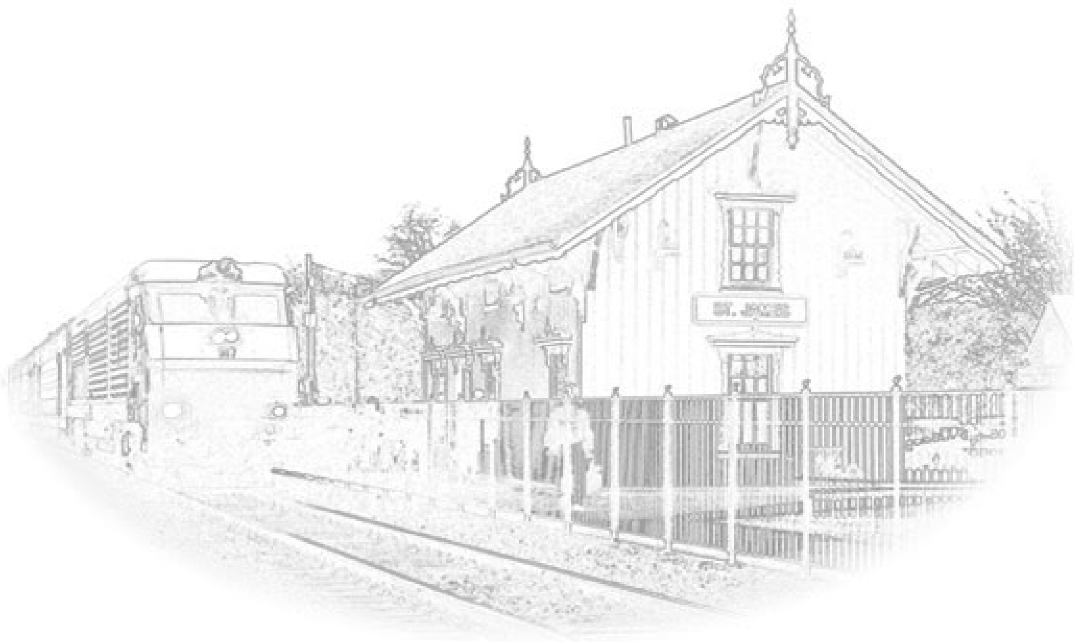


# ST. JAMES INVESTMENT COMPANY

INDIVIDUAL PORTFOLIO MANAGEMENT

# VALUE INVESTOR'S QUARTERLY LETTER

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*"To do nothing at all is the most difficult thing in the world, the most difficult and the most intellectual." - Oscar Wilde*

Investors normally maintain a natural urge to sell profitable investments. Platitudes such as "locking in profits" or "taking money off the table" reinforce this practical behavior. If one buys a stock that doubles, one's instinct is to quickly sell the stock – this behavior is reasonable, because an investor wishes to protect their winnings. This tendency, known as the "disposition effect," explains why investors sell their winners too early and hold losers too long. Or, as famed portfolio manager and author Peter Lynch often noted, "Selling your winners and holding your losers is like cutting the flowers and watering the weeds." This urge to sell is associated with another behavioral pattern – the need or desire to "do something." Inaction is hard when investing. In most endeavors, more activity leads to more output. By contrast, when investing, activity can detract value. As John Bogle, the founder of Vanguard, advised, "Don't do something, just stand there!"

At times, "taking profits" is a valid decision, such as when speculators are chasing the shares of profitless companies with questionable prospects sporting huge market capitalizations. However, the practice of "taking profits" because a stock reached a "target price" may be prudent at times but can also hinder the long-term accumulation of wealth. Case in point, Herb Wertheim, an optometrist in Florida, may be the greatest individual investor that no one knows. According to Forbes, Wertheim is a billionaire, but "his fortune comes not from some flash of entrepreneurial brilliance but from a lifetime of prudent buy-and-hold investing.[1]" Wertheim invested in the initial public offerings (IPO) of both Microsoft (1986) and Apple (1980) and still holds these stocks today. Wertheim's Microsoft position is now worth almost $400 million, while his 1.25 million shares of Apple are worth $820 million. Wertheim explains, "My goal is to buy and almost never sell."

Reviewing Wertheim's Fidelity statements in meeting with Forbes magazine, one could see positions worth hundreds of millions of dollars, purchased decades ago. A $1.5 billion position in Heico, an airplane-parts manufacturer, dates to 1992. There are dozens of other holdings, ranging from GE and Google, to BP and Bank of America. The common theme to Wertheim's investing is a preference for industry and technology companies and his testament to the power of compounding. Instead of concentrating on the metrics in financial statements, Wertheim reads patents and spends hours each week reviewing technical journals. "What's more important to me is, what is your intellectual capital to be able to grow?" He says that if you put your faith in a company's intellectual property, it matters little where the market goes—the product has lasting value.

