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FOREWORD

Martin Capital Management, a limited liability partnership, is an investment advisor registered with the U.S. Securities and Exchange Commission. After years of preparation, its founder began formally dispensing his brand of investment counsel, which this and earlier missives have recorded, in the months before the memorable autumn of 1987. (All firm publications, as well as the SEC filings, including form ADV Part II, are available upon request.) Since then, Martin Capital has grown to serve 96 clients whose combined assets total approximately \$518 million. From its beginnings as a one-man, one-assistant operation, with less than \$25 million in assets, Martin Capital is now headquarters for 12 people, including seven investment professionals and five persons in supporting roles. See end of report for thumbnail biographies.

We at Martin Capital Management hope that in the course of conducting our business we might occasionally encounter other investors with whom we share common values and expectations. If you know of someone for whom the fit appears mutually beneficial, please mention our name. While our \$5 million minimum family account size prevents us from helping some people whom we would very much like to serve, it is necessary to keep our roster of clients small. Our abiding duty is to those who have entrusted their assets to our care, and we will forgo any growth opportunity that may detract from our ability to serve them as they have become accustomed. Careful selection and controlled growth are really about doing a good job and having fun along the way. We never expect to be among the biggest, but our intention to be among the best is not subject to compromise.

Informational and educational materials that seek to highlight the primary tenets of Martin Capital Management's investment philosophy and overall business model are available apart from this annual report. We hope these concise writings will help you gain a deeper understanding of how we conduct the business of managing wealth. Please feel free to call or write us if you would like to receive this informational packet. Or visit our Website at www.mcmadvisors.com.

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Dennis D. Blyly, CFA, Partner, Director of Research, Analyst, and Portfolio Manager
Todd B. Martin, CFA, Partner, Director of Marketing, Analyst, and Portfolio Manager
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Aaron J. Kindig, Junior Analyst
Ann Frantz, CPA, Operations Manager
Kristin Antalavits, Assistant Portfolio Manager and Trader
Karen Sherer, Client Service and Operations Support
June Bails, Executive Assistant
Stephanie Malcom, Executive Assistant

PRIVACY NOTICE

When Martin Capital Management provides investment services to you, we may obtain nonpublic personal information about you from the following sources:

- from you, orally or in documents, or other materials you provide to us; and
- from others, in connection with the transactions or other matters we handle for you.

We do not disclose nonpublic personal information about our clients or former clients to anyone outside our firm, except with the client's consent, as required for the services our clients request, or as otherwise permitted or required by law.

We restrict access to your non-public information to members of our firm — and to employees of our firm who have agreed to maintain the confidentiality of our clients' information.

We maintain physical, electronic, and procedural safeguards to protect your non-public personal information from inadvertent disclosure.

BUSINESS PRINCIPLES

- Our practice of ethics is quite uncomplicated. We simply conduct ourselves in our relationship with you as if the roles could be reversed at any time. If you would like something more formal, we can send you the Code of Ethics of the Association for Investment Management and Research of which the members of your management team, as Chartered Financial Analysts, are full participants. It is well thought out and inclusive.
- We strive to be candid and forthright in our reporting to you. You have placed your trust in us, and we know of no other way to be worthy of that trust. Despite this policy of openness, we will publicly discuss our transactions in marketable securities only when we believe such disclosure will be to your advantage. Good ideas are scarce, and the output of our research efforts is your exclusive property.
- Our portfolio management style is “participatory.” We consider it very important for you to be actively involved in the review of our recommended portfolio policy, in mapping out intermediate-term strategies, and in major asset-allocation decisions. Your involvement should not take a great deal of your time, however. The better we get to know you, the more likely we are to appreciate your unique (and sometimes changing) goals, objectives, preferences, biases, and fears, both spoken and unspoken. With your indulgence, we will continue our practice of encouraging frequent face-to-face get-togethers. We also will persevere in communicating our thoughts to you in writing to make it easier for you to get to know us.
- To the extent that security laws and regulations permit, my own portfolio and that of our firm are invested in the same securities as yours, varying only to the extent that our goals and objectives differ. In other words, “We eat our own cooking.” It probably goes without saying that such a policy demonstrates the sincerity of our position — not necessarily the soundness of it.
- We are a small organization and intend to remain so. A compact organization makes it possible for us to spend our time managing our business rather than each other. Because everyone has much to do, much gets done. Our design appeals to those for whom form is secondary to substance.

INVESTMENT PRINCIPLES

- Our implicit quantitative performance goal is to maximize long-term portfolio returns.
- The universe of marketable securities from which we select most investments is generally limited to: (1) long-term, common-stock holdings; (2) medium-term, fixed-income securities; (3) long-term, fixed-income securities; and (4) short-term cash equivalents. Beyond respecting the investment-policy guidelines established for you, we are not partial to any one of the above categories. We simply search among them for securities that offer the highest after-tax, risk-adjusted returns as determined by “mathematical expectation.”
- We strenuously avoid assuming risks that might result in “permanent” capital loss. We will forgo an outstanding investment opportunity if the flip side of that coin is the risk of an irreversible capital loss. We do expect frequent shorter-term quotational losses as we rarely, if ever, are able to buy a common stock or any other security at its absolute lowest price. So long as we feel our business analysis is sound, further weakness in the market price of a company simply gives us an additional opportunity to purchase shares at an even greater discount relative to its intrinsic value.
- Consistent with our attitude toward catastrophic risk, we have little interest in the use of leverage. We do not margin portfolios and usually avoid making investments in businesses that themselves labor under a heavy burden of debt.
- When we purchase common stocks, we approach the transaction as if we are buying into a private business. We insist on a purchase price that represents a “compelling discount” from intrinsic value. Once a purchase is made, we focus the bulk of our attention on tracking the business itself and ignoring short-term price fluctuations. We are quite content to hold onto our investment in a good business so long as (1) the prospective return on equity capital is expected to be satisfactory, (2) the management continues to conduct itself with competence and honesty, and (3) the market does not become excessively enthusiastic about the future outlook for the business.
- We believe that intrinsic value is in essence the central tendency in the price of an asset. It is the investment concept at the core of our analytical methodology. While intrinsic value is an elusive notion, “earnings power” has become the driving force in fixing a range for intrinsic value. Earnings power allows for the existence of an intangible asset known as “economic goodwill” that can be aggregated with tangible assets to arrive at intrinsic business value. Without such a fundamental benchmark, however vague, one is at risk of becoming awash in the occasional tides of euphoria and pessimism that flood the security markets.
- We generally limit the number of companies we own in any individual portfolio to fewer than 20. Contrary to popular opinion, exceptional investment ideas are uncommon indeed. We do not want to dilute the performance of outstanding investments with potentially mediocre ones purchased solely for the sake of additional, and often redundant, diversification. Despite the intuitive appeal of the broad spreading of your risks, extensive computer-backed testing has demonstrated that 90-95% of all the benefits to be gained from diversification can be achieved with a well-selected portfolio of fewer than 20 businesses.

INTRODUCTION

What better way to grab your attention than to begin with a “good news, bad news” declaration? The “good news” should bring the same feeling of sanctuary that the image of a straw cot must have conferred upon Big John Henry toward the end of an excruciatingly long day “driving” steel drills into the rocks — in the heat, cold, rain, and snow of West Virginia as the milelong Great Bend Tunnel was dug in the 1870s. About 1,000 men and boys worked on the project, many of them newly freed slaves trained only for heavy labor and eager to earn the handsome sum of \$1.25 per day. For every man killed by careless blasting, falling rock, asphyxiation, and silicosis, it is said that another was found in the woods with his throat slashed after walking away from the paymaster or a poker game.

Some readers may be initially puzzled by the writer’s use of the story of Big John Henry and its pertinence to the good news. Others might even believe that my sole purpose for describing in such detail the anguish Big John Henry endured was so that the suffering to which you’ve been subjected annually when telephone book-sized annual reports landed on your doorstep would seem mild by comparison. Not so, I retort. You see, I am a changed man. Repentance is at hand, the sin of copious commission in apparent recess (at least for a year). Thus the good news is staring you in the face, looking up at you as it rests ever so lightly on your outstretched fingers, its pages totaling scarcely more than the appendages of your four extremities. At last, rest for the weary — and comeuppance for the wordy. In “short,” this report is barely half the length of last year’s. As for the “bad” news, read on a page or two ...

Never one to waste a metaphor (though some would see yours truly as laying waste to the language), I return to the story of John Henry, which in fact is replete with relevance to the task that lies ahead. The story of Big John and the digging of the Great Bend Tunnel is one of uncompromising dedication to a mission to the exclusion of all distracting and counterproductive emotions, of staying focused despite all manner of obstacles — from mental anguish and exhaustion to the vagaries of such exogenous elements as the weather and random rock slides, to say nothing of drilling and blasting day after day with no firm assurance that you will ever see the light at the end of the tunnel. Trust, teamwork, and steady nerves were manifested abundantly in the unspoken interdependence among the “drivers” who wielded the 14-pound sledgehammers and the “shakers” or “turners” who steadied the drill bits, often between their legs. As if a word to the wise, it was not how hard the “driver” swung the hammer but rather how unchangeable his rhythm that determined the day’s progress.

Helping it all happen in synergistic sequence were members of the support team who seamlessly supplied the drivers with fresh drills, sharpened by the blacksmith, as all too quickly the drills were blunted by the unforgiving mountain. Finally, John Henry worked on the “heading” of the tunnel, the initial horizontal shaft, perhaps analogous to the first U.S. soldiers on the beach at Iwo Jima. After the heading was driven, charges were planted down in the “bench” to blow out the rock and widen the tunnel. Driving steel for the heading was far more dangerous, since cave-ins were invited by drilling straight ahead and sometimes up into the tunnel roof, not yet shored up with timber. This work also required the most skill with the hammer and the steadfast conviction that, in the midst of darkness and dust, the image of victory would never be overwhelmed by fear, fatigue, or uncertainty.

As to what we at Martin Capital and you, our clients, do together, is the metaphor gaining traction?

The MCM annual report is chronically unconventional, exonerating the writer — it is hoped — from the obligation to conform to traditional or time-honored but monotonous reporting practices, traditions, ceremony, or even etiquette. No glossy pictures, no hyperbole, no fanfare, this year’s truncated offering is respectful of Einstein’s admonition: “Make everything as simple as possible, but no simpler.” Accordingly,

you will find the report a little light on numbers and a little long on opinion. Reasoned judgment has been in short supply in recent years, and this monograph may be a (subconscious?) attempt to help fill the void. All of us are inundated with information about recent events or happenings, especially as reported by newspapers, periodicals, radio, or television. Regurgitating the facts of yesterday may bring a form of catharsis, but it adds little value. On the other hand, reactions to essays that challenge conformist thought might well run the gamut from raising the reader's ire to piquing his or her curiosity. In the process it is our expectation that the reader's general sense of who we are and how we do business will be more clearly defined — and the capacity for sizing up the cultural and philosophical fit will be enhanced.

The essential features of the treatise are: (1) an account of the investment results for 2002 and how they were achieved, (2) a dissertation on the how and why of our research process, (3) a companion discussion on the rationale behind the way we manage your portfolio and, finally, (4) our investment strategy — or “what in the heck do we do now?”

