THIRD QUARTER LETTER

“Fools say they learn by experience. I prefer to profit by others experience.” — Otto von Bismarck

Investment luminary Charles Ellis tells the story of watching the end of the Munich marathon. As each runner was applauded entering the stadium, he or she reached high overhead with both arms in the traditional triumphal “Y,” smiling in victory, as they ran the final lap. At first, Ellis thought it strange these runners were acting like victors when they were not, but then he realized that each had achieved their own realistic goal. Every runner ran their own race according to their own plan and was fully entitled to celebrate. Ellis relates how this lesson applies to investors: the secret to success is to execute your own plan to win your own game. Importantly, as every athlete and investor are aware, the influence of successful predecessors helps define the road toward personal achievement.

In his 24th season as a head coach in the National Football League, Andy Reid of the Kansas City Chiefs has become one of the most influential figures in the game. Many former assistants are now head coaches, but even more coaches have been influenced in some way by his philosophy on playing offense. Reid is an acolyte of Mike Holmgren (Green Bay Packers), who learned the “West Coast offense”, with its emphasis on passing rather than running, from Bill Walsh (San Francisco 49ers). As this style predominated, few ran it better than Reid. But he has also been at the forefront of how the NFL is changing, seeking new concepts from the college game, incorporating them into his system, and reshaping the offensive side of today’s football game. Reid possesses a respectable 19-16 career playoff record with one Super Bowl championship and two conference titles. However, through his years-long experimentation and overhaul of the West Coast offense, Reid has shaped modern NFL offense more than any other coach.

Through years of innovation and mentoring, Reid’s ‘coaching tree’ of acolytes has expanded enormously. Coaches who worked under Reid say his meticulous organization and work ethic rub off. “I can rarely remember a time when I didn’t drive in and his car wasn’t there already, or drive out and his car had left,” said Brad Childress, a former Reid offensive coordinator who later became the Minnesota Vikings’ head coach. A few months after Ron Rivera started working for him, Reid called Rivera into his office and recommended he read Walsh’s “Finding the Winning Edge,” considered required reading among coaches. As Rivera read the book, he realized Reid had borrowed many of the book’s teachings, particularly about how to schedule. When Rivera was the head coach of the Carolina Panthers, he implemented the lessons learned to map out the organization’s entire year, from minicamp practices to when coaches took vacation. Whenever assistant coaches would visit Reid in his office, they would notice a message written on a three-by-five card behind Reid’s desk. It simply read: “Don’t Judge.” Over time Reid’s assistants understood the importance of that basic message: Take people for who they are and for where they are in their life — as football players, as coaches, as a person, and let them be who they are... Reid wants people to run their own race.

Many value-oriented investors trace their investment beginnings to Warren Buffett, who in turn traces his investment foundation back to the principles laid out by Benjamin Graham and David Dodd in their 1934 seminal book Security Analysis. On the 50th anniversary of this classic text, Buffett chronicled the performance of a group of investors who successfully employed the book’s “value approach” to

1 Kilgore, Adam. “Bill Belichick may be the NFL’s best modern coach, but Andy Reid is its most influential.” The Washington Post, October 12, 2018.
investing. In his essay, Buffett described how a group of investors he personally knew utilized these value principles. All ran their own portfolio differently yet successfully according to their own interpretation of value investing. Buffett took issue with the academic literature that argued that the stock market is efficient; that is, that stock prices reflect everything that is known about a company’s prospects and about the state of the economy. Stock market efficiency suggests investors who outperform the market are just lucky. According to academics, “If prices fully reflect available information, this sort of investment adeptness is ruled out.”

Buffett countered the notion of market efficiency with a hypothetical example; a national coin-flipping contest. Imagine one day that all 225 million Americans (this was 1984) wager one dollar, and each calls the flip of a coin. If they call correctly, they win a dollar from those who called wrong. Each day the losers drop out, and on the subsequent day the stakes build as all previous winnings are put back on the line. After ten flips on ten successive days, there will be approximately 220,000 people in the United States who have correctly called ten coin flips in a row. They each will have won a little over $1,000. Assuming that the winners are getting the appropriate rewards from the losers, in another ten days there will be 215 people who successfully called their coin flips twenty times in a row and who, by this exercise, each have turned one dollar into a little over $1 million--$225 million would have been lost, $225 million would have been won.