While the investment acumen and discipline of Herb Wertheim is clearly an outlier, the compounding power of buying and holding the shares of good companies possessing sustainable competitive advantages remains powerful. But it's worth considering how many individuals truly possess the required level of patience to resist selling shares of Microsoft during its incredible growth in the 1990's followed by a decade of decline? At one point there was a consensus view that the personal computer was dead, and Microsoft faced a secular decline in relevance and market share. Today, Microsoft competes with Apple for the title of the world's most valuable publicly traded company. To paraphrase Howard Marks, sentiment reversed from "hopeless" to "flawless." Apple in the late 1990's faced an

[1] Berg, Madeline. The Greatest Investor You've Never Heard Of: An Optometrist Who Beat the Odds to Become a Billionaire. Forbes, February 19, 2019.

apparently hopeless situation as well. Twenty years later, following massive success, the consensus today is that Apple operates flawlessly as a business. Apple and Microsoft together now account for an incredible 13.3% of the S&P 500 index. A valid argument can be made that both companies trade at very expensive valuations, yet both companies sit at the pinnacle of business success.

Simplicity and patience can work wonders when investing. Companies navigate economic cycles in fits and starts while stock prices amplify the tailwinds and headwinds companies cyclically encounter. Business is not linear, and markets are not predictable. Still, one wonders if today's market participants have grown too comfortable with rich stock market valuations, and remain complacent about potential risks to their investment capital. Investor complacency often peaks before markets cycle lower. As distressed investor and prolific writer Howard Marks often notes, while the market is unpredictable, it is important to understand where one stands. In his words, "We never know where we're going, but hopefully we can figure out where we are, and understand what that implies for the odds." According to Marks, there are indicators of cycle peaks that include:[2]

"A high level of investor optimism…. investors who are spurred on by greed. Recent successes because what makes people more optimistic and greedier than having made money recently? Investors who are happy with their gains, or jealous of the gains of others — and jealousy is one of the strongest forces all around the world. Unwise risk tolerance, and eagerness to supply capital. Things like this denote a market which is elevated and a market which is against you. And when are these things seen? At market highs. When the cycle reaches its high, the probability is that these things have occurred and that the odds are against you."

A quick review of the most recent quarter's events paints an uncomfortable picture of where one stands in the current market. Thinly capitalized and highly speculative stocks are leading markets higher in percentage terms, but the familiar and richly valued technology behemoths continue the market's heavy lifting. Apple, Nvidia, Microsoft, Facebook, Tesla, Amazon, Google, AMD and Salesforce.com contributed to 160% of the S&P 500's gains this year. Apple, Nvidia and Microsoft alone accounted for 91% of the market's gains during the first quarter. In other words, the rest of the market lost value, as one might expect with rising interest rates, banks failing, and a slowing economy.

Trading in derivatives tied to the share price of Tesla, the electric car maker, resembles a drunken celebration. According to data from CBOE Global Markets, The Wall Street Journal reported that 7.2 million options contracts recently changed hands in a single trading session, surpassing the prior one-day record of 5.2 million and representing 13% of all U.S. options volume that day. Daily Tesla options volume now stands at an average of three million contracts, double the turnover seen a year ago and more than any security other than the SPDR S&P 500 exchange traded fund.

In late January, retailer Bed Bath & Beyond, having already drawn down its credit-lines, received a default notice from its bank lenders. The following day, the company defaulted on interest payments on its three bond issues. According to Grant's Interest Rate Observer, Bed Bath & Beyond's senior unsecured 5.165% notes of 2044, which trade at a price of 5, imply a complete loss for equity investors. The following day, Bed Bath & Beyond's stock price rallied by 18.1%. Stranger still, less than a week later the company announced that it was issuing $225 million in convertible preferred shares and warrants to raise another $800 million—the stock rallied a further 92% that day.