At the outset we warned of some “bad news.” Be consoled. It's not the equivalent of arriving at a friend's house as the sole dinner guest when, with an “I'm trapped” sinking feeling, you discover that the meal about to be served is one that you abhor to the point of nausea. If you don't want to consume what is served up later, you can simply feed it to the dog under the table! Our “bad” news is, quite simply, a second helping of this writer's ruminations as the last century ended and the present one began. In recent years the investment results have been the end product of decisions made under conditions of above-average uncertainty — both macroeconomic and microeconomic and overlaid with more than a dollop of exaggerated social psychology. We are not, like so many others, going to reflect the events of the last four years with the clarity of hindsight and sanctimonious demeanor. Rather, under separate cover in the weeks ahead you will receive a thematic and, within each theme, chronological compilation of the guts of our annual reports from 1999 through 2002. Unabridged, these accounts are more authentic because they reveal our thoughts and actions, at the end of each year, as history was being made. The perception of the significance and nature of events changes dramatically between the time they occur and when they are viewed with the benefit of hindsight. We hope you find the compiled perspective unique and refreshing, not to mention illuminating.

Although investment advisors tend to be understandably loath to chronicle what they said or wrote yesterday (I suspect this will be one of the few with such an air-your-dirty-laundry candor), we are not. To be sure, sound decisions have a slight plurality over the bad ones. But the humility that comes hand in glove with hard knocks always overcomes vainglory. Like the normally victorious boxer, you can't practice in this profession very long without tripping over your shoelaces. The best you can hope for is to err on the side of caution, which has been our signature. Those with long memories will recall that this boy cried “Wolf!” long before it arrived at our door.

We trust you will find the brevity of this annual report to your liking. We also hope that the compendium that follows will serve as a handy reference guide that, nonetheless, will eventually gather dust until sometime in the years ahead when the wolf surreptitiously reappears. In sheep's clothing, of course.

INVESTMENT PERFORMANCE

Period Ending	MCM	S&P
December 31, 2002	Equities*	500*
Five Years	7.2%	-0.6%
Three Years	11.3%	-14.5%
One Year	-16.3%	-22.1%

* Compounded annually, MCM data net of fees

Year	MCM	S&P
	Equities*	500
1994	-7.8%	1.3%
1995	18.6%	37.5%
1996	32.2%	22.9%
1997	48.2%	33.3%
1998	-12.4%	28.6%
1999	17.4%	21.0%
2000	32.5%	-9.1%
2001	24.3%	-11.9%
2002	-16.3%	-22.1%

* Representative portfolio, net of fees

THE ROLLER COASTER TOOK US FOR QUITE A RIDE

Relatively benign ☺ annual performance data provided in the tables above often betray the sometimes brutal and other times benevolent roller coaster-like movements of the markets and individual securities between the dates that mark the beginning and the end of any calendar year. In the 2001 annual report we made reference to similar occurrences in 2000 and 2001. While the speculative technology and Internet bubble was being pricked in the spring of 2000, bargains galore were found among the unglamorous, if not mundane, businesses that were discarded willy-nilly as the gamblers drew for a hotter hand. The bifurcated market provided opportunity for some, imminent disaster for others — largely depending on whether they were going against the grain or with it. By contrast, the emotionally charged sell-off following the tragic events of September 11, 2001, visited its temporary carnage largely indiscriminately. It had the same effect as a mile-wide tornado approaching a small town.

While different in character from the market-rocking events of both 2000 and 2001, the year just completed dished out its own concoction of challenges and opportunities. The first quarter, a follow-through of the emotional whiplash that often accompanies events that are shocking in both magnitude and unpredictability, saw stock prices rise. Emotional equilibrium was restored during the second quarter, when the ground gained in the first three months of the year was given back. Come the third quarter, and fear reigned supreme. The economy appeared to be in dire straits as a seemingly desperate Federal Reserve Board initiated the 11th consecutive cut in the Fed funds rate, driving it down to an unprecedented 1¼% level.

Unilateral war against Iraq loomed on the horizon. Corporate governance scandals reached epidemic proportions.

The free fall in stock prices had a take-no-prisoners ferocity about it. From the close of the markets on June 30 until the quarter ended on September 30, the Dow Jones Industrials, the S&P 500, and the Nasdaq fell 17.9%, 17.6%, and 19.9%, respectively. Record or near record quarterly percentage declines were established for several popular indices. The metamorphosis in the mood of the players in the market was palpable.

One week into the fourth quarter, and investors' cyclic capacity to seemingly overnight swing like some mad primate from one emotional limb to another manifested itself once again for two months. By December, however, the ardor had cooled with the weather and, at the turn of the year, the three indices mentioned above had regained some of their losses, rising 14.5%, 13.3%, and 19.9% from their October lows. When comparing the percentages just cited with those in the paragraph above, don't forget that the mathematics of compounding require a 100% gain to offset a 50% loss. We will repeat ourselves several pages later to drive home this critical point.

All the above intra-year pyrotechnics notwithstanding, the three indices registered losses of 16.8%, 23.4%, and 31.5% respectively, before dividends. MCM's "typical" equity portfolio declined 16.3% in value. As has been our practice in the past, we chose not to follow the lead of "Mister Market," a notably unstable fellow afflicted with an apparently incurable form of bipolar disorder. During his manic phases we either sit back passively or, if his hunger for equities borders on the insatiable and the prices he's willing to pay approach the absurd, we may attempt to satisfy his appetite. When his despair reaches the point of wild-eyed and irrational action — as it did during the third quarter — we feel obliged to ameliorate his suffering by taking off his hands some of the stock he is so insistent on dropping like a hot potato. Accordingly, during the third and fourth quarter in the aggregate we committed another \$25.5 million to a number of the companies that Mister Market was only too willing to sell.

The ☺ inserted at the outset of this discussion was intentionally facetious. As absolute-return-oriented advisors, we are not at all pleased because our negative return for 2002 was less than that of the S&P 500. In that respect we performed miserably. Short-term market price volatility is a consequence — deemed as favorable or unfavorable depending on the temperament of the person — of being an investor in marketable equity securities. Some investors attach great importance to the daily or even hourly ups and downs, while others, like the undersigned, pay them no heed except when they present us with a mouth-watering opportunity *to do something*. As we mentioned last year, we expect to have negative years on occasion (and our record makes that point clear!). Those who take a longer-term perspective — and the shorter-term fluctuations in stride — tend to be amply rewarded in the long run (our record makes that clear as well).

TIME- VS. DOLLAR-WEIGHTED RETURNS: SUBTLE BUT SIGNIFICANT

The fourth quarter's gain in the dollar amount of aggregate portfolio wealth was thus the combination of two contributing factors: First, the market price's appreciation in the companies we had owned for some time, and second, the surge in price of the companies just purchased during the third and fourth quarter slump. While no precise estimate is practical, we reckon that approximately 87% of the gain in aggregate equity portfolio wealth resulted from the first factor, with the remainder from the second. As noted in last year's annual communiqué, the time-weighted performance reporting convention that we're obliged to follow in the tables at the beginning of this section makes no allowance for the wealth-effect benefits of taking money off the table when the odds are against us or committing additional capital when they seem to be in our favor. In each of the last three years your wealth has fared better than the time-

weighted percentages would suggest. And if performance were measured on a dollar-weighted basis, the difference would disappear.

One more subtlety needs to be brought to your attention. As we have become more fully committed to equities — a rational response, we would argue, to a generally widening margin of safety — sharp slumps in stock prices do not provide the conspicuous opportunities that they once did when we were loaded with cash. To return to a favorite sailing metaphor, if you are flush with cash you may remain safe in the shelter of the harbor until the storm passes. If, on the other hand, you have a significant commitment to equities, you must ride out the storm at sea and, if necessary, “heave to” in the teeth of a gale. If your vessel is sturdy and seaworthy, and you have your sea legs, you can face Mother Nature in all her savagery with equanimity and not trepidation. Moreover, when the weather clears, and the fair winds return, you will find yourself miles ahead of the ever-cautious bloke who’s still securely tethered to the pier. The spoils of victory rarely go to the fainthearted. To conclude the analogy, it seems more sensible to long-term investors (such as ourselves) to devote our energies to finding sturdy ships than attempting to predict the idiosyncratic weather.

Nearly repeating ourselves verbatim from last year: Little has been said — and little needs to be said — about the performance of our fixed-income assets. Since we never compromise on quality, and we keep our durations quite short, suffice it to say we generally expect our returns to match the note’s or bond’s yield to maturity at the time of purchase. We enjoyed a modest bump in total return in the last several years because of falling interest rates, but it was a “borrow from Peter to pay Paul” kind of give-and-take, and it’s therefore nothing to crow about. As noted in the Investment Strategy Section, we attempt to preserve your capital in fixed-income securities and enhance it in equities. It can’t get much simpler than that.

PERFORMANCE FEES: ‘IT’S BEANS FOR SUPPER’

Once again the elemental and uncompromisable, all-seasons fairness of the performance-based fee has made itself painfully known this year. As most of you are aware, our last earned performance fee occurred at the end of the first quarter of 2002. Due to actions taken after the summer solstice, as well as some favor shown later in the year on a number of the companies we own, we’re clawing our way back toward the high-water mark. In the meantime, it’s beans for supper! (Yes, when it comes to investment decisions, we eat our own cooking, as we have noted before.) We can’t promise you when those high fees (that telegraph that your wealth is growing apace) will return, but for your pocketbook and ours, we hope it will be soon! Even though our competitors are eating well charging fixed fees on sometimes greatly diminished wealth, the virtue of the performance-based fee, and its near perfect symmetry in the sharing of the ups and downs, is unparalleled in our industry.

THE RESEARCH PROCESS

“Research” is a word that serves as a catchall for a bewildering array of means engaged toward a common end, from which this discussion will begin. One of the ways investment managers attempt to enhance their clients’ wealth is by performing certain activities that their clients either cannot or choose not to do — because of time, talent, or interest constraints. After all, not everyone is as fired up about investing as we are! One of those endeavors is profitably investing a portion of client assets in the equity securities of publicly traded companies.

The research process begins with the identification of businesses that, upon preliminary inspection, pass through our nearly impervious filters. This is followed by intensive and comprehensive analysis of the business itself, as well as its rivals, all within the competitive construct of the industry in which it operates. The process concludes with the activity that never ends until our relationship with a company is terminated: the regular monitoring of the operating and governance performance of the company over time.

The goal of our entire research effort is to find the few roses among many thorns, those rare species that, often demure and unpretentious (and almost never stunning in their external beauty), have consistently earned high returns on invested capital and are likely to keep doing so, well into the future. It’s relatively easy to sort the roses from everything else based on historical data. But it’s altogether another matter — and the ultimate test of an analyst’s right-brain capacity — to examine every piece of the micro-economic puzzle, assemble it into a coherent whole, and make a compelling case in support of how and why what has been successful in the past will continue working in the years to come.

SAME OL’, SAME OL’: THE CONVENTIONAL RESEARCH CONSTRUCT

In order to zero in on our research process — which is but one of the behind-the-scenes elements, albeit perhaps the most important, of a manager’s services — we must start with certain suppositions to frame our conduct in the context of the larger research universe, of which ours is but one very focused subset. One hypothesis is that it’s generally believed that there’s a symbiotic connection between the above summarized, company-specific “research” activity and the management of a group of such companies, collectively known as a “portfolio.” Whether a portfolio consists of a cornucopia of companies or just a few is seemingly irrelevant to the research process, and yet in many instances it does play — and in our opinion should play — a dominant role in defining the way in which our research function is discharged. Keep that interdependent relationship in mind as you read on, knowing that Martin Capital defines effective diversification quite differently from many of our mainstream brethren. We believe that the military might of a modern army is not so much measured by the number of foot soldiers it can muster, as in antiquity, but rather by the relative potency of the arsenal of weapons it has at its disposal. Another premise, the manager’s time horizon (where is he positioned on the continuum between trader/speculator and long-term investor?) necessarily further delineates the depth and breadth of the research process. Needless to say, our vantage point is at the conservative end of that continuum. Thus to an important extent the depth of the involvement with each company researched must be viewed in the larger context of the firm’s investment philosophy, itself the product of the inquiry into the nature of things based on logical reasoning, as confirmed by empirical evidence.

