

ST. JAMES INVESTMENT COMPANY

INDIVIDUAL PORTFOLIO MANAGEMENT

INVESTMENT ADVISER'S LETTER

APRIL 2020

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FIRST QUARTER LETTER

"An investment operation is one which, upon thorough analysis, promises safety of principal and an adequate return. Operations not meeting these requirements are speculative."

- Benjamin Graham, 'The Intelligent Investor'

Sandy Stoddard from Woods Harbor, Nova Scotia, started fishing commercially when he was fifteen years old. In 2013, when Sandy was fifty-seven years old and the captain of the commercial fishing vessel Logan & Morgan, he experienced something that he *"had never seen anything like it in all those years."*¹ Stoddard was in the wheelhouse while his four crewmen were in the stern, wearing their oil gear slickers and reeling in a long line of baited hooks shortly after dark on March 5, 2013. They had been fishing for halibut near Sable Island off Nova Scotia's east coast in what Stoddard described as typical North Atlantic conditions: a thirty-five knot southeast wind gusting to forty or fifty knots, waves ranging from ten to twelve feet. *"It was just a normal fishing day for us in the winter,"* said Stoddard. *"Then out of nowhere, where it came from, I don't know, a wave picked us up and slammed us down on our butts."*

Stoddard could only guess at the size of the wave, sixty feet high, perhaps seventy feet high? He could only guess because it was dark, and it happened so fast. The wave picked the Logan & Morgan up, and as the boat slipped sideways down the wave's back side, the wall of water accelerated out from under the boat and dropped it broadside into what felt like a bottomless trough. The wave slammed the boat down to an eighty-degree angle, almost on its side, according to Stoddard's best recollection as he tried to explain the rapid series of events. Had there been another big wave behind it, Stoddard is certain that the Logan & Morgan would have gone down.

The boat popped back up, but before it did so, two crewmembers went overboard. Stoddard saw one of them, Gordie Rhyno, go over the side. *"His head went below the rail, but when the boat surged up again, Rhyno says he stood on something, and it flipped him back in,"* said Stoddard. The skipper believes he saw Rhyno up to his neck in water, but when he landed on deck, he was perfectly dry. Stoddard cannot explain how it happened. He just knows it did. Moments after Rhyno was safely back on board, Stoddard heard a yell from below, *"He's gone!"* This time Greg Nickerson had gone over the side and disappeared. Nickerson had slipped under the fiberglass hull, hit the running gear but managed to grab a brace under the boat. The crew threw a life ring to him and pulled Nickerson close to the boat with the life ring line. Then one of the crew lunged down and snagged the life ring's grab rope and pulled Nickerson aboard the ship.

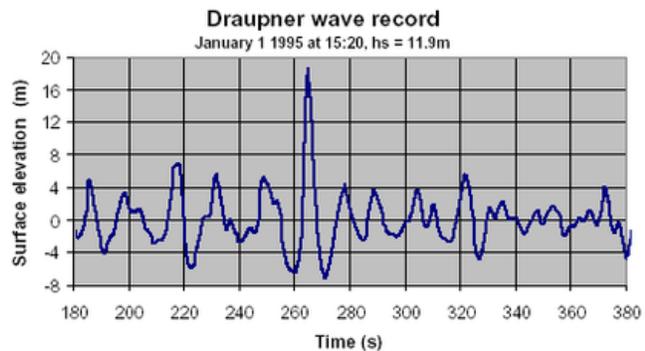
For centuries, sailors have shared descriptions of large "rogue waves" that appear out of nowhere. With little or no hard evidence, scientists long dismissed these stories as tales from the sea. According to the scientific community's best understanding of waves fifty years ago, a one hundred-foot wave should occur once every 30,000 years. However, we now know that rogue waves are not a maritime myth. A wave is a disturbance that moves energy between two points. The most familiar waves occur in water, but there are other kinds as well, such as radio waves that travel invisibly through the air, or even financial waves that pulse through markets. Although a wave rolling across the Atlantic Ocean differs from a radio wave, they all work according to the same principles.

