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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 109 clients whose combined assets total approximately \$586 million. From its beginnings as a one-man, one-assistant operation, with less than \$25 million in assets, Martin Capital is now headquarters for 13 people, including six investment professionals and seven 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, we feel we must keep our roster of clients small in order to maximize the time we spend on research.

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 more information. You can also visit us at www.mcmadvisors.com.

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* Effective January 1, 2007

Martin Capital Management, LLP

PRIVACY NOTICE

Martin Capital Management, LLP (“MCM”) recognizes and respects the privacy expectations of its clients. MCM considers clients’ data to be private and confidential—and holds itself to the highest standards of trust and fiduciary duty in their safekeeping and use. MCM has not sold and will not sell personal information to anyone.

MCM collects nonpublic personal information about clients from the following sources:

- *Account Applications and Other Forms*, which may include a client’s name, address, telephone number, Social Security number, and information about a client’s investment goals and risk tolerance.
- *A Client’s Professional Advisors, such as consultants, attorneys, and accountants*, who may provide financial, investment history, and tax information about a client.
- *Account History*, including information about the transactions MCM has ordered and balances in various accounts.
- *Correspondence*—written, electronic or telephonic—between a client and MCM or a client’s broker or custodian and MCM.

MCM will not release client account information to any third party unless one of the following conditions is met:

- MCM receives prior client consent.
- MCM believes the recipient to be the client or the client’s authorized representative, including the client’s attorney or accountant.
- The recipient is a broker, custodian, or other service provider with whom MCM must share information in order to manage or service a client’s accounts properly.
- MCM is permitted or required by law to release the information to the recipient.

MCM will only use information about a client and a client’s account(s) to:

- Help MCM better serve the client’s investment and financial needs.
- Suggest services or other materials that may be of interest to the client.

- Fulfill our regulatory obligations.
- Administer MCM's business.

MCM maintains physical, electronic, and procedural safeguards that comply with federal standards to guard the privacy of clients' nonpublic personal information.

MCM applies the policies and practices described in this notice to both current and former clients.

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 CFA Institute 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

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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 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.

EXECUTIVE SUMMARY

Introduction

The keynote theme for the 2006 MCM annual report is found embedded in a quote from Charlie Munger on page 15. To paraphrase, Munger advises that one should continuously search and wait for conspicuous, logical, and simple investment opportunities that will be recognizable as such. They will be few and far between, but if one bets heavily when the odds are highly favorable, “using resources available as a result of prudence and patience in the past,” one’s lifetime investment results will be improved dramatically. As productive as this seemingly slow-motion, yet cerebrally active, style has been, it remains almost unknown, largely because most people make little effort to cultivate their intellectual independence, instead taking the path of least resistance in following the conformist crowd.

Moreover, misaligned incentive systems for the sellers of intangible services often put them in direct conflict with the interests of their customers or clients. “Incentive-caused bias” frequently leads to unethical or even illegal activity on the part of the sellers who rationalize their aberrant behavior through a self-delusional psychological process to avoid “cognitive dissonance.” The record-breaking \$36 billion in “carrots” (which could buy a lot of karats) paid to the employees of the five largest investment houses in 2006 should give an investor pause regarding the ends to which the sales personnel, traders, and investment bankers might go for such a king’s ransom.

Additionally, the physical separation of ownership (the principals) and management (their agents) in most American corporations has understandably given rise to reduced accountability and increasingly egregious abuses by the agents of their often unchecked powers. Stock-option abuses, obscene compensation packages, and the usurpation of power are among the crimes and misdemeanors. Emmis Communications Corp. is cited as an example.

Investment Performance

While MCM’s average compounded annual 10-year equity investment performance of 12.4%, after fees, exceeded the Standard & Poor’s 500 by a full 400 basis points, of more immediate interest is that we trailed the S&P for the last three years, 10.4% vs. 3.1%. The underperformance is attributable primarily to “thumb sucking” when we should’ve been acting on three anemic holdings. And for some

accounts the drag of expenses associated with hedging the risk of catastrophic loss negatively impacted overall portfolio results. There is nothing we can do about reducing the cost of insuring selected equity portfolios, since the premiums we are paying are the lowest in years. However, the relative underperformance of our equities compared with the benchmark has been a call to arms. While our investment management process is still highly efficient, we always strive for perfection. After demonstrating the strength of our independent convictions and capacity to find Main Street bargains in the savaging, technology-driven, two-year bear market, 2000–02, when our equities appreciated 59% while the S&P 500 fell 20% and the Nasdaq plunged an astounding 80%, we may have become victims of our own success. To be sure, that was yesterday. In this profession any significant pause to rest on one’s laurels can soon lead to the startling realization that laurels can be downright prickly to the posterior! While we expect you’ll presently see the positive effects of the rigorous examination of our less than masterful misjudgments, perhaps of more immediate import is that we have embarked (reminiscent of 1999) on an investment strategy so uncommon that few investment managers are thinking about it, let alone taking action. Our “contrarian” strategy stems in part from our comparatively unique role as a “wealth manager” for individuals, whereas most of our peers are specialized, one-dimensional horses in a stable of managers. Our mandate is to keep our clients wealthy in absolute terms; the mandate of our peers is to beat their designated benchmark index, meaning they would consider it a good year if they were down 20% and the index were down 25%. Imagine how good you would feel after two consecutive years of such “positive” relative performance ... Enough of such “positive” negative relative returns and you end up in the soup lines! Feeling much as I did in 1998–99, although for entirely different reasons as explained throughout the report, we are preparing for an opportunity set somewhere in the ideally not-too-distant future that will be far more appealing than the dearth of rationally priced opportunities we’re seeing today. [Yes, this report is once again written in the first-person singular by MCM’s senior partner with the concurrence of the managing partner and other partners.] After reaching 70% of our assets in December 2004, capital committed to equities has declined to less than 33% recently. In addition, we have attempted to partially hedge the equities that remain through the use of long-dated LEAPS (Long-term Equity Anticipation Security) options. We believe that we do understand what it takes to earn above-average, long-term returns and why the vast majority of advisors fail to

do so. You may wish to reread the first paragraph in this Executive Summary.

The Equity Risk Premium: Passé?

“This is the reason that history has not dealt kindly with the aftermath of protracted periods of low-risk premiums,” Alan Greenspan warned repeatedly. This eight-page section of the report defines equity risk premiums and provides copious evidence that they are, and have been, at dangerously low levels across the board. While we certainly cannot pinpoint when, we are confident enough to act aggressively in preparing to capitalize on the agonizing for some, opportunistic for others, “aftermath of protracted periods of low-risk premiums.” One of the surest ways for an investor to avoid serious losses—or to capitalize on “shooting fish in a barrel” opportunities—is to have a clear understanding of the degree to which investors are at any given time willing to embrace risk in the pursuit of gain. When investors show reckless disregard for the consequences of risky ventures, run for the hills. When they’re terrified of “risky” investments, misperceived as a result of the losses they have suffered, jump in with both feet. This essay is a must-read for the investor who isn’t interested in the details but is looking for a simple and powerful truism (or two) on which to hang one’s hat.

Rationality

Rationality, according to Warren Buffett, is the most important single word in the investor’s lexicon. Its frequent absence goes a long way in explaining why smart people do dumb things. Despite the importance of rationality and its inverse corollary, irrationality, most investors aren’t particularly well aware of the forces behind irrational behavior that often lead to ruinous results. Accordingly, we devote 15 pages to the subject. We begin by turning to Machiavelli and others to build a case for the practical relevance of the asymmetrical but nonetheless recurring cycles of financial history. For of what good is rationality if history is nothing more than a series of random events? Underlying the importance of rationality has been the relatively recent reintroduction of behavioral psychology to explain why economies and investors act in ways that often do not appear rational. Interestingly, classical economics, its origins dating back to the late 1700s and Adam Smith’s *The Wealth of Nations*, acknowledges the importance of the moral sentiments of the manufacturers and the merchandisers. Neoclassical theory is far more quantitative, thanks to 20th- and 21st-century advances in data-processing technology. Despite

the renaissance of classical economics (behavioral economics as it is now called), many venues, particularly academia, preach modern portfolio theory (MPT) dogma, which has as one of its basic (twofold) tenets that investors are rational beings and the markets are, therefore, efficient.

We believe that the impediments to rationality are a host of biases, both conscious and subconscious, as well as the emotions of envy and fear, which we define and discuss at length. Presently, envy is in full bloom. Fear, the provocateur of the most irrational of behaviors, has been dormant but could arise from its slumbers virtually overnight.

From there we move to the way we assimilate information and ideas—and the respective roles that the left and right hemispheres of the brain play in different thought processes. Right-brainers process information holistically unlike left-brainers, who are more logical and sequential. In the world of investments we reap in an always uncertain tomorrow what we sow today. How we envision the future is greatly influenced by how we process information. Intuition, predominantly a right-brain attribute, is gaining more credence for its application under conditions where the outcomes are uncertain. Several prominent authors have sought to integrate intuition with reason to achieve optimal rational outcomes, particularly in solving complex multidisciplinary problems. This is quite a stretch for the mechanistic thinkers who have difficulty connecting the left- and right-brain characteristics.

The Perfect Storm Redux

On the heels of last year's Perfect Storm? essay, we revisit the subject with a vengeance this year. After 36 pages of discourse, it should be clear that we still don't take this threat lightly. We begin by flashing back, with the help of three world-famous intellectuals and practitioners, who are also friends, to the equity risk premium nemesis, which reminds investors of the importance of focusing on risk before they think about return. We then review what we thought possible a year ago and what actually came to pass, particularly with regard to the housing Bubble.

This year we introduce economist Hyman Minsky, the profession's watered-down equivalent of Sir Isaac Newton, and his revolutionary ideas about the interconnectedness of the financial and economic systems—and the notion that they are in a constant state of flux. These are the same ideas proposed by Marc Faber in his "financial" vs. "real" economy exposition about which we've written

over the last several years. Minsky's cause-and-effect perspective is as intriguing as it is provocative, particularly his analysis of the Great Depression, which is, in this writer's opinion, more plausible than that of John Kenneth Galbraith in his popular book *The Great Depression*. More than 12 pages are dedicated to the work of friend Doug Noland and his scholarly dissertation on the escalating disarray in the worldwide financial system. His well-articulated concerns about the global credit glut, banking, the dollar, and derivatives, among other threats to stability, should not be swept under the carpet. Warren Buffett is quoted from the nine-month-old Berkshire Hathaway 2005 annual report on the threat that derivatives pose to both the financial system and the economy. After pointing out the awful fix in which Federal Reserve Chairman Ben Bernanke presently finds himself, we wrap up the essay by updating two ratios to which we referred in the last two annual reports: the total market cap to gross domestic product and the total debt-to-GDP ratios. These ratios serve as simple approximations of where we think we are in the grand secular (which, in economic parlance, refers to long-term rather than non-religious) cycles. The total market-cap-to-GDP ratio is approximately 145%, compared to a 70-year historical range (ending in 1995) of 30–80%, with an average of 60%. Since 1995 the ratio has gone through the roof. Likewise, the total debt-to-GDP ratio, after hitting 270% in the depths of the Depression, repented for nearly 50 years in the range of 120% to 140%. Memories of the great travails having faded, along with a new crop of risk-hungry speculators for whom the study of financial history is not germane to the pursuit of (for lack of a more discreet word) money and all that it represents, coupled with a gradual decline in interest rates from the early 1980s, resulted in this leverage ratio hitting a record 330% of GDP in 2006. This may be heralded as a new era, but then the lessons from the ages teach us unequivocally that there are no new eras in finance, only new iterations of old errors.

Before you become too sanguine about the way things are and overconfident about any assumptions you may entertain as to why they will always be this way, carefully read the following from George Eliot's tragic story *Silas Marner*.

The sense of security more frequently springs from habit than from conviction, and for this reason it often subsists [endures] after such a change in the conditions as might have been expected to suggest alarm. The lapse of time during which a given event has not happened is, in this logic of habit, constantly alleged as a reason why the event should never happen, even when

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the lapse of time is precisely the added condition
which makes the event imminent.

A Tale of Two Americas Rethought

In this 20-page section we attempt to determine where the finger of blame might be pointed during a time, at some unspecified point in the future, of great economic distress—an eventuality we deem possible but have no idea as to its probability. The scapegoat will not, we believe, be those who occupy the top-income quintile in the U.S. Census Bureau’s study of income differentials in this country. It is not the overstated inequity between the top and bottom income quintiles, to which we attend in detail, that will draw the wrath of the masses. Rather, it is the super-rich, the titans of Wall Street and the corporate chieftains with compensation packages 400 times greater than those of the workers on the factory floor at whom public anger will be coalesced and directed. If you think the social safety nets rigged in the 1930s will protect the public from the reckless shenanigans of those in high places, this essay is a must-read. It closes with excerpts from a speech given more than 75 years ago in a time of overwhelming national crisis. It is not outside the realm of possibility that words such as these could well be heard again in the not-too-distant future.

INTRODUCTION

The 2005 annual report concluded with the following precept, and it seems proper and fitting to begin the 2006 report with the same three power-packed, one-sentence vignettes from a very wise and wealthy octogenarian:

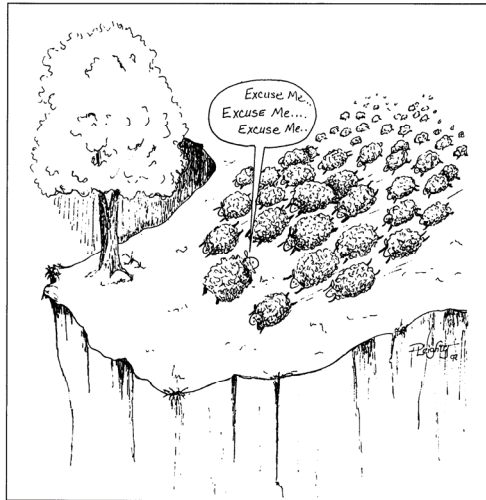
Our experience tends to confirm a long-held notion that *being prepared*, on a *few occasions in a lifetime*, to *act promptly in scale*, and doing some *simple and logical thing*, will often dramatically improve the financial results of that lifetime.

A *few* major opportunities, *clearly recognizable as such*, will usually come to one who *continuously searches and waits*, with a *curious mind that loves diagnoses involving multiple variables*.

