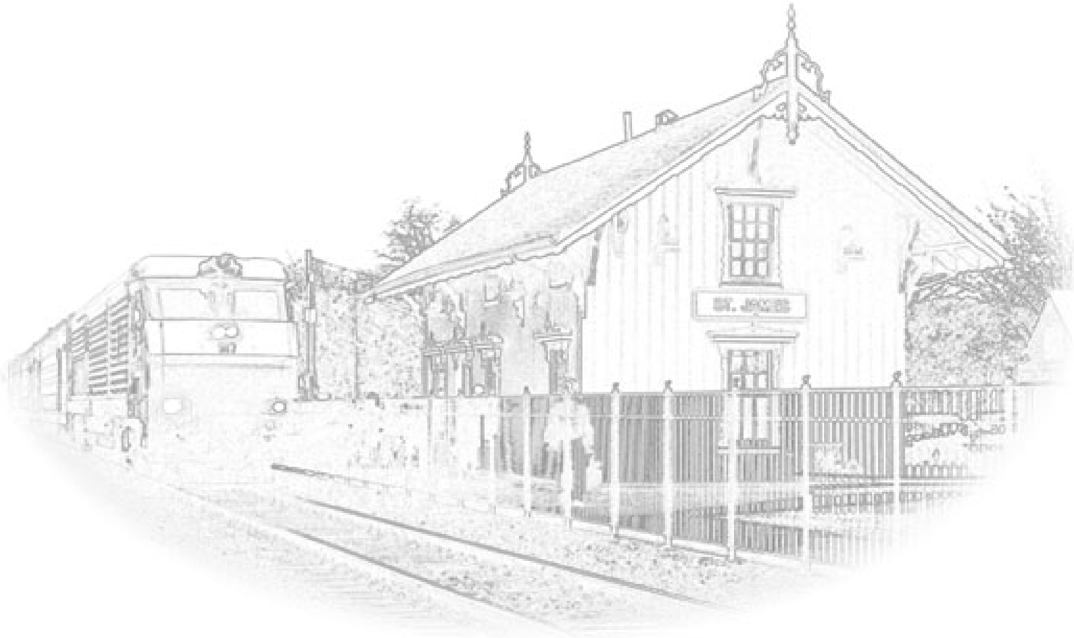

ST. JAMES INVESTMENT COMPANY

INDIVIDUAL PORTFOLIO MANAGEMENT

INVESTMENT ADVISER'S LETTER

JULY 2020

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SECOND QUARTER LETTER

"Many shall be restored that now are fallen and many shall fall that now are in honor."-Horace

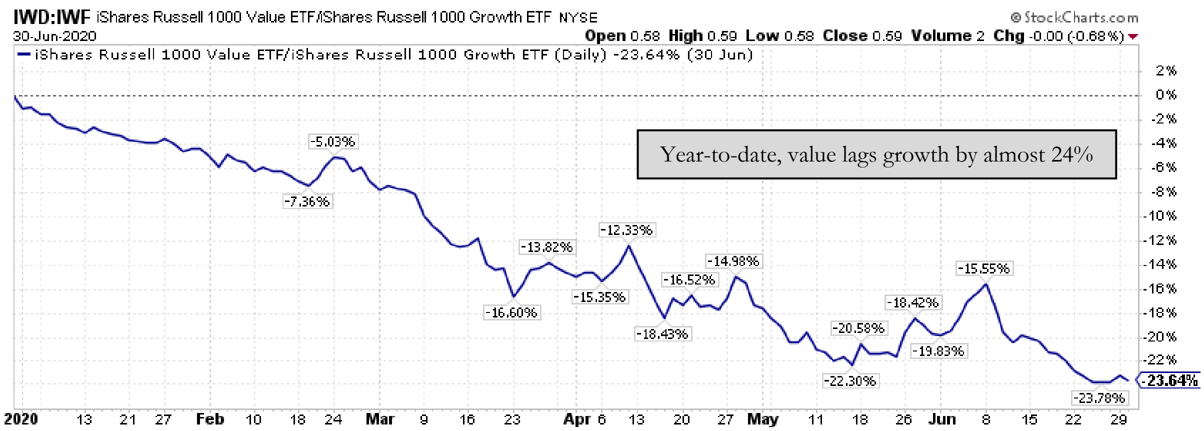
Capital markets have existed for as long as humans have engaged in trade. In France during the twelfth century, a network of *courtier de change* managed agricultural debts on behalf of banks. The merchants of Venice traded government securities as early as the thirteenth century, as well as the bankers in the nearby cities of Pisa, Verona, Genoa, and Florence. The first stock markets appeared in the sixteenth century in Belgium. Antwerp was the commercial center of Belgium and home to the Van der Beurze family; today, the word 'bourse' is common in Europe to mean a market organized for the purpose of trading securities. The world's first publicly traded company was the East India Company—established with the goal of pooling the risk of sailing to the far corners of the world. When European explorers discovered the East Indies, enterprising ship merchants immediately charted trade explorations. Unfortunately, few of these voyages ever returned home.

