

# EQUITY SELECTION PROCESS



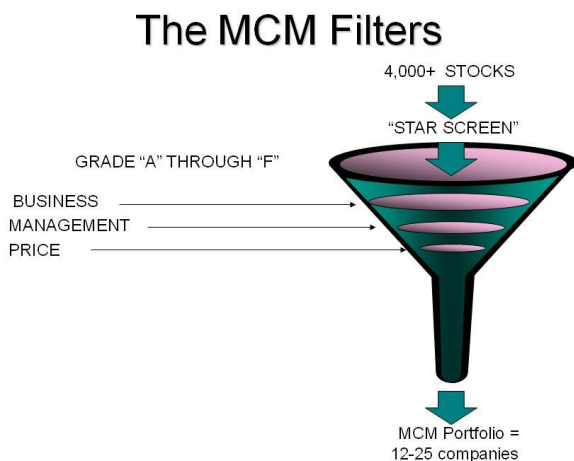
Equity research and selection are at the very core of what we do. Martin Capital Management constantly searches for businesses that are truly worthy of long-term investment. Instead of buying a little of everything, thus tending to be average, we focus on relatively few companies – large, medium, or small in size – that are most likely to produce positive results for our clients. Here's how we find them:

## NARROWING THE UNIVERSE: CIRCLES OF COMPETENCE

There are thousands of publicly-traded businesses in the United States, each with its own opportunities and pitfalls. So how do we know where to even begin looking for great investment ideas? You might say we grow them in our vegetable patches. We assign each of our equity analysts a manageable piece of commercial ground to nurture and closely observe. These small patches are called **circles of competence**. Our analysts become so familiar with their territory, they spot strong candidate companies within their sectors before most general-orientation analysts. Separating plants from weeds is easier when you know every inch of the garden.

## THE “STAR SCREEN”

Because of our attention to specific sectors, we know which companies are the standouts. The **stars**, if you will, often tend to be overpriced and may not be good investments at the moment – but knowledge of these businesses proves to be quite useful. We often set up screening programs that compare the financial data of star performers with other companies. By looking at signature features like high return on earnings, high insider ownership, low (or no) acquisitions, and low debt ratios, we find companies that strongly correlate with a “best practices” business from our stable. But we have to be careful here. As we all know, *look-alikes* are not necessarily *act-alikes*; and not every business that looks good on paper actually functions well in reality. We need to go further in our research to find out which, if any, of these potential stars actually have what it takes. For that purpose, we employ a series of filters designed to look at candidate investment opportunities in granular detail, assigning a grade of “A” through “F” at each stage of the funneling process.



## FILTER #1: THE BUSINESS

Consider the experience of buying your first home. Was it purchased sight-unseen? Few people would even think about buying real estate without first thoroughly investigating the physical condition of the house (asset) and its location (environment). The same logic can be applied to buying equities. Our focus starts on the asset – the **business**. An inspection of the physical plant, an assessment of the business model, an analysis of the competitive environment, and a review of the financial statements are among the research activities that help gauge the *intrinsic value* of the total enterprise. We also use research data to project future cash flows and compare them to the current stock purchase price – a metric that largely

determines return on investment. Generally speaking, a business is unlikely to penetrate our filter unless it has a long history of producing an average ROE of 15% or more over time. Moreover, we have a strong preference for companies that have achieved sustainable competitive advantages (as evidenced by superior economic returns) and operate in relatively stable and predictable industries, where proper assessment of past performance is useful in understanding the future. If no precedent exists, forecasting future events and trends becomes much more difficult and therefore less certain.

## FILTER #2: THE MANAGEMENT

While the business model is crucial, even some of the best companies in the world have been run into the ground by poor leadership and lack of vision. Thus, the second critical variable in investment selection is the **management** of the business under consideration. Are the managers responsible stewards with a track record of both sustaining the business and growing

it? Do they have the ethics and integrity to lead the company through inevitable periods of difficulty? Assessing the competence and integrity of a company's management team can be challenging and, some would say, inherently subjective. After all, exactly how does one quantify integrity? The truth is, there will always be qualitative components in making judgments about management, and we try to address those by meeting in person with the managers of the companies we elect to study for possible inclusion in the MCM portfolio. Furthermore, because of our circles of competence, there is also a good chance we already have contacts in the industry of the company we're studying, and those people can provide additional valuable insight. Like an astute baseball scout, it pays to know not only the managers... but the players and coaches on the other teams who know those managers' tendencies.

That said, empirical, quantitative data from balance sheets, income statements, and other documents also shed light on company leaders. The attitude of management toward shareholders becomes readily apparent from the paper trail of decisions about allocation of capital. Proxy statements often expose important details about compensation and stock option policies in addition to possible conflicts of interest. Acquisitions are also quite revealing. In most instances, the only constituency guaranteed to be better off after an acquisition is management because a CEO's compensation is typically a function of the size of the company.

### **FILTER #3: THE PRICE**

The characteristics examined thus far are beyond our control. We cannot change a business model to create a more sustainable competitive advantage; we cannot change the demeanor of a manager or management team to behave in a more shareholder-friendly fashion. But at this last stage of the filtering process, we finally encounter a determinant that is entirely our call: **price**. Of course, we can't set the asking price for any common stock – the market does that. But we *can* determine what we think is a fair price to pay for the company being studied and then patiently wait until that price is low enough relative to the company's intrinsic value to provide a margin of safety for our investing clients.

In shopping terms, you might happen across a cashmere sweater of impeccable quality – but at \$750, the price is simply too high for the value of the item. Three weeks later, perhaps after the frenzied demand of the holiday shopping season abates, the same exact sweater ends up on the clearance rack priced at \$50. Having done your homework, it's an easy decision: It's still a great sweater, and that's a terrific deal. In much the same fashion, we examine the quality of the merchandise in the stock market. Having a good idea of a company's value, we then resist the urge to buy until we're convinced we've gotten a bargain. Though no investment is a slam-dunk certainty, this value-driven process accomplishes two things for the investor: 1) It increases the odds of a positive outcome by recognizing that stock prices over time tend to gravitate toward the intrinsic value of the business – “buy low, sell high,” and 2) It reduces the potential size of a loss that may occur if the stock price falls, because it was purchased at a reduced cost to begin with.

### **OUR EDGE**

Few businesses make it through all these filters. The ones that do survive are subjected to even more detailed study. Our true edge comes from analysts who know more about their companies than most other investors and firms. This is a direct result of developing specific areas of research expertise – circles of competence. In the end, we compile a concentrated (or focused) portfolio that represents our very best investment ideas. Adding less desirable stocks in the name of diversification simply increases the odds of seeing average returns over the long haul. We strive to do much better than that.