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[2] Navigating Market Cycles with Howard Marks. Real Vision Finance. https://www.youtube.com/watch?v=zjImJwQ44Vc

AMC Entertainment Holdings, perhaps the poster child of 2021 retail speculation, still hemorrhages money. To replenish its capital, AMC submitted two shareholder proposals to sell more shares in 2022, but investors voted down both proposals. Not to be denied, the movie theater company's Chief Executive Officer Adam Aron, who personally sold $42.1 million worth of stock over the past two years, devised a new plan--merge the company's two equity classes back into one and then execute a 10-for-1 reverse stock split. According to the company's proxy statement, there are now 517.6 million shares of AMC stock outstanding as well as 929.8 million shares of AMC Preferred Equity units, known as "Apes" by the reddit retail army, for a combined total of 1.4 billion shares. Before Covid in early 2020, AMC had 104.2 million shares of common stock outstanding; meaning, Aron already diluted existing shareholders by a factor of seven in just three years. Under the newly approved proposal, Aron can further dilute shareholders by a factor of 3.8—there could soon be the equivalent of 26 times more AMC shares in circulation than before Covid. Despite this massive dilution of ownership, AMC's aggrieved shareholders responded by running up AMC shares by 23% for the quarter.

"Getting the odds on your side" is how Howard Marks believes one should think about investing. The good investors wait for opportunities where the odds are stacked in their favor. When market conditions are unfavorable and the odds are not on one's side, the risk to one's investment capital increases. When good opportunities are few, patience and positioning one's portfolio to exploit the inevitable cycle lows are the correct courses of action. "When there is nothing clever to do, it's a mistake to try to be clever," states Marks. Better yet, when the odds are not in one's favor, the best strategy is to patiently bide one's time and prepare. According to legendary commodity investor Jim Rogers, the best preparation is to read everything.[3]

"The best advice I ever got was on an airplane. It was in my early days on Wall Street. I was flying to Chicago, and I sat next to an older guy. Anyway, I remember him as being an old guy, which means he may have been forty. He told me to read everything. If you get interested in a company and you read the annual report, he said, you will have done more than 98% of the people on Wall Street. And if you read the footnotes in the annual report, you will have done more than 100% of the people on Wall Street. I realized right away that if I just literally read a company's annual report and the notes -- or better yet, two or three years of reports—that I would know much more than others."

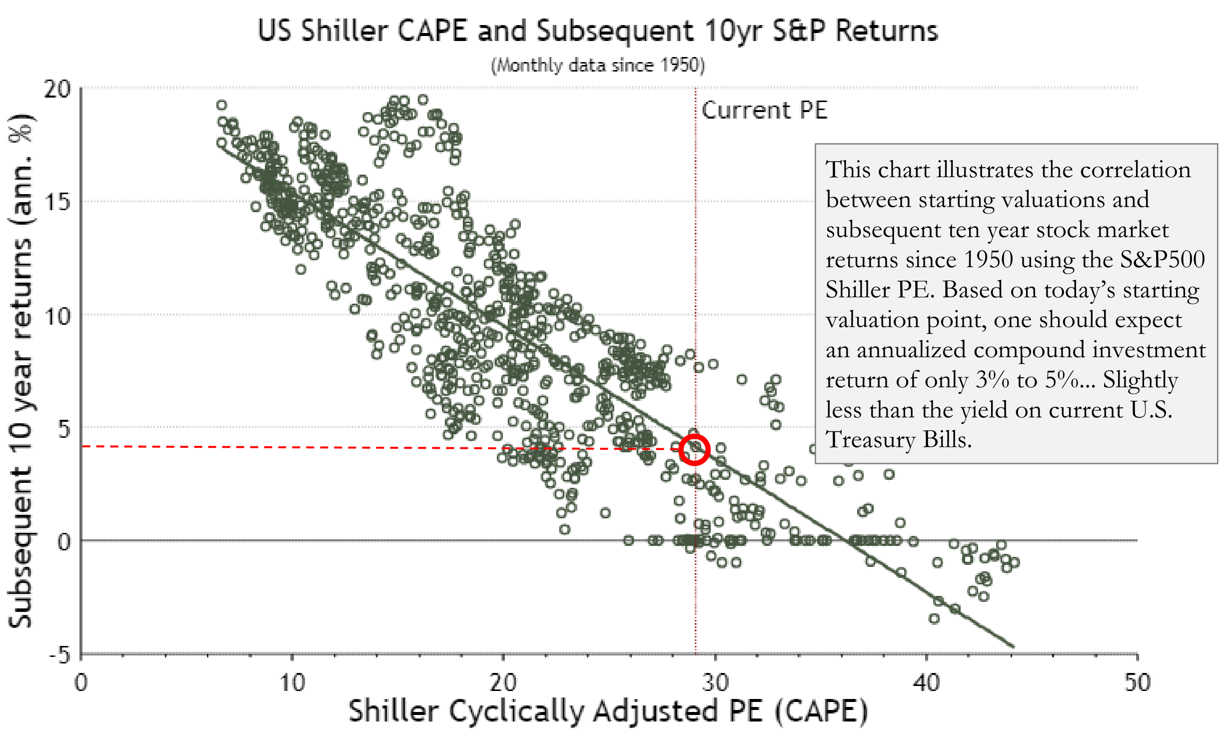

While preparing for market turns can help one improve the odds of successful investing, starting valuations remain critical to one's long term success. After last year's declines in the financial markets, much debate today revolves around whether the stock market is "cheap enough." A company's price-to-earnings ratio (P/E) is a comparison of a stock's current price compared to the company's reported or projected earnings-per-share (EPS). For example, Tesla reported earnings of $3.62 per diluted share outstanding in 2022. Tesla's current stock price is $207; therefore, the company's