Financiers realized they needed to mitigate their risk. As a result, they formed a unique corporation in 1600 called the Governor and Company of Merchants of London trading with the East Indies, the first company to use a limited liability formula. Rather than invest in one voyage and risk the loss of all investment capital, investors could purchase shares in multiple companies. Even if they lost their investment in one out of three or four ship companies, an investor could still generate a profit on their remaining capital. The formula proved successful. Within a decade, similar charters in other businesses existed throughout England, France, Belgium, and the Netherlands. In 1602, the Dutch East India Company officially became the world's first publicly traded company when it released shares of the company on the Amsterdam Stock Exchange. The company issued stocks and bonds to investors, entitling them to a fixed percentage of East India Company's profits.

Stock markets today remain one of the most important means for companies to raise money. The liquidity to trade securities quickly and easily is an attractive feature when compared to other less liquid investments such as property. In a stock market, investors trade certificates that indicate partial ownership in businesses for a set price. Through these transactions, companies can raise the initial capital necessary for various aspects of operation, and those who buy the certificates become entitled to a portion of the business' assets and earnings. At its most basic level, the stock market provides an organized way for businesses to connect with potential investors who might want to purchase stocks and become partial owners.

The patriarch of value investing, Ben Graham, once said, "*In the short run the market is a voting machine, but in the long run it is a weighing machine*." As markets have evolved into modern electronic exchanges, Graham's statement remains timeless yet still confusing to most investors. Graham used the statement to illustrate that, from time to time, the stock market can become nothing more than a beauty pageant, placing rich valuations on current Wall Street darlings. The voting machine is a short-term scoreboard that measures how investors feel about the prospects of a business or stock at any given moment. Factors like quarterly earnings reports, price targets pushed by Wall Street analysts and the media's conversation of the day can heavily sway voting sentiment. The voting machine can be loud, lively, and exciting. By contrast, the weighing machine is the present value of the future earnings of the business. Factors that affect the weighing machine of a business are the growth of that business, the duration of that business' competitive advantage and the amount of capital owners will receive in the future. Popularity sways the voting machine over short periods of time, while fundamentals, cash flow and valuations drive the weighing machine over longer cycles of time.

The voting machine deals with expectations and the weighing machine deals with the actual economic benefits provided to the owners. The voting machine focuses on price while the weighing machine centers on fundamentals. In recent years, market participants have voted overwhelmingly for companies possessing growth characteristics as opposed to companies exhibiting value. Year-to-date, the trend is accelerating with value underperforming growth by 24%. The market is certainly not voting for a company like Loews Corporation, one of the largest diversified companies in the United States. The company owns 89% of CNA Financial, a publicly traded insurance company with a market capitalization of $8.9 billion. If one adds Loews' net cash position of $1.35 billion to its interest in CNA Financial, the amount totals $9.2 billion, or 97% of Loews' current value. The 3% difference, or $300 million, is the value assigned by the market for Loews' total ownership of Boardwalk Pipelines ($821 million operating profit in 2019), Loews Hotels (15,668 luxury hotel rooms and $227 million operating profit in 2019) and Altium Packaging, purchased in 2017 for $1.2 billion with additional acquisitions made to further build out company. Loews continues to lose the popularity contest and receive few votes for the value within the company.



The S&P 500 index closed the second quarter at 3100, exactly where it was at the beginning of November 2019. If one knew back in the Fall of 2019 that the unemployment rate would jump from 3.6% to 14.7%, economic growth would go from +2% to -10%, earnings estimates per share would drop from $180 to $129 for 2020, that the country would lose ten years of retail sales growth in one month, that the U.S. would endure the worst plunge in industrial production since the records began in 1921 and that there would be twenty-one million jobs lost in a two-month span....would one believe that the market still traded at the same level? The most recent Bank of America fund manager survey shows that 78% of respondents admit that the stock market is overvalued but remain fully invested. Fund managers are chasing stocks, understanding that the underlying fundamentals are poor and the economic underpinnings fragile. They are voting for what is popular rather than weighing the fundamentals.

