

ST. JAMES INVESTMENT COMPANY

INDIVIDUAL PORTFOLIO MANAGEMENT

INVESTMENT ADVISER'S LETTER

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SECOND QUARTER LETTER

MARKET COMMENTS

“Every age is fed on illusion.” -- Joseph Conrad

“The recurrence of periods of boom which are followed by periods of depression is the unavoidable outcome of the attempts, repeated again and again, to lower the gross market rate of interest by means of credit expansion. True, governments can reduce the rate of interest in the short run. They can issue additional paper money. They can thus create an artificial boom and the appearance of prosperity. But such a boom is bound to collapse soon or late and to bring about a depression.” -- Ludwig von Mises

When working with complex systems, one must realize that modifying a part of a system can have unforeseen consequences for the whole. Take the example of Yellowstone National Park as presented by Alston Chase in his book *Playing God in Yellowstone*. Officially designated by an act of Congress in 1872, Yellowstone had seen much of its large animal population—elk, bison, antelope, deer—disappear due to overhunting in the preceding decades. To put a stop to this carnage, the United States Cavalry was sent in to rescue Yellowstone in 1886, and until 1916, when the National Park Service was created, ran the park. One of the army’s first orders of business was to revive the park’s large game population.

In short order many thought that the army saved Yellowstone. After a few years of special feed and favorable treatment, the elk population grew rapidly. In fact, the animals became so plentiful they started overgrazing, depleting essential flora and causing soil erosion. From there, events cascaded: The decline in aspen and willow trees, consumed by the hungry elk, shrunk the beaver population. The dams the beavers built were important to the ecosystem because they slowed the spring runoff from streams, prevented erosion, and kept the water clean so that trout could spawn. Without the beavers, Yellowstone’s ecosystem deteriorated rapidly.

The managers of the park were oblivious to the fact that the elk population explosion was responsible for the trouble, as they overlooked the fact that Yellowstone is actually too small and too cold to support a large animal population during the winter. When 60% of the elk population starved to death or died of disease in the winter of 1919-1920, the National Park Service ignored the lack of food and falsely blamed the deaths on predators. As a result they killed wolves, mountain lions, and coyotes. Yet the more predators that they killed, the worse the situation grew. The population of game animals began to experience erratic boom and bust cycles. This only encouraged the park managers to double down in their efforts, triggering a grim feedback loop. By the mid-1920s, the National Park Service had all but eliminated the predators within the park and had shot the very last wolves in 1926 (only to reintroduce them seventy years later!).

And so it went from one seasonal animal population disaster to the next until 1934 when the Park Service finally began to understand the limits of their ability to influence nature. The inept supervision of Yellowstone illustrated a mistake that surrounds complex systems: how addressing one component of a complex system can have unintended consequences for the system as a whole. Alston Chase wrote that the National Park Service “had been playing God for ninety-five years and everything they did appear to make the park worse. In their attempts to manage this beautiful wild area, they seemed caught in a terrible ratchet, where each mistake made the park worse off and no mistake could be corrected.”

Unintended consequences come from even the best-intentioned individual-level actions because our modern world contains more interconnected systems than ever before. As a result, we encounter these systems with greater frequency and with greater consequences. In the same way, when central banks hinder the market's ability to price assets and risk, they remove the essential information investors need to make rational and informed decisions. Eventually, unintended consequences destroy convenient monetary strategies that temporarily support a systemically unsustainable market. Or as Charles Hugh-Smith appropriately described it: "Unintended consequences almost always equal or exceed the benefits of whatever your temporary gains were in a complex system. We see this over and over again, in all sorts of different complex systems."¹

In the current market environment, the actions of central banks only delay the inevitable. Centrally planned and instituted remedies can and will trigger unintended consequences by the very planners who want to minimize the short term pain. Just as the National Park Service instituted plan after plan to restore the elk herds within Yellowstone, the very actions of the National Park Service caused well-intentioned but still catastrophic consequences because they did not understand the real problem. In the same spirit, the Federal Reserve "saves" the economy in 2008 by lowering interest rates to zero. The consequence is the transfer of wealth from savers, who once earned attractive rates of interest on their savings, to the banks, which can now borrow money for near-zero and loan it out to businesses and consumers at substantially higher rates; thereby, generating billions of dollars that once flowed to savers in the form of interest income. By making cash unattractive to hold, the Federal Reserve intended to push investors with cash into risk assets such as stocks and real estate.