[3] O'Keefe, Brian. Best Advice I Ever Got. Fortune, September 6, 2009.

P/E ratio is 57.2. By comparison, the S&P 500 index trades at a 23.8 P/E to 2022 reported earnings. A more comprehensive version of the P/E ratio of the S&P 500 index is to compare the market value of all publicly traded stocks against the country's economic output as measured by gross domestic product (GDP). This ratio dispenses with the underlying judgments and complexities about whether and how to adjust for companies that may have negative earnings. This ratio simply relates the market value that investors have assigned to the entirety of public corporate earnings. That valuation ratio is 155% today, higher than the market peaks of 2000 and 2008; a level not indicative that one has the odds on their side.

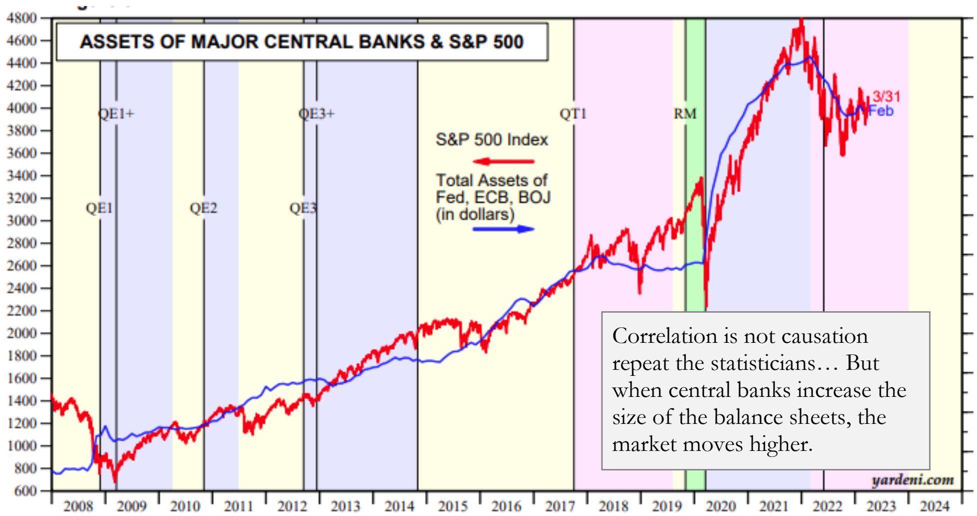
*Into Thin Air* by Jon Krakauer chronicles one of the deadliest years on Mount Everest, when twelve mountaineers died trying to scale the highest peak on earth. Michael Wilson, Chief US Equity Strategist at Morgan Stanley, recently wrote an essay that compared traits of climbers who try to reach Everest's summit without proper regard for the risks with investors who fail to appreciate today's investment risks. While scaling Everest has some highly technical aspects, the most dangerous feature is its sheer size. The peak is 3,000 feet above the start of the "death zone" – the altitude at which oxygen pressure is insufficient to sustain human life for an extended period. Many fatalities in high-altitude mountaineering have been caused by the death zone, a perfect analogy according to Wilson, who sees today's valuations as an investment death zone. Whether by choice or out of necessity, investors have followed stock prices to dizzying heights once again as liquidity (bottled oxygen to mountain climbers) allows them to invest in areas where they know they should not go and cannot live very long.

Speculators climb in the pursuit of greed, assuming they will be able to descend without catastrophic consequences. But the oxygen eventually runs out and those who ignore the risks get hurt. With the turn of the new year, Wilson notes that investors decided to make another market summit attempt, this time taking an even more dangerous route with the most speculative stocks leading the way. The bear market rally that began in October from low expectations has morphed into a speculative frenzy based on multiple narratives, spurring investors on to speculative and dangerous regions. While the oxygen supply can last a bit longer, it can also trick investors into thinking they are safer than they really are, because eventually, valuations always matter.



