Wells Fargo & Co.	WFC	\$ 216.3	\$ 18,897
Pfizer Inc	PFE	\$ 207.7	\$ 14,570
JPMorgan Chase & Co.	JPM	\$ 204.5	\$ 21,284
AT&T Inc	T	\$ 194.6	\$ 7,264
Coca-Cola Co (The)	KO	\$ 182.3	\$ 9,019
Oracle Corp.	ORCL	\$ 162.1	\$ 9,981
Verizon Communications Inc	VZ	\$ 153.0	\$ 1,141
Citigroup Inc	C	\$ 152.2	\$ 7,541
Philip Morris International Inc	PM	\$ 151.5	\$ 8,800
		\$ 4,737	\$ 322,601
		34%	3.8

Over the past eighteen months, any move lower in the markets has been quick and orderly. Maybe that is what concerns us most. Few investors are fearful because there is so much calm in the markets. But that calm can quickly turn into anxiety, which can quickly turn into all-out panic. Because it has taken years to inject so much liquidity, any disorderly unwinding of this liquidity has the potential to quickly become a panic—a financial risk that no investor should underestimate.

The central bankers at the Federal Reserve claim to control far more than they can or indeed should be allowed to control. These bankers expect more debt to create a wealth effect that in turn improves the job market. But here is the problem: investors must remain submissive for this scheme to function properly and we can almost guarantee that investors will not remain passive when they see through this illusion. Individuals pursue their self-interest in order to maximize their own situation. Collectively, these individuals can act in unpredictable ways. Any effort by central banks to manage or suppress the inherent volatility of an infinitely complex economy will eventually prove unsuccessful.

The Federal Reserve's attempt to be everything to everyone will not end well. Jim Grant, writing in *Grant's Interest Rate Observer*, calls the Federal Reserve's activism a "monetary revolution" -- one that few seem to recognize. Grant writes:

"To any who lack historical grounding, the monetary revolution might seem like no revolution at all. Once upon a time, Mr. Market could hardly have imagined life with QE. Now, he can't seem to imagine life without it -- witness last week's panic selling in Tokyo and New York in response to ambiguous remarks about when the Fed might cease and desist from buying \$85 billion of Treasuries and mortgages a month. A scary innovation to start with, QE has become a seemingly indispensable prop to the structure of speculation that the Fed's own policies have helped to raise up."

As one might imagine, quantitative easing is easy to enter and nearly impossible to exit. The mechanics of any attempted exit will sharply affect the bond market. Large pools of capital managed by hedge funds and Wall Street banks employ healthy doses of debt to leverage their returns. In other words, they manage heavily margined bond portfolios. These types of investors do not own bonds; they rent bonds. A similar dynamic exists in the stock market. Rate-sensitive stocks like utilities and REITs decline sharply at the slightest hint of a tighter monetary policy.

Investors sometimes forget how risky it can be to buy low-yielding bonds even if there's no chance the company will fail to make the interest payments. For example, recently issued bonds by Apple have fallen as much as 14% in their first seven weeks. The reason Apple's bonds are down has nothing to do with the company itself. Apple is admittedly a safe and well-capitalized company with little chance that it will fail to repay its debts -- the company has \$145 billion in cash and just \$17 billion in debt. But unfortunately for some investors, they paid too much for Apple's bonds, and now Mr. Market is correcting that mistake. Apple had zero debt on its balance sheet until it sold \$17 billion worth of bonds at the end of April -- the largest corporate debt transaction in history. The bonds that fell 14% were 30-year bonds that yielded 3.85%, in hindsight clearly too low for a 30-year bond. Now, these investors are sitting on a 14% loss only seven short weeks after these "safe" bonds were issued. The Apple story illustrates that "safe" investments are certainly not "risk free" investments in today's financial environment.

Former Federal Reserve chairman Paul Volcker is one of the few chairmen in history to implement an unpopular tight monetary policy (the polar opposite of our current chairman, Ben Bernanke). In the early 1980s, Volcker restored some measure of credibility to the Federal Reserve. He reduced the money supply, preventing an inflationary spiral from destroying the dollar. Volcker recently spoke at the Economics Club of New York.

"Credibility is an enormous asset. Once earned, it must not be frittered away by yielding to the notion that a little inflation right now is a good a thing -- a good thing to release animal spirits and to pep up investment. The implicit assumption behind that siren call must be that the inflation rate can be manipulated to reach economic objectives... up today, maybe a little more tomorrow and then pulled back on command. Good luck in that. All experience demonstrates that inflation, when fairly and deliberately started, is hard to control and reverse."

Volcker's insightful words are clearly falling on deaf ears with the world's central banks.

INVESTMENT PHILOSOPHY

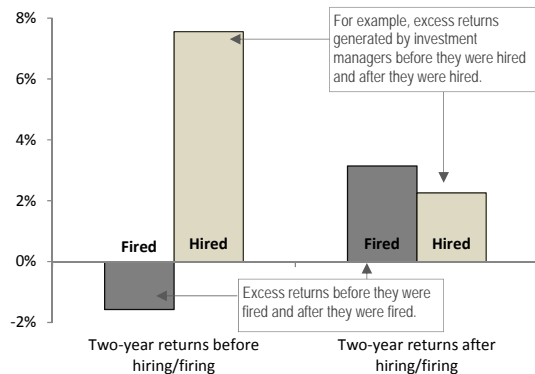
While most investors recognize the idea behind reversion to the mean, many ignore or misunderstand the concept. The basic idea is that for many types of systems, an outcome that is noticeably above or below average will be followed by an outcome that is closer to the average.