The unintended consequences of the Federal Reserve's actions are now such that investors find themselves forced back into various asset markets, at valuations that are once again at extraordinarily expensive levels. By hindering the market's ability to generate accurate pricing information, the Federal Reserve and the Federal government generate enormously destructive unintended consequences. Consider that every time the economy enters recession, the Federal Reserve goes into full overdrive to stop the recession. Unfortunately, the historical data is clear: the trade-off for less volatility is a lower growth rate of the economy. The following table presents some simple data on the economy in the United States since 1930²:

Time Period	Total Years	Average GDP Growth Rate	Volatility of GDP Growth Rate	Number of Recessions	Total Months in Recession	Average Duration Months	% Months in Recession
1930 - 1970	41	3.9%	6.9%	8	114	14.3	22%
1934 - 1970	37	5.2%	5.9%	7	71	10.1	16%
1971 - 2012	42	2.9%	2.1%	6	72	12.0	14%

Bureau of Economic Analysis(BEA), <http://www.bea.gov>

In the period from 1971-2012, economic growth slowed meaningfully versus prior periods, as did the volatility of economic growth. However, even with lower volatility, the occurrence of recessions and their average duration has not really changed. The Bureau of Economic Analysis (BEA) annual data begins in 1930. Using 1930 as the starting point incorporates the worst downturn in US history. The year of 1934 is the first full year after President Roosevelt took the country off the gold standard. For the

¹ Charles Hugh-Smith of OfTwoMinds.com, June 2, 2014

² Doug Rudisch, <http://larrylarry1.wordpress.com>, February 21, 2014

majority of today's economists, who believe the Federal Reserve's ability to alter the money supply is a good thing, 1934 would be the first full year starting point for the modern U.S. economy. 1971 is the next dividing line—the year the Bretton-Woods fixed exchange rate system was fully abandoned, giving central banks around the world freedom to interfere with any semblance of free markets.

During periods of very low rates, capital is misallocated as markets grow addicted to the artificial safety net provided by the Federal Reserve. While monetary policy can make things appear better in the short-term (new home and auto sales, higher stock market, etc.), businesses and investors lose confidence in the system and exhibit an unwillingness to take risk. Investors do not trust an economy boosted by unsustainable monetary and fiscal policy, and therefore do not want to make longer term growth oriented and employment creating investments (as demonstrated by cash sitting idly on corporate balance sheets). The actions of the Federal Reserve are akin to parents that reward their children for bad behavior as opposed to trying to do what is right for their children over the long term. Despite all the monetary intervention, U.S. economic and job growth remains anemic. The Federal Reserve has now become a central part of the problem, as opposed to the solution.

When the Federal Reserve, or any central bank for that matter, lowers interest rates in an effort to prompt greater current spending it forces a wealth transfer from savers to speculators. We believe this is not only unethical and immoral, but unsound. In simple economics terms, monetary stimulus does not work as advertised by central bankers because you cannot get something for nothing. There are no free lunches. Although policies that suppress interest-rates appear to provide a free lunch, in the end, the bill ends up being much higher. Strangely enough, central bankers readily admit that their "monetary accommodation" hurts savers in the present, but with their very next breathe they claim that the benefits to the overall economy outweigh the disadvantages to savers.

Central bankers apparently possess a level of wisdom that both enables and entitles them to determine who should become poorer and who should become richer, all with the aim of elevating the economy. Their behavior is no different than the National Park Service determining which animal populations in Yellowstone Park should increase and which should decrease. For example, here's how the European Central Bank (ECB) justified its June 5th decision to reduce interest rates from already low levels:³

"The ECB's interest rate decisions will benefit savers in the end because they support growth and thus create a climate in which interest rates can gradually return to higher levels....A central bank's core business is making it more or less attractive for households and businesses to save or borrow, but this is not done in the spirit of punishment or reward. By reducing interest rates and thus making it less attractive for people to save and more attractive to borrow, the central bank encourages people to spend money or invest. If, on the other hand, a central bank increases interest rates, the incentive shifts towards more saving and less spending in the aggregate, which can help cool an economy suffering from high inflation. This behavior is not specific to the ECB; it applies to all central banks."

Only the last sentence in the paragraph above is true—the ECB is just as bad as other central banks. The key element that central banks deliberately or accidentally ignore is the variable of time. Increased saving does not mean reduced spending; it means reduced spending on consumer goods in the present in exchange for greater spending on consumer goods in the future. Likewise, reduced saving does not mean increased spending; it means increased consumer spending in the present in exchange for reduced

