ST. JAMES INVESTMENT COMPANY

INDIVIDUAL PORTFOLIO MANAGEMENT

VALUE INVESTOR'S QUARTERLY LETTER

OCTOBER 2024

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"Everyone is entitled to be wrong about their opinions, but no one has the right to be wrong about their facts." -Bernard Baruch.

The Florida Land Boom of the 1920s stands as one of the most remarkable economic bubbles in U.S. history, as the Sunshine State became the epicenter of a speculative frenzy in 1925. Florida was once seen mainly as a farming state, but the 1920s ushered in a new era of prosperity and leisure. Many Americans now had the time and financial means to invest in real estate. For the first time in U.S. history, workers enjoyed paid vacations, pensions, and other benefits that allowed them to travel and invest. The automobile's arrival made Florida even more accessible for middle-class families seeking vacation and investment opportunities.

The promise of wealth and prosperity captivated millions of Americans during this era. The belief that anyone could become wealthy through the right investment was widespread, and Florida land was a compelling choice. Credit was readily available, and economic optimism was high, making investing in Florida real estate easy. The presidential administration of Warren G. Harding, with its policies of lower taxes and business prosperity, mirrored the state government of Florida, which sought to accommodate the growing number of visitors. Before 1920, Florida's visitors were primarily the elderly, wealthy, or ill. However, the "Land Boom" attracted middle-class Americans and the state and cities borrowed heavily to improve infrastructure and public services.

Many early investors made significant gains by selling land to others. Journalists from northern cities glorified these early successes of the Florida Land Boom, with stories of investors doubling their profits in only months. Real estate firms quickly realized that auctions were more profitable than fixed prices, and as land prices soared, so did the desire for profit. One notable story involved an elderly man in Pinellas County who was committed to a sanitarium by his sons for spending his life savings of $1,700 on a piece of property. When the land's value skyrocketed to $300,000 in 1925, the man's lawyer successfully petitioned for his release, and he then subsequently sued his children.[1] The line between genius and foolishness began to blur. Miami was at the epicenter of the Florida Land Boom, and the city transformed from a sleepy town to a bustling metropolis with modest skyscrapers and legendary real estate profits. The boom's influence spread throughout Florida, with no land too poor or remote to attract buyers.

The most spectacular developments were in Southeast Florida, where Henry Flagler's railroad provided direct access to New York City. Much like the railroad barons of the Gilded Age, the great land developers of the era played a crucial role in shaping Florida's future. These developers did not just build houses; they created entire cities and a way of life known as "the Florida lifestyle." The architectural style of the time, Mediterranean Revival, capitalized on Florida's warm climate and outdoor living. Developers like Dave Davis, who transformed mud islands into the urban suburb of Davis Islands, and Carl Fisher, who turned Miami Beach into a world-famous resort, were active in this transformation. With its strict architectural guidelines and innovative amenities, George Merrick's creation of Coral Gables further exemplified the boom's impact.

[1] Robert Leonard, "The Great Florida Land Boom," https://floridahistory.org/landboom.htm

The Florida real estate boom, which began in the spring of 1923, peaked in the summer of 1925. Building permits in Miami surged, with monthly totals reaching $4 million in August 1924 and topping $15 million by October 1925. Property prices skyrocketed, with lots that once sold for $2,000 to $3,000 selling for over $50,000. Under Frank B. Shutts, the Miami Herald became the world's largest newspaper by business volume during this period. The demand for advertising was so high that the paper often turned down pages of advertisements. The Herald's printing presses, originally from The Denver Post, ran constantly until new presses were installed in 1926, just as the boom ended.[2]

A few voices did indeed advise caution. Forbes magazine warned that Florida land prices were based on speculation rather than actual value. Bernard Baruch, an American financier and respected stock market speculator, noted, "To most people, it seemed as though the prosperity would never stop, that everyone would simply go on making and spending more and more money." At the height of the boom, Baruch visited Palm Beach and then drove to Miami, past the ornate residences of the new multimillionaires. On his trip, he noted the miles and miles of property with nothing but shrubs and scattered trees and wondered how all these people had enough money to buy and build at such prices. He thought "Where would the money come from?"

On the assumption that every American would soon settle in Florida, or at least vacation there, people fought to buy land, usually unimproved and often uninhabitable, at ever-higher prices. Land values frequently doubled, tripled, and sometimes quadrupled in only a few months. Building lots that once sold for a few hundred dollars sold for as high as $20,000. It was a speculative mania in every facet of the classic definition. By 1925, trouble began to emerge. Companies started laying off workers, and cities like St. Petersburg and Key West were now heavily indebted. Land prices had reached unsustainable heights, and new buyers stopped coming to the Sunshine State. The market became saturated with sellers, and the "Yankee dollars" that had fueled the boom vanished. Cities that had borrowed heavily to finance infrastructure projects now faced financial ruin. Few people realized they were gambling—they thought they were "investing" in a sure thing.

