ST. JAMES INVESTMENT ADVISORS

COMMITTED TO VALUE INVESTING

INVESTMENT ADVISER'S LETTER

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FOURTH QUARTER LETTER

*MARK*ET DISCUSSION

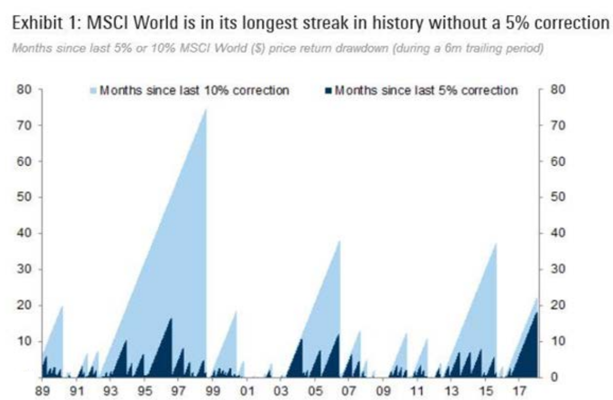
Happy New Year! We hope this update finds you and your family well. The markets during 2017 experienced record gains as aggressive, higher risk investing was rewarded while more conservative, less risky investing lagged.

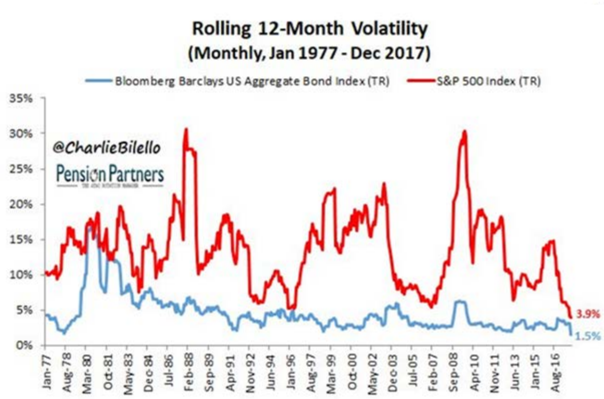
As we start 2018, the predominant view is that with the official signing of tax cuts by President Trump, there is nothing that can stop the rush of higher economic and profit growth, and stock prices.

But, as was the case in prior market cycles, sometimes the identification of headwinds is hiding in plain sight. Could this possibly be elevated market valuations compared to historical norms or too much market complacency and/or investor enthusiasm to keep pace with arbitrary benchmark indexes?

Presently the US stock market has smashed virtually all records, however some remain.

The S&P 500 Index is rapidly approaching 400 days without a 5% correction and it still has several days to go before it breaches the record of *409 consecutive day* record set on August 3, 1959.





And if we look at the MSCI World index, it is currently at its longest streak in history without a 5% correction.

The volatility in stocks (3.9%) & bonds (1.5%) in 2017 was lower than any other 1-year period in history (note: monthly data).

INVESTING VERSUS SPECULATION

One of the greatest investment books ever written is "Margin of Safety" by author Seth A. Klarman in which he discusses risk-averse value investing strategies for the thoughtful investor. In my humble opinion Mr. Klarman ranks as one of the all-time great investors on par with Warren Buffett and Benjamin Graham.

Due to the current market euphoria I thought it would be appropriate to discuss some of his thoughts regarding successful long-term investing.

In his book, Mr. Klarman discusses Investing Versus Speculation:

"Mark Twain said that there are two times in a man's life when he should not speculate: when he can't afford it and when he can. Because this is so, understanding the difference between investment and speculation is the first step in achieving investment success.

Investors believe that over the long run security prices tend to reflect fundamental developments involving the underlying businesses. Investors in a stock thus expect to profit in at least one of three possible ways: from free cash flow generated by the underlying business, which eventually will be reflected in a higher share price or distributed as dividends; from an increase in the multiple that investors are willing to pay for the underlying business as reflected in a higher share price; or by a narrowing of the gap between share price and underlying business value.