Finally, before moving on to the practical aspects of how MCM conducts research, we state the obvious when we say that any choice involves trade-offs. For example, we have purposefully chosen to be an independent, self-owned firm, beholden to no one but our clients. That simply but importantly means our clients will always know that our investments are selected exclusively on the basis of their own merits. Our

organization will never be exposed to the near irresistible temptation present at firms that provide both investment banking and research services under the same umbrella.¹

When a research analyst's compensation is tied, even in part, to what he or she writes in support of the business development efforts of the firm's investment bankers, the so-called "Chinese wall" crumbles and the end customer ultimately commits capital to an idea, the integrity of which may have been compromised. In fact, the real customer could well be the investment banker for whom the researcher writes more marketing-oriented than cryptically analytical reports, and the retail customer who, by default, may be the dupe. Of late the brokerage firms have been roundly castigated in public forums because of gross disregard for ethical principles of this egregious sort. We simply cannot outsource any of our research responsibility to firms whose research output might possibly be a detrimental concession to the practical realities of life on Wall Street, even after the proposed tightening summarized in the footnote below.

Another significant trade-off relates to the narrow focus of a boutique firm such as ours compared with broad-spectrum monolithic firms like Merrill Lynch (whose Investment Management Services Division provides a broad spectrum of excellent services to MCM) and Goldman Sachs, to name but two of the largest players. Competition among the majors to service an extensive array of customers, including their own in-house investment banking operations, whose research needs are as varied as the selections found on an Applebee's menu, leaves them no alternative but to provide research coverage on virtually all industries, many of which do not warrant even a cursory look from a serious long-term investor. Despite the mandate under which the larger firms must operate, the harsh reality, in our opinion, is that there are very few businesses whose competitive advantages are so dominant that even a casual observer can safely conclude that five or 10 years hence the business will be much more valuable than it is today.

To be sure, the majors are quite observant: They know their customers. The broker's biggest single source of commission income, the \$6.56 trillion mutual fund industry (November data), tends to be grossly overdiversified by design and turns its portfolio of securities with frequency approaching 100% a year, making mutual fund "investing" appear oxymoronic. Of course, that leaves the individual investor, whose earnings are taxed, at a significant after-tax disadvantage. Such tax inefficiency is properly rationalized because a persuasive minority of \$2.4 trillion in mutual fund assets are in 401(k) and other tax-advantaged funds.

Although an aside, the following should be worth your while. It has been at investors' peril that they occasionally fail to examine motives: Brokers have traditionally been paid on the basis of activity, not accretion in wealth. Reflecting in part a pricing strategy shift in response to the cutthroat competition in the commission business (brought on by E*TRADE and countless other Internet vendors), more and more firms are now offering incentives to their sales personnel to "capture assets," charging fixed fees on those portfolios instead of commissions. The asset-based fee provides several conspicuous advantages for the broker over the activity-based commission structure. Most obvious, it stabilizes revenues at a relatively high

¹ Several days before Christmas 2002 securities industry regulators announced a \$1.4 billion peace accord with the nation's largest securities firms. A 14-page list of "structural reforms" is being released in January and is to include the perennially proposed-but-never-perfected "severing of the links between research and investment banking," including analysts' pay. For five years firms must pay for "independent" stock research for investors, to complement their own analysts' reports. The implementation of this effort, given the vast difference in resources that will be applied to each endeavor, appears problematic at best. As for IPOs, the practice of "spinning" (giving hot shares to executives and directors to induce them to provide investment banking business) and analysts' attendance at "road shows" will be banned. While the pact seems like a toothless tiger compared with the legislation that came out of the great Depression (Securities Act of 1933, Securities and Exchange Act of 1934, Investment Company Act of 1940, among others), the spirit behind enforcement — particularly at the SEC — could make a big difference. We will watch with a skeptical eye.

level during bear markets when trading volume often slacks off. Whatever the pricing mechanism, there seems to be a less-than-perfect symmetry between how their customer gets rich and how they get rich.

One need only spend a few hours watching CNBC to grasp the way in which what constitutes investment (and the research process that undergirds it, as Benjamin Graham defined it 70 years ago) has been transmogrified. Being grounded in the conviction that certain investment truths are inviolate, the latest iteration remains a curious and extreme deviation from what we have long thought of as baseline reality. Perhaps most conspicuous is the aforementioned preoccupation with near-term business developments and short-term price swings. Analysts, or so they are called, conclude their work by providing an explicit near-term price target for the stock. Just the concrete simplicity that the customer wants, to be sure, but nothing more than an unsupported end to the analytical processing for which there is no rational means. The multivariable model required to cite a specific price target is dependent upon differential calculus, which breaks down because some of the key model components are simply unknowable. The end product is mere conjecture, despite how authoritatively it is delivered.

Hand in hand with the preoccupation with short-term price fluctuations is an absorption with quarterly earnings, abetted by company managers all too willing to oblige by providing short-term earnings “guidance” to “analysts.” While rarely talked about, the cozy relationship between companies and analysts who “follow” them as a dog follows his master — to the point where guidance can only mean blatantly compromised analytical independence — ties nicely back into the “Chinese wall” conflict. Besides, such apparent earnings precision flies in the face of the real business and economic world.

In attempting to perpetuate the illusion of earning stability, in part because of the ostracism that awaits if managers miss their “numbers,” CEOs and CFOs have often in desperation resorted to accounting chicanery that has become headline fodder for months (and the lamentable scourge of the accounting profession). When put together, the pieces of this rather complex puzzle form a clear and disquieting picture. Simply stated, that’s the way things are but surely not the way things will be five to 10 years from now. Our task is to understand the motives of the various parties who might have malevolent interests and to avoid those who may attempt to compromise our view of things. That includes managers whose allegiance is to other than the shareholders.

It’s highly improbable that the airline, metals, or automotive industries will ever be represented in our portfolios as long-term investments. And yet you’ll find them scattered throughout mutual fund portfolios whose primary focus is on the aforementioned short-term market price changes. The stocks of these industries often are driven by “momentum” investing (another contradiction in terms and the equivalent of “catching a wave” in surfer parlance) whose performance benchmark is the S&P 500 or some other index that more closely parallels the particular fund’s investment style. A fund’s unspoken mandate is to beat its chosen benchmark (which only a modest minority do) by a margin at least sufficient to cover management fees and thereby attempt to justify its existence. Such management, for lack of a more descriptive word, takes the form of modified closet indexing, with returns presumably enhanced by overweighting favored industries and underweighting those deemed to be below-average. Given our resources, if we were, for some inexplicable reason, to attempt such a feat, our service would be a mile wide and an inch deep.

This long preamble helps to define who we are not and, by extension, what we hope to be, as well as what we expect to accomplish as analysts in serving the needs of our very unique constituents.

THE MCM RESEARCH MODEL

Managing Around Uncertainty

As long-term investors (our desired holding period is forever!), our perspective is that of a business analyst, not so much a securities analyst. Accordingly, an estimation of the present worth of a company is in large measure a function of the projected cost of money and the forecast of future cash flows of a business, both of which are estimated under conditions of inherent uncertainty, which ambiguity only increases as one looks farther into the future. Change is the only constant on which a forecaster can rely. Interestingly, with great businesses it's sometimes easier to be generally right about the long term than the short term, much like the seaworthy vessel that is buffeted like all others when the storms hit and yet remains steadfast on its journey after the seas have quieted. Other ships, meanwhile, limp into port, or worse. Fortunately, all those who prognosticate do so under the same conditions. Those who are most adept at recognizing and incorporating the element of uncertainty into their decision-making processes stand a better chance of achieving superior outcomes.

Our meticulous use of three filters, described at length in the 2000 annual report (beginning on page 22), alleviates uncertainty to some degree. The following synopsis may refresh your memory. Filter No. 1 mandates that the company must demonstrate a record of superior economic returns. The second filter requires that the business be simple enough that we can understand it. The third addresses the highly subjective issue of management competence and loyalty.

The Virtue of Simplicity

In a conscious and concerted effort to reduce the amount of risk associated with general unpredictability of future events, we seek out businesses that are easy to understand. Unlike the scoring system in gymnastics, diving or ice skating, there is no commensurate investment return advantage to be gained by attempting to understand companies whose complexity is the equivalent of attempting a quadruple toe loop. Simply put, the effervescence of Coca-Cola is easier to stomach than it is to bend an ear to find resonance and harmony in the mélange of hums, whirs, or chinks that is the musical score of, say, General Electric. In point of fact, the degree of difficulty almost always works against the goal of estimating the intrinsic worth of the business. As the number of "sensitive assumptions" one must make increases, the confidence in the valuation outcome of incorporating those variables in an ever-more-intricate model diminishes accordingly.

It isn't only complexity that becomes a thorn in our analytical side. Companies with short product life cycles (contrast Cheerios breakfast cereal with handheld digital devices) are comparatively difficult to value. To conclude this train of thought without implying that it's all-inclusive, an unstable competitive environment (think only of the cutthroat competitive rivalry in consumer electronics) is anathema to fashioning anything approaching reasonable approximations of what the future might look like.

The Past Can Be Prologue

When Tiger Woods steps up to the first tee, paired with a randomly selected and relatively unknown player with no wins under his belt, what process will you employ in speculating about who is most likely to come out on top? If your choices are not handicapped as in parimutuel wagering, the rational observer is going to pick the favorite over the long shot. To be sure, there's always the risk that Tiger will go into a slump, perhaps an extended one. Moreover, rivals have responded by spending endless hours lifting weights, modifying their swings under the watchful eyes of their personal pros, to say nothing of pounding countless balls on the driving range in an attempt to close the gap with Tiger. Still, it's generally a better bet to go with a proven winner, even though the competition is intent on imitation. That analogy can be loosely applied to

business forecasting. We believe that past success in business is often a good place to start as one looks forward, if one is quick to acknowledge that outsized profitability attracts competitors like steel shavings to a magnet. Until you truly understand the nature of the competitive advantage that has given rise to second- or third-sigma profitability, it's difficult if not irresponsible to opine as to its sustainability.

Returning to Mr. Woods, his length off the tee only seems to be his major competitive advantage. In this observer's opinion it is his mental toughness, self-discipline, self-control, and course management that are his real edge. This young man goes into tournaments expecting to win — not because he is arrogant but because he has prepared diligently to be the best. Those strengths show up in every aspect of his game. So long as he can maintain his state of mind — no mean feat over time — he will surely lift a lot more Waterford Crystal trophies over his head. The same can be said of Michael Jordan in his heyday.

For each of these, however, there are many flashes in the pan, to say nothing of the multitudes who simply don't have the basic stuff of greatness. Ironically, the market is a relatively proficient handicapping system, except when it's in one of its extreme manic-depressive moods. Given the human factor in the wagering mechanism, the market often has a tendency to develop a cult-like following — and pay a disproportionately premium price — for certain perennial favorites. To the extent that the "price" of Tiger Woods has embedded in it this veneration premium, sometimes more money can be made by betting on the consistent journeyman whose presence is rarely captured on camera unless he's in Sunday's last pairing but usually finishes in the top 10. This is one of the many areas where research and portfolio management overlap.