¹ Jim Flannery, "A Rogue Wave and An Improbable Outcome," July 16, 2013, <https://wgills502.blogspot.com>.
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Until the 1990s, British mathematician Michael Longuet-Higgins heavily influenced scientific thought about how waves form at sea.² Higgins' work, published during the 1950s, stated that when two or more waves collide, they may combine to create a larger wave through a process called constructive interference. The height of the new wave should simply be the total of the heights of the original waves. A rogue wave can only form if enough waves come together at the same point, according to this view. However, during the 1960s evidence emerged that wave formation was not so simple. Scientists noticed that while waves might start out with constant frequencies and wavelengths, they would then unexpectedly change after generation. Those waves with longer wavelengths were catching those waves with shorter wavelengths. This meant that energy concentrated in large, short-lived waves.

For many years, most scientists believed that this instability only occurred in laboratory-generated waves travelling in the same direction—an artificial situation. However, actual evidence contradicted that assumption. Rogue waves occurred more frequently than theory predicted. On December 12, 1978, at three o'clock in the morning, a German cargo ship called *The München* sent out a mayday message from the middle of the Atlantic Ocean. Despite extensive rescue efforts, the ship vanished along with twenty-seven people. Search efforts recovered a single lifeboat, one typically stowed sixty-six feet above the water line—the recovered lifeboat exhibited no signs of having been purposefully lowered. An extreme force apparently struck and dislodged the lifeboat. Once again, anecdotal evidence supported the idea of rogue waves, but what really shocked the scientific field was the Draupner wave.

At 3:20PM on New Year's Day in 1995, a rogue wave crashed into the Draupner oil platform off the coast of Norway. Because winds blew at hurricane force and thirty-nine foot waves repeatedly struck the oil drilling platform, workers remained indoors. No one saw the wave, but a downward-pointing laser rangefinder recorded and measured the eighty-five foot wave, when measured from trough to peak. According to existing theoretical assumptions, such a wave was possible only once every ten thousand years.



The giant Draupner wave introduced a new chapter to the science of waves. Rogue waves in the ocean receive a lot of attention, especially from ship designers who must build hulls and keels that are strong enough to withstand these monstrous waves. A German research project known as MAXWAVE, studied the phenomenon of oceanic rogue waves. When scientists from the MAXWAVE project analyzed 30,000 satellite images covering a three-week period during 2003, they found ten waves around the globe that had reached or exceeded eighty feet in height, a number once thought impossible. In the last twenty years, researchers have confirmed that rogue waves are more common than scientist once thought. Scientists now realize that waves are not linear systems, as Longuet-Higgins argued, but rather waves are an example of a non-linear system. A non-linear equation is one in which a change in output is not proportional to the change in input. If waves interact in a non-linear way, it might not be possible to calculate the height of a new wave by adding the originals together. Instead, one wave in a group might grow rapidly at the expense of others.

² Nic Fleming, "Rogue Waves Are Actually Real," BBC Earth, May 12, 2017

Rogue waves also occur in the financial markets, another non-linear system. When President Calvin Coolidge delivered his 1928 State of the Union address, he noted that America had never "*met with a more pleasing prospect than that which appears at the present time.*" For the first time, more Americans lived in cities than on farms. The nation's total wealth more than doubled between 1920 and 1929, and this economic growth swept many Americans into the middle class. Stocks were also soaring; between 1924 and 1929 the Dow Jones Industrial Average quadrupled. At that time, it was the longest bull market ever recorded. Unsurprisingly, this exuberance lured more investors to the market, investing on margin with borrowed money. By 1929, stock speculators borrowed two out of every five dollars loaned by banks.³ The market peaked on September 3, 1929, but few noticed. The Dow index stood at 381.17, up 27% from the previous year. However, over the next few weeks, stock prices began to move downward, and the lower they fell, the faster stocks dropped.

