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Q&A

5 Stock Picks From a Play It Safe Balanced Fund

After dodging the crisis then riding the rally, Barry James' Rainbow Fund is bullish on bonds and a few big stocks.

By TERESA RIVAS

Barry James knows about managing risk.

In 2008, when the Standard & Poor's 500 lost 37%, the James Balanced Golden Rainbow Fund (ticker: GLRBX) lost just 5.5%.

Yet James isn't just good in a crisis. His fund, which garners a five-star rating from Morningstar, has consistently outperformed its peers and is in the top percentile of its category for the past decade. In the past 15 years, the fund returned an annualized 6.5%, compared with 5% for the S&P 500.

So when James says that there's elevated risk in the marketplace, it's worth listening to his strategy.

James doesn't see a repeat of 2008 on the horizon: Instead he believes a modest correction is possible in the near future, a period in which investors who hold bonds and large-cap stocks will be the winners. Over the first half of the year he boosted the fund's bond holdings to about 55% of assets from 42% at the end of 2013.

Alpha, Ohio-based James Investment Research is a family affair, where James' father, founder Frank James, serves as chairman, and Barry's brother David is director of research. The trio is finding attractive stocks for value-oriented investors in various industries, from airlines to railroads. Read highlights below.

***Barrons.com:* Your top holdings are dominated by U.S. Treasuries and big stocks, a shift from several years ago when you favored small stocks. What's your rationale?**

Barry James: Our research was saying this would be the year of the bond—we even had t-shirts made up earlier this year. We were thinking that interest rates were higher than they were supposed to have gone last year, because of lots of worries about the Federal Reserve tapering and the fears about inflation and rapid economic growth.

The other aspect is that risks have been rising in stocks, [which is why] we were getting a little more defensive when it came to equities. We saw a transitional point within the market: We looked at large-cap stocks and small-cap stocks and found that about two out of every three small stocks are in their own personal bear market today, meaning they are down more than 20% from the recent highs. But when it comes to large-cap stocks, it is only about 20% of those, and if you get to the S&P 500 it is only about 5% are in their own personal bear market. What you see is this market that is kind of being masked by the indexing: looking somewhat healthier than what the market as a whole has been. So we've tried to focus more on large-cap stocks, so that today about 60% of the equities in the fund are large-cap.

Do those elevated risk levels point to another big drop as in 2008?

Barry James: We don't see parallels. Two big things are different: We've had a reduction in equities in the number of shares available for the marketplace to buy, which is a major support, and of course we've had quantitative easing. So the only thing that is in any way similar today [to 2008] is that we are going through a transition away from quantitative easing and that sugar bowl, which had pushed everything into stocks. David has done some interesting research about this.

Manager's Bio

Name: Barry James
Age: 57
Title: President, CEO, portfolio manager
Education: Bachelor's in humanities, U.S. Air Force Academy; master's in science and administration, Boston University
Hobbies: Travel, hunting, fly fishing

David James: Consensus on world economic growth continues to move downward. We've seen some of that in the U.S., and now in Germany and France. The price of

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copper has been heading down. The price of oil seems to have fairly peaked, and if it hadn't been for geopolitical reasons we should see oil much lower than it is today. The Baltic Dry Index is off over 50% so far this year. All of these things are saying you need to be more cautious. That says that long-term bonds should be a great place to be; [hence the] year of the bond. But the stock market just continues to forget about all of that and continues to rally. We would not be surprised to see the stock market have a bit of a comeuppance as the punch bowl goes away. But long term we are still bulls.

Frank James: Also, the last several months of a midterm [election] year, such as this year, tend to be very strong. The market gets to be very weak up until about the time October/November roll around, when it makes a big shift.

Alaska Air (ALK) is your largest stock holding.

Barry James: We try to find stocks that have good relative valuations, good profitability and good long-term strength. Alaska Airlines has relatively reasonable valuation levels and the return on assets has been good. We want to find stocks that have been outperforming the market over long periods of time, and this certainly fits the bill there. They've also done a good job in managing their debt. They've reduced their interest expenses by double digits in the last year. I think they have the highest grade of any of the airlines. We still look at it as something that we would buy more of.

Frank James: For the first time ever we have three stocks on the buy list that are airlines. Affluent people go by air when they take a vacation. This affluent class is using their dollars more often, and it seems to me that may relate some way back to the action of the Federal Reserve. It has pumped in a lot of money in the economy, and much of that has flooded to people who are already affluent; that could be a reflection of what we are seeing in air travel.