The mad scramble for wealth was exciting but, eventually, the bubble collapsed. Speculators realized buying land unseen on credit was no longer a "sure thing." Financial historian Peter Bernstein wrote that moves in perception—what Bernstein referred to as "paradigm shifts"—can drive significant changes in markets and economics. "Paradigm shifts are the inevitable result of forecast errors, the raw material from which paradigm shifts are fashioned,"[3] wrote Bernstein. Paradigm shifts often result from

[2] Kenneth Balinger, *Miami Millions*, Page 6

[3] Peter L. Bernstein, "What Prompts Paradigm Shifts?", Financial Analysts Journal, November/December 1996.

new ideas or technological innovations that alter how people think about markets and investments. When a new paradigm—like the idea that Florida land would continue to appreciate indefinitely—captures the public's attention, it can drive excessive optimism and speculative behavior. The speculative froth and resultant bubbles appear because of a fundamental change in how market participants perceive value.

Today's hot stock sectors like artificial intelligence, cryptocurrencies, and cloud computing, resembles past periods of overoptimism and a belief in unlimited growth. According to Bernstein, a paradigm shift may signal that traditional valuation metrics no longer matter. A fundamental shift in how markets perceive value is a polite way for market participants to acknowledge that it is more profitable to ignore value and solely pay attention to short-term price momentum. Otherwise, a strict adherence to value might cause one to miss a generational investment opportunity. Overconfident in their assumptions that today's growth trends will persist, speculators are chasing the stock prices of the largest, most "magnificent" technology companies.

The prudent value investor wonders if "value" matters anymore. Yet, a valuation exercise sits at the core of every economic transaction. The point of valuing a company is that value gauges the supply and demand of capital available to the company, a critical component of long-term investment returns. Today's U.S. stock market is a seller's market—investors currently exhibit minimal concerns about valuation. Still, valuation remains critically important to the seller; no private business owner would ever sell their company without a thorough valuation assessment. By contrast, the popularity of speculative, momentum-based investment strategies ignores valuation and essentially hands over "free money" to the sellers in shares of today's publicly traded companies.

An increasing number of value-oriented investors believe value investing may never prove rewarding again—a strange conclusion since valuations are critical to every economic transaction. An economy cannot function properly without a thoughtful assessment of value. Managers of value-focused stock funds believe the risk to their careers is so powerful that they must now deviate from their stated investment strategy and invest in the companies leading this booming technology-driven market. Out of 141 mutual funds focused on large-cap value, only one in twenty strictly follows their stated value investing style, according to data from Bloomberg Intelligence. Some "value" funds have invested over half of their assets in companies that do not meet the formal criteria for value stocks, often allocating client capital to stocks that promise significant earnings growth in the future regardless of valuation.[4]

"The cheating becomes so extreme that you can't tell the difference between a value stock portfolio and a growth portfolio," said Jim Cullen, the co-founder of New York-based Schafer Cullen Capital Management. While giving in to the

[4] Lu Wang, "An 86-Year-Old Investor Warns Peers on Value-Stock Betrayal", Bloomberg, September 13, 2024.

pressure to deviate from the investment strategy might offer a short-term solution, Cullen believes it sets the stage for long-term failure. The problem arises when the value investing style is again favorable, but a fund manager has strayed too far from their stated strategy. "The way to get around that whole danger of volatility is to have discipline," said Cullen, who began his financial career with Merrill Lynch in 1965.

Value investing remains unpopular in the artificial intelligence-fueled era of the "Magnificent Seven" technology stocks that still dominate the U.S. stock market. Investing in undervalued stocks rather than looking for fast-growing companies (regardless of valuation) stumbled after value investing's relative performance peaked in early 2007. Although hard to believe today, value stocks appeared expensive by historical standards in 2007, with relative valuation levels reaching forty percent of their brethren's respective valuations in the growth sector. Value as a style of investment began its long slide and finally bottomed in the summer of 2020 when value stocks were left for dead and traded cheaper relative to growth stocks than they did at the peak of the dot-com bubble.[5]

Not surprisingly, in the last decade the Russell Value Index has underperformed its growth counterpart, with the number of actively managed funds dedicated to value declining by 15% since 2015. The surviving funds have increasingly invested in technology stocks and other popular growth names. According to data from the Goldman Sachs Group, as of the end of June, the average large-cap value fund was heavily invested in technology stocks, including Apple, Microsoft, Nvidia, Amazon.com, Meta Platforms, and Alphabet. The widespread practice of value managers investing in growth stocks highlights the pressures to participate in momentum-driven markets. Underperforming managers risk losing assets and their jobs, which creates pressure to deviate from their stated investment strategy.