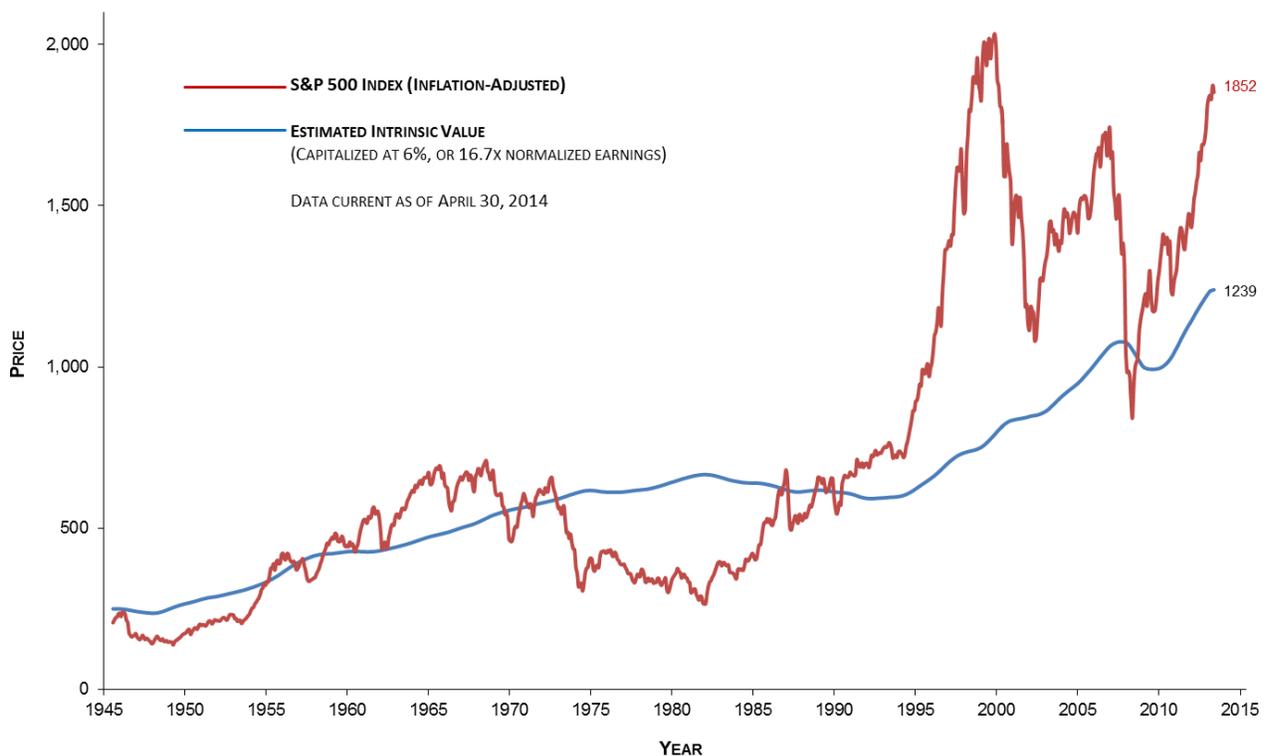
³ https://www.ecb.europa.eu/press/tvservices/webcast/html/webcast_140605.en.html

consumer spending in the future. This tradeoff between current and future consumer spending will happen most efficiently, and for the greatest benefit to the overall economy, if it is allowed to happen naturally. Meaning, interest rates should reflect the collective market’s actual time preferences. If the collective market of individuals are better positioned to determine when they should increase their savings (by reducing their current spending on consumer goods), in order to repair balance sheets weakened by excessive prior consumer spending, then the worst thing that central bankers can do is place obstacles in the way by creating artificial incentives for additional borrowing and spending.

After six years of unprecedented monetary experiments, the Federal Reserve continues to tinker with the balance of our complex market systems by artificially suppressing bond yields. Incredibly, the Federal Reserve now owns one-quarter of all US government debt and the performance of debt and equity markets suggests both markets are being driven less by economic fundamentals than by easy money. Based on unintended consequence of the Federal Reserve’s actions, investors now find themselves forced back into stocks, which once again reside at valuations that are extraordinarily expensive.

A core tenant of value investing is that, over the long-term, stocks should track their underlying intrinsic value. When a stock market is dramatically above its intrinsic value, the index will usually drop or move sideways until it eventually converges with its underlying intrinsic value. Likewise, when a stock market is dramatically below its intrinsic value, it will usually rise towards its underlying intrinsic value.