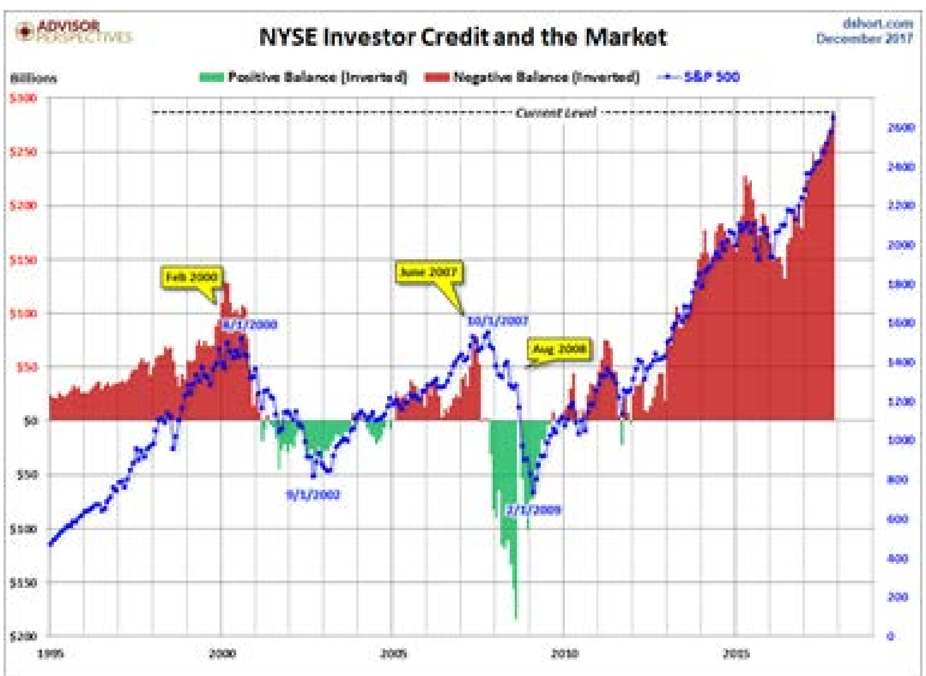
Speculators, by contrast, buy and sell securities based on whether they believe those securities will next rise or fall in price. Their judgment regarding future price movements is based, not on fundamentals, but on a prediction of the behavior of others. They regard securities as pieces of paper to be swapped back and forth and are generally ignorant of or indifferent to investment fundamentals. They buy securities because they "act" well and sell when they don't. Indeed, even if it were certain that the world would end tomorrow, it is likely that some speculators would continue to trade securities based on what they thought the market would do today.

Speculators are obsessed with predicting and guessing the direction of stock prices. Every morning on cable television, every afternoon on the stock market report, every weekend in *Barron's*, every week in dozens of market newsletters, and whenever business people get together, there is rampant conjecture on where the market is heading.

Market participants do not wear badges that identify them as investors or speculators. It is sometimes difficult to tell the two apart without studying their behavior at length………Indeed, many "investment professionals" actually perform as speculators much of the time because of the way they define their mission, pursuing short-term trading profits from predictions of market fluctuations rather than long-term investment profits based on business fundamentals.

As we shall see, investors have a reasonable chance of achieving long-term investment success; speculators, by contrast, are likely to lose money over time………

The financial markets offer many temptations to vulnerable investors. It is easy to do the wrong thing, to speculate rather than invest. Emotion lies dangerously close to the surface for most investors and can be particularly intense when market prices move dramatically in either direction. It is crucial that investors understand the difference between speculating and investing and learn to take advantage of the opportunities presented by Mr. Market."



After reading the above, do you consider yourself an investor or a speculator? Rest assured, we consider ourselves firmly entrenched as an investor focused on the fundamentals!

The chart on the left, from Doug Short, shows that investors today are employing more leverage – i.e. Speculation - than ever before. Even when you adjust margin debt for the overall size of the economy it's at a new record high.

INDEX INVESTING

Mr. Klarman also discusses index investing in his book:

“Index Funds: The Trend Toward Mindless Investing. An important stock market development in the past several years has been the rush by institutional investors in to indexing………Indexing is the practice of buying all the components of a market index, such as the Standard & Poor's 500 Index, in proportion to the weightings of the index and then passively holding them. An index fund manager does not look to buy or sell even at attractive prices. Even more unusual, index fund managers may never have read the financial statements of the companies in which they invest and may not even know what businesses these companies are in…………By contrast, value investing is predicated on the belief that the financial markets are not efficient. Value investors believe that stock prices depart from underlying value and that investors can achieve above-market returns by buying undervalued securities. To value investors the concept of indexing is at best silly and at worst quite hazardous. Warren Buffett has observed that "in any sort of a contest-financial, mental or physical-it's an enormous advantage to have opponents who have been taught that it's useless to even try.'" I believe that over time value investors will outperform the market and that choosing to match it is both lazy and shortsighted. Indexing is a dangerously flawed strategy for several reasons. First, it becomes self-defeating when more and more investors adopt it. Although indexing is predicated on efficient markets, the higher the percentage of all investors who index, the more inefficient the markets become as fewer and fewer investors would be performing research and fundamental analysis. Indeed, at the extreme, if everyone practiced indexing, stock prices would never change relative to each other because no one would be left to move them.