Buffett sarcastically noted some college professor will probably mention if 225 million orangutans had engaged in a similar exercise, the results would be much the same — 215 orangutans with twenty straight winning flips. However, there is an important distinction; If one had taken 225 million orangutans distributed roughly as the U.S. population, and 215 winners remained after twenty days, but forty came from the same zoo in Omaha, one could reasonably assume that something might be different. That is, if one found such an extraordinary concentration of success among a similar group of practitioners, it’s a worthwhile exercise to identify attributes explaining this concentration. As opposed to a geographical commonality, Buffett called this an intellectual origin—a disproportionate number of successful coin-flippers in the investment world came from a very small intellectual village that he named Graham-and-Doddsville.

This group of successful investors shared a common patriarch, Benjamin Graham. But the children who left Graham-and-Doddsville have called their “flips” in very different ways. They have traveled to different places in the market and bought and sold different stocks and companies, yet they have had a combined record that cannot be explained by random chance. The common intellectual theme of the investors from Graham-and-Doddsville is that they all searched for discrepancies between the value of a business and the price of small pieces of that business that trade in the stock market. Terms like beta, the capital asset pricing model, or covariance in returns among securities would never pass their lips. These investors focus on two variables: price and value. Names of the original investors of Graham-and-Doddsville have faded with time but include Walter Schloss (Walter & Edwin Schloss Associates), Tom Knapp (TBK Partners), Bill Ruane (Sequoia Fund), Charlie Munger (Wesco Financial Corporation), Rick Guerin (Pacific Partners) and Stan Perlmeter (Perlmeter Investments).

Buffet selected these men years before their success, based upon their framework for investment decision-making. While they differed greatly in style, these investors mentally ran their own race to always buy the business, not the stock. A few of them sometimes bought whole businesses more often than they purchased small pieces of businesses, but their attitude was the same. Some of them held portfolios with dozens of stocks; others concentrated on a handful, but all exploited the difference

---

between the market price of a business and its intrinsic value. The Graham-and-Doddsville ‘coaching
tree’ has expanded greatly over several generations, but its members always seek to exploit gaps
between price and value. If the price of a stock can be influenced by a “herd” on Wall Street with prices
set at the margin by the most emotional person, or the greediest person, there will continue to be wide
discrepancies between price and value in the marketplace, and those who read their Graham & Dodd
will continue to prosper.

Finding historical investors who have successfully traversed difficult times helps one validate their own
investment experiences in markets today—markets that perhaps little resemble what the investors of
Graham-and-Doddsville encountered. Yet there is always something to learn, and there is always
something to add to one’s collective repertoire by understanding the experiences of those who have
succeeded before us. This holds true for investing as it does in life. Value strategies have been tested
academically and have been proven to work, yet we often wonder why value investing is not more
popular with institutional investors. We guess that discipline and patience are human emotions
necessary for a value investment philosophy, conditions impossible for academics to replicate.

When one asks value investors today who they study, they invariably mention Benjamin Graham and
Warren Buffett, perhaps a few of the ‘Superinvestors of Graham-and-Doddsville,’ as well as more recent
individuals such as Seth Klarman or Howard Marks. No one ever mentions Floyd Odlum, a lawyer
turned investor who not only survived the Great Depression unscathed but was also the rare individual
to make money during this tumultuous period. Investors today can still learn from Odlum’s strategy of
underpaying for assets. “We can have no finer role model,” the eponymous financial author James Grant
summarized. “First and foremost, he [Odlum] was a value investor — a member of that eccentric tribe
that believes it’s better to underpay than to overpay.”

Floyd Bostwick Odlum was born in 1892 in Union City, Michigan. When Floyd was sixteen, the family
moved to Colorado. Floyd studied law at the University of Colorado and received his degree in 1914.
After getting married in 1915, Odlum accepted a job as an attorney for the Utah Power and Light
company. Three years later, he moved to New York City and worked for the Simpson, Thatcher, and
Bartlett law firm, as well as the Electric Bond and Share Company. With a decent income from his job
as a law clerk, Odlum started trading in the stock market. He initially saw the market as a playground
for speculation. Like most beginning speculators, Odlum paid a steep tuition price to the market. After
losing his entire $40,000 of starting capital, Odlum retreated from the markets. However, it was this
early $40,000 loss that turned Odlum from speculator to investor.