Corporate America Is Not Your Grandfather's Democracy

As noted above, once we narrow our universe by eliminating those companies whose historical record does not inspire confidence, we then further winnow it to include only those companies where behind-the-numbers analysis confirms the virtue of simplicity, particularly where a few salient competitive advantages appear quite sustainable. At some point in this process, of course, we find ourselves in the executive suite. How a company is governed looms large in our process of separating the wheat from the chaff. Charlie Munger, Warren Buffett's partner, chooses to view the world not as a series of random events but rather as a series of models that tend to repeat themselves. Charlie is always abrupt and often disconcertingly frank in offering his opinions. So it is with us as we view corporate governance through Charlie's prism.

At the outset, it's essential to recognize that the process of administering corporations is unlike that of most other organizations with which we are all familiar. While the corporate governance form is patterned after the common political or social democratic archetype, it rarely functions as such. The board of directors, the body of men and women who usually number less than 25, is ostensibly the final authority. However, unlike the suspense common to most political elections, corporate boards tend to be predictably self-perpetuating, often with the chief executive officer handpicking the slate, whose election, by virtue of the electoral process, is virtually assured. The very nature of the relationship between a CEO and "his" board under this arrangement is rife with obvious conflicts of interest, with manifold incentives and few safeguards if one chooses to put self ahead of shareholders.

With the system of checks and balances fragile at best, corporate governance is susceptible to flagrant abuse at almost every turn. To be sure, Sarbanes-Oxley legislation is an attempt to shore up investor confidence in corporate governance. Still, officers' and directors' liability insurance premiums continue to skyrocket, perhaps overpricing after the fact to compensate for underpricing during the time of maximum malfeasance, a common and quite understandable industry practice. Like the attempt to rebuild the "Chinese wall" mentioned above, applying the spirit of Thomas Jefferson's famous aphorism, "Eternal vigilance is the

price of liberty,” may be the most effective long-term solution. The future of capitalism may hang in the balance ...

The above caveat notwithstanding, most boards are not “Dens of Thieves,” nor are most CEOs the antithesis of Robin Hood. Still, there’s a rather widespread and mendacious trend — that, like the boards themselves, tends to be self-perpetuating — toward all manner of executive compensation programs that are grossly disproportionate to the mere pittance that common workers earn for their share of the spoils of American capitalism — so blatantly unjust that Charlie Munger would dub such inequity as simply “white-collar theft.” Fortunately, much anecdotal evidence, to say nothing of the revealing SEC-mandated disclosures included in the proxy statement, is readily available so that we might reach a speedy preliminary conclusion about the integrity of the CEO and board. Companies that don’t at first blush meet our minimum qualitative allegiance standards are dismissed out of hand. Companies that change their stripes after we become owners, like the “last mile” telecommunications wire maker we owned several years ago, are propitiously yet perfunctorily sold. When in doubt, get out.

Without prolonging this discussion unduly, no Herculean effort is required to determine where the power resides at both ends of the spectrum — from a functionally and factually independently authoritative board to the CEO and a board of straw men (and women) who respond only after front-page public revulsion moves them to action and invariably long after the damage is done. It’s in the broad expanse between the two — the gray area — where the analyst proves his or her mettle. As you might suspect, a goodly number of companies are neither fish nor fowl, making analysis of the orientation of management a key objective/subjective consideration for us.

The Giant Imponderable: Corporate Leadership

Even if the board and CEO pass the ethical litmus test, the next step, attempting to determine the level of collective corporate competence, presents even greater challenges. A sterling past record, for example, may reveal more about the nature of the business than the vision and leadership of those in positions of control. Are those in charge lucky or smart or, as is often the case, a little bit of both? “Level 5 leaders,” as defined by renowned leadership guru Jim Collins (such leaders are documented to be among the most effective in achieving and sustaining greatness for long periods of time), are by their nature fiercely strong-willed and yet humble, making it particularly difficult to pick them out. You won’t find them “standing out in a crowd”; more than likely they’ll be sitting down! By contrast, most corporate pickpockets are easily spotted by the relatively experienced eye.

The culture of a company is the totality of socially transmitted behavior patterns, traits, values, beliefs, and many other manifestations of human work and thought. To the extent that culture is complementary to the vision and mission of the company’s leaders — in fact, in all likelihood a logical extension — overall competence is enhanced. Testing for the extent to which an empowering culture permeates the organization is, to put it mildly, most difficult. Countless other characteristics, including the extent to which decision making is decentralized, figure in calculating how much genius from the top trickles down to impact the customer’s “to buy or not to buy” decision. Collins, within his Level 5 Leadership paradigm, challenges managers who aspire to excel to think of their company as three concentric circles: “what it can be best at, how its economics work best, and what ignites its people’s passions. Eliminate *everything* else.” While there are no “silver bullets” in getting one’s arms around complex nuances of corporate governance and leadership, there is sweetness in simplicity.

One of the responsibilities of the undersigned as part of the research process is to get to know well many of the CEOs of the companies we own — or hope to own when the price is right. Admittedly fascinated by the powerful corporate potential that is unleashed as a direct result of inspired and efficacious

leadership, the writer finds the study of this difficult to identify and impossible to quantify corporate asset particularly appealing.

Calibrating for Competence

Performing the research process with the utmost “due diligence” is the minimal accepted standard for that endeavor. The business analysis of an individual company may take several hundred hours of studying at least the last five years of annual reports (we’re sticklers for continuity of thought and action over time) and SEC filings. This also involves reading everything we can from any number of sources about the company and the industry in which it competes; developing different and perhaps opposing perspectives on the company by communicating with vendors, customers, and competitors; scheduling on-site visits to get to know the decision makers as well as possible; attempting to put a finger on the cultural pulse of the organization during the process; and so on.

Basketball coach Bobby Knight, the Patton-like disciplinarian, was noted for having modified the expression “practice makes perfect” to “perfect practice makes perfect.” For starters, at least in terms of degree, MCM is without a coach, or at least can boast no more than having a player coach. In fact, it should come as no surprise to anyone that the undersigned is not the most skilled analyst in the firm.

Accordingly, absent the presence of someone screaming in our face, his nose inches from ours, we must find other internal means to constantly improve our level of play or effectiveness. Assuming we all have the requisite skills, experience (practice) must be made more perfect if we are to grow cumulatively in analytical competence. We have instituted a relatively simple but effective feedback system to enhance the learning from our mistakes. We collegially track the error — and there will always be errors to one degree or another — between an analyst’s initial earnings and cash-flow forecasts and the actual results as they occur.

Any variance may be the result of exogenous or random events over which we have no control or, if they recur with some regularity, they could reveal the analyst’s inability to grasp the very nature and structure of the business itself. In addition, variances common to more than one of the businesses for which an analyst is responsible may expose the presence of certain biases that subtly and systematically compromise the analyst’s objectivity, about which more will be written below.

The word “collegial” was carefully chosen above. Our research atmosphere is not by design competitive; rather it’s one that fosters collaboration. MCM’s professionals’ compensation program, the bulk of which is variable, is tied directly to the dollar amount of new wealth our investments create for our clients, with a proviso that severely penalizes us when we are digging ourselves out of holes that we dug. To use a baseball analogy to emphasize its keep-us-focused-on-the-end-result nuances, a strikeout more than nullifies a home run. Once again, it takes a 100% gain to offset a 50% loss.

When the analyst endorses a given company before his peers, a protocol we always follow, he is less likely to be met by a group of well-wishers than by a barrage of probing questions. No matter how good an idea may appear, it’s a rare occasion indeed where a devil’s advocate doesn’t appear. “Alexander’s question” is invariably posed: What shred of new evidence would be necessary for you to change your mind? However much we like a company we must force ourselves to be congenitally skeptical, always looking for disconfirming evidence. Occasionally the undersigned has even written dissenting opinions! (Remember, the only similarity between critics and creators is that both words start with the letter “c”!)

This system of checks and balances, which is devoid of acrimony, works because we all drink from the same well. A really bad idea may “well” vitiate it. We go so far as to formally invite the CEO of the company being considered to grade the quality of the draft of the analyst’s research report in terms of how well he has grasped the true nature of the business, including the width and depth of the moat that provides a

buffer against the onslaught of competitors in the endless battle for the customer's dollar. To be sure, we dig deep enough to discover that all companies have vulnerabilities. We are careful in our written research to enumerate those factors that could, under certain circumstances, diminish the attractiveness of the investment, which we then monitor closely thereafter.

Remaining unbiased and dispassionate throughout the process is often the greatest challenge we face in producing coldly rational business analyses. It requires tough mental discipline and ceaseless vigilance for an analyst, who is vulnerable to any number of biases that may compromise the impartiality of his research. Behavioral psychologists have identified a host of such biases that inhibit impartial judgment. Among the more common are the overconfidence bias, the availability bias, framing, anchoring, adjustment, and more, all of which are discussed in a Portfolio Managers' Perspective with the title "Judgment Calls" written by Dennis Blyly and published in April 2001 — available upon request. Our concentrated approach to portfolio management and heavy reliance on the use of filters reflect an understanding of the limitations of the human mind. We share in the belief that *intuition often can lead one astray in an environment of uncertainty*, frequently resulting in biased and irrational decision making. We keep a paper trail of all our earnings forecasts and recommendations and frequently review it to help us recalibrate our thinking.

Much of what constitutes our research process is the handiwork of Dennis Blyly, our director of research, ably assisted by Todd Martin and Drew Wilson. The role of the annual report writer is to articulate the process with reasonable coherence. You, dear reader, are the judge of the efficacy of that effort.

PORTFOLIO MANAGEMENT

Despite the obvious interdependence of research and portfolio management, the following will attempt to treat them as discrete decision-making systems. The process of portfolio management begins and ends with the preoccupation of assisting our clients in forming rational expectations regarding multiyear expected portfolio returns in light of their tolerance for risk as we jointly define it — and to factor into the equation full recognition of constraints and preferences unique to each client. The above is formalized in the personalized Investment Policy Statement, which then serves as our marching orders.

Within the discipline of portfolio management, we confess to being a “one-trick pony.” We adhere to certain management principles, on which we simply cannot compromise, that are present to a large degree in all portfolios.

EFFICIENT DIVERSIFICATION

First, and most conspicuously, we believe in and strenuously practice the seemingly counterintuitive “efficient diversification” (our term) model. Our practice runs counter to the “more is better” diversification mantra that is pervasive among the large universe of practitioners of Modern Portfolio Theory. We count ourselves as members of a small band of nonconformists, led by Warren Buffett, who resist the temptation to mindlessly imitate others. It was hypothesized earlier that intuition can be counterproductive to productive investment. As an example, despite an abundance of computerized back-testing evidence confirming that a portfolio of 12 to 15 solid but dissimilar companies affords 90-95% of all the protection that diversification is capable of providing,² the average mainline institutional portfolio often contains five to 20 times that number of companies. The best explanation we’ve found for why that practice persists in the face of such evidence is: “That’s the way we’ve always done it.”