In the last hour of trading on Thursday, October 23, 1929 stock prices suddenly plummeted. When the closing bell rang at 3 o'clock that afternoon, Wall Street stood in shock. No one was sure what had just happened, but that evening provided enough time for fear and panic to set in. When the market opened again the next day, prices plunged with renewed violence. Back in 1929, a ticker tape machine printed stock transactions on a paper strip at 285 words a minute. Thirteen million shares traded that day, the highest daily volume in the exchange's history at that point. The ticker tape ran for another four hours after the market closed. And then came Black Monday. As soon as the opening bell rang on October 28, prices began to drop. Huge blocks of shares traded, as previously invincible companies like U.S. Steel and General Electric began to tumble. By the end of the day, the Dow index had dropped 13%. So many shares traded that day that traders did not have time to record all the transactions. Brokers worked late into the night, sleeping in their offices or on the floor, in anticipation of October 29.

As the story goes, no one ever heard the opening bell on Black Tuesday because of all the shouting and screaming. In the first thirty minutes, three million shares traded. Phone lines jammed. The volume of Western Union telegrams traveling across the country tripled. The ticker tape machines ran out of paper by mid-morning. People knew that they were losing money, but trading was so chaotic that they did not know by how much. Brokers called in margin loans; if a stockholder could not repay the loan, the broker sold their stock. Many investors lost their life savings in an instant. So many trades transpired, with each trade recorded on a slip of paper, that traders no longer knew where to store them. Many trade slips ended up in the garbage. According to one observer, "*They hollered and screamed, they clawed at one another's collars. It was like a bunch of crazy men. Every once in a while, when Radio or Steel or Auburn would take another tumble, you'd see some poor devil collapse and fall to the floor.*"⁴ The New York Stock Exchange's board of governors considered closing the market, but decided against it, in case the move increased the panic. When the market closed that day, more than 16.4 million shares traded, and 15,000 miles of ticker tape printed.

Stock owners lost thirty billion dollars, more than twice the country's national debt. The Dow index had dropped another 12% on Black Tuesday. Stocks continued to fall over subsequent weeks, finally bottoming out on November 13, 1929. The market recovered for a few months and then slid down again. Companies incurred huge layoffs, unemployment soared, wages plummeted, and the economy collapsed. Although World War II helped pull the country out of its economic depression, the stock market did not recover to its pre-crash highs until 1954. For many investors, the 1929 Crash was the equivalent of a rogue wave—an enormous concentrated selling pulse in a short-lived wave.

³ Clair Suddath, "Brief History of the Crash of 1929," Time, October 29, 2008

⁴ "The Wall Street Crash," EyeWitness to History, www.eyewitnesstohistory.com (2000).
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One investor who never wanted to experience another rogue wave-like stock market crash was Benjamin Graham. Graham, widely known as the 'father of value investing,' was an investor, economist and academic. He grew up under extreme poverty, which motivated him to earn enough money to make his family comfortable. Always a bright student, Graham entered Columbia University on a scholarship, graduating in 1914 as salutatorian of his class. Several weeks before his graduation, Columbia University offered him teaching positions in three different faculties: Greek and Latin philosophy, English, and mathematics. Although the job would have given him financial security, he declined the offer and joined Wall Street.⁵

After earning and saving enough, Graham formed his own partnership firm, the Graham Newman Company, in 1926 at the age of thirty-two. The partnership adopted some radical strategies for its day, which not only safeguarded its clients' capital, but also enabled them to provide a 670% return over a ten-year period. While betting that the price of one stock would rise, they would simultaneously place another bet that the price of another stock would fall. By employing this hedge, Graham could fully leverage the partnership's available capital without having to maintain a cash cushion. In 1926, Graham also created an investment fund, the Graham Joint Account. Over the first three years, 1926 to 1928, Graham's new fund earned 25.7% annually against the Dow Jones Industrial Average's annual return of 20.2%. Graham beat the market index on the way up, and he also "outperformed" the market on the way down. From 1929 to 1932, Graham's fund lost 70% compared to the Dow's 80% loss. The loss devastated Graham. He knew that he had failed.