Odlum returned to the markets, but his investment approach was vastly different. He formed his first
partnership in 1923 under the generic name of “The United States Company.” The partnership consisted
of Odlum, his friend George Howard and their wives. They seeded the partnership with $39,000
($635,000 today when adjusted for inflation). Over the next two years, The United States Company grew
its capital seventeen-fold. What started as a small partnership amongst friends, turned into $660,000
($10.5M adjusted for inflation), while Odlum still worked full-time as a law clerk.

As a reborn member of the value tribe, Odlum searched for dollars trading at fifty cents, primarily in
utility stocks and special situations. He defined a special situation as “an investment involving not only
primary financial sponsorship, but usually also responsibility for the management of the enterprise.”
He was not interested in flipping a business for a quick profit. Odlum wanted to see a special situation
through until success. “We will stay with the investment until the essentials of the job have been done,

---

and then move on to another special situation.” Between 1925 and 1928, Odlum steadily grew the partnership to $6 million ($94M adjusted for inflation). As 1928 progressed, Odlum sensed too much euphoria in the market and in early 1929, he rolled his original partnership into a new vehicle, The Atlas Corporation. Wary of a stock market peak, Odlum sold half his assets and remained in cash. He further increased his cash by issuing $9 million worth of Atlas Corporation securities to an eager market. With a total of $14 million in cash (a sum greater than almost anybody else on Wall Street except a few banks) Floyd patiently waited.

Following the 1929 market crash, Odlum took advantage of opportunities in mining, energy, motion picture production, aircraft and airlines, department stores, as well as manufacturing, hotels, and real estate. However, his primary focus during the Depression was buying investment trusts using a simple strategy. He sought investment trusts that had fallen to levels such that the trust’s value was trading far below the value of the marketable securities within the trust. Odlum would buy these trusts, liquidate their assets, and harvest the profits for his company. He was buying dollar bills for the proverbial $0.50. When he did not have enough cash, he sold shares in Atlas to fund the purchases. After exchanging his stock for the trust’s stock, Odlum would merge or dissolve the existing trust, retaining the cash and assets within Atlas. In total, Odlum bought and merged twenty-two investment trusts. By 1935, Odlum grew Atlas Corporation’s assets to $150 million ($3.1B adjusted for inflation) and controlled many diverse businesses, including Greyhound Bus, motion picture studio Paramount, Hilton Hotels, several women’s apparel companies, uranium mines, a bank, an office building, and an oil company.4

Odlum ran his own race and compounded capital at an unparalleled annual rate that is impossible to comprehend. One can draw two important lessons from his investing career. First, one does not always need to be fully invested in the market. Odlum was a deep value investor—when value was scarce, he went to cash. He did not force investments or lower his investment criteria...he simply sat in cash. Second, boring can be very profitable. In today’s technology-obsessed market, many investors forget that boring, slow-growing cash producers that compound retained profits can produce extraordinary investment returns with time and the magic of compounding. The core tenets of Odlum’s investment philosophy still apply today; put money to work only if one is sure of the odds. Low entry prices limit downside risk or in the parlance of Benjamin Graham, a contemporary of Floyd Odlum, paying a price low enough to create a margin of safety.

As Paul Harvey would say, “And now for the rest of the story.” Odlum’s long career left an imprint on virtually every segment of corporate America. One of the main decisions made by Odlum that affected the course of business and of the nation was his insistence on the development of the Atlas missile, which later would lead man on his way to the moon. When the U.S. government reduced financing for the missile’s development in the 1950’s, Odlum injected Atlas Corporation funds into the development and research for three years until the U.S. government again gave the program priority. Of the nation’s space program, he later said, “I think the money could have been spent better otherwise. But it’s too early to tote up the value of its byproducts. My wife thinks the moon shots were terrific.”5

Jeremy Grantham, chief investment strategist of GMO and prominent member of the value tribe, recently commented that most of the time (85% or thereabouts he guessed) markets behave quite normally.6 In these periods, investors are happy enough, but these periods do not truly matter. It is only the other 15% of the time that matters, when investors get carried away and become irrational.