And then all that is required is a willingness to *bet heavily when the odds are extremely favorable*, using resources available as a result of *prudence and patience in the past* [italics added].

—Charlie Munger

Please don't kill the messenger, but I believe that if ever there was a time for resolute independence of thought and the companion virtue



of patience, as Warren Buffett's brilliant alter ego teaches us above, that time is now. It is often our human nature that stands stubbornly between our impulses and our own best interests. Immersed in the minutiae of the moment, we often lose sight of the big picture and make decisions that are seemingly beneficial in the short run but potentially disastrous in

the long. Reflecting on the role of prejudice—or preconceived, unexamined biases—in human thought, Einstein argued: "*Few* [italics

added] people are capable of expressing with equanimity opinions which differ from the prejudices of their social environment. *Most* [italics added] people are even incapable of forming such opinions.” For long-term readers of MCM missives, Einstein’s words may call to mind another quotation, this from Ernest Dimnet’s *The Art of Thinking* that was included on page 177 in *Speculative Contagion*: “Nothing is more striking than the absence of intellectual independence in most human beings: they conform in opinion, as they do in manners, and are perfectly content with repeating formulas.”

What follows in the pages ahead is an expedition into the dense forest of what many in the financial establishment might consider unconventional thought but which, in fact, represents my best attempt at an unprejudiced, unbiased assessment of the terrain of contemporary finance. In seeking logical completeness, it is likely that I will test the patience of many, if not most, readers with the inclusion of myriad details and seemingly arcane discussions of financial folderol. Accordingly, an Executive Summary is provided at the outset for those who long for the equivalent of a 1040EZ tax return. ☺

“Get the incentives right.” Throughout this report evidence abounds that Charlie Munger’s simple but powerful admonition has been silenced by the deafening roar of the hordes in their run for the riches. Misaligned incentives are among the root causes of the charade that is characterized as a “risk-taking culture,” the deceptive self-characterization of one of the leading investment brokerages, as you will read below. Rest assured, it’s not the brokerage that’s taking the financial risk. Those folks are experts in the game of “hot potato.” Turning to his beloved Ben Franklin, Munger observes that to persuade one must appeal to another’s interests and not merely his reason alone. We witness time and again what Munger calls the “incentive-caused bias.” An otherwise civilized and upright person, if driven by incentives, both conscious and subconscious, that do not have well-crafted safeguards against “cognitive drift,” will often slip into unethical, immoral, or even illegal behavior in order to achieve the objectives to which these incentives are directed, employing a rationalizing process to which I often refer: “cognitive dissonance.” Since the resulting behaviors are, at the very least, an irritation to the refined conscience ... in order to avoid the psychological conflict that ensues, individuals often change their perception of reality.

Let’s turn briefly to the canons (or canyons) of Wall Street—and the seat of much more power than most citizens realize—for a brief example of how incentives have the potential to create potentially dangerous biases. Five days before the yuletide celebration Goldman Sachs Group Inc. bestowed its high-spirited largesse on Lloyd

Blankfein, CEO since only midway through the year, when his predecessor, Henry Paulson,¹ took the post of U.S. Secretary of the Treasury. While the promo picture that accompanied the *Wall Street Journal* article was likely pulled from a dated file, Blankfein's self-assured smile seemed oddly out of place. A more reflective person might wear a somewhat different expression when contemplating (is it naïve to assume that these fellows ever ruminate, or is the track through life so programmed on fast-forward that there is simply no pause button on their time machine?) whether he is intrinsically worth his pay package when compared with the back-office drones at Goldman who individually toil for one-tenth of 1% of his pay. Blankfein's \$54 million pay package took top-dog honors, easily besting John Mack at Morgan Stanley, who had returned to the job for a full year for his comparatively paltry \$41 mill. Not wanting to look like a piker, Merrill Lynch trumped in shortly thereafter with \$48

¹ Why, one must ask, did Henry Paulson get off the road to riches at Goldman in order to take the post earlier held by Robert Rubin, another Goldman Sacks chairman? After all, he did little to dissuade President Bush from pursuing what may someday be considered counterproductive economic policies during his tenure at Goldman. Ben Stein, a man of diverse curiosities and a skeptical bent whose wit and wisdom I have enjoyed over the years, questioned the motives of Mr. Paulson as the Treasury secretary gave his blessings to an "unofficial" Committee on Capital Markets Regulation. The committee's mission is to study "whether securities regulation and litigation that actually protect shareholders are harming American 'competitiveness,' which Mr. Paulson has said is an important issue for him." The blue-ribbon committee includes the heads of big financial and accounting firms, as well as manufacturers. Among those present, at least in name, was John L. Thornton, chairman of the Brookings Institution and, yes, former president of Goldman Sachs. "There it is again, the real government of United States," laments Stein. The henhouse is being redesigned by the foxes.

Meanwhile, as this group of conflicted insiders discusses the fate of the chickens, corporate frauds continue unabated. Backdating stock options is nothing less than insider trading on a grand scale, according to lawyer Stein. Going-private transactions proliferate, a form of stupendous looting where management buys assets from shareholders at below-market prices and becomes rich in the process. "Corporate executives," Stein notes, "are paid on a scale that would make a bank robber blush ... The nabobs of American industry, being terribly rich with someone else's money, feel justly excused from having to say they're sorry or even to except responsibility under the law. Exercising the ultimate power, if the laws say you are responsible, for heaven's sake, change them," Stein sardonically observes. How can this happen, you might ask? See Proverbs 16:2 for both proximate cause and consequence.

million for its top gun. Wall Street is an inbred, self-perpetuating fantasyland where massaging humongous egos and petty jealousies takes plenty of baby oil. Parenthetically, you can read more about envy in the section titled Rationality and about executive compensation in A Tale of Two Americas Rethought. The pay packages on Wall Street are up 40%, or more, over 2005, reflecting the fourth year of rising markets and the boom in private-equity buyouts and hedge-fund trading. As for his credentials, Mr. Blankfein, 52, a former tax lawyer and gold salesman who rose to become head of the firm's fixed-income, currency, and commodities division in 1998, "epitomizes Goldman's risk-taking culture." Need one look further for evidence, albeit anecdotal, of an incentive system that has gone so frighteningly awry that it may even be weakening the foundations of our economic system, established centuries ago by such economic architects as Adam Smith?

Agency costs or, as I would dub it, agency abuse, is rampant in American business, as well as elsewhere in our society. Cockeyed shareholder-exploiting incentive systems proliferate in such arenas as public accounting, investment banking, mutual funds, hedge funds, private equity, mortgage lending, and derivatives trading. Please note that the preceding list is partial; it could go on and on. The love of money and power has become the root of much evil.² An example, much closer to home, with which most readers are familiar, is the system of incentives and the structure of governance at Emmis Communications Corp., an abomination that would give Adam Smith apoplexy were he alive today.

Money, of course, is not intrinsically bad. As Charlie Munger points out, it is a powerful and effective incentive that, on balance, has been a "mainspring for modern civilization." Its effectiveness, he suggests, can be traced to its ability to appeal to a primal human trait,

² While no incentive system is perfect, we believe ours at MCM is as close to that ideal as we know how to make it. The alignment between the implicit financial goals of our clients and the rewards (or lack thereof) of each partner, associate, and employee is both immediate and proportional. We are rewarded, at a fraction of prevailing fees, for high absolute returns and are penalized, rather severely because of our high-water mark, if our absolute returns are significantly negative. The system was easy to design. I simply asked the question "What kind of fee arrangement would I prefer if I were the client?" as someday my estate will be. We make every effort to live up to the praise received from Warren Buffett on the book jacket of *Speculative Contagion*: "For many years I've enjoyed reading Frank Martin's letters. This collection contains much investment wisdom and, just as important, sets a standard for the advisor-client relationship."

acquisitiveness, by allowing economic power to become more mobile and fungible.

Of course, money is now the main reward that drives habits. A monkey can be trained to seek and work for an intrinsically worthless token, as if it were a banana, if the token is routinely exchangeable for a banana. So it is also with humans working for money—only more so, because human money is exchangeable for many desired things in addition to food, and one ordinarily gains status from either holding or spending it. Moreover, a rich person will often, through habit, work or connive energetically for more money long after he has almost no need for more.

The problem arises when money and/or the blind pursuit of power become the sole incentives, displacing the moral and spiritual rewards one receives from a life of ethical behavior toward fellow humans. Such pursuits also overpower the sway of negative incentives—that is, the punishments that laws prescribe for various misdeeds. The transformation of money from a means of ethical exchange into an instrument for the self-aggrandizing accumulation of power, influence, and control puts the integrity of our entire economic system at risk.

This is what I believe has occurred at Emmis Communications: CEO Smulyan has conferred upon himself, admittedly under the very noses of the all-too-trusting shareholders who purchased the IPO in 1994, uncontested dictatorial powers. Long accustomed to the role of monarch, only made possible by his super voting majority Class B shares, Smulyan has perfected the delusion of “cognitive dissonance” to the point of actually believing that a 13.7% economic interest in the company gives him absolute control over its destiny. Meanwhile, his chosen handmaiden and manservants, the board of directors, sit by passively, collecting their directors’ (and other) fees, rationalizing their ethical lethargy on the grounds that “this is the way it’s always been.” In another venue, as noted later in this section, the rush to contrition for predating stock options, an illegal activity, resulted in an initial round of an astounding 100 corporate confessions. In that instance the common excuse was “everyone else was doing it.” The Emmis board members have apparently defaulted to the idiom “let sleeping dogs lie,” as they are neither under legal imperative nor beholden to widespread public “hue and cry” to exert any effort to lift their “fat prats” (as my mother used to say) from their comfy directors’ armchairs or to disengage from the prattle that must constitute much

boardroom discourse, such as it is. Unlike the hapless shareholders, who, for all intents and purposes, have no vote to effect change and whose only exit option is to sell their shares at a discounted price that reflects the “Smulyan markdown,” directors are not so encumbered. They are free to vote with their feet. Of course, that requires a measure of moral indignation that, as noted at the end of the following footnote, seems sadly lacking among the board members at Emmis.³

Admittedly, this is a somber note on which to ring in the MCM 2006 annual report. We’ve felt called upon to tell it like it is, not like we myopically wish it might be. Perhaps by so doing, we will at least be a faint voice in the wind crying out for change from within before change from without threatens the very sanctity of the system that has served the economic welfare of people of our nation so well over its comparatively young life.

Let me close this introduction with a few heartfelt “thank yous.” Kristen Smith, my most able assistant, applies her considerable skills to the annual report project with aplomb. Without her help you would likely receive this epistle about the time the mums bloom in the fall. Frank Hess, Ph.D., brought his exceptional mastery of the language and vast knowledge of history, coupled with a prodigious intellect, to play (as a newcomer to the world of finance) the role of editor/devil’s advocate during the writing. Dan Shenk, proprietor of CopyProof, is the consummate wordsmith who has not only improved the literary quality of this report for years but has made the final proofing experience most enjoyable for me. Aaron Kindig and Tom Dugan, as they have in the past, provided invaluable research

³ For those not familiar with this travesty of agent/principal justice, please visit our website (www.mcmadvisors.com). By way of brief introduction, the agent/principal dilemma, dating back to English common law, arose out of the delineation of power and authority between absentee ownership and management. The agent’s primary fiduciary duty is to be loyal to the principal. The agent is obligated to not breach the duty of loyalty to the principal should a conflict of interest arise nor should the agent make a private profit or unjustly enrich himself at the expense of the principal. As will be apparent in the section *The Perfect Storm Redux*, much power in corporate America has shifted from the principal to the agent, giving license to the distorted system of incentives from which much corporate malfeasance has arisen.

As for the manifold fiduciary transgressions at Emmis, in addition to the millions of dollars at stake for our clients, like Ben Stein, I simply could not have lived with myself had I remained silent in the face of such a miscarriage of justice. No less a man than Abraham Lincoln said, “To sin by silence when they should protest makes cowards of men.”

assistance. Finally, Todd, Dennis, and Drew made time to read the manuscript and offered their usual keen insights. Others, too many to name, also opined constructively on the document. I thank them all.

INVESTMENT PERFORMANCE

Period Ending December 31, 2006	MCM Equities *	S&P 500 *
Ten Years	12.4%	8.4%
Five Years	4.9%	6.2%
Three Years	3.1%	10.4%
One Year	5.0%	15.8%

* Compounded annually, MCM data net of fees

Year	MCM Equities *	S&P 500
1994	-7.5%	1.3%
1995	19.1%	37.6%
1996	31.8%	23.0%
1997	45.1%	33.4%
1998	-7.4%	28.6%
1999	18.8%	21.0%
2000	29.3%	-9.1%
2001	22.7%	-11.9%
2002	-13.6%	-22.1%
2003	33.9%	28.7%
2004	4.7%	10.9%
2005	-0.2%	4.9%
2006	5.0%	15.8%

* Net of fees

This year's review of our annual performance will differ somewhat from recent reports.⁴ Let's begin forthrightly with a note of contrition: Irrespective of what the performance numbers may convey,

⁴ As noted earlier, for certain accounts the drag of expenses associated with hedging the risk of catastrophic loss negatively impacted overall portfolio results—both in 2006 and 2005. Because the hedges were not universally utilized, the above performance data do not reflect the cost of the hedges nor will their benefits/costs be included in the future.

we fell well short of acceptable behavior in failing to fess up to our investment judgment mistakes and then further complicated the adverse impact by not handling them adroitly. Fifth/Third, Dollar General, and Emmis Communications served as a collective ball and chain around the leg of investment performance and remained in the portfolio, for the most part, because of what I euphemistically term “thumb sucking” on my part. Charlie Munger, who came up with that expression, also is fond of saying “Invert, always invert.” We should have applied that mental discipline to the expression “Time heals all wounds.” Inverted, it is “Time wounds all heels.” Though we could cite much-improved “what if” investment performance if we conveniently excluded our losers—like the U.S. Bureau of Labor Statistics “adjustment” to the Consumer Price Index (CPI) that excludes food and energy costs—but you are not that gullible and we are not that stupid! Admittedly, we have set high standards for ourselves. If we were ruthlessly self-analytical, we could tell you about our errors of omission—the companies we should’ve bought (based on 20-20 hindsight) but didn’t. This “frank” admission about a segment of what we consider a superior business model that needs to be tweaked is not meant to be a sweeping *mea culpa*. As noted in the Executive Summary, “While our investment management process is still highly efficient, we always strive for perfection.” We owe you no less than our best.