COMPARING ACTUAL REAL STOCK PRICE WITH ESTIMATED INTRINSIC VALUE



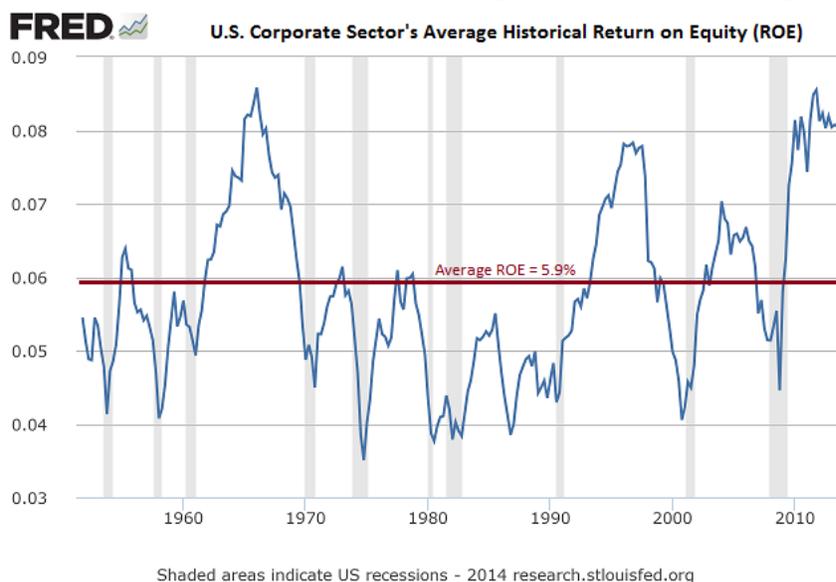
Think of intrinsic value as “gravity” on the underlying price of the market—over time the price should gravitate towards intrinsic value. One method of defining the intrinsic value for the stock market is to use the average historical valuation of the stock market index.

The current stock market has reached a point where it now trades well above its intrinsic value. We believe that the Federal Reserve is largely responsible for this level of overvaluation due to the fact that we have now entered the sixth year of short-term interest rates near zero. Many investors now avoid holding cash in zero percent yielding money market funds and reallocate money into the stock market with the hope of earning a higher rate of return. This has pushed the stock market dramatically higher.

The chart on page 5 compares the level of the stock market, as measured by the S&P 500 Index, against its underlying intrinsic value of 16.7 times cyclically adjusted earnings—its average valuation level since the end of World War II. The S&P 500 Index currently trades at roughly 50% above its intrinsic value. On each previous occasion when the index traded this far above its intrinsic value the stock market eventually gravitated back towards, if not below, the intrinsic value line. Therefore, investors should not be surprised if, over the next few years, the underlying index and its intrinsic value converge. However, we do not know if this will occur suddenly via a 20% or greater correction in the stock market, or a period of grinding out low single digit returns over the next decade.

Interestingly, the inverse of the average stock market valuation level of 16.7 times cyclically adjusted earnings equals 6%, or the same average annual total return for U.S. stock from 1871 until today. Additionally, 6% is the same growth rate of corporate earnings in the S&P 500 Index since 1950. It is not a coincidence that stocks in the United States have produced an average real total return of around 6%--which matches the average historical return on equity (ROE) for U.S. corporations. In theory, the average real total return that accrues to shareholders should match the average corporate ROE. For a simple model to explain this relationship, we assume that the following premises hold true over the very long term:

- The corporate sector operates at a 6% average ROE because it generates a 6% average profit on its true book value, which is defined to mean assets at replacement cost minus liabilities.
- Publicly traded stock shares trade, on average, at “fair value”, which we assume equals true book value.



The tendency for valuations to revert to the mean is what allows us to estimate long-term future returns. We know what long-term future returns are going to be, on average, if stocks are purchased at fair value—a 6% real rate of return plus the average rate of inflation. Although valuations prove critically important when making longer-term capital allocation decisions, they can prove quite frustrating if one is attempting to time the market’s short-term price movements.

INVESTMENT PHILOSOPHY

"Observation over many years has taught us that the chief losses to investors come from the purchase of low-quality securities at times of good business conditions. The purchasers view the good current earnings as equivalent to 'earning power' and assume that prosperity is equivalent to safety." --Benjamin Graham

*"Reversion to the mean is the **iron rule** of the financial markets." --John Bogle*

Applying Bogle's "Iron Rule" to individual security analysis dictates that every security is a claim on an expected stream of future cash flows that will be delivered to the investor over time. Given that expected stream of future cash flows, the current price of the security moves opposite to the expected future return on that security. Particularly at market tops, investors seem to believe that, regardless of the extent of the preceding advance, future returns remain entirely unaffected. The repeated eagerness of investors to extrapolate returns and ignore the "Iron Rule" has and will remain the source of most investment losses. The higher the price an investor pays for that stream of cash flows, the lower the expected return. The lower the price an investor pays for that stream of cash flows, the higher the expected return.

The degree of easy monetary policy has been exceptional; therefore, whenever this accommodative policy ends, the inevitable tightening should also be unprecedented. The recovery of the stock market does not necessarily reflect improved economic fundamentals, but rather a greater appetite for risk among investors. At best, this delays any natural adjustment. A tightening in US monetary policy always causes fallout and this time will be no different. In fact, it may be worse, since the tightening starts from extremely accommodative monetary policy. With the stock market hitting new all-time highs on a daily basis, we continue to see a glaring disconnect between fundamentals and valuations, combined with very low volatility.



When you consider what happened the last time volatility was this low, we find such complacency both mystifying and concerning. However, we also see the potential for investment opportunities just over the horizon.....but patience is a necessity.

With kind regards,

ST. JAMES INVESTMENT COMPANY

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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 almost fifteen 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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