Francis Galton, a half-cousin of Charles Darwin, was a 19th century scientist who once undertook an effort to study the dispersion of human heights. In his study (*Regression towards Mediocrity in Hereditary Stature* 1886) Galton collected the height measurements of four hundred parents and more than nine hundred of their grown children. He combined the heights of the mothers and fathers into what he called “mid-parent stature” and found that they followed a normal distribution. Galton then calculated the height of their children and found that they reverted to the mean. Or in Galton’s exact words, “It appeared from these experiments that the offspring did not tend to resemble their parent seeds in size, but to be always more mediocre than they—to be smaller than the parents, if the parents were large; to be larger than the parents, if the parents were very small.” Galton’s study demonstrated reversion to the mean.

With almost any undertaking, the outcome stems from a combination of skill and luck. Naturally, the actual activity determines the amount of skill and luck involved. For example, there is no skill necessary when playing a slot machine, a combination of skill and luck when playing poker, and almost all skill when playing chess. Logically, any system that combines skill and luck will revert to the mean over time. The difference between a good outcome and a poor outcome may simply reflect the varying combinations of some skill with some luck.

With regards to investing, many individual investors earn returns below that of the S&P 500 Index because they chase performance in hot markets while selling out of sectors and markets that have suffered sharp drops. And, while many investment professionals may understand that both skill and luck play a role in determining investment returns, they too can fail to incorporate that knowledge in investment decisions. Amit Goyal, a finance professor at Emory University, and Sunil Wahal, a finance professor at Arizona State University, analyzed how 3,400 retirement plans, endowments and foundations hired and fired investment management companies over a ten-year period. The researchers found that plan sponsors tended to hire investment managers who had performed well in the recent past. Conversely, plan sponsors primarily fired investment managers because of recent poor performance. However, the researchers noted that in subsequent years, many of the investment managers who were fired went on to outperform the managers who were hired.

Source: Table X from “The Selection and Termination of Investment Management Firms by Plan Sponsors,” *Journal of Finance* (2008)

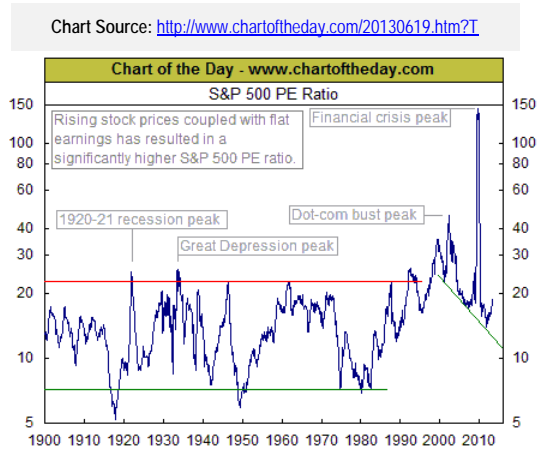


When we analyze profit margins for U.S. publicly traded companies, we find that companies have collectively never generated more than ten cents of profit for every dollar of sales. History consistently demonstrates that profit margins are cyclical and eventually revert to the mean. Or, as James Montier, a strategist with money management company GMO, simply put it: “What goes up must come down.” Not surprisingly, elevated profit margins that eventually revert to the mean could have negative consequences for equity markets. Lower profit margins will likely lead to a much lower stock market, even if the economy were to gradually improve and the market’s price/earnings ratio to remain constant.

Per James Montier, the average profit margin between 1926 and 1999 was 4.9% – less than half the current profit margin. GMO projects that profit margins will only partially revert to the mean over the next seven years - a simple assumption that could be the single biggest factor from preventing the stock market from producing any real return over this time period. Wall Street, of course, asserts that record-high profit margins will continue to expand as technological innovations have increased productivity and thereby lowered labor costs. By contrast, we favor arguments that link record high profit margins with record high government fiscal deficits and an absence of personal savings.

We also believe that low interest rates have served as a major force in propelling stock markets higher. Regrettably for Wall Street, the Federal Reserve cannot lower interest rates below zero, so this tailwind is perhaps finally approaching the end of its thirty year positive contribution to stock market valuations. According to Ibbotson Associates, from 1926 to 1999, the yield on 20-year U.S. Treasuries averaged 5.30%. The 20-year Treasury currently yields 2.67%, up from 2.1% one year ago.

The following chart shows the S&P 500's P/E ratio since 1900, where the mean P/E ratio has been 16. The P/E ratio peaked at 44 during the technology dot.com bust and has been reverting to the mean over the past thirteen years with the exception of the 2008 financial crisis. Disappointingly, no secular equity bear market since 1900 ended until after the S&P500's P/E ratio hit the horizontal green line drawn on this chart -- a P/E ratio ranging from 6 to 8. We fail to see a good reason to believe that this time will be any different. The S&P500's P/E ratio has been in a downward trend since 2000 but still has a long way to go to reach the range of valuations at which secular bear markets end.



If P/E ratios, long-term interest rates and profit margins revert to the mean, how will an investor position their portfolio? Sir John Templeton said that "The four most dangerous words in investing are 'This time it's different.'" As we unequivocally believe that this time it is NOT different, we accept as true the inevitability of mean reversion - a simple statement which has enormous implications.

Have investors relied on skill or luck to navigate the market's 135% rise since the March 2009 low? Margin of safety, intrinsic value, return on invested capital, patience for entry price, and disciplined sell strategy are all components of a skill set we employ. We invest based on value rather than speculate on price because we control our skill set when determining value. As speculators hope they get lucky with prices, we suggest hope is not an investment strategy – because investing, when it looks the easiest, is at its hardest.

Kind regards,

Robert J. Mark
Portfolio Manager

Larry J. Redell

William R. Sachs

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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.

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