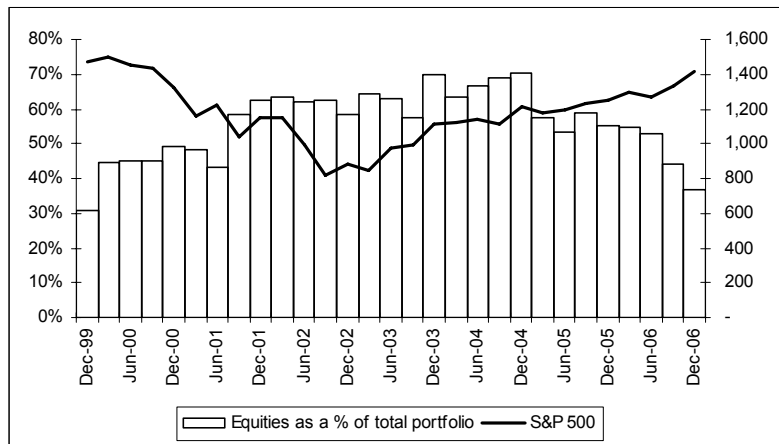
The first step in correcting a judgment error is to stop denying its existence. Inclined otherwise, though we might be, the facts leave us no choice! The section titled Rationality speaks directly and exhaustively to those behavioral propensities, emotions, and biases that hobble the rational thought process. We believe that learning can be cumulative in our profession if we, as Jim Collins advises in his book *Good to Great*, “brutally examine the facts.” We have examined our thinking processes with great care and have, accordingly, redefined “research” to make it more inclusive, reconfiguring it to include everything that ultimately impacts the performance of your portfolio. Now called the “Investment Management Process,” it includes:

- Investment-idea originations.
- The due-diligence process that, if the analyst encounters no “deal breakers” along the way, yields another company that is added to our inventory of eligible businesses.
- The production of a more succinct and reader-friendly research report for client consumption (the longer and more detailed unabridged report will remain available upon request).

- The regular monitoring of the market price so we can take action if and when the market price eventually swoons to a level low enough relative to our appraisal of intrinsic worth that our margin of safety is compelling *and* that the expected return therefrom exceeds our threshold rate.
- The process of trading—the purchase and sale of investments—which has been given a higher profile and a more clearly defined role in the Investment Management Process.
- The measuring of a purchased company’s performance against our approximate business expectations, while maintaining a high degree of skepticism throughout the holding period, looking always for disconfirming evidence, a discipline that runs counter to the “optimistic bias” with which many, if not most, in the financial world are saddled.

Finally, as this report bears full witness, at certain inflection points in economic and market history, we will make every attempt to effectively blend the overarching secular trends that are ultimately grounded in the proclivities of mankind (the “macro” or big picture) with the “micro” (company-specific issues) in our decision making.

The Allocation of Client Capital



In the graph above, which covers the time span from the fourth quarter of 1999 through the fourth quarter of 2006, the solid line S&P 500 index is plotted against the percentage of MCM equities

owned compared with the total assets we manage.⁵ Plain-vanilla, Main Street-type companies were discarded like so much rubbish during the technology mania and sold at bargain-basement prices to raise funds for the rising stars. At the time the question on our minds was “How far would the fallout extend when the technology Bubble finally bursts?” Only 30% of your capital was committed to equities. As the tech Bubble began imploding on March 10, 2000, we felt more comfortable in purchasing the relatively prosaic companies that we had long followed at prices that provided a generous margin of safety and an expected return greater than our threshold. Rotation is a Wall Street term for the mass migration of money from one idea to the next. Overnight, once-ardent fans of technology stocks rushed for the exits. No doubt some of the money rotated to the more pedestrian companies we owned. As often happens inside and outside the investment world, glamour can be fleeting—and the Clydesdales did not look so plodding after all. Accordingly, because of the increased availability of prudently priced companies, our commitment to equities more than doubled to 60%-plus when the S&P 500 reached its double bottom, first in the fall of 2002 and in the spring of 2003, as the impending attack on Iraq became imminent. Obviously, a fair portion of the increase in equity exposure was due to price appreciation. In addition, we bought heavily into the weakness following 9/11. By the fourth quarter of 2004 our commitment to equities began a two-year decline to less than 33% at the time this report went to press. There are three principal explanations:

- First, stocks we had acquired earlier at lower prices had risen to the point where their five-year expected returns had fallen to the low single digits, warranting sale. Because the pickings have once again become slim due to rising prices, generally they were not replaced.
- Second, we had an influx of cash from new and existing clients. Unlike most managers, it is not our policy to immediately invest new money when received. Rather, we commit those funds company by company based on price, margin of safety, and expected return. Accordingly, much of that new money remains idle, patiently awaiting rational opportunities.

⁵ Except for hedges purchased beginning in the third quarter of 2004 as discussed later, non-equity assets are of the plain-vanilla, highest-quality types available: They include cash; top-grade, money-market funds; short-term “full faith and credit” U.S. Treasury notes; and short- to intermediate-term pre-refunded or escrowed-to-maturity Aaa-rated tax-exempt bonds.

- Finally, as the words of wisdom from Charlie Munger in the Introduction make abundantly clear, there are times when patience and lots of cash may be advantageous to those who are prepared.

In addition (see the section on Rationality), if one is going to cultivate the temperament to take advantage of tomorrow's opportunity set, which may be much more attractive than today's, giving up today's opportunities and keeping kegs of dry powder is the only way. Bottom line: You *can't* have your Kate and Edith too. In keeping with our assessment that we're in one of those ambiguous time periods (we'd rather be generally right than precisely wrong), we began buying "catastrophic risk portfolio insurance" (in the industry vernacular ... out-of-the-money, long-term, LEAP put options) in the third quarter of 2004, with the premiums paid representing about 1.4% of our equities. Because we have yet to sell one of our earlier hedges that has been replaced by one that expires in December 2008, and because we continue to be net sellers of equities, the market value of put options outstanding as a percentage of equities is temporarily 3.8%. Like the premiums you pay on your home to protect your property against loss, they seem like money down the rat hole until a hurricane or tornado blows through. On average, the insurance will annually cost us 1% to 2% of the value of your equity portfolio.

Admittedly, there are many reasons why we use options sparingly. We overcame our reluctance in the last several years because of our escalating concerns about catastrophic risks—knowing full well in advance that those risks, real or imagined, are utterly unpredictable as to their timing and magnitude—and because the premiums for options are the cheapest in a decade as they are determined more by trailing "rear-view mirror" market volatility, which has been stable, rather than potential future changes in volatility. Thus, in the relatively stable markets of the past several years, the premiums for a fixed dollar amount of insurance fell to their lowest levels in the last decade.

Finally, while we provide aggregate data above, individual accounts differ in terms of their investment policies. Some are fully invested in equities by direction of the owner, while others have none. Still, the aggregate data give you some idea of our thinking. Our declining exposure to equities, the asset class with the greatest price variability, is a sword that obviously cuts two ways. As long as the markets continue to rise, we'll be penalized on a dollar-weighted basis. Of course, the antithesis is true if the market were to swoon.

Most readers are aware that the undersigned is most happy having all his money invested in good businesses, public or private. While it's painful sitting on the sidelines while everyone else seems to be having such a good time, it's the price you must pay in order to have fun when others have been forced to the bench. In finicky, richly priced markets like those that have existed over the last three years, we simply cannot play good defense at the same time we're playing offense—nor can we hope to keep pace with those managers who think the race we're running is a 100-yard dash. It is in these infrequent environments where the patience of our clients makes all the difference. One of the reasons that Warren Buffett closed down his investment partnerships in 1969 is that he tired of the second-guessing. Most of the time we think it's a small price to pay for the wonderful relationships that we have with you, our clients. In that regard, to be sure, we do have a slight preference for times of rapidly rising client wealth. ☺

Playing defense comes at a price. Treasury securities yield about 4.5% after fees but before taxes. The returns from the safe-haven investments are not likely to vary much, whether the stock market is booming or busting. This strategic macro positioning is consistent with 'The Perfect Storm?' scenario in last year's annual report and much of what is conveyed in this year's report. The opportunity cost of keeping our powder dry and our temperament constructive for what might be a significantly more attractive opportunity set sometime in the not-too-distant future (how's that for precision?!) seems reasonable, rational, and prudent for long-term investors.

At MCM, having never been inclined to straddle the fence—and always being willing to sacrifice supposed opportunity if the flip side is permanent capital loss—our strategy should be abundantly clear to all who read these words. If we *are* in a new era, and the investment metrics of the past are no longer relevant, we may indeed fall behind our peers. While the outcome is never known in advance, the immutability of (1) the passions of humanity, as discussed in the section titled Rationality, and (2) the imperturbability of the concept of regression to the mean, remains firm, as does our conviction regarding our strategy, as was the case in 1998 and 1999. The consequences of losing clients (because of impatience, envy, or lack of conviction in our strategy) pale in comparison to exposing them to potential serious erosion of their capital through mindless imitation of others in our industry—or through engagement in speculative activities with which we have no experience or demonstrated competence. “To thine own self [beliefs] be true,” implored no less a man than William Shakespeare. Our confidence in our ability to prevail, so long as we

never lose sight of the rational bedrock upon which our philosophy is built, is resolute. Moreover, as I think back on the ever-evolving philosophy that has served me well during my 40 years as an investor, I am encouraged by the words of Peter Bernstein: “When you invest, it’s not your wealth today, but it’s your future that you’re really managing.” The adage, which may be an original, that has been my guidepost—“If you manage the risks wisely, the returns will take care of themselves”—kept me out of harm’s way in 1973–74, 1987, and 2000–02. I make mention in a generalized way of how my lifetime net worth has fared only to humbly make the point that many important lessons have been learned during 40 years in the trenches. Cutting to the chase: The estimated average rate of return on my investments over four decades is north of 15% compounded annually. I attribute such results to two key factors: (1) nine investment decisions that were characterized by low potential risks and high potential returns on which I bet heavily and (2) never putting myself in a position of exposing any significant amount of capital to permanent loss. In another arena football legend Vince Lombardi summed it up rather succinctly: “Some people try to find things in this game that don’t exist, but football is only two things—blocking and tackling.”

Continuing the couplet connection, there are two object lessons we’d like to bring to your attention from studying our mentors. First, Charlie Munger left his law practice in 1965 after only three years, although his informal relationship remains to this day. In his search for financial independence he was busy with Jack Wheeler building the asset base for their partnership, Wheeler, Munger.

Year	Charlie Munger	
	Inv. Partnership	Dow
1962	20.1%	-7.6%
1963	47.8%	20.6%
1964	33.1%	18.7%
1965	6.0%	14.2%
1966	8.3%	-15.7%
1967	37.5%	19.0%
1968	27.0%	7.7%
1969	21.3%	-11.6%
1970	-0.1%	8.7%
1971	20.6%	9.9%
1972	7.3%	18.2%
1973	-31.9%	-13.1%
1974	-31.5%	-23.1%
1975	73.2%	44.4%

The partnership lasted from 1962 to 1975. For the first 11 years the partnership compounded at 20%, net of fees, compared with 6.7% for the Dow. During the bear market of 1973–74, the partnership’s return fell 31.9% and 31.5%, respectively, in those two years. Even though the partnership rallied 73.2% in 1975, the average compounded return for the 14 years of the partnership fell dramatically from 20% to 13.7%, net, which still greatly exceeded the 5% return from

the Dow but reveals the high cost exacted by the two consecutive sharply negative years, coupled with *having to add those two fruitless years to the mathematics of compounding*. This is not a new idea; Ben Franklin first identified the magic of compound interest in the late 1700s. Long-term, absolute-return investors understand those dire consequences and go to some lengths, as we have done, to avoid them. Having escaped the clutches of the 1973–74 bear market, I resolved never to put my clients (and myself) through such a gut-wrenching experience. My vicarious experience with such events is sufficient. While I did not know of Munger’s experience at the time, I read extensively of the personal and interpersonal agony that Ben Graham and his family and friends suffered in the 1930s (see the appendix to *Speculative Contagion*, pages 263–281). After the double-whammy experience of watching his portfolio fall by half over two long and anguishing years, no doubt made all the more difficult by the endless stream of plaintive calls from clients who were surely not as philosophical or well-grounded as he, Munger reached a conclusion similar to the one Buffett made in 1969: He no longer wanted to manage funds directly for investors, instead resolving to “build equity through stock ownership in a holding company” (Berkshire Hathaway). As we look forward and attempt to apply the lessons learned from those far smarter than we, the imperative is unmistakable: “To win, first you must not lose.”

The second lesson comes from examining the results of Berkshire Hathaway in the eight years since January 1, 1999. Because Warren Buffett believes that per-share book value is a reasonable approximation of and convenient proxy for intrinsic value, changes in after-tax book value, with securities holdings “marked to market” pursuant to the 1979 alteration in the accounting rules, is the basis by which the numbers are derived. The net effect of losses resulting from

Year	MCM Equities *	Berkshire	S&P 500
1999	18.8%	0.5%	21.0%
2000	29.3%	6.5%	-9.1%
2001	22.7%	-6.2%	-11.9%
2002	-13.6%	10.0%	-22.1%
2003	33.9%	21.0%	28.7%
2004	4.7%	10.5%	10.9%
2005	-0.2%	6.4%	4.9%
2006	5.0%	11.7%	15.8%

* Net of fees
Berkshire 2006 return is for the period through 9/30/2006

Katrina and Rita in 2005 and the absence of any major catastrophic losses through the first nine months of 2006 skew the Berkshire results modestly, yet not enough for further comment. In an effort to make a point, we have

included a performance of MCM's equities, net of fees, alongside book value growth of Berkshire and the total-return S&P 500 benchmark.

It's important to note that MCM's annual returns are calculated before capital-gains taxes, which, fortunately, have no effect on tax-exempt portfolios and relatively little effect on those portfolios paying the 15% capital-gains tax. Also, the capital structure of Berkshire differs from MCM, so any attempts at an apples-to-apples comparison of MCM and Berkshire would be inappropriate. Besides, that's not the point of this exercise.