Presently, popular Indexes such as the Dow Jones Industrial Average, shows the stock market is now more overbought than at any other time during the entire history of this index which was created way back in 1896 (chart via Nasdaq.com).

The average individual investor is most bullish at market tops and most bearish at market bottoms. In short “emotions” kick in instead of logically pursuing the exact opposite investment stance. As investors get more emotional there is a greater and greater urge to compare their portfolio returns to an index. Comparison of your performance to an index that does not consider any of your own personal goals, needs and risk tolerance is potentially the most dangerous thing that you can do as an investor.

Comparison in the financial arena is the main reason investors have trouble patiently sitting on their hands, letting whatever process they are comfortable with work for them. They get waylaid by some comparison along the way and lose their focus. If you tell a client that they made 10% on their account, they are very pleased. If you subsequently inform them that ‘everyone else’ made 20%, you have made them upset.

Investing is not a competition and there can be terrible consequences for treating it as such.

Incorrect benchmarking may lead investors to chase performance of an index that has performed well, or, on the flip side, to sell an investment that has not performed well recently.

For more than two decades, Boston-based research firm Dalbar has shown that the average investor makes bad moves when it comes to market timing. People tend to pile into a hot investment as it is peaking, and they rush back out when it turns down. Rather than achieving the desired effect of maximizing returns, attempts at market timing generally worsen portfolio performance.

If I may paraphrase Iron Mike Tyson: “Everyone's a buy-and-hold index investor until they get punched in the face.”

CONCLUSION

We conclude with Mr. Klarman’s discussion of Value Investing and the Margin of Safety.

“Value investing is the discipline of buying securities at a significant discount from their current under lying values and holding them until more of their value is realized………Value investing combines the conservative analysis of underlying value with the requisite discipline and patience to buy only when a sufficient discount from that value is available………Sometimes a value investor will review in depth a great many potential investments without finding a single one that is sufficiently attractive. Such persistence is necessary, however, since value is often well hidden………The disciplined pursuit of bargains makes value investing very much a risk-adverse approach. The greatest challenge for value investors is maintaining the required discipline. Being a value investor usually means standing apart from the crowd, challenging conventional wisdom, and opposing the prevailing investment winds. It can be a very lonely undertaking. A value investor may experience poor, even horrendous, performance compared with that of other investors or the market as a whole during prolonged periods of market overvaluation………Value investing is simple to understand but difficult to implement. Value investors are not super sophisticated analytical wizards who create and apply intricate computer models to find attractive opportunities or assess underlying value. The hard part is discipline, patience, and judgment."

As investors Committed to Value Investing, we are accustomed to being "out of step" with markets for stretches of time. We are often early both in buying cheap assets and selling expensive ones.

We feel good about our investment process and our ability to implement it because we think it is based on timeless principles. Our job, as Warren Buffett has said, is to "buy when others are fearful and to sell when they are being greedy."

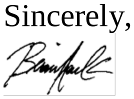
The reason we invest the way we do is that we think it gives us the highest probability of success over long investment periods. We are investing client capital as we would our own to meet long-term financial needs. We are not focused on short-term performance contests.

All in all, 2017 was one for the record books as higher risk investing was rewarded while less risky investing lagged. We believe it is a good time to focus on value stocks and their margin of safety versus the present market inclination towards momentum investing and its role within index investing.

I'll finish with a statement by renowned investor Howard Marks that accurately summarizes our approach:

*"**The best response when seas are choppy is to focus on completing the long-term voyage and not think about whether the next wave is going to push the nose of the boat up or down.** Our investment destination is best reached by accurately valuing assets, assessing the relationship between price and that value, and acting resolutely and unemotionally when mispricings are detected. That's still the best – I think the only – reliable path to investment success. Nothing about the current environment alters that one bit".*

Sincerely,



St. James Investment Advisors

ST. JAMES INVESTMENT ADVISORS

We are professional portfolio managers Committed to Value Investing.

We are an independent, fee-only, U.S. Securities and Exchange Commission registered investment advisory firm, providing customized portfolio management services to individuals and their financial advisors.

Our investment methodology blends a combination of fundamental analysis, discipline and patience with the goal of creating long-term returns based on the time-proven principles of value investing.

As thoughtful value investors, our sole focus as a firm is to manage private investment accounts for individuals and financial advisors throughout the United States.

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