The “less is more” school of thought, though it runs counter to accepted practices of portfolio management, stands up surprisingly well to rigorously independent scrutiny. For starters, most first-generation creators of wealth do so through investment in one company. Can you imagine any financial undertaking (pun, unfortunately, intended) that is inherently more speculative! Moreover, the owners often are integral to the management of the business. I hearken back to the overconfidence bias with tongue in cheek! Admittedly, there’s a “survivor’s” bias at play here that skews the inferences one might make from the above to the point of perhaps invalidating them. The strong, of which there are relatively few, persevere and frequently achieve fame and prominence, and the failures, far greater in number, are soon forgotten as they fade into oblivion. But there is still an object lesson to be learned here. Somewhere between the ownership of a single business and a portfolio of hundreds, there must be a quantity, in the abstract sense of the word, where diversification does not overwhelm opportunity on one hand and where concentration does not compromise safety on the other. In other words, where is the vital, dynamic balance? Let’s look at it

² Diversification assuages the impact, to the bad or to the good, of down or up off-the-charts price performance (which itself is ultimately tied to the underlying profitability of the business) of one or a few companies in a portfolio. While the following feature of expansive diversification is often overlooked, it is not designed to protect an investor against a general market meltdown (commonly known as “market risk”). In fact, as the last few years have made clear, to the tune of \$7 trillion, broad diversification virtually guarantees full participation in a pervasive bear market. Index funds, which replicate a popular capitalization-weighted index like the S&P 500 (the institutional rage of several years ago), have failed miserably in protecting wealth. Ironically, now that the market has fallen so dramatically, the case for indexing has begun to make much more sense. Broad diversification hedges the investor against one but not both of the risks. “Efficient diversification” offers the possibility of providing protection against both.

another way. Say you're able to make a long list of companies ranked from top to bottom in terms of perceived investment opportunity. Each time you move down the list to add the next best prospect (in the name of diversification) you incrementally reduce the overall potential of the portfolio. At some point — rather early in the exercise, we will argue — the law of diminishing returns, net of risk, comes into play.

As touched on in the last footnote, diversification is mistakenly thought of as the panacea for risk, when in fact its risk-modulating capability is limited to random or company-specific risk. The most dependable way to actually avoid “market risk,” the systemic curse against which diversification among equity securities provides no protection, is to invest your money in fixed-income securities (where there is also market risk if you commit to distant maturities and, of course, interest-rate risk if you stay short; so much for the free lunch!). Unfortunately, the expected returns — particularly if market risk is minimized — are in the low single digits. The circumstances under which we purchased the relatively small number of companies that comprise your portfolio is likely to mitigate market risk somewhat, particularly if you embrace the concepts postulated below. The market prices at the time of purchase were, with few exceptions, deep in each company's bear market territory, irrespective of the overall market's state of distress or exuberance, typically selling for 50% or more below their highs — but more importantly, well below what we thought the businesses were intrinsically worth.

SAFETY IN THE MARGIN

The final sentence in the preceding paragraph introduces the concept of “margin of safety”, the three most important words in the lexicon of “value”³ investing. Margin of safety is the second principle to which we, as portfolio managers, adhere to unflinchingly. Though the farmer in the northern climes sows months in advance of the harvest with the hope of reaping when the corn is fully developed and dry on the cob, rarely does everything happen according to the best-laid plans. While as noted above we are careful to minimize biases in our thinking or superficialities in our due diligence that might be the equivalent of planting seeds on barren ground, there's a multitude of possible external “slips 'twixt the cup and the lip.” We are not hothouse farmers, and the vagaries of the elements present daily challenges. The unexpected is always to be expected. The insistence on a margin of safety is the practical and precautionary acknowledgment of this reality. Its effect is to minimize the consequences of uncertainty for each portfolio.

INTRINSIC VALUE AND INEFFICIENT MARKETS

The next principle is a bit more abstract than the others and contains several interdependent add-on elements. In the first place, we believe that the intrinsic worth of an asset may be roughly derived through independent, rational, and educated analysis of all relevant internal and external variables. The degree of approximation is a function of the type and nature of the asset. At one extreme, it's a simple matter to assign

³ The need to differentiate investment management services results in structuring style into neat and tidy — and discrete — categories. “Growth” and “value” are universally marketed of as freestanding disciplines. Warren Buffett disagrees. “The two approaches are joined at the hip,” he says. “Growth is always a component in the calculation of value, constituting a variable whose importance can range from negligible to enormous and whose impact can be negative as well as positive.” Think only of the airline industry to see how growth can be destructive to value. The popular term “value investing” connotes the purchase of stocks at a low price-to-earnings, price-to-book or a high dividend yield. Even if those characteristics appear in common, there is no assurance that there is sufficient “value” to justify the price paid — the irrefutable and universal definition of value.

a precise value to a five-year Treasury note, if only one independent variable is known. At the other end of the spectrum, the range of possible values is almost impossible to limit or circumscribe for a not particularly well-capitalized high-tech company in a fiercely competitive segment characterized by a very short product development and obsolescence cycle. The marketplace is frequently efficient in pricing businesses; i.e., informed and levelheaded investors at the margin purchase and sell shares at prices that are reasonably reflective of the aforementioned intrinsic worth of the business.

Markets, however, aren't always efficient. In fact, as evidenced on a number of occasions in the last five years (most recently during the third quarter of this year when the Dow plummeted so far as to gain the ignominious distinction of being the worst quarter since the "crash" in the fourth quarter of 1987), prices and underlying values have diverged significantly for months at a time. This is an inferential but nonetheless rational conclusion based on the premise that the intrinsic worth of good businesses tends to be relatively stable in the short run. Market prices, exhibiting the excitability and occasional irrationality of investors who are sometimes observed as being highly emotional creatures (exacerbated by contagion), manifest a much less unperturbed temperament!

IS RISK A CONSTANT?

If you are with us so far, the logical extension of this line of reasoning runs headlong into one of the cherished tenets of Modern Portfolio Theory, the portfolio management style most widely taught at business schools around the country. The variable, of course, is risk, about which we have written extensively in the past and thus will but briefly touch on here. Under MPT, risk is a constant in the short term, with the degree of risk a function of the price volatility of the stock vis-à-vis the market. Out of respect for this widely practiced portfolio management discipline, MPT is uncompromisingly quantitative. Risk, therefore, must be reduced to a solitary number if it is to fit nicely into MPT's mathematical models; the technical term for that number is *beta*. We have no quantitative models, meaning our definition of risk can be both qualitative and prosaic: quite simply, the possibility of suffering loss.

In the preceding section we argued that the methodically derived intrinsic worth of a business was comparatively stable relative to the periodic fits of collective bipolar disorder exhibited by investors whose calculus used to price stocks at that moment is anything but orderly, rational, and systematic. Isn't it logical, therefore, to allow for the possibility that risk varies according to the relationship between market price and the underlying intrinsic value? In other words, when markets are going through a manic phase, and emotionally charged investors are pricing businesses well above what they're intrinsically worth, are investments in said shares not vulnerable to a greater possibility of suffering loss than when, often the same investors (later overcome with the remorse and concomitant despair that frequently follows impulsive purchases), give them away for chicken feed?

Finally, we conclude this section with a corollary. It seems perfectly obvious to us that if risk is variable, then expected return might be also. If that is the case, then the relationship between risk and return for the long-term investor must be none other than inverted: A price that implies a higher-than-average likelihood of loss cannot promise much on the order of positive returns and vice versa. Based on the above line of reasoning, we'll leave you with this thought: If you expect to achieve high investment returns, you must wait patiently for opportune times to commit capital when prices — and hence risks — are low. In many circles the contention that risk and return are not positively correlated is economic sacrilege. We'll leave it to you to decide.

DYNAMIC ASSET ALLOCATION

While we're out on a limb, let's take a quick look at the old saw known as "asset allocation." What is the rationale behind this smorgasbord approach to portfolio management? Is it an aggressive technique, with the consultant attempting to place money in all the hotspots while avoiding dead-money sinkholes? Or is it a defensive cover-your-posterior strategy, spreading your bets widely so that the productive will offset the unproductive, and the general rise (or fall) of the markets will be captured? How about the less imaginative domestic markets portfolio management practice of allocating a specified portion of assets to equities, with the remainder going to fixed-income securities? We would argue that this practice is based on at least one questionable assumption: that, irrespective of price, common stocks are intrinsically riskier than fixed-income securities. Once again we're verging on economic irreverence. Based on our simplistic definition of risk, we might well argue that a 30-year Treasury bond at today's yields may have as much market risk as the S&P 500 selling at 25 times earnings.

Since we limit our investment universe to domestic equity and fixed-income securities, for reasons explained in earlier reports, we view the process of allocating assets among the two primary classes as dynamic and not static. Money is thought to be fungible, constantly and methodically migrating toward individual assets that provide the highest expected return, net of equity risk premium required of common stocks (because of their aforementioned variable coupon and indeterminable maturity date and price).

Let's assume, rather imprecisely we must admit, that we would be indifferent to owning a given company or U.S. Treasury note if the company's five-year expected return were 400 basis points (4 percentage points) greater. What if the company's stock were priced so that, in our judgment, we are reasonably confident of a 15% total return compounded annually over five years — and the market yield on a five-year Treasury note is 3%. With an excess return of more than 10%, a generous margin of safety, however it's defined, we cannot think of a good reason why capital should not migrate. Rather than set arbitrary asset allocation limits ourselves, we take our cue from our own valuation work and the market's periodic flights of fancy or fits of depression, whether directed at individual companies or whole industries or markets. If we believe the markets to be occasionally inefficient, then there's a natural wealth-protecting/enhancing mechanism always at work. When prices are rich and expected returns correspondingly low, there will be a dearth of rational arguments in favor of owning equities, so (by default) money will systematically move toward the safe harbor of fixed-income securities. Conversely, under conditions, often but not necessarily bear markets, where certain businesses sell in the market for prices that offer high expected returns with a significant margin of safety, money will logically move in the opposite direction.

Obviously, as our actions would suggest over the last several years, this logic is equally valid within the same asset class! In fact, except in extremely expensive markets — and there are even exceptions to that rule as was apparent in the spring of 2000 — much of the upward movement toward higher expected returns will be within the equity class itself.

THINKING AND BEHAVING LIKE A BUSINESS OWNER

A third and more mundane principle again points out the interdependent relationship between research and portfolio management. Many of our clients (1) acquired their wealth as long-term owners of private businesses and (2) pay taxes at the maximum rate. Our typically very low rate of portfolio turnover matches well with our clients' long-cultivated perspective on investment. First, as long-term investors ourselves we derive our returns from growth in the underlying asset itself, not from short-term gyrations in its market price. This is precisely how the owner of a private business views his or her investment. Returning to the farm analogy, we aren't inclined to harvest until the corn has grown from seed to mature

crop. This takes time (in investment terms), often well beyond the 12 months necessary to turn gains into the long-term variety, those that are taxed at a most advantageous 20% rate.

CAPITALIZING ON THE INSECURITY OF SECURITY MARKETS

As noted in the Investment Performance section, most investors seem to be fixated on watching the daily price fluctuations of their portfolio holdings, with their spirits rising and falling in rhythm with the market's appraisal of their portfolio's worth. Although this approach is common in the extreme, we see the pattern as meeting a surfeit of emotional needs other than those conducive to rational portfolio management. Rather, always attempting to turn a disadvantage into an advantage as patient (some might say predatory) investors, we attempt to capitalize on *price volatility* in *liquid markets* (two of the few advantages of owning the shares of publicly traded businesses over nonmarketable private companies).

As noted above, what we believe to be unwarranted market despondency provides us with the opportunity to purchase our "margin of safety" insurance at a comparatively low premium. On the flip side of the coin, "irrational exuberance" often leads to holding-period returns that exceed the intrinsic growth rate of the underlying asset. Couple the two, and a portfolio manager, by virtue of his confidence in the analyst's (often one in the same) valuation of the business and his ability to go against the grain by "buying into unwarranted weakness" and "selling into preposterous strength," is in the position to add significant value to the portfolio. No investment axiom is easier to understand than "buy low, sell high," and none is harder to implement in the real world. The logic goes with the grain, and yet the decision to step up to the plate all by one's lonesome goes against it.