In my judgment the relative historical underperformance of Berkshire since the year leading up to the peak in the technology and the dot.com craze (7.5% compared with a compounded average of more than 20% since 1965) is a combination of several variables, the weightings of which are unknown to us. In terms of marketable securities, the large-capitalization growth companies were overpriced at the outset and then continued to lose market prominence because in today's credit-glut, private-capital-dominated world the premiums that investors once paid for marketability among the giants have shrunk. With regard to Berkshire's wholly owned subsidiaries, the lethargic economic environment following the bursting of the Bubble did not help.

Perhaps most important, though, has been the dearth of meaningful (sizable and attractively priced) investment opportunities in a climate, as noted in virtually every annual report during the span, that has progressively deteriorated. Buffett has made point-blank statements on executive compensation, ruinous dollar policies, the black hole of derivatives (with which he has had ongoing painful experience), parasitic hedge funds, private capital "helpers" (as characterized in his mythical story Gotrocks) ... The list goes on. In *Poor Charlie's Almanack* (Current Outlook comments, May 2004), Charlie Munger lamented the lack of opportunities.

Our cash is speaking for itself. If we had a lot of wonderful ideas, we wouldn't have so much cash. Berkshire and Wesco are full of cash that we don't know what to do with. Berkshire has \$70 billion if you count the bonds, and Wesco is drowning in cash. It's the most extreme it's ever been. In the past we've just been patient, and we were able to put it to work.

Based on the Berkshire third-quarter 2006 balance sheet, there is still roughly \$70 billion in cash and bonds, although shareholders' equity has increased about \$20 billion to \$102 billion.

Buffett's patience was tested and ultimately rewarded during the dog days of 1973–74. Like the undersigned, I'm sure he has no idea when his forbearance will be validated, but patient he will surely continue to be. "Necessity never made a good bargain," observed Franklin.

Because most of our assets are in marketable securities, we expect to perform better than the popular averages in secularly rising *rational* markets that are at least reasonably priced. Because of the enormous availability of comparatively low-cost credit, along with the quality of earnings, which (because of misaligned incentive systems) are suspect, we believe that the "wonderful process of enrichment," to quote John Kenneth Galbraith, who died last spring at 98, has rendered rationality temporarily impotent. Galbraith, who served presidents from FDR through Lyndon Johnson, understood the vulnerability of one who makes such claims. He further opined: "There are, however, few matters on which such a warning [that the markets have for the time being lost sight of their bearings] is less welcomed. In the short run, it will be said to be an attack, motivated by either deficient understanding or uncontrolled envy ..." Like Buffett, we recognize that there is a flip side to the coin of easy-money-driven pricing anomalies and, should events cause the coin to be tossed and it lands tails up, we expect to back up the proverbial truck. As for secularly declining markets, which are anathema to the goal of achieving attractive long-term rates of compounded return, our behavior over the last several years would suggest that we attempt to avoid them like a plague, even at the cost of lost opportunities in the meantime. If you do the math, we simply have no rational alternative.

We closed the investment performance section last year as follows: "We once again applaud our clients for embracing our strategy as long-term, value-oriented investors. Thanks to you, we enjoy a significant competitive advantage by being able to view the investment landscape from that perspective. If we, like many other managers, were goaded by our clients, or their intermediaries, to focus on short-term performance as the end, rather than on the means to achieve well-above-average performance over the long haul, we would be looking back 10 years at results that would be ... well, average. We aspire to be many things, but mediocre is not among them. As for the future, which is of great interest to us, we strongly believe that the means we have chosen to cope with, if not capitalize on, uncertainty will make the experience of looking back on today—in 2016—quite satisfactory for all of us. Not exactly your traditional investment strategy ...!"

As the rest of this report makes abundantly clear, we believe that a better opportunity set lies out there somewhere “round the bend,” and we have made appropriate preparations.

THE EQUITY RISK PREMIUM: PASSE?

Once upon a time there was an investment principle, for generations deemed sacred, that held that the returns from riskier investments should exceed those from ones deemed less so. The logic was straightforward. Investors who committed capital to investments whose outcomes were less certain (riskier) expected, nay, demanded concessions in the form of lower purchase prices (i.e., higher expected returns) as compensation for venturing forth from more predictable outcome alternatives, e.g., Treasury securities.⁶ Over the last 40 years 10-year, forward-average, total annual compounded returns from the S&P 500 have ranged from 1% to 19%. In order to determine the premium in return from equities vis-à-vis the safest alternatives, you must subtract the opportunity cost forgone in owning U.S. Treasury notes, the average yield-to-maturity of which was 7%. After such adjustments, the premium in average annual compounded return from equities over U.S. Treasury notes for 10-year intervals has ranged from -6% to 12%. The average excess return from equities dating back to 1926 is about 5%. In very approximate terms, stocks averaged 10% per year (6% from capital appreciation and 4% from dividends), and the average yield to maturity on U.S. Treasury notes was about 5%. Of course, nothing is ever as simple as it seems. The “survivorship bias” (the S&P 500 is composed only and obviously of those companies that

⁶ Professor Roger Ibbotson’s seminal work, updated annually in book form, *Stocks, Bonds, Bills and Inflation Yearbook*, is an extensive database for studying the empirical evidence. Ironically, (in 2001) Ibbotson founded Zebra Capital, a hedge fund using quantitative alpha forecasting models that employ equity market-neutral, long/short directional, and multi-strategies. What the “quant” who made his name at the University of Chicago learned from studying the returns from various asset classes for more than a quarter of a century is unclear if anything is to be inferred from the hedge-fund strategies Zebra advertises. As Charlie Munger is fond of saying: “To a man with a hammer everything looks like a nail.” Although unable to find any information on the hedge fund, I would note that he sold Ibbotson & Associates to Morningstar in late 2005 for \$83 million. Ibbotson, based on my reading, is but one of many academics who have used (or misused) their academic credentials to lever their way into the mutual-fund game. My intuitive antennae are up and alert.

have survived) must be addressed, as well as the “equity premium puzzle,” which remains a mystery at least insofar as the empirically based academics are concerned, if the equity risk premium is to become a working tool.

Richard Thaler, Ph.D., a behavioral economics advocate, proposed in a May 1995 co-authored paper that myopic loss aversion provides a plausible solution to the puzzle. The authors assert that investors tend to evaluate their portfolio in a relatively shortsighted way and that, as loss aversion implies, they are highly sensitive to losses over this time period. The evaluation time period of approximately one year was implied in the authors’ model by an equity premium of 6% and a 2x loss-aversion multiplier (a general finding of loss-aversion research). For long-term investors like MCM, Mr. Thaler’s short-horizon model doesn’t fit.

It would appear that academia is approaching the matter of the premium that should be expected in return from riskier investments from a relatively narrow perspective. Although Thayer is a behavioralist, I think this right-brain puzzle is not amenable to a left-brain solution. Intuitively, concluding that an equity risk premium should exist seems quite rational. We don’t need, and probably can’t get, exact times or other parameters to apply the principle to our investment process. Moreover, recognizing the existence of the survivorship bias and making some rough adjustment for it should suffice for the practitioner, if not the scholar.

Further, like risk, the equity risk premium embedded in stock prices is a wily critter, defying standardized definition. It seems, anecdotally, that investors are not always rational (now *there’s* a shocking revelation!) and that during periods of deeply depressed markets their aversion to risk seems to be at its greatest. Contrariwise, during euphoric periods of high prices risk is often relegated to an afterthought.

The longer-term, equity risk premium can only be determined *ex post facto*. In reviewing the Ibbotson data for the last 50 years, we examined the aftermath of the well-known market peaks in the mid-1960s and in the late 1990s, as well as what followed the trough in 1974. With the benefit of hindsight—and arbitrarily choosing a 15-year, forward-looking time horizon—the data reconcile with commonsense conclusions: Investors, whose memories of prior misadventures tend to fade in the face of new adventures (the “availability bias”), unconsciously and insidiously drop their guard against the scourge of accepting risks for which they are not fully compensated by legitimate expectation of excess return. This is a collective phenomenon, reinforced by observing the actions of others.

After World War II, as memories of the Great Depression and paralyzing risk aversion waned, common stocks gradually regained favor with the public. Although there was a sharp break in 1962 when John Kennedy squared off with the steel industry, the nadir in equity risk premiums was reached four years later. The consequences of the increasingly pervasive disregard for risk, as noted by Alan Greenspan (see *The Perfect Storm Redux*, page 64), are inevitably unappealing. The average compounded annual total return for the S&P 500 for the 15 years following the low equity risk premiums in 1966 was 7.1%. By comparison, average annual inflation was 7.2%, and the total return from the U.S. Treasury bills was 7%. Much blood was shed during those agonizing years, to no avail. Imagine those who set out on a long trek in 1966 or 1972 in search of their fortune, only to discover years later that they had been unwittingly walking on a treadmill. It should be noted that the secular period of malaise was not linear. Although the times were inordinately risky, for the adroit there was good money to be made between 1966 and 1972. Skating on thin ice, however, is not without its perils, as Charlie Munger (see section titled *Investment Performance*, page 27) discovered in 1973 and 1974 when the thin layer could no longer provide adequate support. It is hoped that the reader will notice a certain symmetry in the following: The market peak in 1966, as defined by the low equity risk premiums, was followed by one last hurrah, often referred to as the “nifty 50” mania, in 1972, six years later. We expect that the similarities will not elude the careful reader as he or she examines the minuscule equity risk premiums today, not unlike 2000 when investors seemed indifferent to risk in certain favored industries. Of course, as Jeremy Grantham said recently, the equity risk premium for all asset classes worldwide is less than 1%. Remembering well the episode 40 years ago, the greatest damage was not inflicted in the years immediately following 1966 but, rather, in 1973–74. Also interesting is the fact that those who started swinging at the fat pitches in the midst of the carnage of 1974 experienced average compounded returns through 2005 of 13.4%, even though the secular high in expected returns from equities was not reached in 1981, from whence the total returns through 2005 were almost identical at 13.3%.

Of course, if you had backed away from the plate in 1999, your total return would have been 18.5% for the 18 years. For the nimble, the bifurcated market of 2000 and the spreading malaise as the decline continued into the fall of 2002 and the winter of 2003 provided an interlude of enterprising, albeit short-lived, opportunities. By Buffett’s own admission, opportunities were both limited and elusive in the new millennium’s first bear market, partly due to

Berkshire's size and relative inflexibility. Besides, the kind of companies he would have preferred to buy, like Coca-Cola and Gillette, were still so expensive that he later publicly regretted not having sold them in 1999. Buffett's imitation of Rip Van Winkle is reminiscent of the Oracle of Omaha from 1969 to 1973–74, when he finally stepped back into the batter's box. One practically salivates at the present-day parallels and possibilities ... In what must be characterized as a historical anomaly, the high absolute expected returns from equities in 1981 were due in no small measure to the record high absolute expected returns from long-dated, fixed-income securities, with the yields on the highest grade U.S. Treasury securities reaching nearly 15% in 1981 (compared with 5% on average for the preceding 80 years). At the time (the memory is still vivid) I concluded that spectacular returns would be earned from investments in either equities or long-term bonds, particularly those with zero coupons. Only one simple and comparatively certain assumption had to be made for the conclusion to be proved valid: Runaway inflation had to be contained if the dollar was to maintain its position as the world's reserve currency—and the United States was to avoid anything approaching the hyperinflation of the Weimar Republic in Germany in 1923 as it attempted to print its way out of World War I reparations debts by devaluing the currency.⁷

Rewind to the early '80s in this country. Whether it was Paul Volcker and/or market forces that broke the back of inflation is immaterial to the argument that all forces were aligned to make it happen. At the time I knew that much of what was to come hinged on one pivotal variable. Today I feel no differently. If equity risk premiums advance to the mean, and most likely beyond, (1) this is no time to be broadly invested in common stocks and (2) following a

⁷ The German government required almost 2,000 printing presses, running around the clock, printing money on one side to save time. In early 1922 10,000 marks would buy more than 250 pounds of meat. By early November 1923, it took 100 billion marks to buy two glasses of beer, while bread was 80 billion marks a loaf. Simply to go to the grocery store, Germans lugged suitcases and pushed shopping carts, each filled with literally billions if not trillions of marks. Employees asked to receive their wages each morning so that they could shop at noon before merchants posted the afternoon price rises. On November 15 a new currency, the *retenmark*, was introduced. The *retenmark* was theoretically backed by all land and industry owned by the government. One new *retenmark* was worth a trillion of the old marks. Prices stabilized under the new currency; however, the wealth of most of the nation's citizens had been obliterated. Had the inflation not been curtailed by early 1924, political chaos certainly would have ensued.

catharsis, the antithesis will be true. In 1974 Warren Buffett declared in his colorful way, “I feel like a sex-starved man in a harem.”

The most recent peak, perhaps similar in symmetry to 1966, occurred in 1999. Working with hard data through the third quarter of 2006, the seven-year period starting in 1999 produced a paltry .75% average compounded total return on the S&P 500. Given the low equity risk premiums that exist today—in part due to the contra-secular-trend rally that began in the early winter of 2003 when preparations to invade Iraq were under way—we find it difficult to envision ourselves looking back from 2016 at average compounded annual total returns much greater than mid-single digits for the S&P 500. Our reasoning includes simple extrapolation of historical GDP growth, assuming a regression to the mean of profit margins⁸ and a

Equity Risk Premium Summary			
Metric	2006	2016	Annual Growth
GDP			7%
Corporate Profit Margin (AT)	10%	6%	-5%
Corporate Profits			2%
S&P PE	16.5	15	-1%
S&P Price Change			1%
Dividends and Buybacks			3%
S&P Total Return			4%
US Treasury Expected Return			5%
Projected Equity Risk Premium			-1%
Equity Risk Premium 1958-2006			5%

terminal price-earnings ratio of 15.

When you subtract the cost of money, using U.S. Treasury notes as the proxy, the equity risk premium dwindles toward zero or below, as the table, with

historically reasonable assumptions, indicates. Moreover, in light of the

⁸ According to a December *Fortune* magazine article, which quoted data from the U.S. Commerce Department’s Bureau of Economic Analysis, after-tax corporate profits reached a record 10.1% of GDP in the first nine months of 2006. Hyman Minsky, about whom you will read later, would think it no coincidence that before plunging in the 1930s, profit margins hit 8.9% of GNP in 1929. The BEA says the true economic profits have been stuck at 7.5% since 2004 because of the impact of inflation on inventory values (oil likely to be the biggest factor); the Bush administration’s temporary tax incentives; and other distortions, such as hurricanes. Still, the 7.5% number is well above average. Much of the benefit has come from lower worker compensation (offset in large measure by a benefits package) and lower interest rates. While perhaps more symbolic than substantial, the great credit-generating machine has contributed handsomely to margin expansion. JPMorgan Chase and Goldman Sachs profit margins in 2001 were 9.17% and 5.28%, respectively. For the first nine months of 2006, they had mushroomed to 17.68% and 21.48%, respectively. Because of the amorphous nature of the financial sector, it’s difficult to get a precise picture of its contribution, but I don’t think we need to have precision to make the point.