The U.S. Federal Reserve Bank's balance sheet has expanded by $3 trillion in the past three months, an increase of more than 70%, or more than the entire credit reserve increase from December 2007 to November 2013. There is a 90% correlation between the Federal Reserve's balance sheet and risk assets—when the Federal Reserve's balance expands, the riskiest stocks move higher. Central banks have created an environment where the psychology is "*heads you win, tails we bail you out*." When questioned what Federal Reserve Chairman Jay Powell thought about its role in recreating a bubble-like investment climate, Powell responded: "The concept that we would hold back because we think asset prices were too high...what would happen to the people we're supposed to be serving?"

On June 15, the Federal Reserve Bank announced that it would buy individual corporate bonds in addition to exchange traded funds (ETFs). The Federal Reserve structured its Secondary Market Corporate Credit Facility (SMCCF) to hold three types of investments, "Eligible Individual Corporate Bonds" and "Eligible ETFs" and a new third category: "Eligible Broad Market Index Bonds". This new category allows the central bank to begin buying individual corporate bonds in larger volumes than previously anticipated. The top three constituents of this third category are automobile giants Toyota, Volkswagen, and Daimler. One wonders how the Federal Reserve purchasing the bonds of foreign automobile manufacturers serves the people and small businesses on Main Street America.

The Federal Reserve's actions amount to ballot stuffing the voting box. It is all about fiscal and monetary stimulus. A federal judge approved plans for bankrupt rental car company Hertz to sell up to $1 billion in stock to capitalize on the ten-fold rise in HTZ shares AFTER the company filed for bankruptcy. The company fully disclosed multiple times that "t*he common stock could ultimately be worthless*" but the warnings did not deter buyers. A small Chinese real estate company, that trades on Nasdaq under the ticker symbol DUO, in one day surged 1300% on no news. The company's name is Fangdd Network Group, which is similar to the popular acronym "FAANG," representing Facebook, Apple, Amazon, Netflix, and Google. FAANG shares were rallying that day; therefore, a large contingent of new traders believed that Fangdd should somehow trade higher as well. Clearly the voting machine is far more fun than the weighing machine. Sahil Bloom in a series of posts on Twitter used a story to explain how the central bank's actions can change market behavior: [1]

> It is the year 1500 and you enter a market in Renaissance-era Italy. There are buyers and there are sellers. Prices of the various goods are determined by the interaction by and among these individuals. Now in walks Mr. FEDerico, a man of endless means. Mr. FEDerico climbs a tower in the center of the market and proclaims, "I am a buyer of any and all goods in this market, regardless of their price." He climbs down off the tower and exits the market to return to his mansion. What happens in the market when he leaves? Sellers, knowing they have a buyer, increase their prices. Buyers, previously unwilling to pay these prices, realize they can flip and sell the goods at a higher price, so increase their bids. Even you, the silent observer from the future, want in on the fun! The fun continues for a while.
>
> Buyers and sellers flip goods at higher and higher prices, turning profits as they do. Wealth accumulates. The poor and middle class must go to a market several cities away. They cannot afford to pay 5000 Florin for a bag of corn. But one day, Mr. FEDerico returns to the market, climbs the tower, and proclaims, "This market is incredible, bustling and vibrant. I am no longer needed and will move on to new cities in need of my brilliance!" What happens next? Without a buyer at any price, sellers frantically try to sell. But buyers are silent, and prices plummet. Back in your time machine, you see the irony - Mr. FEDerico never actually had to buy anything, only his intention to do so.

With the market's rally off the March lows and the estimated annualized decline in gross domestic product (GDP), a measure of all final goods and services produced, equity valuations now sit at record highs according to Jesse Felder of *The Felder Report*. The new reading in the Buffett Yardstick produces a ten-year forecast for stock market returns of -6% per year, including dividends.[2] We doubt any of this resonates with Barstool Sports founder and new stock trader, David Portnoy, who has determined that day trading is 'the easiest game' in town. With most sports currently on hold due to the coronavirus, Portnoy has taken to day trading. Portnoy does not lack confidence in his new endeavor, saying recently in a video posted on Twitter: "There's nobody who can argue that Warren Buffett is better at the stock

[1] Bloom, Sahil. Twitter Post. May 9, 2020, 10:19 AM. https://twitter.com/SahilBloom/status/1259141067938557952

[2] Market Capitalization to GDP is a long-term valuation indicator that is popular due to Warren Buffett. Back in 2001, he remarked in a Fortune Magazine interview that "it is probably the best single measure of where valuations stand at any given moment."

market than I am right now. I am better than he is. That's a fact." Other comments Portnoy made about Buffett were not suitable for print.