---

Grantham suggests approximately 12% of the time irrationality is excessive optimism—complete with meme stock short squeezes, IPO frenzies, and an emphasis on narratives vs. valuations. And lastly, but only representing about 3% of the time, investors panic and sell regardless of value. Grantham cites examples such as when the S&P 500 index dropped to 666 in 2009, or when many stocks traded at levels where one only paid 2.5 times annual company profits in 1974. These times of euphoria and panic are the most important for portfolios and the most dangerous for career investment professionals, particularly those who trace their intellectual origins to Graham-and-Doddsville. It is difficult to not drink from the spiked punch bowl, but the eccentric members of the value tribe must continue running their own race, employing their own plan to win their distinctive game.

Grantham stresses that the current irrational period is very different from ordinary bull and bear markets. Averaging ordinary bull and bear markets with a handful of outliers dilutes the data and produces misleading signals. Therefore, he strongly suggests treating “superbubbles” as unique occurrences that exhibit a change in investor behavior. After a long economic upswing and a long bull market in stocks and bonds, when the financial and economic systems look nearly perfect with low inflation and high profit margins fueled by unprecedented accommodation, investor behavior reaches a crescendo. There is an obvious explosion of confidence, speculation, and crazy wishful thinking. After a lifetime of study, Grantham lists common traits that connect this unique group of superbubbles (1929, 1972, 2000, and the current period): the divergence between conservative and speculative stocks, sharp bear market rallies, the rapid onset of recession, and the increased probabilities of further unexpected financial and economic accidents.

Since the end of the 2008 financial crisis, growth investing has outperformed value investing by a factor of two. While there are many different definitions, growth investors generally focus on topline revenue growth at the expense of near-term profits, while value investors focus on the present value of cash generated by a company. The environment over the past dozen years has been near perfect for a growth investment style and brutally frustrating for members of the value tribe. Beginning in late 2016, markets experienced a phase change in investor behavior—Grantham’s “irrationality of excessive optimism” hit full swing, reaching a crescendo in December of 2021—a full, blown superbubble.
The breaking of these superbubbles takes multiple stages. The bubble forms and then experiences a setback when some disturbance in the economic or political environment causes investors to realize that perfection will not last forever. Valuations take a step backwards before fundamentals finally deteriorate and the market crashes to a low, but no one knows if it is an intermediate low or the final low. Investors surmise, the S&P 500 index reached 4,800 in December 2021, so now at 3,600 the market must be cheap. Never a discussion about valuations when the market touched 4,800, but a proclamation of cheapness when comparing today’s market price with the all-time market high nine months ago. Bear market rallies are the hook that keeps market participants hopeful: the market touched 4,800 before, maybe it can reach 4,800 again. From the November low in 1929 to the April 1930 high, the market rallied 46% – a 55% recovery of the loss from the peak. In 1973, after the initial decline, the summer rally recovered 59% of the S&P 500’s total loss from the high. In 2000, the NASDAQ recovered 60% of its initial losses in just two months. In 2022, at the intraday peak on August 16, the S&P 500 recovered 58% of its losses from its June low.

Charles Ellis famously compared the investment process to a game of amateur tennis, where the winner is the one who makes the fewest mistakes. "If you can just volley the ball back to your opponent, eventually your opponent will hit it out of bounds or into the net. On the other hand, if you try to smash a shot and crush your opponent (like the pros do), you’re much more likely to hit the ball into the net yourself. The way you win a loser's game is to not play." The winning approach to tennis is simple to understand, but certainly not easy to implement; likewise, the key to winning the investing game is by avoiding mistakes. Successful investing can be almost easy: Avoid harmful mistakes and do what will achieve one’s own long-term objectives. Trying to gain too much by taking too much risk almost always leads to losses. Investors should learn to concentrate on wisely defining their own long-term objectives and focus on not losing as the most important part of each specific investment decision.

Only in hindsight will we know if the current market is entering Grantham’s “3% of the time” phase, where investors panic and sell regardless of value. Fortunately, this adverse possibility is not a concern for us. We have run our own race, by our own plan, for over twenty-three years and have no intention of changing course. The discipline and patience that value investors painfully employed during the superbubble phase will benefit them during the panic phase. Like our intellectual forebearers from Graham-and-Doddsville, when the “herd” on Wall Street finally capitulates, we stand ready to take advantage of the discrepancies between price and value in the marketplace.

With kind regards,

[Signature]

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.