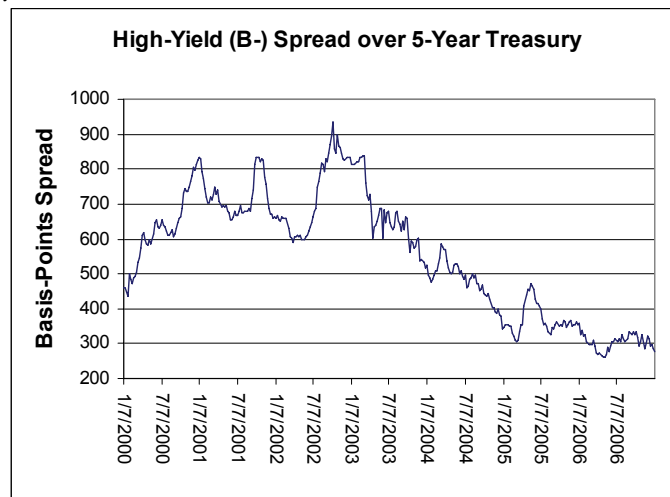
possibility of a trend-busting credit or derivatives implosion, a serious recession (for those with long memories, the last one was in 1974–75 or 1981–83, depending on how you keep score) or any number of other random events, it would be irresponsible of us not to mention the chance of another event of the 1973–74. Bear markets of that variety have the compounding effect of piling unmitigated misery on top of extensive erosion of capital. On the flip side, given the modest opportunities that we presume we are forgoing (and since we believe that the odds favor some shock of indeterminable origins that may create an opportunity set as mouthwatering as 1974), patience may reward us with an opportunity to commit large amounts of safe-harbored capital (cash and immediately liquid equivalents) during a period when expected equity risk premiums are extremely high and from which, accordingly, 10- to 15-year expected returns also will be well above the historical norm of 10%.

Of course, if and when we find the kind of businesses we want to own for the long haul at prices that largely ensure that the economic returns of the business will find their way to us as shareholders, we will commit capital to them. The reasons why such investments are scarce today should be obvious. With the number of mutual funds, hedge funds, and the private equity players—along with the unparalleled amount of money chasing equity investments of all types—pricing anomalies are in woefully short supply. Highly leveraged traders like hedge funds, that don't worry about long-term capital gains, arbitrage frenetically for nickels and dimes. Free lunches are hard to find. My cohort Seth Klarman minces no words when he describes today's capital markets: "The asset allocation world is an increasingly desperate place. Capital freely sloshes across asset classes to those purporting to have uncovered the tiniest market inefficiency or mispricing. This has the effect of bidding up prices, thereby lowering the expected return and raising the risk on individual securities and classes of securities. Some say this reflects investors' acceptance of a lower risk premium; we would call it overpaying."

For those who think we have been emancipated from the burden of the equity risk premium or that they have the prescience to exit before someone screams "Fire!" in a crowded theater, I respectfully suggest you reread the Eliot quotation at the conclusion of my synopsis of *The Perfect Storm Redux* in the Executive Summary. For those who want to dig deeper, a careful reading of three books I mentioned elsewhere, *Fooled by Randomness*, *Ubiquity*, and/or *Deep Simplicity* should cure you of any such illusions of perspicacity.

If you still have doubts, there is another simple analogous technique to measure the propensity to assume risk that corroborates

the findings above. In the ensuing chart the spread between high-risk junk bonds,⁹ the equivalent to equities in the fixed-income world, and the five-year Treasury note are presented graphically. In times of distress, as is clearly demonstrated, spreads widen. Conversely, they narrow when return supersedes risk as the investor's primary concern. It's the dramatic decline from the 900-basis-points spread at the trough of the collapse of the technology Bubble to the 280-basis-points spread that exists today that should give risk-averse investors plenty to chew on.



⁹ The junk bond, first introduced by Michael Milken during the 1980s, came onto the scene no doubt ahead of its time in terms of the evolving general propensity among investors to assume more and more unremunerated risk. This was largely because of the audacity and larger-than-life persona of Milken himself. It all began with his misrepresentation of the seminal W. Braddock Hickman study of corporate bond returns, which he flagrantly and shamelessly used in the promotion of bogus research on the probability of default. He thus buried fraud within the documentation of junk-bond issues and provided groundless “independent” ratings for new issues. After Milken’s dénouement (including incarceration) and a short-lived period of investor introspection, junk bonds again are well-nigh ubiquitous. While once the almost exclusive product of Milken’s Drexel Burnham, most of the major brokerages are now in the game, issuing vast volumes of junk. Of no surprise, many competitors and lots of merchandise have slashed the once-usurious fees which, according to a recent *Bloomberg* article, are at a 20-year low. More than 4% (of the principal or par value) when Milken and Drexel had a corner on the market, issuers now fetch a comparatively paltry 1.5% for hawking an investment that will surely sully their reputations in the years to come. Even white-collar crime doesn’t pay like it used to in the “good old days.”

In the same way that junk-bond spreads are incredibly narrow, the yield spreads between the debts of developing countries and lesser-developed countries have contracted in a very similar and very significant way. In both cases the message is the same: Riskier assets are very expensive relative to less-risky assets. The differences in P/E ratios between/among Nasdaq, the Russell 2000, and the S&P 500 would convey a similar message.

Page back, if you will, to the words of interlude from Charlie Munger that opened the Introduction: “A few major opportunities, clearly recognizable as such, will usually come to one who continuously searches and waits ...” A year ago I quoted Peter Bernstein, who in turn had referred to Shakespeare’s Hamlet, who addressed the time issue of hesitation in the face of uncertainty as detrimental to constructive action: “The native hue of resolution is sicklied o’er with the pale cast of thought ... and enterprises of great pith and a moment ... lose the name of action.” Bernstein retorted: “Yet once we act, we forfeit the option of waiting until new information comes along.” The truth likely lies somewhere between the polar aphorisms “He who hesitates is lost” (see variation below) and “Haste makes waste.”

Seth Klarman states the obvious for the few who are not anchored in the present when he proposes that the opportunity set of tomorrow is likely to be different from that of today. One can infer that such an opportunity set may not be entirely at the “whim of the gods” as was deemed the outcome before mathematical probabilities came to be used to calculate odds—but may be generalized about if one subscribes to a belief in reversion (and you presently find yourself a standard deviation or two away from the mean). Concludes wise octogenarian Bernstein, who has lived a full life exhibiting the virtue of patience: “As a result, not acting has value. The more uncertain the outcome [Klarman would be more precise by saying the more certain you are of an unpleasant outcome], the greater may be the value of procrastination. Hamlet had it wrong, according to Bernstein: he who hesitates is halfway home.”

Sadly, for the serious investor, there is no emancipation from the obligation to act rationally. To listen to the siren call from the horde of new-era believers is certainly to suffer their same fate. Abraham Lincoln was harsh in his assessment of delusions of those who so willingly fall in with the crowd: “The only person who is a worse liar than a faith healer is his patient.”

RATIONALITY

The pivotal word in the workaday vocabulary of Warren Buffett and Charlie Munger is “rationality.” So essential is its understanding and application to successful investing that, in the pages to follow, I will go to great lengths (in my typical roundabout way) to define what it means and why it is relevant. Over the years we have described rationality largely in terms of what it isn’t. That is, we’ve pointed out irrational behaviors as the means of defaulting into the definition of rationality. In the paragraphs below, we will discuss common emotional impediments to rationality: groupthink, biases, envy, and fear. The word “rational” derives from the Latin word “ratio,” which means “calculation” or “reason”; to be rational means having or exercising the ability to reason. Rationality is a characteristic of people’s behavior where no arbitrary or random action stands between the pursuit of a conscious purpose or goal and the means to achieve it. Thus, if the chosen means are indeed conducive to achieving the purpose or goal, they are judged rational. If not, they are judged irrational. It gets a little sticky when one raises the issue that purposes and goals can be judged rational or irrational, and thus we’re forced to make certain assumptions about values. Since our investment-performance goals are narrowly defined—optimize long-term, risk-adjusted compounded returns—value confusion is unlikely. It might be said that because the goals are not important in the definition of rationality (in our application), it really demands only unswerving consistency in choice making.

To further clarify the meaning of rationality, it should be noted that it is not necessarily the same as logic, because logic may be irrelevant to achieving a purpose or goal. Syllogisms, for example, a form of deductive reasoning starting with a major premise, followed by a minor one, leading to a logical conclusion, may be valid but not necessarily sound or reasonable. The scope of rationality is much broader than logic, as it includes, according to Wikipedia, “uncertain but sensible arguments based on probability, expectation, personal experience and the like, whereas logic deals principally with provable facts and demonstrably valid relations between them, as in the syllogism defined above.”

Is History Relevant to Rationality?

Although history may seem a strange place to start, if history is deemed something more than irrelevant, then we have some comparative basis for judging the degree to which our current thinking is rational. In other words, if we are commencing a means-ends,

problem-solving process today for which there is analogous (although obviously not identical) historical precedent and we're thus forearmed with the record of the outcome of the former episode, we have some rough capacity to begin evaluating the rationality of the decision-making process on which we're presently embarking.

To be sure, the relevance of history as a tool for finding refined meaning in the present and in foreseeing possibilities for the future is not without its worthy detractors. Men and women throughout the ages—of enormous intellect, wisdom, and understanding—have weighed in on either side of the seemingly forever irresolvable debate. George Bernard Shaw offers the cynic's view: "We learn from history that we learn nothing from history," whereas George Santayana is credited with the adage you have read on these pages before: "Those who cannot remember the past are condemned to repeat it." Etienne Gilson, the 20th-century French philosopher, historian, and popular writer who was greatly influenced by Thomas Aquinas (an Aristotelian and an empiricist) wrote: "History is the only laboratory we have in which to test the consequences of thought." Gilson's insights appeal to my sense of logic, as well as my hope that not all of life's lessons must be learned anew by every succeeding generation. The quotation from which much of my thinking springs, however, is from a 15th-century political philosopher for whom, ironically, a pejorative expression, "Machiavellian," a misnomer, is that by which he most often is remembered.

In point of fact, Machiavelli was centuries ahead of his time as a political philosopher. He wrote on how a republic should be conceived and organized to include the concepts of checks and balances, the strength of a tripartite structure, and the superiority of a republic over a principality. Those ideas are as valid today as they were five centuries ago. Indeed, applications of Machiavelli's practical political philosophy can be found in the governments of many democracies today, including the United States. As to the relevance of history to imagining possibilities for the future, Machiavelli observed:

Whoever wishes to foresee the future must consult the past; for human events ever resemble those of preceding times. This arises from the fact that they are produced by men who ever have been, and ever shall be, *animated by the same passions* [emphasis added], and thus they necessarily have the same results.

Once again, the line of reasoning that gave rise to this quotation has great intuitive appeal for me and has long inspired me to

be among those who aspire to foresee the future by observing those who are its active agents of change: people. History would be dead, of course, without human impetus behind every recorded event. The phrase “animated by the same passions” suggests that these emotions, defined in more detail below, remain forever unsusceptible to change. I submit the common threat—and implementation—of war woven throughout much of history as incontestable evidence that there has been little progress in purifying the “passions of man.”

It would appear that the only constant in all of human history is the underlying immutability of the proclivities of *Homo sapiens* (ironically, Latin for “wise man” or “knowing man,” at least relative to his forebears). And if we look not to the events of which these predispositions are simply the outward manifestations but to the repetitious nature of man’s “passions” upon which they are based, we can more fully embrace the insights from the late Pulitzer prize-winning author of *All the King’s Men*, Robert Penn Warren: “History cannot give us a program for the future, but it can give us a fuller understanding of ourselves, and of our *common humanity*, so that we can better face the future.” Since no amount of entreaty from the undersigned will convey the importance attached to the foundational relevance of the cyclical nature of the passions of people to all that follows, I occasionally grasp at humor to encourage you to trudge on, turning to a most unlikely observer of human behavior, Albert Einstein: “Any man who can drive safely while kissing a pretty girl is simply not giving the kiss the attention it deserves.” Please pull over and give this “pretty girl” your undivided attention!

Behavioral Finance and Economics

Behavioral finance and behavioral economics are closely related fields that apply scientific research to human and social cognitive and emotional biases, the “passions of man,” if you will, to better understand the rationality of financial and economic decisions and how they affect market prices, returns, and the allocation of resources. Both fields are primarily concerned with the *rationality*, or lack thereof, of economic players of all stripes. As is apparent to readers of MCM annual reports or *Speculative Contagion*, for better or worse the logic of behavioral economics and finance has greatly, and perhaps irrevocably, impacted the way I view the intertwined worlds of economics and finance.

Classical economics, with close links to psychology (and likely the genesis of modern-day behavioral finance and economics), is widely regarded as the first contemporary school of economic thought.

Adam Smith's *The Wealth of Nations*, published in 1776, in all probability is the field's intellectual cornerstone. Smith wrote another important text describing psychological principles of individual behavior, *The Theory of Moral Sentiments*, in which he observed that capitalism devoid of the moral conduct of its participants will fail. Other famous original contributors to classical economic thought include David Ricardo, Thomas Malthus, and John Stuart Mill, while occasionally such later economists as John Maynard Keynes and Karl Marx are added to this elite list. The classical school was active into the mid-19th century and was followed by neoclassical economics in Britain beginning around 1870.

Economists began to distance themselves from psychology during the emergence of neo-classical economic thought as they sought to reshape the discipline as a natural science. No doubt exponential advances in data processing and management helped transform economics for a time from art to science. Econometrics and modern portfolio theory were surely outgrowths of the burgeoning capacity to manipulate massive amounts of data that information technology offered. Psychology had largely been displaced from economic discussions beginning in the mid-20th century by the wondrous and mysterious number cruncher, the mainframe computer.