BRINGING IT ALL TOGETHER

The sequential discussions of research and portfolio management are an attempt to rationally and systematically define the means by which we accrete value as investment managers for our clients *and* to make clear both who we are and who we are not. Throughout you'll notice that trade-offs must be acknowledged and respected at every turn. In order to do what we must, we need to do without many product and service offerings that simply aren't relevant to our mission. By inviting you into our thought processes, you will be better equipped to determine whether our approach to investment is both intellectually coherent and compatible with yours. The beneficial side effect of such disclosures is to build a community of like-minded investors. We believe that investment management relationships formed on the precepts of honesty, openness, and full disclosure are the most productive, both economically and interpersonally.

INVESTMENT STRATEGY

Although this report is annual, the formidable task of formulating a rational investment strategy in a chaotic world is like warily tiptoeing back and forth along a gymnast's five-meter balance beam. Forces from all sides persistently threaten to knock you off your perch. They include:

- The ongoing nightmare, aggravated by fear of the unknown, of another surprise attack by fanatical terrorists.
- Possible war with Iraq that could explode into a regional or global conflict of unknowable proportions.
- A schizophrenic economy that seems to defy diagnosis (and therefore effective treatment).
- A global economic malaise that threatens to spread like a pandemic disease.
- A destructive bear market, savaging stock market wealth and leaving policymakers without precedent to anticipate its effect on consumer behavior.
- A dollar that has rested on its laurels far too long.
- A political environment that, at least in terms of a coherent macroeconomic policy, has yet to define itself.

The ledger of “macro maladies” continues to grow. Moreover, the prices of businesses, on average, still seem rich relative to the plethora of ambiguities, real and imagined — and respected investors, not the least of whom is Warren Buffett, have made broad-brush prognostications about the relatively anemic performances to be expected from the popular averages for some years to come.

Every business day we face the daunting task of enhancing the value of your capital without putting it in harm's way. In so doing, however, we are fortified by the simple wisdom of John Maynard Keynes: “It is better to be generally right than precisely wrong.”

DOW 36,000: NEW STRATEGY FOR PROFITING FROM COMING RISE IN STOCK MARKET

By way of backdrop, a sea change in a deeply ingrained perception about what constitutes investment is upon us. The profound catharsis, deleteriously reversing the treacherous and insidious transition from investment to speculation (and all the accoutrements that distinguished the capital markets and its various links to the economy during the '90s) is firmly under way.

To begin, let me set the scene in 1998-99. Following are a few symptomatic indications of the pervasive susceptibility and concomitant euphoria that led to the emergence of “irrational exuberance” in many popular industries, stealthily and progressively biasing the reasoning of the horde of investors who, “at the margin” (those actually doing the buying and selling and therefore setting prices), pushed prices higher and higher as the bull market of the '90s reached full flower, surging relentlessly toward its own demise. A crowd, as we have often written in the past, is amenable to suggestion, the simpler (and often the more preposterous) the better. What stage-whispered prompting could be more explicit, understandable, and forceful to a lay person than the one made by James K. Glassman and Kevin A. Hassett, co-authors of *Dow 36,000: the New Strategy for Profiting from the Coming Rise in the Stock Market* that hit the bookstands in September 1999, just months before the wild-eyed ride ended in stunning collapse. *Dow 40,000: Strategies for Profiting from the Greatest Bull Market in History*, hurriedly penned by money manager David Elias,

trumped the Glassman and Hasset effort, only to be overtrumped by Charles Kadlec, chief investment strategist for Seligman Advisors Inc., who wrote *Dow 100,000: the Fact or Fiction*.

The latter two expect their Dow targets to be met in 2016 and 2020, respectively, implying historically palatable compounded annual returns of 9% and 11.1%. The latter authors' analytical methodology is fairly standard, and Kadlec's writing, among the three books (and for whatever it's worth), is the most eloquent. On the other hand, Glassman, a *Washington Post* columnist, and Hasset, an economist and resident scholar at the American Enterprise Institute (AEI) where Glassman is also a fellow, must have roundly embarrassed AEI — and possibly herded gullible investors by the thousands to their financial slaughter — because of impossible forecasts supported by cockeyed reasoning. Straining investors' credulity to the limit, they foresaw the Dow reaching 36,000 in three to five years, implying ludicrous annual rates of return of 52% and 28%, respectively. Among other transgressions, they coined a new acronym (that perfectly symbolized the absurdity of the times): "PRP" — a "perfectly reasonable price." Find the three-letter word near the end of the second full paragraph on the following page that rhymes with PRP that conveys our feelings about its appropriateness. A case of the blind leading the blind along the edge of the cliff ...

As for the investment eggheads, a conference was conducted in Palm Beach, Florida, in December 2000 for the senior executives of investment advisory firms (where, because of some breakdown in the screening process, I found myself in attendance). One would be quite right in concluding that such an august gathering would insist on more substance than the so-called investor who gets his tips from CNBC's boundlessly blathering broadcasters. Among the featured presenters at the conference was the obligatorily upbeat Jeremy Siegel, professor of finance at the Wharton School of the University of Pennsylvania and author of the much ballyhooed book, *Stocks for the Long Term*. As you may recall, we took Siegel to task in the 1998 annual report for repackaging the generally sound concept that Edgar Lawrence Smith introduced in 1924, under the nearly identical title, *Common Stocks as Long-term Investments*, and (disregarding Keynes' admonition) for trumpeting the virtues of common stock investing *at precisely the wrong time*. This atrocity of timing was not unlike the Ford Foundation-funded, well-reasoned, and scholarly study persuasively endorsing the concept of "total return" investing, maladroitly rolled out on the eve of the 1973-74 bear market. While Siegel's demeanor was a little less ebullient because of the Nasdaq's eight-month plunge leading up to the conference, he remained the prancing Pollyanna that December in Florida.

As a postscript and with the benefit of hindsight, Siegel just didn't get it, as the table below reveals. Ironically, though, in the long run Siegel will be right, just as Edgar Lawrence Smith was. For many of his fans, however, the reality of greatly diminished wealth in the meantime is proving nettlesome if not downright troublesome.

	<u>12/29/00</u>	<u>10/9/02</u>
S&P 500	1,320.28	776.76
Dow Jones Industrials	10,786.85	7,286.27
Nasdaq Composite Index	2,470.52	1114.11

Such was the mindset of both the small and the mighty as we approached the precipice in the late winter of 2000. The signature mental attitude or disposition that predetermines a person's responses to and interpretations of any monumental speculative bubble is a compulsive preoccupation with a fixed idea. For the soon-to-be-humbled investment professional the polite word was "return," whereas for the untutored the bourgeois word "greed" was operative. Both manifested symptoms of restlessness and irritability. Conspicuous by its absence was any awareness of the storm cloud of mushrooming risk looming ever larger on the horizon. In reality a form of unabashed envy, the thought of being left behind as the freight train of

unimaginable riches pulled out of the station was more than many investors could stomach. Where it was going, or how it might get there, was of little importance. The fact that it was leaving the station was all that mattered.

Remember how CNBC, the continually televised “tout sheet,” whose commercial commission (ethical standards were generally suspended wherever a buck could be made) was to opine on whatever investors were craving to hear, came out of nowhere to remorselessly cater to such copycat speculating. Nature abhors a vacuum. (Parenthetically, the shrinkage in advertising revenues garnered by such telltale indicators of investor sentiment should be a reliable coincidental indicator.) The CNBC of today, its programming milieu exuding a reactive case of economic self-righteousness — always solicitous of the viewers’ mood — seems more contrite than it did two years ago and will likely, in this writer’s opinion, be a shadow of its former self five years hence. That having been said, CNBC, like a chainsaw, can be a useful tool in the right hands. Besides, I like CNBC Wall Street-bred analyst/commentator David Faber, an astute and vocal critic of corporate skullduggery, as well as author of a timely book, *The Faber Report*, which I found to be an excellent read.

THE RECKONING

As night follows day, a speculative binge, like a drunken spree, must come to an end — and for many of the same reasons. Overnight exhilaration gives way to disillusionment and despair. The investor who had asked, “How much *will* I make” now, with an anxious look in his eyes, nervously poses the question, “How much *can* I lose?” Risk replaces return as the operative word. Preservation of capital displaces enhancement of wealth as the prevailing objective. Focusing on our ever-aging population, according to surveys by the American Association of Retired Persons, a Washington advocacy group for people age 50 and older, the universe of affected investors is surprisingly large. The portion of people 55 to 64 invested in stocks climbed to 58% in 1998 from 28% in 1989. “Where you once had home value as the largest asset for many people, now it’s often stock value.” Among investors surveyed between the ages of 50 and 70, fully 77% said their holdings have dropped in the last two years, with 37% losing between 10% and 25%, and 25% losing between one-quarter and one-half. About one in five older Americans who lost money in the stock market during the past two years has postponed his retirement date, and 10% of those already retired are at work again because of stock market losses. Overall, two-thirds of older investors with losses, including those who haven’t retired at all, say they are making lifestyle adjustments — from budgeting more carefully (59%) to taking fewer vacations (34%) to postponing a major purchase (30%). And 43% worry that, in the future, they will be less comfortable in retirement than they previously had expected. One in five fears that he or she may have trouble paying for health care and prescription drugs. Whether it’s the AARP — or, perhaps more fittingly, the urp — generation or the Internet day trader, the relentless erosion in wealth is not a trifling matter and, as noted below, the full extent of its economic repercussions is yet to be known. Will Rogers’ famous dictum will once again be resurrected: “I’m more concerned about the return *of* my principal than the return *on* my principal.” This change in general psychology will occur as always, long after its relevance has peaked.

SOBER IN THE MORNING

And that last sentence, a natural segue, lays the groundwork for our strategy. Among Warren Buffett’s pithy sayings, the following is particularly apropos: “We are fearful when others are greedy, and greedy when others are fearful.” Having generally avoided the epidemic of excessive or uncontrolled speculative indulgence, we, unlike the hung-over party animal who is likely to upchuck at the mere offer of another drink, have a relatively clearheaded thirst for opportunity. Moreover, and equally important, in contrast to party surroundings where liquor flows freely, no one is shoving a drink in our hand every time we

turn around. We are liberated not only from libations but from the crowd's bothersome banter, freed from the urge to mindlessly imitate others, as we go about our business. If one is to have any hope of making headway in the emotional-roller-coaster world of investment, one must avoid distractions that will get in the way of keeping an even temperament, thereby truncating both the highs and the lows. Investment teetotalers that we are, there will be no "bellying up to the bar" on our watch.

BOTTOMS UP

Not to worry, the analogy of the prior paragraph stops there. The title of this section refers to our preoccupation with microeconomics (a focus on the firm) rather than macroeconomics (concentration on the system) as we attempt to rationally find our way through the maze that will lead us to durable investment success. Our first turn in the labyrinth — and one that separates us from much of the crowd — is that we spend the great portion of our time and energy studying businesses as opposed to the myriad forces that constitute the external environment in which those businesses operate. Admittedly, businesses do not function in a vacuum. It's just that we're inclined to stick with the knowable and avoid spending too much of our time speculating about what is unknowable. For example, we have absolutely no idea whether, when, where, or how another terrorist attack might be launched in America. No amount of rumination will add one percentage point to the probability that we can pinpoint such an event. Not to downplay the tragedy of 9-11, which affected us as it surely affected you ... but (for the most part) it was "business as usual" within days of the attack.