Jeremy Grantham, co-founder and chief investment strategist at Boston-based money manager Grantham, Mayo, Van Otterloo & Company (GMO), offered a stark warning to speculators. Grantham recently told clients that the explosive surge in markets since late March has separated prices from fundamentals. Grantham's research indicates that long-term returns on U.S. equities may be negative over the next seven to ten years. Although difficult to believe, particularly for traders who vote for stocks as opposed to weighing stocks, GMO research notes that the S&P 500 would have to drop by at least thirty percent in order to restore valuations to a more plausible level. Before one quickly dismisses Grantham's heresy, one must respect that he presciently sounded the alarm before the technology collapse in 2000 and the housing crisis in 2008. Asked what level of exposure investors should have to U.S. equities, Grantham offered an unambiguous view: "I think a good number now is zero and less than zero might not be a bad idea if you can stand that." The reality is that almost no one can withstand 'zero' exposure to the stock market—the voting machine overpowers the weighing machine.

Stanley Druckenmiller, a brilliant hedge fund manager for over thirty years, shares a similar market outlook to Grantham but reaches his conclusions from a different perspective. Druckenmiller previously worked for legendary investor George Soros until 2000. The pair famously bet against the British pound in 1992 and generated a massive profit. He closed his fund in 2010 but remains one of Wall Street's sharpest and most respected investors. In 1978, Pittsburgh National Bank hired the young Druckenmiller to cover oil equities. In short time, Druckenmiller replaced his boss and became head of research at Pittsburgh National Bank. Druckenmiller explained his rapid ascent at the bank in an interview for the book, *The New Market Wizards*:

> "The director of investments was Speros Drelles—brilliant but also eccentric. When he promoted me, I was twenty-five, my exiting boss was fifty and all the other analysts had MBAs and had been in the department longer than me. He said: You know why I'm doing this, don't you? For the same reason they send eighteen-

> year-olds into war—they're too dumb to know not to charge. I think there's going to be a huge, liquidity-driven bull market sometime in the next decade. I have a lot of scars from the past ten years, while you don't. I think we'll make a great team because you'll be too stupid and inexperienced to know not to try to buy everything."

As Speros Drelles suspected, what worked in the 1980s and 1990s differed materially from what worked in the 1970s. Drelles would often tell Druckenmiller that "*Sixty million Frenchman can't be wrong*." He taught the young Druckenmiller about the wisdom of the market, that the crowd is collectively smarter than any one individual. Francis Galton, a statistician, first discussed this idea of a collective intelligence in 1906 during a competition at a local fair. Approximately eight hundred people tried to guess the weight of an ox. To Galton's surprise, the average of all the guesses was 1,197 pounds; the actual weight of the ox was 1,198 pounds. Countless studies have repeated this experiment and all show similar results—the crowd collectively outperforms the individual. However, the crowd is only smarter than the individual if there exists a diversity of opinion, not when everyone is voting for the same thing.

When applying this concept to markets, George Soros explained that it is critical to know when to be part of the "herd" and follow the trend, and when to disengage and be a contrarian: "Being so critical, I am often considered a contrarian. But I am very cautious about going against the herd; I am liable to be trampled on… Most of the time I am a trend follower, but all the time I am aware that I am a member of the herd and I am on the lookout for inflection points… I watch out for telltale signs that a trend may be exhausted. Then I disengage from the herd and look for a different investment thesis."