A number of factors contributed to the resurgence of the reliance on psychology and its foundational role in the incipient discipline of behavioral economics. Expected utility models, as discussed in the 2005 MCM annual report (pages 64 and 65), began to gain wide acceptance, which generated testable hypotheses about decision making in the midst of uncertainty. Soon a number of observed and repeatable anomalies challenged these hypotheses. Furthermore, during the 1960s cognitive psychology began to describe the human brain as an information-processing device (in contrast to behaviorist models advanced by such behavioral scientists as Ivan Petrovich Pavlov and B.F. Skinner). Psychologists in this field began to benchmark their cognitive models of decision making in the context of risk and uncertainty against economic models of *rational* behavior.

Perhaps the most important paper in the development of the behavioral finance and economics fields was written in 1979 by Amos Tversky and Daniel Kahneman—who were awarded the Nobel Prize in 2002 (Tversky posthumously) “for having integrated insights from psychological research into economic science, especially concerning human judgment and decision making under uncertainty.” Their paper, “Prospect Theory: Decision Making under Risk,” used cognitive psychological techniques to explain a number of documented anomalies in *rational* economic decision making.

It is commonly, and in my judgment narrowly, thought that marketwide anomalies cannot generally be explained by individuals suffering from cognitive biases, as individual biases often don't have a large enough effect to change market prices and returns, to say nothing of the likelihood that individual biases could potentially cancel each other out. According to the academics, cognitive biases have significant effects only if there is a social contamination with a strong emotional content (collective greed—or, as you'll read later, perhaps more appropriately described as envy ... or fear), leading to more widespread eventualities, such as herding and groupthink. Behavioral finance and behavioral economics rest as much on social psychology as on individual psychology. The title of the book *Speculative Contagion: An Antidote for Speculative Epidemics* attempts to capture the scope of this phenomenon. The cause and effect of contagion, made more potent (like high winds in a forest fire) by advances in communications technology, can vastly amplify the effects of speculative epidemics and their often unavoidable consequences—fear-driven, massive, and *irrational* episodes of pell-mell asset disgorgement. Gustave LeBon's *The Crowd*, published in 1895, contrasted the behavior of an individual acting in isolation with what amounts almost to a bipolar personality shift when said individual subordinates his will to that of a crowd. LeBon's work has been the most instrumental yet in shaping my views on the aberrant nature of crowd psychology and the often irrational behaviors emanating from agitated crowds. I'm confident the book will gain increased recognition and acceptance in the field of behavioral economics and finance in the years ahead.

Despite being an integral part of classical economic theory, the renaissance of the “passions of man” (referring to the earlier Machiavelli quote) as part of the economic equation was as certain to re-emerge as the Lotus (and then Excel) spreadsheets were sure to fade into the surreal fog of computer-driven forecasting. Warren Buffett has stated his antipathy toward the “comforting” but misleading sense of exactitude implied by electronic spreadsheets—and the distraction they provide to his unbridled intuition—by referring, as we did earlier, to Keynes' famous quote: “I would rather be generally right than precisely wrong.” Somewhat analogous here is the false sense of security spell-check programs give the linguistically challenged.

Behavioral finance and economics do not see human beings (as the main cogs in the economic wheel) as entirely mechanistic. Far from it. “I believe in looking reality straight in the eye and denying it,” observes Garrison Keillor, humorist and host of the Prairie Home Companion radio show featuring a fictitious Minnesota small town,

Lake Wobegon, a place in which parody is given full play: “where all the women are strong, the men are good-looking, and the children are above average.” At its root, behavioralism looks at the anecdotal evidence and declares that human beings, whether individually or thinking and behaving in concert, are simply not uniformly *rational* creatures. For example, heuristics, a newly popular name for an age-old, problem-solving technique where people make decisions based on approximate rules of thumb, is not strictly *rational* analysis. Similarly, the term “framing” explains that the way a problem or decision is presented to the decision maker will have direct bearing on his or her action—or inaction.

Finally, under the banner of market inefficiencies there are explanations for observed market outcomes that are contrary to *rational* expectations and market efficiency.

Impediments to Rationality: Biases, Envy, and Fear

Bias is a four-letter word when applied to the decision-making process. Compton’s *American Heritage Dictionary* defines it in this context as “a preference or an inclination, especially one that inhibits impartial judgment.” Biases come in many different varieties (there are 45 references to biases in *Speculative Contagion* and 11 in the 2005 annual report) and, while they can be profoundly detrimental to rational processing, in a relative emotional sense they are benign. The optimistic, survivorship, or availability biases, to name several, do not excite extreme arousal of the sentiments.

Moving up a step on the irrationality ladder, we now address the emotion of envy, sometimes confused with greed. A rudimentary understanding of semantics, the oft-subtle differences in language forms, is essential to avoid offending the reader and to actually promote a constructive effect, that of self-enlightenment. For example, the words greed and envy tend to be used as synonyms, when in fact they are worlds apart. Greed is defined as an “excessive desire to acquire or possess more than one needs or deserves, especially with regard to material wealth,” according to Compton’s. Ebenezer Scrooge, the Disney cartoon character Scrooge McDuck, and the Shakespearean character Shylock stand as symbols of greed. You’ll notice that greed is an absolute and not a relative term. The greedy person is assumed to be self-absorbed and indifferent to his or her relative standing among others so inclined. No matter how you spin greed or greedy, it is rarely perceived as an attractive trait when attributed to another.

Envy, on the other hand, is a propensity to view the well-being of others with various degrees of distress. It appears to be

difficult for many people to see their own well-being in some absolute sense, because the standard we often use to see how well off we are is not the intrinsic worth of our own welfare but how it compares with that of others. According to Aristotle in *Rhetoric*, “Envy is pain at the good fortune of others.” Remember Aristotle when you read *A Tale of Two Americas Revisited*.

Relative proximity seems to be pertinent to the intensity of envy. The phrase “keeping up with the Joneses” presumes we know the Joneses. Few of us compare our well-being with the people in Africa who suffer from endemic malnutrition made all the more tragic by the AIDS epidemic. Envy is less conspicuous than greed and, quite likely, as a result, more pervasive. As such feelings usually operate at the subconscious level, most of us are only subliminally aware—if at all—of our own envy. If one listens carefully to group conversations, evidence of envy, whether invidious or benign, is often in evidence. While I cannot speak with authority about others, I confess to being infected, not always judging myself against my own intrinsic standards, but occasionally relative to someone else’s. On no less an authority than the Bible, the sooner one recognizes and gains control over the envy impulse, the happier and more content he or she will be.

In the sometimes deleterious—and risky!—process of introspection, we all find ourselves occasionally falling prey to feelings of envy. In the world of business, money, and finance, we encounter envy at every level, from the bicycle couriers darting among the limousines on Wall Street to the penthouse executive suites 50 stories above. It isn’t greed so much as envy that gives rise to discontent and resentment when (recall the big-kahuna Wall Street pay packages from the Introduction) returning seasoned veteran John Mack of Morgan Stanley learned of Goldman’s one-upmanship comp package, given to Lloyd Blankfein, whom Mack may deem his inferior or no more than his equal. Recall the Garrison Keillor parody above, the notion that all the children in Lake Wobegon are above-average, which becomes ludicrous when the results of executive self-appraisals are reviewed. Neither man in the preceding example can responsibly consume, let alone count (if it were in tangible forms such as gold rather than merely a book entry) such enormous amounts of money. And before moving on, let’s not forget the “bonus envy” of professional athletes whose outrageous salaries for playing little boys’ games continue to cascade upward in never-ending cycles of “can you top this?” Psychologists have a field day with envy. Envy and the righteousness of egalitarian justice are commonly allied, though in the world of finance the association must be considered tenuous given the infrequent appearance of altruism.

Investment envy often masquerades as the palpable restlessness (usually directed at those to whom investment responsibility has been assigned) in evidence when individual investors find themselves failing to keep pace with “the averages” (a subtle but powerful double entendre), particularly if the benchmark averages are rising. The onset of this agitated state can be rather quick, depending on the client and will take on more animated forms if the underperformance continues for some time. Ironically, I observed that not a single MCM client uttered a word of “dismay” about not keeping pace with the “averages” as they plunged from 2000 through 2002, all the while MCM’s equity holdings rose more than 50%! Of course, we monitor the quarterly performance of the companies we own in hopes of detecting early signs of longer-term deterioration in demand or an intensification of competitive rivalries that might ultimately lead to diminished investment expectations. If we know the companies well enough, we may be able to distinguish between those that are in fact faltering and those that are simply willingly taking a hit to short-term performance in order to position themselves strategically for greatly improved long-term results. Likewise, our clients, in their own self-interest, are advised to carefully observe our short-term underperformance to see whether it is predictive of a fundamentally weak analytical process or simply strategic positioning. In a candid self-assessment, I would say it has been a little of both at Martin Capital of late. Fortunately, an always less-than-ideal analytical process is likely to be permanently predictive only if left unattended. Like a burr under the saddle, the sooner it’s removed the steadier the horse and the more comfortable the rider. You’ll read about removing the “burr” in the Performance section ...

Parenthetically, of more prophetic significance is the envy that pervades many boardrooms and executive suites across corporate America. Misdirected ingenuity has resulted in a steady stream of new iterations of stock-option machinations, the latest but certainly not the last being the pervasive practice of “predating” options. Folks, despite the fact that the activity is illegal, the typical response is “well, everyone else is doing it.” Ethical relativism is alive and well. One of the more egregious examples involved the posthumous predating of options for a deceased director. Such behavior takes some of the wind out of the sails of those who contend that options are an incentive for superior executive performance! Dead men don’t dance, no matter what the tune. For the first time ever, the most recent *Forbes 400* listing of “The Richest People in America” proclaimed that the list was made up entirely of billionaires. The cover of the special issue featured Donald, Donald Jr., and Ivanka Trump, all looking narcissistically rich

with nary a smile creasing their plastic faces nor a twinkle of happiness in their indifferent, even insolent, eyes. *Forbes*, have you no shame? Could you have picked a more pathetic trio of icons? The sanctity of the institution of capitalism is like a strong wall that, through such ill-advised actions, is repeatedly and progressively defaced and disfigured and perhaps, under the most strenuous of circumstances, ultimately may fall. Among the many crises America faces, the desperate straits of ethical misconduct among those who should be our greatest leaders, may have far-reaching consequences. Their stratospheric salaries notwithstanding, it's paradoxical indeed that professional athletes are reminded time and again of their status as role models for young kids and implored to act accordingly when the captains of industry flaunt their reprehensible conduct as if it's a status symbol. As recommended last year, I encourage every reader to watch the movie *Cinderella Man* starring, for the benefit of female readers, Russell Crowe. Those who do not remember the past are condemned ...

Returning to the task at hand, while a subtle point, envy is often characterized as taking one of two forms: the malicious or invidious form, or a benign, emulative, or admiring variety. Invidious envy is envy that involves an unsavory motivation, where benign envy does not. One way to differentiate whether envy necessarily involves a desire that the rival lose the possession or quality is to hold that, while envy sometimes involves this desire, it need not. Fortunately, we rarely encounter the former.

Charlie Munger, contemporary philosopher and Warren Buffett partner, is the master of homing in on the heart of the matter. He sums up the misery of envy succinctly and bluntly. "*Be satisfied with what you have.* Here's one truth that perhaps your typical investment counselor would disagree with: If you're comparably rich and someone else is getting richer faster than you by, for example investing in risky stocks, so what?! Someone will always be getting richer faster than you. This is not a tragedy. *Beware of envy.* The idea of caring that someone is making money faster [than you are] is one of the deadly sins. Envy is a really stupid sin because it's the only one you could never possibly have any fun at. There's a lot of pain and no fun. Why would I want to get on that trolley?"¹⁰ Charlie, please don't mince words on my account!

¹⁰*Poor Charlie's Almanack: The Wit and Wisdom of Charles T. Munger*

Fear Itself

Warren Buffett has often stated “I wish to be fearful when others are greedy and greedy when others are fearful.” A discussion of envy is not complete without looking at another far more pernicious emotional response common to investors. It is usually fear that is the primal driver of bear markets, and it is the relative intensity of fear that causes falling markets to be comparatively torturous in intensity and steep in descent, like falling off a cliff, compared with the far more gradual, frequently arduous, ascent of bull markets, often metaphorically referred to as “climbing the wall of worry.” The emotions and biases that are present in different degrees in bull markets are simply not as potent a behavioral force as fear. When the prices of businesses in extended bull markets eventually become detached from underlying business values, and market prices themselves become the proxy for value, investors are unknowingly walking closer and closer to the edge of the financial cliff. For when fear strikes, there’s nothing to grab hold of for safety. Nothing is more ethereal or flimsy than the market price as the surrogate measure of value. “The oldest and strongest emotion of mankind is fear, and the oldest and strongest kind of fear is fear of the unknown,” wrote 20th-century horror story author H.P. Lovecraft. Enter no-man’s-land at your own peril. “Neither a man nor a crowd nor a nation can be trusted to act humanely or to think sanely under the influence of a great fear,” observed Bertrand Russell.

Psychologically, fear is an emotional sensation and response initiated by an aversion to some perceived risk or threat. Actions performed under stress of fear are the legitimate offspring of the human will. Grave fear diminishes willpower but cannot be said to totally take it away, except in some very exceptional cases. It is the fear of which Lovecraft wrote, the fear of the unknown, that often “dethrones reason” in the markets for intangible assets. The less capable investors are of seeing through and beyond a ticker symbol and a forever-fluctuating market price (the inescapable focus of many investors in the absence of anything more tangible against which to benchmark) to the per-share intrinsic value of the underlying business, the more likely they will be gripped by irrational fears if the stock price heads south. Euphoria over endless riches is rapidly replaced by its polar opposite, the often intellectually crippling (and monumentally irrational) fear of total loss.

Investment in securities, which represent assets but are themselves essentially valueless, is relatively foreign to consumers and investors alike who in most purchase decisions have had some

comparative experience and can figuratively kick the tires of most assets they buy for consumption or investment. Moreover, investment involves an initial outlay of capital for which the economic efficacy of the expenditure may not be known for years. Indeed, the very word “investment” connotes a future orientation. With the purchase of a consumable physical asset or most services, the optimal benefit, both functionally and psychically, is relatively immediate—e.g., the purchase of a computer, a John Deere garden tractor, a manicure, a haircut, or a new car. Based on one’s personal experience, the consumer of goods expects the value of the asset to decline over time. Obviously, the opposite is true with investment in securities. It’s potentially quite disturbing to make a substantial outlay of capital for something the investor can neither see nor touch, and for which he or she receives no current satisfaction or utility, and then witness forthwith the market marking down its value. Even if a man impulsively acquires a Ferrari he cannot afford, there are several psychological mechanisms he can use to justify his irrational behavior. There are no such crutches to lean on in the financial markets.