Every single business we own kept running as usual, right through the maelstrom. None, to our knowledge, ever considered closing up shop. Berkshire Hathaway, the only one affected in a meaningful way, took a \$2.5 billion hit (against a start-of-year equity capital base of \$61.7 billion) as the insurer of several of the assets that were destroyed and the workers' compensation claims that arose. The record shows that well-managed and well-capitalized businesses with durable competitive advantages, like the seaworthy ship mentioned earlier, survive — and often thrive vis-à-vis their weaker competition — in environments of manifold uncertainty. This kind of information is most valuable because it is in the realm of the knowable.

The "macro trap," because it is so generalized and nonspecific, helps to agitate our anxieties, which is precisely why we don't let it dominate our thinking. Various sectors of the economy were directly affected by 9-11, of course. Commercial airline travel was sharply curtailed in a knee-jerk reaction. Again, truly hoping not to appear callous in my attempt to be coolly analytical, the "rear-view mirror mentality" helped fly United Airlines right into bankruptcy court. Fears notwithstanding, in all likelihood the safest time in years to fly commercially was immediately after the attacks when vigilance at all levels was at its peak — and yet the airports were empty. More importantly, having expended the critical element of surprise in one venue, the terrorists would surely have chosen another if subsequent attacks were in the offing. But the public reaction was indicative of human nature in times of crisis. We "fight the last war" because our vision of the past is always clearer than our foggy notions of the future. That propensity is, as discussed above, at work in the capital markets today.

THE MARGIN-OF-SAFETY PARADOX

Not wanting to appear nonchalant, we must face up to some hard decisions in this possibly atypical but not unprecedented economic environment. Remaining rational and circumspect in the months if not years ahead will largely determine how well we fulfill our mission to our clients. Are we in a cyclical economic contraction from which we will soon emerge or something more insidious and protracted? A quote from Benjamin Graham is indelibly imprinted on my mind:

But the “new era” commencing in 1927 involved at bottom the abandonment of the analytical approach; and while emphasis was still seemingly placed on facts and figures, these were manipulated by a sort of pseudoanalysis to support the delusions of the period. The market collapse in October 1929 was no surprise to such analysts as had kept their heads, but the extent of the business collapse which later developed, with its devastating effects on established earning power, again threw their calculations out of gear. Hence the ultimate result was that serious analysis suffered a double discrediting: the first — prior to the crash — due to the persistence of imaginary values, and the second — after the crash — due to the disappearance of real values.⁴

Parallels with the malaise that has garroted Japan since 1989, not so much the means but the end, cannot be dismissed out of hand, even though we realize that the “availability bias” (the tendency to give disproportionate weight to more recent or readily available experiences or events) is at work here. Listening to Alan Greenspan’s words, as well as being very attentive to his inflections, we find it clear that he wonders and worries about whether he has inadvertently taken us to the economic precipice.

If “real values” disappear, how does an analyst get a handle on the intrinsic worth of a business if his “confidence interval” for that swing variable is a mile wide after allowing for the possibility, however unlikely, that “the extent of the business collapse which later developed, with its devastating effects on established earning power, again threw their calculations out of gear”? If the estimation of intrinsic value is deemed substantially unreliable, there is simply no way to determine the extent to which the current market price affords a margin of safety.

Countless technology and dot.com (Wall Street shorthand for the first of Mahatma Gandhi’s “Seven Deadly Sins: Wealth Without Work”) companies serve as vivid contemporary examples of the valuation conundrum that Ben Graham described 70 years ago. Even today, after stocks of many companies of that ilk have withered to less than 10% of their highs, we still cannot determine whether they are cheap or dear. But do not despair, for that example is of limited utility. Companies in those industries were just as difficult to value in the best of times. The dilemma was captured in a Christmas cartoon picturing a frustrated reindeer complaining to one of the elves: “We give away all our products. We don’t make a dime. I’m telling you, Santa runs this place like a dot.com.”

WAITING PATIENTLY FOR THOSE HANGING CURVES

We at Martin Capital are ever mindful that the size of our paycheck is in direct proportion to the amount of increase in your wealth above and beyond that pesky but ethically critical high-water-mark hurdle, which is also a convenient daily reminder that “in order to win, the first thing you must do is not lose.”

Returning to our much maligned baseball metaphor, as noted in the section on portfolio management, there is little to be gained — if the economic contraction proves to be persistent — by going after every pitch. It’s in your best interest, as well as ours (as we’ve often said), to wait patiently for the sweet pitch, refusing to swing at anything else. Thanks to the forbearance of our clients, in this game we’ll never lose our place at the plate by being forced to take a base on balls. How simple, you say. But we would beg to differ. Even if the game of baseball were scored this way, batters’ egos would soon take over, and they’d flail away. After all, the athlete who is paid to swing, “wood.” Steely self-control is the operative phrase in times like these. Patience is the order of the day. To be sure, if this contraction transcends the

⁴ Graham, Benjamin, & Dodd, David T. (1934), *Security Analysis*. New York, New York, and London, England: Whittlesey House, McGraw-Hill Book Company, Inc., pp. 31-32.

cyclical, it will be much more difficult to tell the slider from a fastball headed for our sweet spot. And yet it isn't impossible. There are many hard-to-read pitches — and a few juicy ones, the hanging curves, that leave the pitcher's hand destined for solid contact with the bat. Those are the ones we wait for. The many we can't clearly decipher we let pass without regret.

Returning to the task at hand, the economic environment forces us to narrow our focus to those companies that are easy to understand and *relatively* simple to value and whose competitive advantages, including a rock-solid capital structure and level-headed yet opportunistic corporate leadership, enhance their chances of coming out on top whenever the contraction ends and the next expansion begins, even if it's some years away.

LET'S GET MATHEMATICAL

“The value of any stock, bond, or business today is determined by the cash inflows and outflows — discounted at an appropriate interest rate — that can be expected to occur *during the remaining life of the asset*” [emphasis added]. That foundational one-size-fits-all investment maxim is older than Methuselah. Please note that this valuation model applies to all investments. The pricing of common stocks, of course, is less exact than bonds: Their “coupons” are variable, and there is no predetermined maturity date or price. Let's frame the challenge investors face in terms of the mathematics of finance, using the above present-value model. Several assumptions, however, must be made (prior to concluding with an obvious question). The assumptions are:

- An investment is made in a first-class company that has earned 15% on its unleveraged equity capital, approximating the long-term American industry average.
- Economic hard times exacted their toll, resulting in the company losing money for three years and causing its net worth to shrink by a third.
- The stock was purchased at 15 times earnings and subsequently falls by 50%.
- After the storm has passed, the company returns to its historical profitability ratios, and 10 years later the stock sells for 15 times earnings.

Now, the question: “What was the holding-period return during those turbulent times?” The answer, for which we will happily provide details for those who are interested: 7.9%. For the mathematically challenged, a simpler example would be if we assume that the economic hard times were such that the company earned a lower than historical average return on its unleveraged equity capital of 12% over the 13 years. If we argue that, at the end of the period, the stock again sells for 15 times earnings, the annual return rises to 12% (the same return as the underlying business earned on its equity capital). Regardless of the example, the investment return hinges on the earnings power of the business and the price the market is willing to pay for those earnings at the beginning and the end. If our ship is seaworthy, we can take each storm as it comes with equanimity, never losing sight of our destination.

Warren Buffett, after a long hiatus following the liquidation of his partnerships in 1965, came back in 1973-74 with a vengeance. He summarized his enthusiasm, rather impolitely we must admit, for the bargain-priced equities he was gobbling up. Said he: “I feel like a sex-starved man in a harem.” What few people know is that at the time the market reached its low point, Buffett's holdings were a full 50% underwater.

Sometimes percentages can distort an investor's perception of reality. The following is a theoretical example: Let's say a stock falls 50% in year one, from \$10 to \$5. (Let's assume intrinsic worth was able to be approximated and was constant over the three years at \$5.) The next year it declines another 50% to

\$2.50. Finally, after another 50% decline in the third year, it reaches \$1.25, a decline of 87.5% from its first-year high, similar (though not so orderly) to the Dow Jones Industrial average during the crash and subsequent bear market of 1929-32 or the Nasdaq's total reversal of fortunes from over 5000 in March 2000 to just over 1100 this past October, as indicated in the table above. Using the example to hypothetically and approximately index Buffett's experience, after avoiding the lion's share of the 1973-74 bloodbath, he missed what turned out to be the bottom by a mere \$1.25 and, undaunted by his paper losses, he kept making purchases.

How would you judge Buffett's overall perspicacity? First, and most important in this writer's judgment, his initial stroke of genius was in doing nothing when there was nothing to do — i.e., committing capital to the folly at \$10 ... *or \$12 or \$15 or whatever price at which the stock eventually peaked.* He just stood there flat-footed, with the bat on his shoulder, watching pitches whiz by. Admittedly, those times are rare when the pitcher is throwing you nothing but unhittable junk. Mind you, Mr. Buffett wasn't asleep, he was simply thinking instead of swinging. As important as that decision was, because no transaction took place, *it was never even recorded.* And yet it counted — avoiding impossible pitches or knucklehead pitchers plays a huge role in the pursuit of investment success. Likewise, his brilliance was not diminished whatsoever because he didn't pick the exact bottom. Those who unrealistically aspire to the impossible, a la Don Quixote, inevitably go away empty-handed. In fact, Buffett's genius was confirmed again when he persistently took advantage of the ever-widening gap between the market price and intrinsic value.

There is little doubt in my mind that, had the market continued to fall beyond its eventual 1974 lows of 62.28, for the S&P 500, Buffett would have stayed at the plate, with the same look on his face as the fisherman who stands beside a stocked pond. Each new low would undoubtedly represent opportunities to add some of his existing holdings at even more attractive prices, as well as to make initial purchases of new ones that appeared on his radar screen for the first time as their prices fell. *Although the percentage decline was identical three years running, its investment significance diminished with each successive year.* While we hope not to find ourselves in this position, if we do, count on us not to forget what we are here to do: namely, to honor our responsibility to you.

THE BOTTOM LINE FOR EQUITIES

There are purposes served by these two examples. First, remember the Keynesian quote in the third paragraph of this section. Like Buffett from 1965 to 1972 (and later in 1973-74), we believe we have been "generally right" about what brought us to this time and place, and we will conscientiously apply our best efforts to stay ahead of the curve as we look through the windshield and not at the rear-view mirror. In the abstract sense, if we are any more precise than Buffett in our timing, it will be more coincidental than intentional. The cost of obsessing on precision is to often miss the forest for the trees. Second, we will always try to look across the valley to the foothills beyond, to visualize our destination. At last we can say to long-chastised Jeremy Siegel, this may be your moment, the time to "stock" the bookshelves at Barnes & Noble with *Stocks for the Long Term*. Predictably, if none is to be found, it wouldn't be audacious to surmise that one would be "generally right" buying "stocks for the long term"! Sometimes your trust in the basic precepts of investing seems foolhardy, only to be proved prudent some years hence. As Blaise Pascal said in another context about the ever present dilemma with which the opportunistic investor must live: "Too much to deny and too little to be sure." Nobody shoots a gun to start this race.

As for the tangible, the mathematics of finance bridges the gap between conjecture and reality, putting meat on the bones of the theoretical skeletal framework. We know there is much uncertainty we must accept with a wary eye — and yet also with educated equanimity if we expect to earn acceptable returns from the asset class with the most productive history and, in all likelihood, the most productive "long term" future. Ultimately, the "bottom line" for equities must be the "bottoms up" orientation.