Graham barely survived the worst four-year period ever in the stock market. Not surprisingly, the financial loss left a lasting impression on him. Jim Grant, publisher of *Grant's Interest Rate Observer*, explained exactly what went wrong during a 2008 speech:

"Value investors were supposed to have a deep-rooted aversion to financial leverage, but Graham and his partners went into the crash in a highly encumbered position. He relates that he was operating with two and a half million dollars in capital and that two and a half million of longs was hedged with two and a half million of shorts. So far so good. But Graham had in addition, as much as four and a half million in unhedged long positions against which he had borrowed 2 million. "We were convinced," Graham explained, "that all of our long securities were intrinsically worth more than the market price." Mark that word intrinsically. Now forget it. Graham said, "Although many of our issues were little known to active Wall Street hands, similar ones had previously shown a praiseworthy tendency to come to life in a decent interval after we bought them and give us a chance to sell out at a nice profit." So, he had come into the crash levered and with the muscle memory of value redeeming itself because it was intrinsically value laden.

Then came the turn of the seasons... Graham's fund was down 20 percent in 1929...50 percent in 1930, and 16 percent in 1931. By 1932, the year in which the Dow bottomed at 41 spot 22, Graham had managed to achieve a kind of moral victory by losing a mere two percent. Still, there was only thirty cents remaining of each dollar entrusted to a stewardship at the peak only three years before."⁶

Using leverage in the form of margin debt was common in the 1920s. Leverage helped propel the long bull market from 1921 to 1929. The attraction of leverage is that it makes great returns even better. Nobody advertises the downside—leverage makes losses catastrophic. After the financial and emotional devastation of four years of losses, Graham swore off the use of leverage. That was Graham's first lesson. The second lesson was that in a long, drawn-out bull market, investors grow complacent.

⁵ "Benjamin Graham Biography," The Famous People, www.thefamouspeople.com/profiles/benjamin-graham-156.php

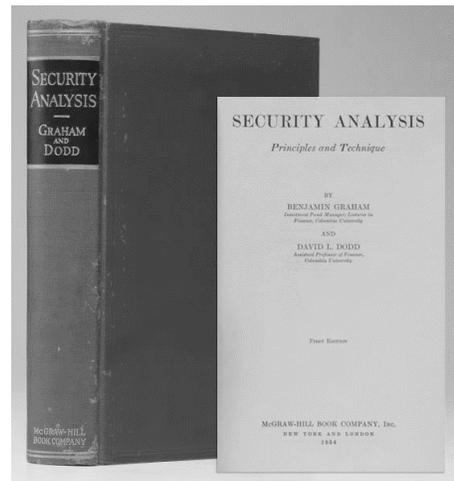
⁶ Novel Investor, "18th Annual Graham & Dodd Breakfast," October 2, 2008.

Graham realized that he had become complacent. He carried a 44% margin debt on his fund because every previous time he bought cheaply, the market provided him an opportunity to sell at a profit. Year after year of “buying the dip” worked. That is, until it no longer worked. How one recovers, mentally and financially, from such a devastating loss, is an emotional and personal experience. Yet Graham did indeed dig himself out financially. By 1935, Graham had fully recovered his investors’ losses.

But mentally it was another story. As rational as Graham was, the experience completely redefined him. He became a much more conservative investor. As Jim Grant told it, the experience seeped into his writing:

“I’m going to close with, to me, what is the great irony of Graham’s career as an analyst and as a participant in the financial markets... So, Mr. Market was not content to ruin everyone’s life between the years 1929 and ’32. He wanted another lesson in 1937 just to make sure that you knew he was serious. So, in 1937, there was what they call — the Roosevelt people call — a recession. It sounded so much more palatable than depression. The stock market, again, took a pratfall, say 40 percent. By this time, I think Graham had had enough. He was a wonderful, indeed, a great human being in so many ways, but he was a mortal being and he had had it. He had had it. And you could see his weariness shine through in the 1940 edition [Security Analysis] a little bit. And let this too be a lesson to us.”