Moreover, because most corporate assets are geographically dispersed, to say nothing of being practically inaccessible to the average retail investor, the only practical link between the assets and liabilities of a company and the investor is via the company’s disclosures of its audited financial statements. Foggy accounting, where full disclosure too frequently has been displaced by obfuscation, has left investors justifiably suspicious if not cynical.

Psychologists say that fear can be distinguished between serious fear (*metus gravis*) and trifling fear (*metus levis*). The first is the type that grows out of the discernment of some formidable impending peril: If this be really, and without qualification, of large proportions, then the fear is said to be absolutely great; otherwise it is only relatively so, as for instance, when account is taken of the greater susceptibility of certain classes of persons, such as the aforementioned investors. In the subsequent section A Tale of Two Americas Rethought, the apprehension about which the undersigned writes is considered to be of the *metus gravis* variety. While the probability of the outcome, as described in the next section, is unknowable, the consequences are so dire as to make probabilistic assumptions about its likelihood immaterial. Similarly, the potentially fatal consequences of playing Russian roulette render the one-in-six odds irrelevant. To prove the point, will the reader be any more willing to play the game if the odds were one in 100, regardless of the greater payoff? If your answer is “yes,” please stop reading immediately and call 911.

Right- vs. Left-Brain Dominance, Intuition, and Rationality

Modern science has made great strides in understanding how the human brain works. The left hemisphere of the brain processes information in a linear, sequential, and logical manner. It processes from parts to whole. It takes pieces, lines them up, and arranges them in a logical order, after which it draws conclusions. The right brain however, processes from whole to parts, holistically. It starts with the answer. It sees the big picture first, not the details.



If you view the adjacent graphic by taking in its totality, looking at the figurative forest instead of the trees, you will soon see a Dalmatian dog emerge, sniffing the ground in the shade of overhanging trees. The dog is not recognized by first identifying its parts

(feet, ears, nose, tail, etc.), and then inferring the dog from those component parts. Instead, the dog is initially perceived as a whole, all at once.

This is consistent with a right-brain-dominant approach to decision making where the person always wants to know the “why” behind everything. If you process primarily on the right side of the brain, you use *intuition*. You may know the right answer to a problem but not be sure how you got it. You may have to start with the answer and work backward. In writing this report, it is the left brain that pays attention to mechanics such as spelling, agreement, and punctuation. But the right side pays attention to coherence and meaning; that is, my right brain tells me when it “feels” right.

Please understand that “dominance,” when noting to which hemisphere of the brain one naturally defaults, can range from extreme to almost imperceptible. If there’s an ideal, it’s probably the individual who is strong in both hemispheres and thus able to discern which one to defer to in any given decision-making application.

It appears that rational conclusions may be reached either logically or intuitively—or by some combination thereof. In the field of investment, where decisions are based on comparing estimated

future cash flows against an initial outlay of capital, the soundness of the decision, judged by the amount and timing of the cash received relative to the magnitude of the outlay, usually will not be known for a long time. Moreover, the vagaries of the future will make the estimation of future cash flows subject to considerable error, depending, of course, on the characteristics of the investment. In terms of outcomes, the vehicles with the lowest likelihood of error are short- or intermediate-term U.S. Treasury securities—wherein the estimate of the amount and timing of future cash flows has historically been precise to the dollar and the day. The only element of uncertainty is the rate at which those cash flows will be reinvested. Businesses whose future cash flows are highly uncertain would be found at the other end of the continuum.

In common-stock investment, logic-based analysis gets you to the foundational point of postulating a rational set of assumptions for extrapolating the past into the future. As for establishing a “confidence interval” in which the future cash flows are likely to be circumscribed, logical analysis may come a cropper under certain scenarios. *Ubiquity* by Mark Buchanan, *The Tipping Point* by Malcolm Gladwell, *Deep Simplicity* by John Gribbin, and *Fooled by Randomness* by Nassim Taleb all speak in their own way to the often unpredictable timing and apparent disproportion between the cause and effect of future events. As much as it would suit our convenience for the future to be neat and tidy, the events that constitute the endless stream of “tomorrows” (while they have as their common denominator the “passions of man”) regularly remind us how foolish it is to entertain that notion. At such a point of increased uncertainty, logic as a problem-solving technique tends to become less effective. In musing on those capabilities that would likely yield optimal results from what we call an “investment-management process” team, we must go well beyond such left-brain-dominant measures as the intelligence quotient (IQ).

The Myers-Briggs Type Indicator (MBTI), using Carl Jung’s theories in his work *Psychological Types*, is a personality test designed to identify several significant personal preferences. Sensing and intuition, the perceiving polarities of the four personal Myers-Briggs preference polarities with which many people are familiar are of immediate interest. (For the curious reader, the undersigned is an ENTJ, the second-least common in the U.S. of the 16 categories at 1.8%; the least common is INFJ at 1.5%. I always “sensed” I wasn’t at the mid-point of the Bell Curve, but little did I realize how abnormal I really am!) Sensing people tend to focus on the present and on concrete information gained from their five senses. A sensing person does not necessarily have control over received data, but only how to process it

once he or she has it; therefore, conclusions reached may be irrational in that the data are incomplete. Intuitive types, by contrast, tend to focus on the future, with a view toward patterns and possibilities. These people prefer to receive data from the subconscious or by seeing relationships via insights. To be sure, scientific skeptics and academic psychologists have criticized the MBTI Indicator in research literature, claiming that it “lacks convincing validity data.”

In his section on “personal mastery,” Peter Senge, author of *The Fifth Discipline*, embraces the increased attention and acceptance of intuition, coupled with “rationality” (“logic,” in the context of this report, would better be the better word choice) in problem solving.

People with high levels of personal mastery do not set out to integrate reason and intuition. Rather, they achieve it naturally—as a byproduct of their commitment to use all resources at their disposal. They cannot afford to choose between reason and intuition, or head and heart ...

Systems thinking may hold a key to integrating reason and intuition. Intuition eludes the grasp of linear thinking, with its exclusive emphasis on cause and effect that are close in time and space. The result is that most of our intuitions don't make “sense”—that is, they cannot be explained in terms of linear logic.

Very often, experienced managers have rich intuitions about complex systems, which they cannot explain. Their intuitions tell them that cause and effect are not close in time and space, that obvious solutions will produce more harm than good, and that short-term fixes produce long-term problems. But they cannot explain their ideas in simple linear cause-effect language. They end up saying, “Just do it this way. It will work.”

... The conflict between intuition and linear, nonsystematic thinking has planted the seed that *rationality* itself is opposed to intuition. This view is demonstrably false if we consider the synergy of reason and intuition that characterizes virtually all great thinkers. Einstein said, “I never discovered anything with my rational mind.” He once described how he discovered the principle of relativity by imagining himself traveling on a light beam. He could not take brilliant intuitions and

convert them into succinct, rationally testable propositions.

As managers gain facility with systems thinking as an alternative language, they find that many of their intuitions become inexplicable. Eventually, reintegrating reason and intuition may prove to be one of the primary contributions of systems thinking.

More on Rationality, Logic, and Intuition

Sandra Weintraub is the author of *The Hidden Intelligence: Innovation Through Intuition* (1998). When quizzed about her age, the Harvard-educated, thoughtful, and soft-spoken woman with whom I've enjoyed a number of most pleasant conversations admits only to being north of 50. I mention that merely to imply that age-related wisdom is an attribute to which she might be able to lay claim! Upon reading the preceding sentence, she retorted: "For most people, perhaps advancing age does bring wisdom, but I find that people who actively seek it get there a bit quicker. Also, I've known children as young as 15 who are remarkably prescient, beyond one's expectations, and I've also know people in their 80s and beyond who still hold on to the same prejudices and 'wrong-headedness' that they exhibited in their younger days." In addition to providing encouragement regarding my writing in general, Weintraub offered several constructive suggestions that have made this section better than it would have been without her help. Parenthetically, one of the joys in writing this annual communiqué is in meeting and getting to know little bit about people who make a difference—and do so with humility and grace, like Weintraub. Although she is quick to credit Lynne Robinson, author of several books on intuition, including *Compass of the Soul*, for her creative commercialization of the use of intuition in the organizational construct, my intuition and the belief that "still water runs deep" led me to read Weintraub's book.

Integrating intuition with brain-hemisphere dominance, Weintraub postulates: "The left brain knows what is, but the right brain knows what can be. The right brain reads the future and makes connections to the present via its intuitive network." In terms of the practical utility of intuition, she quotes Steve DeVore, founder and CEO of SyberVision Systems, who speaks of his company's study on what it is that motivates high achievers: "One of the spiritual characteristics of the high achiever that we have identified is what we call 'the sense of higher self.'" They are among those who believe that they have almost supernatural abilities and for whom nothing is

impossible. They feel a commanding presence as though they can control their environment and their circumstances.

Despite the absence of courses on intuition in most formal educational settings, a study by Jagdish Parikh at Harvard Business School found that business executives in a cross-cultural study attribute 80% of their success to acting on intuitive insights, according to Weintraub. It is said that Parikh received some 13,000 responses to his questionnaire and found that more than 75% of those respondents felt they used intuition and logic about equally. Of no surprise, and to disassociate intuition in general from “woman’s intuition,” Parikh observed that some 48% of female respondents said that they use more intuition than logic in their personal lives. Another statistic should turn a head or two: More than 50%—and perhaps as high as 80%—of the respondents agreed that higher intuitive capabilities would contribute to greater success in business. Equally interesting, few managers who use intuition would openly admit to same. According to Weintraub, the explanation may be rooted in our hard-data-driven culture.

The reason could be that intuition remains the “secret” that few will talk about in our culture. In Parikh’s cross-cultural study of nine countries, the United States ranked far below the United Kingdom and Japan in their acknowledged use of intuition in business-related decision making. Thus intuition appears to be a quality that our culture not only doesn’t support but even sees as nonexistent ... or unreliable at best. If most executives in the survey agreed that higher intuitive abilities would contribute to greater success, why does the word *intuition* seem to be anathema in the American culture? It is likely that those whose jobs are accountable to others cannot afford to trust information based on intuition, because their supervisors need hard data, not what is perceived as probability. Another reason may be that we live in a left-brain culture, one largely dependent on logic and analysis. Since intuition, pattern recognition, and holistic understanding are located in the right brain, they are culturally invisible. In other words, the right brain grasps the forest, sees the big picture, and the overall configuration, while the left brain counts the trees and notes the details. For most people, counting the trees is easier than seeing the forest. The number of trees in the forest is exact; the shape and contents of the forest are not. Relying on what can be seen and verified is more comforting for most people than trying to relate to a muddled and muddy big picture that cannot be seen with any type of precision. Professor Howard Stevenson at Harvard Business School defines intuition as seeing patterns, and he suspects that the highly intuitive person has a more developed right

brain and sees patterns that others do not. This may be one reason why intuitive CEOs are successful. They can use both their left and right brains and extrapolate from the patterns they see to make good predictions, projections, and decisions.

As is apparent from these annual missives, the undersigned is as much, if not more, interested in the soft data as in the hard. In light of more than 40 years of watching the rhythmic “passions” of investors, I suppose it would not be irrational of me to lay claim to a certain degree of calibrated intuition. From cycle troughs where the fear of loss and the ensuing panic give way to extended periods of acrimonious recriminations, abject despair, and acute risk aversion to cycle peaks characterized by the “gold rush” mentality whose constant and essential companion is invariably the utter disregard for risk ... piecemeal anecdotal evidence abounds that the subconscious mind loves to chew on. The long expanses in between are less amenable to the kind of decisive conclusions that the extremes generally provide.

Jeffrey Mishlove, Director of the Intuition Network observes that “virtually every profession distinguishes between the highly intuitive sense of the virtuoso or genius as opposed to the competent, workmanlike performance of other professionals.” In many diverse fields of endeavor—and here our interest is in investment management—the key factor that seems to distinguish great intuitive genius is that of timing. A grandmaster of chess once said, “In chess, as in love and music, timing is of the essence.” He could’ve added “investing” to that list. It is as if, at the highest levels of a profession or artistic pursuit, one’s whole being is fully engaged in the apprehension of the nuances and rhythms of the relevant activities, both internal and external. Intuition is an exquisite sensitivity. No less a philosopher than Immanuel Kant maintained that it is “through intuition that we construct and maintain the basic elements of our world—our sense of space and time, our sense of identity, our sense of the truth of things, our sense of beauty and goodness. Intuition, derived from the very structure or essence of our minds, is viewed in philosophy as being prior to all perception and all reasoning.”

Weintraub admits that the ultimate challenge in applying our right-brain capacities resides in learning how to distinguish between emotion, wishful thinking, and intuition. She provides encouragement by noting that while “some people seem to be better at being intuitive than others, it is an ability we can all acquire. Being intuitive is like learning how to swim or play a musical instrument. Some musicians are virtuosos, but the rest of us with a little experimentation and practice (and earplugs?) could, at minimum, hack out a simple tune.” She quotes Oliver Wendell Holmes who recognized that many of us

never explore our latent talents: “Alas for those who never sing but die with all their music still inside of them.”

Putting the Puzzle Together

Rationality is a quintessential behavioral paradigm for the serious investor. It requires never losing sight of the end while at the same time applying reasonable and prudent means. Despite the sometimes overwhelming impulse to submit to the will of the crowd or to engage in mindless imitation of others, particularly during market extremes, the rational investor must remain resolutely independent, deriving any comfort he or she can from the lessons history teaches us. The task is daunting. Understanding the insidious nature of the emotions of envy in good times and fear in bad times, as discussed above, is essential if one is to keep them under control. Either you rule your emotions, or they will rule you. More subtle, the biases to which all of us are subject must be fearlessly identified and rigorously managed. Finally, the fact that highly intuitive investment virtuosos must give full rein to their cultivated talents almost seems counterintuitive. When cyberspace is on everyone’s lips, delving into the seemingly mundane inner space seems archaic. Warren Buffett says it takes him about five minutes to determine whether an investment proposal is worthy of his time and capital. For those unfamiliar with his due diligence process, he doesn’t use spreadsheets, offering circulars, legions of lawyers, investment bankers, and accountants to make his *Blink* (see the book by that name written by *The Tipping Point* author Malcolm Gladwell) decisions. He uses his well-honed intuition, cultivated and nurtured over 50 years.