Logically, the stock market responds to future expected profits derived from the long-term health of the economy. At times, we wonder if the framework that we collectively use to understand the economy is an illusion? One form of economic prosperity derives from savings, investment, labor, production and improving productivity. But increasingly, another form of economic prosperity depends on access to credit and abundant liquidity to grease the wheels of finance in order to inflate asset values. This inflated asset "wealth" then fuels a vast expansion of credit and consumption as asset prices soar in value, increasing the collateral available to borrow against and fund sharply higher levels of consumption. Rather than save and invest, today's economy hinges on borrowing and spending.

When the value of one's modest home soars from $300,000 to $800,000 in a few years, that $500,000 in gain was not the result of any improvement in utility. The house provides the same shelter it did when it was worth far less. The $500,000 gain is the result of access to low-cost credit and fifteen years of investors desperately searching for a yield greater than zero. Eventually, this expansion of "money" trickles into the real economy and the result is inflationary. Valuations increase but the underlying asset has not gained any utility. Once the cost of credit drops to near-zero, there is no remaining underwriting discipline: any loan for any investment can be justified by the subsequent increase in asset values. Since everything will rise in value, the optimal means to maximize gains incentives the leverage of one's balance sheet to gain control of as many assets as possible.




Central banks are eventually forced to raise interest rates and reduce credit expansion to prevent an inflationary spiral. Once credit is no longer expanding rapidly, the air leaks out of asset prices. Marginal borrowers can no longer roll over their debt—default become inevitable once markets tighten. Once valuations stop rising, the bubble's "prosperity" is revealed as illusory. This "wealth" was not generated by improvements in productivity or the production of more goods and services; it was based on soaring valuations driven by abundant credit and faith in central banks. Looking ahead, does one continue to invest under the same assumptions that have powered asset prices higher for the past twenty-five years? This very question is why legendary hedge fund manager Stanley Druckenmiller recently summarized today's investment dilemma, *"I've been doing this for forty-five years and between the pandemic, the war and the crazy policy response in the United States and worldwide, this is the hardest environment I have ever encountered to try and have any confidence in a forecast six to twelve months ahead."*

Not having incurred the scars from volatile periods in previous markets, each new generation of investors suffers from a collective form of involuntary amnesia. Despite reading about it at length, one will never understand the despair suffered by investors during the Depression in the 1930s, the shocking collapse of the "Nifty-Fifty" in 1973-74, the panic of Black Monday in 1987 or the confusion during the 2008 financial crisis. These moments, while at times costly to both one's investment capital and pride, can shape and influence investor behavior for decades to come. If one was fortunate enough to be young during such a period, then the lessons learned did not appear so expensive with the benefit of time. The worst outcome is the investor who experiences an historically volatile episode but learns nothing from it. The individual who makes mistakes is not a fool—it is the person who makes the same mistakes, time and time again.

Fifteen years removed from the 2008 crisis, Wall Street still operates today with a sense of amnesia. Investors must always prepare for the unexpected, including sudden, sharp swings in markets and the economy. Events that never happened before will undoubtedly occur. Whatever adverse scenario one contemplates, reality can be worse. The consideration of risk, the permanent destruction of one's investment capital, should always be of paramount concern. Fortunately, as Herb Wertheim demonstrated, the compounding effect of buying and holding the shares of good companies possessing sustainable competitive advantages remains as powerful as ever. To benefit from these investment virtues, one needs patience and time and a firm understanding of what one owns to tolerate the inherent uncertainty in markets. During Markel Corporation's most recent earnings call with shareholders, CEO Tom Gayner, summarized their mindset for dealing with uncertainty when allocating capital:

*As a public company, we update you one quarter at a time; however, our North Star remains the dual time horizon of forever and right now. We believe that the combination of the long-term time horizon embodied by the concept of forever, coupled with the discipline and urgency of the right now provides a balance that serves us well. Quarters are like the rings inside the trunk of a mighty sequoia tree that give you a useful piece of information about one small chapter in the life of the tree, but any given ring is just one in a sequence of many*.

While a sequoia accumulates rings over several millennia, investing for most is limited to a continuum of one's lifetime. While some attempt to win every lap of the race, one must always remember that to succeed at investing, one must finish the race. Conservative portfolio positioning enables one to maintain a long-term focus, while seeking new opportunities when others are distracted or even forced to sell. Risk is not necessarily inherent in an investment, but risk is always relative to the price paid. As Peter Lynch noted, "Just because the price goes down doesn't mean you're wrong. Just because the price goes up doesn't mean you're right." Logical and consistent processing of facts is what ultimately determines the right approach to investing.

With kind regards,

*ST. JAMES INVESTMENT COMPANY*

# 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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