While value investment managers struggle, individual investors exhibit few inhibitions. JPMorgan estimates that U.S. households' stock allocations have steadily increased, accounting for 42% of their total financial assets, the most on record based on data from 1952. In early August, stocks suddenly dropped over anxiety about the health of the U.S. economy and the unwinding of a widespread institutional trade tied to the Japanese yen. The dip proved short-lived, showing investors' eagerness to keep pouring money into the market. Even during the brief turmoil in early August, investors kept buying stocks. According to EPFR data, U.S. equity funds drew inflows for eight consecutive weeks through late August. William Bohrod, a sixty-seven-year-old dentist in New Jersey, summed up today's market mindset: "The most conservative [investment] approach is '*all in, all the time*.'"[6]

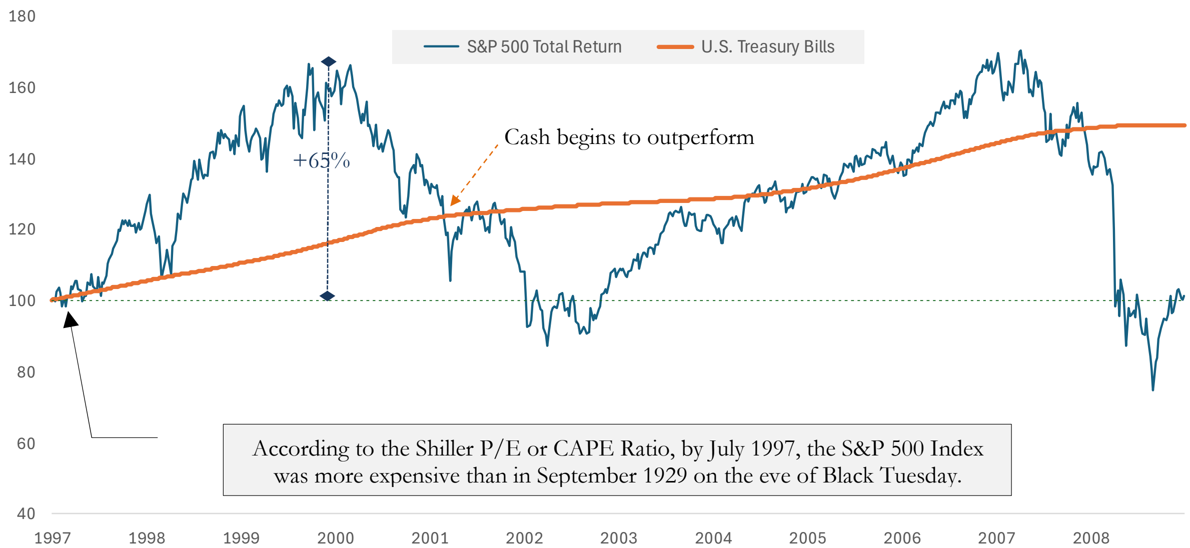
One often forgets that uncertainty is the only certainty in life. In the long run, the investment strategy that outperforms is the one that best weathers troubled times yet benefits in favorable environments. This antifragile strategy is an investment approach incorporating optionality or different paths to success. The ability to have choices is most appreciated when facing a situation with no choice—many investors, like the dentist in New Jersey, own portfolios with minimal optionality. At market extremes, investors naturally extrapolate the past into the future. They fail to imagine any change in market direction. Investing in the prevailing price trends can be very successful for a time. But eventually, the unpredictable strikes. Technological innovation, unprecedented monetary and fiscal policy, and changing geopolitical relationships will eventually disrupt the status quo. An antifragile investment strategy will persevere, but an asset allocation that is '*all in, all the time*' in stocks minimizes optionality.

[5] Rob Arnott, "Value Investing is Due for a Comeback," Financial Times – Opinion Market Insight, August 13, 2024.

[6] Gunjan Banerji, "Americans Are Really, Really Bullish on Stocks," *The Wall Street Journal*, September 3, 2024.

If valuations drive all economic decisions, one must understand value's meaning. John Burr Williams' work, in his 1938 book "*The Theory of Investment Value*," first introduced the concept of valuing a company by estimating its future cash flows and discounting those cash flows to a present value. Warren Buffett incorporated this novel concept into his investment approach when determining the intrinsic value of a business. Benjamin Graham, Buffett's mentor, emphasized buying stocks with a margin of safety, meaning he sought to purchase shares of a company at a discount to one's estimate of fair value. Charlie Munger, Buffett's longtime business partner, emphasized concentrating on companies with sustainable competitive advantages or "economic moats," something that protects the business from competition and permits it to maintain pricing power and profitability. Combining these logical concepts creates a robust valuation framework.