LAST BUT NOT LEAST: FIXED-INCOME SECURITIES

As for fixed-income securities, we will continue to treat them as the default class for the investor who authorizes us to commit as much of his or her capital to equities as are available at prices that imply tantalizing expected returns. For the investor who is less tolerant of price volatility, there will likely be a cap on the percentage of the portfolio that can be invested in equities. In the second instance (as in the first), we would be fully invested, within the defined limits, only if such action is justified on the grounds of prudence. For the investor who might specify that no more than 50% of his or her portfolio be committed to equities, under certain circumstances as much as 100% could be invested in fixed-income securities. Under the most unusual of circumstances — not encountered since this firm's inception — the same could be said for an account that is authorized to be fully invested in equities. (Parenthetically, in the early '80s this writer's portfolio was invested 100% in tax-exempt bonds, the lowest coupon of which was 14%; the tax rate was 50%). Accordingly, we take our investments in fixed-income securities very seriously. We always have been sticklers for the highest-quality fixed-income securities. In that regard, we're confident that no other investment manager in our market could measure up to our standards. While compromising on quality will almost certainly produce an incrementally higher current yield, bonds offer no growth in intrinsic-worth opportunities comparable to equity securities. A bond indenture makes two primary promises: to make generally fixed semiannual interest payments and to redeem the bond at par value on the maturity date. If there is no upside, it makes no sense to us whatsoever to expose our clients to risk on the downside.

Within our high-grade fixed-income portfolios we attempt to add value through "duration" management, i.e., we will own shorter-duration (industry jargon that quantifies the sensitivity of the bond's price to changes in interest rates) notes or bonds if we think Treasury note and bond interest rates are more likely to be heading up than down, which is what our admittedly cloudy crystal ball is telling us now. We also manage fixed-income securities in an effort to maximize tax efficiency. We constantly monitor taxable and tax-free yield differentials in order to steer our high-tax-bracket clients' portfolios toward maximum tax efficiency. In short, the choice between municipal bonds and U.S. Treasury bills, notes, or bonds is not as cut and dried as it appears.

FINAL THOUGHTS ...

Ideas are like hummingbirds. They flit into your field of vision from who knows where. They are one of nature's miniature wonders, so small that if you aren't attuned to their presence, you may well miss them.

In December I received a humdinger of an e-mail from a close friend whom I admire greatly. The communiqué was rich with affirming ideas. In it he included several quotations from the best-selling business book, *Good to Great*, by Jim Collins, who was introduced earlier in the report. I now pass on these nuggets to you with purposeful intent.

- “No matter what we achieve, if we don't spend the vast majority of our time with people we love and respect, we cannot possibly have a great life.”
- Another ... “The people we interviewed from the good-to-great companies clearly loved what they did, largely because they loved who they did it with.”
- Collins offers sage advice on staffing: “When in doubt, don't hire — keep looking. The right people will do the right things and deliver the best results they're capable of, regardless of the incentive system. In determining the right people, the good-to-great companies placed greater weight on character attributes than on specific educational background, practical skills, specialized knowledge, or work experience. Not that specific knowledge or skills are unimportant, but they viewed these traits as more teachable (or at least learnable), whereas they believed dimensions like character [and] work ethic [were] more ingrained.”

This friend, a rather introspective fellow, has provided continuing encouragement and direction as we have brought into the Martin Capital Management fold the essential and precious human building blocks for long-term success. By luck or design, or perhaps because Collins has been looking over our shoulder (who's to say?), I am having a “great life,” and I hope that all within our cadre share that view. Our MCM culture is one of empowerment, with decentralized authority and responsibility, and self-control replacing central control. Our office looks like a colony of ants (much better, don't you think, than the elf metaphor from last year?!), making it a study in efficiency, synergy, and community. Our vision is being fulfilled because of the people who are its incarnation.

Rather than single out individuals and their accomplishments this year, which I will surely do again next year, I've chosen to highlight the cooperative spirit and collaborative efforts that have become our corporate personality. It's an old saw, but it truly is all for one and one for all around Suite 302. We trust you notice this in the quality of the personal service we provide.

My friend closed his e-mail with the following: “It struck me as I read [Collins' book]: You are a truly blessed man to be able to work at something you love, with people you love.” I would only add that the love extends to those whom we serve as if they are family. For 15 years I have been expressing my heartfelt gratitude to those who have made my job a joy. I thought the feeling might fade, like a spring flower, in time. On the contrary, this feeling irrepressibly grows bigger and stronger, not unlike a tiny sapling, over time, becoming a mighty oak. Thanks to you ...

Frank K. Martin, CFA
Managing Partner

THE MARTIN CAPITAL MANAGEMENT TEAM

Frank K. Martin, CFA, Managing Partner

Frank has 35 years of investment industry experience. He founded McDonald Capital Management, Inc., in 1987, and the firm was reorganized as a partnership in 1991 and renamed Martin Capital Management. Frank graduated from Northwestern University in 1964 with a major in investment management and earned an MBA, with honors, including membership in *Beta Gamma Sigma*, the honor society of collegiate schools of business, from Indiana University at South Bend in 1978. From 1964 to 1966 he served as an officer in the U.S. Navy. He is a Chartered Financial Analyst. Frank has served on the board of directors of several manufacturing companies, as well as a variety of social service organizations. He is currently a member of the boards of the Elkhart General Hospital Foundation; Fourth Freedom Forum, Goshen; Sauder Stewardship Foundation, Inc., Archbold, Ohio; and the Frank and Marilyn Martin Family Foundation. He is founder and chairman of the board of **DREAMSWORK**, a mentoring and scholarship program for inner-city children. After publishing a biography of his father, William F. Martin, in 2000, he began preliminary work on a proposed book, *In Temporary Trust*.

Dennis D. Blyly, CFA, Partner

Dennis has 17 years of investment industry experience. He was an associate with Martin Capital Management and its predecessor firm for six years before being admitted to the partnership in 1994. Prior to joining Martin Capital, he was an investment officer for NBD Bancorp. Dennis graduated with honors from Grinnell College in Iowa with a major in economics and is a Chartered Financial Analyst. He earned an MBA, with honors, including membership in *Beta Gamma Sigma*, from Northwestern University's Kellogg School of Management. Dennis is currently a member of the boards of ADEC, Inc., Bristol; Hertzler Systems, Goshen; Pleasant Street Homes, LLC; and the Elkhart Chamber of Commerce.

Todd B. Martin, CFA, Partner

Todd has 14 years of investment industry experience. He has been with Martin Capital as an associate since 1993 and was admitted to the partnership in 1997. Prior to that time, he was an investment officer with First Chicago Corp. His undergraduate degree is in economics from DePauw University, Greencastle, Indiana. He earned the Chartered Financial Analyst designation in 1993 and graduated *magna cum laude*, with membership in *Beta Gamma Sigma*, from the MBA program at the University of Notre Dame in 1997, where he remains affiliated as a guest lecturer at the graduate business school. Todd is currently a member of the boards of Child Abuse Prevention Services (chairman); the Elkhart County United Way; the Frank and Marilyn Martin Family Foundation; and St. Joseph Capital Bank (chairman of the audit committee), Mishawaka.

Andrew P. Wilson, CFA

Prior to joining Martin Capital in 1995, Drew was an employee benefits consultant with Watson Wyatt Worldwide. Specializing in qualified retirement plans, Drew had clients who included several FORTUNE 500 companies. He graduated *magna cum laude*, with membership in *Beta Gamma Sigma*, from Loyola University, Chicago, where he majored in finance. Drew earned the CFA designation in 1998. He is currently a member of the Indiana University at South Bend School of Business and Economics Advisory Board. Drew began the top-ranked two-year Executive MBA Program at Northwestern University's Kellogg School of Management in the fall. Like Dennis and Todd before him, he is managing the multiple demands on his time with alacrity.

Joseph T. Iams, CPA

Joe, who joined Martin Capital in October 2001, had 18 years of experience as the chief financial officer of Universal Bearings, Inc., a bearing manufacturer serving the automotive industry. Before joining UBI in 1983, he practiced public accounting for six years with McGladrey & Pullen in South Bend, Indiana, and earned the CPA designation in 1982. His undergraduate degree is from Xavier University, Cincinnati, Ohio, where he majored in accounting. Joe graduated *cum laude* from the MBA program at the University of Notre Dame in 1997. He is a member of the American Institute of Certified Public Accountants and the Indiana CPA Society. Joe passed Level I of the CFA program in September 2002 and is preparing to sit for Level II in June 2003.

Aaron J. Kindig

Aaron joined MCM in December 2002 as a financial analyst. He earned a BS in accounting and business administration from Bluffton (Ohio) College in 1995. His honors include the Financial Executives Institute Award and Pi Delta Honor Society. He tutored accounting students for three years. After graduation he spent three years in the banking industry, followed by 4½ years in the investment services field. Aaron has passed Level I and II of the CFA program; he is preparing for the final of the three cumulative exams in June 2003.

Charles R. Kirk

Charlie's one year of retirement was the shortest on record at MCM. It appears he missed us as much as we missed him. While his contribution is much more valuable than the hours would suggest, it is both part-time and seasonal (don't ask for him during bird-hunting season!). Charlie has 28 years of experience in plastics manufacturing. He was employed by Industrial Plastics Corp., an Elkhart-based profile extrusion company, for 18 years, the last 10 of which he served as president. For the next four years he worked for operating units of Trinova Corp., IPC's acquirer, as general manager of the IPC division and as group vice president. From 1993 to 1995 he was president of Elkhart Plastics, Inc., a custom rotational molder. Charlie received a BA in 1963 and an MA in 1964, both from the University of Akron. In 1968 he received his PhD from Temple University. He serves on the advisory board of Sensant Corp., San Jose, California.

Ann T. Frantz, CPA

Ann began her career in public accounting with Crowe Chizek, Elkhart, in 1983. Prior to becoming Martin Capital's Operations Manager in August 1999, she was the benefits manager for Crown International, Inc., Elkhart. Ann graduated in 1982 from Indiana University at South Bend with a BS in business and earned the CPA designation in 1986. She is a member of the Indiana CPA Society.

Kristin Antalavits

Kristin was recruited by Martin Capital in January 2000 as a portfolio manager's assistant and securities trader. She majored in accounting at Simpson College, Indianola, Iowa, where she earned her BA in 1990. Before joining the firm, she was employed by Northern Trust Bank, Chicago, as a senior representative in the investment managers liaison group.

Karen M. Sherer

Karen has more than 20 years of experience in the financial services industry. Before joining Martin Capital in June 2001, she was employed by Compass Financial Advisors as a registered representative. Karen also was employed for 16 years with Bank One where she held various positions. She worked in the trust department for 10 years; in 1996 she was promoted to trust administrator, then to trust officer in 1998. Karen earned her BS in organizational management from Goshen College in 1995.

June Bails

June, who joined MCM in August 2002, has worked in the financial services industry for the last seven years. Most recently she was employed as a case analyst by the Todd Organization, which specializes in executive benefits and non-qualified retirement plans. She was a registered representative and office manager at Compass Financial Advisors for five years. June is currently enrolled at Bethel College in Mishawaka pursuing an associate's degree in professional writing.

Stephanie Malcom

Stephanie joined Martin Capital in November 2000 as an executive assistant. She graduated from Elkhart Memorial High School and has attended various seminars on office management. Stephanie came to the firm from Elkhart-based Energy Management Systems.

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