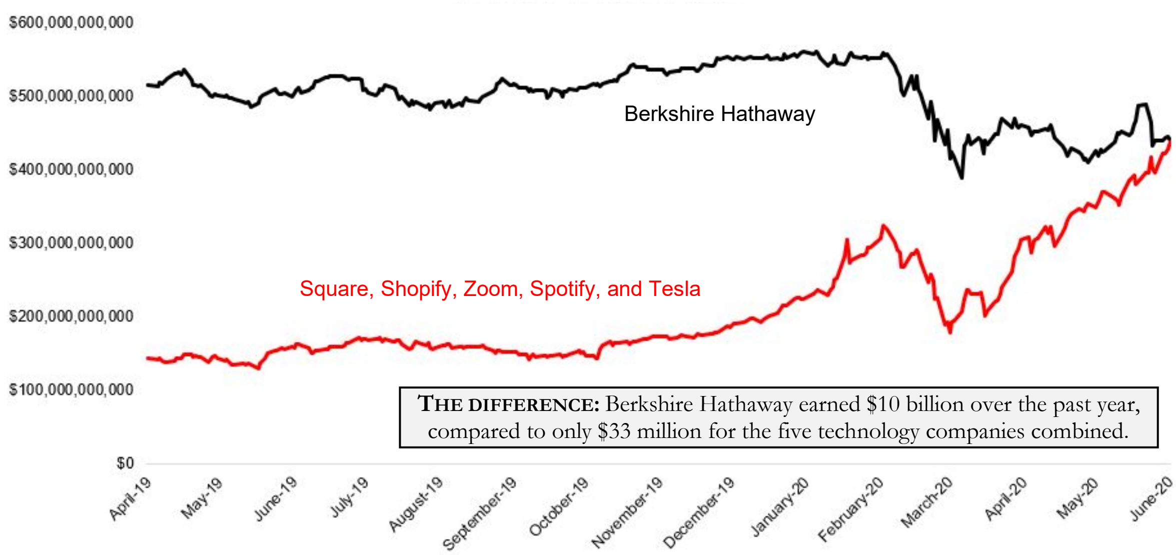
Soros understood that bull markets climb a wall of worry—disbelief powers market trends. By contrast, one should only be a contrarian when the market stops confirming the consensus. Market participants begin to use very similar trading strategies because their good performance reinforces their common beliefs. The market grows brittle because everyone is following the same strategies. A market crashes when there is no diversity of opinion; everyone is voting for the same stocks. Soros understood that price and sentiment create a reflexive loop. Price drives sentiment which in turn drives price. Both Soros and Drelles taught Druckenmiller this concept. Druckenmiller learned early in his career to listen and respect the market, to harness the wisdom of the crowds, and to only fade a trend once a consensus was clear, but the market no longer confirmed the crowd's collective opinion. Understanding investor sentiment is as much an art as it is a science. When in doubt, Soros deferred to the market. This sounds easy in theory but remains extraordinarily difficult in practice, and near impossible for value investors who insist on using the weighing machine.

During an interview at the Economic Club of New York on May 12, Druckenmiller explained that Wall Street had misread the damage from the pandemic and had lost its moorings: "The risk-reward for equity is maybe as bad as I've seen it in my career. The wild card here is the Fed can always step up their asset purchases." The Federal Reserve Bank promptly made a fool of Druckenmiller, forcing him to admit in June that he had been far too careful: "I would say since that time, a couple things have happened technically. I would also say I underestimated how many red lines, and how far, the Fed would go. I have been far too cautious. I was up 2% the day of the bottom and I've made all of 3% during the market's 40% rally." Even Stanley Druckenmiller, an extraordinary trader who excels at voting with the herd yet positioning himself to accurately weigh markets, struggles in the current market environment.

Druckenmiller may be too critical of himself, but the mob is growing increasingly critical of Warren Buffett and his company Berkshire Hathaway. Too big, too slow, too old-fashioned—the criticisms mount as Berkshire Hathaway struggles. The famous investor had his worst performance versus the

S&P 500 in 2019, and 2020 is looking just as bad. Instead of highlighting Berkshire's fortress-like balance sheet, those sitting in the bleachers argue that it is time to fundamentally rethink Berkshire's mix of businesses and investments. Buffett has made some questionable investment decisions in recent years. The company wrote down its holding in Kraft Heinz by $3 billion last year, while the $10 billion investment in Occidental Petroleum no longer pays a cash dividend and the stock warrants now appear worthless. More recently, Buffett increased his shareholdings in the largest domestic airlines at the beginning of the year before selling them during the stock market's coronavirus liquidation in March.

VALUE COMPARISON BY MARKET CAPITALIZATION
The combined value of Square, Shopify, Zoom, Spotify, and Tesla equals Berkshire Hathaway



Berkshire Hathaway's cash position has increased to $137 billion, or 32% of the company's market capitalization. To the surprise of many, Buffett did not deploy any of that dry powder during the market's plunge in March. "We haven't seen anything attractive," explained Buffett to Berkshire Hathaway shareholders in May. Perhaps Buffett's caution is because Berkshire Hathaway remains focused on the weighing machine, not the voting machine as evidenced in the chart above.[3] Buffett built Berkshire Hathaway to reward investors over time but not on time. Investing always involves making decisions under uncertainty. Investors seldom know what the market will do in the near term. However, value investors understand that if they vote for assets rather than patiently weighing their potential investments, they run the real risk of permanently impairing their capital.

With kind regards,

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[3] Batnick, Michael. Twitter Post. June 18, 2020, 9:48 AM. https://twitter.com/michaelbatnick/status/1273628636780822530

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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.