Despite his grueling financial ordeal, Graham never abandoned his underlying philosophy. After an 89% peak-to-trough decline in the Dow Jones Industrial Average, it was understandable why a generation of investors would never return to the market. The fact that Graham remained steadfast in his conviction that security analysis was a worthwhile endeavor was quite remarkable. Despite the hard times and enormous drawdown in performance, Graham continued to operate under the assumption that value investing remained the most intelligent way to allocate one’s investment capital. The stock market crash also caused him to reflect deeply on his actions, resulting in the publication of his first book, ‘Security Analysis.’



Published in 1934 and cowritten with David Dodd, another young instructor at Columbia University, ‘Security Analysis’ was the first book to systematically deal with the study of investments. The country, as well as the rest of the world, was in the middle of the Great Depression, a period that brought unimaginable turmoil to the financial markets. In 1940, Graham and Dodd responded to the new financial landscape with a comprehensive revision to their book. Many investors consider the second edition of ‘Security Analysis’ to be the definitive word from the most influential investment philosopher of our time. Warren Buffett studied from ‘Security Analysis’ while he was at Columbia University in 1950 and 1951. Buffett, who studied under both Graham and Dodd, wrote in the Forward to the sixth edition of ‘Security Analysis’ that *“they laid out a roadmap for investing that I have now been following for fifty-seven years. There’s been no reason to look for another.”*

Graham's roadmap consisted of basic ideas that are timeless and essential for long-term investing success. He detailed the concept of buying stocks based on the underlying value of the business and turned it into a science at a time when almost all investors viewed stocks as speculative. To Graham, these business assets were valuable because of their stable earnings power or simply because of their

liquid cash value. By contrast, far too many people approach the stock market with a focus on making money quickly. Such a mindset involves speculation, rather than investment, and is based on hope that share prices will rise regardless of valuation. Speculation pays minimal attention to downside risk and is particularly popular during rising markets. When times are good, few remain sufficiently disciplined to maintain strict standards of valuation and risk aversion.

Value investing, today as in the time of Graham and Dodd, is the practice of purchasing securities or assets for less than they are worth. Investing in attractively-priced securities provides a “margin of safety” – the room one needs to account for errors, imprecision or any of the other various fluctuations of the economy and stock market, including rogue waves. Some mistakenly consider value investing a mechanical tool for identifying cheap assets, but value investing is an investment philosophy that emphasizes the need to perform fundamental analysis, pursue long-term investment results, limit risk, and resist crowd psychology.

Following the near disaster of the Logan & Morgan, Captain Stoddard purchased foul weather gear with inherent buoyancy as an extra precaution for his crew in the event of another rogue wave. Stoddard reflected that *“You’ll never be able to predict something like that happening, so it’s best to be prepared. I’m hoping I go another forty years before I see something like that happen again. But then again, it could happen again tomorrow.”* Similarly, markets can be wildly inefficient, with great divergences between price and an asset’s underlying value. Even in the darkest days, Graham and Dodd remained faithful to their principles, including their view that the economy and markets sometimes go through painful cycles, which the investor must endure: *“While we were writing, we had to combat a widespread conviction that the financial debacle was to be the permanent order.”*⁷ Graham and Dodd knew that the economy and the stock market would eventually rebound, because at the core of their investment philosophy is the principle that volatility creates investment opportunity.

With kind regards,

A handwritten signature in black ink, appearing to be a stylized name, possibly 'St. James'.

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⁷ Benjamin Graham and David L. Dodd, “Security Analysis,” First Edition, Page xliv

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 and friends have trusted us for twenty 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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