What are the other two airlines?

Frank James: Hawaiian Holdings (HA) and Southwest Airlines (LUV).

Mylan (MYL) and Merck (MRK) were two names you were adding to recently.

Barry James: Pharmaceuticals lagged for a while this year, and now they seem to be making a bit of a comeback. Mylan isn't something that we would buy today. But it is something that we continue to hold as it has pretty strong return on assets.

Merck is the King Kong of the space. Even though it participated a bit with the pullback in the industry, it has come charging back, and it is one that we would continue to buy. It is reasonably priced, earnings are solid, and return on assets is almost 10%. It has been outperforming the market and buying back shares—and when you buy back 3% of your shares in a $171 billion company, that's spending some money.

What other names do you see as attractive?

David James: American Railcar Industries (ARII). What's happening with energy is amazing: The U.S. is the No. 1 oil producer in the world, and that sounds like a really great thing for oil. But we've learned that there are caveats. If you get enough production, then the price of oil starts to come down, and explorers suffer while refiners are doing well. But then geopolitical intrigue is keeping oil right around the century mark. No matter what, we need to move the energy from place to place, and one of the best ways to make that happen is through the railcar system. American Railcar builds a lot of these specialized energy tankers, and they also lease some of these out. Their valuation is about average, so they are not quite as cheap as they had been, but they are still not overly expensive. Their profitability continues to be strong as well.

Thanks.

The James Balanced: Golden Rainbow Fund Disclosure

Investing involves risks, including loss of principal. Investors should consider the investment objectives, risks, charges and expenses of the Fund carefully before investing; this and other information about The James Advantage Funds is in the prospectus, which can be obtained by calling 1-800-99-JAMES.

Small-Cap and Mid-Cap investing involves greater risk not associated with investing in more established companies, such as greater price volatility, business risk, less liquidity and increased competitive threat. You should note that the James Advantage Funds are professionally managed mutual funds while the indices are unmanaged, do not incur expenses and are not available for investment. Investing involves risks, including loss of principal.

The James Balanced Golden Rainbow Fund seeks to provide total return through a combination of growth and income and preservation of capital in declining markets.

Performance as of 6/30/14

1-yr	5-yr	10-yr
14.32%	10.91%	8.07%

The Fund's expense ratio was 1.07% as of 6/30/14.

Performance data quoted represent past performance. Past performance is no guarantee of future results and investment returns and principal value of the Fund will fluctuate so that shares, when redeemed, may be worth more or less than their original cost. Current performance may be higher or lower than the performance quoted. Call 1-800-99-JAMES or visit www.jamesfunds.com for current month end performance.

As of 5/31/14 the following percentages of the Fund were invested in the stocks mentioned: Alaska Air Group (ALK) 2.28%, Hawaiian Holdings (HA) 0.02%, Southwest Airlines (LUV) 0.25%, Mylan (MYL) 1.06%, Merck (MRK) 0.83% and American Railcar Industries (ARII) 0.63%. The top ten equity holdings in the Funds as of 4/30/14 were: Alaska Air Group Inc. 2.25%, Western Digital Corp. 1.44%, Macy's Inc. 1.24%, Deluxe Corp. 1.11%, Mylan Inc./PA 1.10%, AMERCO 1.02%, HollyFrontier Corp. 0.99%, TRW Automotive Holdings Corp. 0.95%, Ford Motor Co. 0.90% and Kroger Co./The 0.89%.

The Baltic Dry Index (BDI) is an index that tracks the price of transporting dry bulk cargo like cement, coal, iron ore, and grain on bulk freighters. As many of these commodities are raw materials that go into production of finished goods, the BDI is often take to be an indicator of economic growth and production. The index is maintained by the London-based Baltic Exchange. One cannot invest directly into an index.

Quantitative easing is an unconventional monetary policy in which a central bank purchases government securities or other securities from the market in order to lower interest rates and increase the money supply. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.

The views expressed in this reprint are those of the author and participants as of June 30, 2014, and are not intended as a forecast or as investment recommendations. Information provided with respect to the Fund's Portfolio Holdings, Sector Weightings, Number of Holdings, Performance and Expense ratios are as of the dates described in the article and are subject to change at any time.

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