Seth Klarman, a highly regarded value investor and founder of Baupost Group, describes cash in an investment portfolio as providing valuable optionality—the flexibility and potential for future opportunities, even though it may underperform in the short term. Klarman often describes cash as "dry powder," allowing investors to take advantage of market dislocations and undervalued assets when they become available. In bear markets, when many assets are declining in value, cash will allow the investor to purchase assets at lower prices without selling existing holdings at a loss. In Klarman's view, holding cash is not just about safety; it's about positioning oneself to capitalize on opportunities when they arise. Understanding the optionality of cash coupled with a logical valuation framework gives the prudent investor a value investment strategy to weather almost any market.



Fully invested in an overvalued stock market limits one's ability to seize bargains when prices drop. Imagine the disciplined value investor in the summer of 1997 saw that valuations for the S&P 500 Index now exceeded levels last seen in September 1929, on the eve of the Great Crash known as Black Tuesday. Concerned, the investor reallocates some of their equity exposure to cash in the form of U.S. Treasury Bills. As the investor sits there in cash, the market shockingly appreciates by another 65% over the next three years. However, by late summer 2021, the value investor's cash position has outperformed the S&P 500 since 1997. Not until August 2006, on a total return basis, did the S&P 500 Index begin to outperform cash. The discerning value investor had ample opportunity to redeploy his 'dry powder' into equities at far more favorable entry points.

Investors increasingly disregard valuations during speculative markets, to the point where valuations are dismissed altogether for price-insensitive speculation. As John Burr Williams noted eighty-six years ago, valuations derive from a very long-term stream of future cash flows delivered to the investor over time—valuations are not a multiple of next year's operating earnings, as promoted by Wall Street. The price paid for an investment is the primary factor in determining future investment returns. When investors pay a high price relative to future cash flows, the expected investment returns will be lower over the long term. Accordingly, when investors purchase assets at lower prices, the potential for higher future returns increases. Buying Florida land in 1920 provided a far different investment return profile than those who purchased land in late 1925.

Yale University professor Robert Shiller popularized the cyclically adjusted price-to-earnings ratio (CAPE).[7] This valuation ratio measures a stock's price relative to the company's earnings per share over ten years to smooth out fluctuations. At 35.1, today's valuation ratio sits near the 96th percentile. This is not to say that a market decline is imminent or expected, only that current valuations suggest future gains in the stock market are limited over a long-time horizon. After all, according to Shiller's CAPE ratio, the S&P 500 Index was more expensive than ever before in June 1997 but still appreciated another 65% before peaking in August 2000. Bernard Baruch said, "Everyone is entitled to be wrong about their opinions, but no one has the right to be wrong about their facts." One can have an opinion about the stock market's direction, but one cannot dispute current valuations in a historical context.

As recently as June 30, 2022, Berkshire Hathaway, under Warren Buffett's management, held a cash position that totaled 31% of the Berkshire equity portfolio. Two years later, on June 30, 2024, Buffett's cash position equaled 88% of the company's stock portfolio.[8] Given Buffett's much-publicized ongoing stock sales, one can assume that September's balance sheet will show a position in cash greater than stocks. As financial commentator James Grant wryly noted, "One might conclude that the greatest equity investor is fast converting his corporate life's work into a money-market fund." Known for always being an optimist, Buffett wrote in the 2023 Berkshire annual report. "For whatever reasons, markets now exhibit far more casino-like behavior than they did when I was young. The casino now resides in many homes and daily tempts the occupants."

Past performance does guarantee future results. Everyone knows it, yet most willingly ignore the standard industry disclosure. Investors often suffer from behavioral biases that result in performance-chasing behavior, as witnessed in the Florida Land Boom. They are fearful when the market declines but greedy and speculative after periods of sharply rising stock prices. Chasing returns often leads one to buy high and sell low at the most inappropriate times. As Bernard Baruch cautioned long ago, "*Don't try to buy at the bottom and sell at the top. It can't be done except by liars.*"

With kind regards,

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[7] https://shillerdata.com/

[8] https://berkshirehathaway.com/reports.html

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We founded the St. James Investment Company in 1999, initially managing the wealth of our family and friends residing in the hamlet of St. James, New York. For over twenty-five years, we have been privileged and grateful for the trust placed in us to invest alongside our own capital.

St. James Investment Company is an independent, fee-only, SEC-registered investment advisory firm, providing value-centric portfolio management to individuals, family offices, retirement plans, and private companies.

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