As I reread what was written in this section, it became apparent that if the reader is looking for firsthand evidence about the manner in which an intuitive person attempts to communicate logically, this rambling gambit might well suffice!

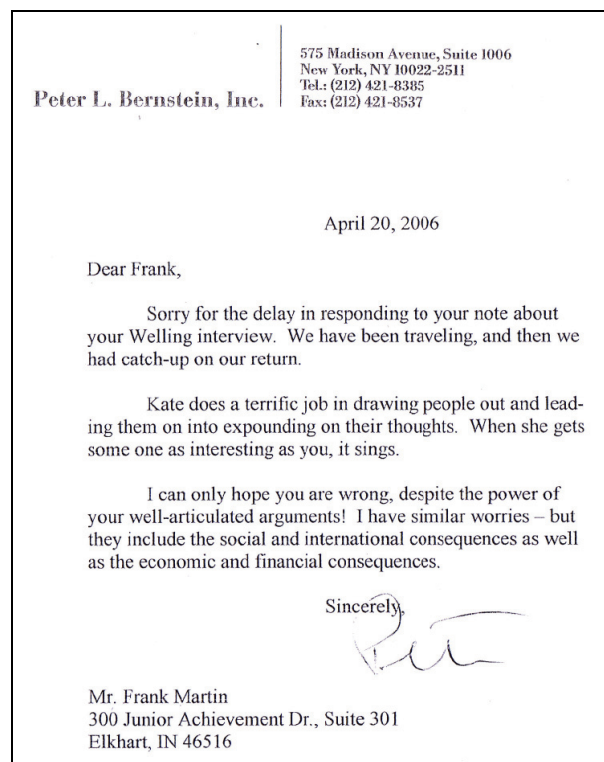
THE PERFECT STORM REDUX

Irrepressible octogenarian Peter Bernstein, 87, has long been one of my heroes, a man of great intellect, courage, and conviction. Many of you may still have the classic Christmas book of 1999, *Against the Gods: The Remarkable Story of Risk*, sitting on your bookshelf, one of four books published since Peter turned 75. As you will recall, I quoted extensively from *Against the Gods* in the 2005 annual report, in the section A Remarkable Story of Risk—Run Amuck. The following was excerpted from a *Money* magazine interview with Bernstein in

October 2004 and provides additional insights into the depth and breadth of this most extraordinary man:

In Wall Street's herd of narrow and twitchy minds, he is patient wisdom personified. Over the vast sweep of his long career, he has probably learned more about more aspects of investing than anyone else alive. Even a summary of his career puts most "experts" to shame: classmate of John F. Kennedy at Harvard, intelligence officer during World War II, researcher at the Federal Reserve Bank, economics professor, money manager, pioneer in investment analysis, historian, expert on risk and author.

After reading my friend Kate Welling's piece on The Perfect Storm?, he sent me the attached note.



Bernstein's note left me in a quandary. As usual, his field of vision was much broader than mine and instead of giving me some encouragement that I was barking up the right tree, he reminded me

(in effect) that word *tree* was meant to be plural. My initial reaction was cerebral overload as I hearkened back to the sign posted outside the Springfield Retirement Community (from an archive of “The Simpsons” TV show), “Thank you for not discussing the outside world.” My immediate afterthought is the immensely “helpful” word of caution from a subway station sign, “For your safety, please do not exit the tram while it is in motion.” Thus you have The Perfect Storm Redux ...

Being stuck on the tram, I returned to *Money* for further direction from Bernstein:

Markets are shaped by what I call ‘memory banks.’ Experience shapes memory; memory shapes our view of the future. In 1958, younger people were coming in who had a different memory bank [when bond yields first rose above stock yields and have remained so for almost 50 years]. That’s also what happened [in 1999] when tech stocks were enormously exciting; most of the new participants in the market had no memory of what a bear market is like, and so their sense of risk was muted.

Bernstein goes on to say:

Understanding that we do not know the future is such a simple statement, but it’s so important. Investors do better where risk management is a conscious part of the process. Maximizing return is a strategy that makes sense only in very specific circumstances. In general, survival is the only road to riches. Let me say that again: Survival is the only road to riches. You should try to maximize return only if losses would not threaten your survival ...

For those who exude confidence in their perspicacity today, Bernstein might look them straight in the eye and inquire:

Can you manage yourself in a bubble, and can you manage yourself on the other side? It’s very easy to say yes when you haven’t been there. But it’s very hot in that oven. And can you save your ego, as well as your wealth? I think I might have just said something important. Your wealth is like your children—the primary link between your present and the future. You should try to think about it in the same way. You want your children to have freedom but you also want them to be good

people who can take care of themselves. You don't want to blow it, because you don't get a second chance. When you invest, it's not your wealth today, but it's your future that you're really managing.

How vivid is your memory of the inflationary nightmares of the 1970s? Bernstein contends that nobody under 50 really experienced it, as they were then too young to be accountable decision makers. The historian that he is, Bernstein thinks sustaining that distant memory is more important to the future than all the more fresh memories of the tech Bubble and its aftermath.

Seth Klarman is another kindred spirit whom I visited in Boston in 2005 and who was kind enough to write a blurb for *Speculative Contagion*. By way of pedigree, Klarman, president of the Baupost Group, averaged about 20% per year for 24 years with only one negative year. Like Peter Bernstein and the undersigned, Klarman is fanatical about managing risk in this environment—or any environment for that matter. The following is an excerpt from the September 2006 issue of *Superinvestor Digest*.

Focus on risk before focusing on return

Seth Klarman's foremost principle of operation is to maintain a high degree of risk aversion.

- Rule #1: Don't lose money. Rule #2: Never forget Rule #1.
- Klarman believes that the primary goal of value investors is to avoid losing money.
- There are three key elements of Klarman's value-investment strategy.
 - A bottom-up approach, searching via fundamental analysis.
 - Absolute-return strategy.
 - Pay attention to risk.

Cash is the ultimate risk aversion. But clients are uncomfortable. Why should people pay a money manager to hold cash? They are paying the manager to wait for the opportunity to invest.

Think of the assets-under-management as if it is your own money. What other people think doesn't

matter ... Ignore questions like “How does it look to our clients and peers?”

Peter Bernstein’s and Seth Klarman’s warnings about the hazards of disregarding, underestimating, or denying risks left me no choice but to revisit the subject nobody wants to talk about: a possibility that the confluence of different forces from different directions could, sometime, somehow, somewhere result in an financial and/or economic storm so unexpected and devastating as to be called by the unusual name “perfect.”

Finally, another wag who eschews slavish adherence to the established doctrine and whose record of remarkable secular forecasts (because he’s always thinking far ahead of the crowd) puts him among the visionary elite—e.g., the forecasting of the “crash” of 1987, the incredibly prescient peak-of-the-market declaration of the end of the Japanese Bubble economy and market in 1989, the iconoclastic advocacy of purchasing gold in 2001 before it doubled, among others ... Marc Faber, who also lent his good name in a blurb for *Speculative Contagion*, is not nearly so oblique as the rest of us! During a January 8, 2007, Bloomberg Television interview Faber unabashedly advised that global assets are poised for a “severe correction, and it’s time to sell. In the next few months, we could get a severe correction in all asset markets. In a selling panic you should buy, but in the buying mania that we have now the wisest course of action is to liquidate.”

As you read several pages ago in Investment Performance, please rest assured that at MCM we are prepared for virtually any eventuality—except for a stock market that goes through the roof. Although we don’t think we, or anyone else for that matter, can consistently forecast with precision, and we know of some other calls that Faber made that did not materialize, we listen nonetheless.

Little Things Can Make a Big Difference

Since 2000 Malcolm Gladwell has written a couple of bestsellers, *Blink* and *The Tipping Point* (the above heading is the subtitle from the latter), which build a case for social and, presumably without a great leap, financial epidemics. Using analogies, Gladwell says it’s as difficult for people to estimate dramatic, exponential change as it is for them to “conceive that a piece of paper folded over 50 times could reach the sun.” As you read on, please look beyond each fold of the piece of paper to the possible outcomes if it is folded time and again.

Segueing to the present financial and economic world, although the paper has been folded a few more times, it is problematic as to whether it has reached the exponential or epidemic stage.

Outward indicators like the Dow Jones Industrial average, as CNBC reminds us incessantly as if all the world is made up of stock watchers and day traders, is recording new highs as I write. While the still-bloodied Nasdaq sells for 50% of its early-2000 peak, the S&P 500, including dividends, continues its advance dating back to 2003, sporting an impressive showing of 15.8% in 2006, which follows 4.9% in 2005 and 10.9% in 2004. Stocks of banks and investment houses of all stripes that together sell every financial product imaginable have surged impressively. None of this should be particularly shocking, as was discussed in *The Equity Risk Premium: Passé?* Investors tend to be anchored in the present and are inclined to linearly extrapolate the past. Collectively, they appear incapable of envisioning radically different opportunity sets in the future that differ significantly from the present.

Flashback to 2005

As you may recall, *The Perfect Storm?* section in the 2005 annual report began with a brief discussion of the “three wise men”: Dr. Ben Bernanke; John Dugan, comptroller of the U.S. Currency; and Alan Greenspan.

Bernanke struck me at the time as a good but untried man, a well-educated foot soldier with little or no battlefield experience who found himself on the front lines of a global economic and financial conflict of unprecedented proportions. At this juncture he is, as one might expect, far more reactionary than proactive. Moreover, the strength and confidence that Greenspan exuded, much like the jaunty FDR in the 1930s (regardless of whether you considered the former Fed chairman more smoke than fire), seems conspicuously absent in the greenhorn Bernanke. It's anybody's guess as to what will be revealed if and when he receives his baptism by fire. We can only hope for the best. In a November 28 speech on the economic outlook, Bernanke communicated more in what he didn't say than what he did. He mechanistically hit the soft spots, such as housing, autos, slowing GDP growth, incipient core inflation, and the recent slowdown in productivity gains. He spent little time discussing the impact on the globalization of financial markets, trade imbalances, the dollar's weakness, runaway asset inflation, derivatives and structured finance, and *de minimus* equity risk premiums and credit-quality spreads. His view appeared to be a static one of a largely closed system with no discernible inclination to venture into stochastic analysis. The ever-evolving capitalist system—particularly the post-neo-classical era in which we now find ourselves—is apparently not fully embraced by

Bernanke. I will later elaborate on this era, with the help of economists Hyman Minsky (1919–96) and Joseph Schumpeter (1883–1950), whose thinking, incidentally, is refreshingly beyond the largely neo-classical academic framework, particularly in the second half of the 20th century.

John Dugan continued to speak out against reckless banking throughout 2006, though his strident tones moderated somewhat. In reading all of his speeches I sensed he was acutely aware of the problems but, at the same time, was looking for politically palatable solutions. As you'll recall, in November of 2005 he then referred to the "top of the credit cycle." With regard to residential housing, it appears he hit the nail on the head. While the economic shock of a housing downturn ramps up slowly, many of the major homebuilding stocks fell 50% or more from their second-half-2005 highs, discounting what was to come. As for our failure to seize the opportunity in the housing market, chalk that up as another error of omission.

Yet to make the headlines is the heavy concentration of bank lending in commercial development. Dugan warned us about this impending crisis and, with a lag, I think he won't be far off the mark. One last word on Mr. Dugan (whom we quoted extensively last year) and his prognostications ... The comptroller of the U.S. Currency regulates 50% of the (federally chartered) commercial-bank assets, which constitute a small fraction of the worldwide credit-generating machine. In fact, the issuance of credit has become so widespread that the central bankers, including Bernanke, may be no more than bit players. The colloquialism "Too many divas, not enough stage" comes to mind. Loosely translated it means the egos among the power players (in so many subsets in the world of finance) are simply too big for the space allotted. How do we put all those genies back into their bottles?? John Gribbin, in a book of almost unfathomable depth, *Deep Simplicity—Bringing Order to Chaos and Complexity*, briefly addresses positive-feedback loops (in the credit markets) that we would argue are functioning with unpredictable yet alarming efficiency, right on the edge of chaos and all that implies. Gribbin postulates that because we are on the inside of the economy looking out and because human beings are an integral part of the very system they're trying to analyze (see Minsky, Soros, and Merton several pages later), "Anyone who believes that governments are in control of economies is living in a cloud-cuckoo-land."

Beware the Popular Housing Price Statistics

Having completed our discussion of Mr. Dugan's apprehensions about the effect of reckless financing on the housing industry, I'd like to digress to a sidebar about the official numbers on house prices on the coasts. They may be deeply misleading, according to impressive research under the byline David Leonhardt, in a *New York Times* article, "What Statistics on Home Sales Aren't Saying," dated December 6, 2006. Depending on which data set you look at, he notes that prices have either continued to rise, albeit modestly, or have fallen slightly over the last year. But Leonhardt is quick to point out that the statistics have a number of flaws, perhaps the biggest being that they are based only on homes that have actually sold. The numbers overlook all those homes that have been languishing on the market for months, getting only offers that their owners have not been willing to accept.

In reality, Leonhardt contends that homes across much of Florida, California, and the Northeast are worth a lot less than they were a year ago. In referring to an auction in Naples, a prominent Naples real estate agent estimated that a typical house there, sold in the normal way, would go for about 20% less than it did the previous fall. In the Boston area, prices have fallen about 10–15% since the middle of 2005, estimated Chobee Hoy, who owns a real estate brokerage firm in Brookline. Jerome J. Manning, who runs the Massachusetts-based auction company that conducted the Naples auction, told Leonhardt he thought that values had dropped about 20% around Boston. For bean counters, that adds up to more than a hill o' beans in Beantown. The U.S. government, meanwhile, says the average price rose 1% over the 12 months ending this past summer. But there's a glitch in how well the government tracks the Boston market: The index excludes any mortgage larger than \$417,000.

The markets in Northern Virginia, Portland (Maine), Sacramento, and San Diego are down are down 10–15% using the same metrics. In New York City, where co-op boards generally bar the door to absentee speculators and creative mortgages—and where Wall Street bonuses are breaking all records (see Introduction)—prices seem to have slid a bit the last few months, but only to roughly their 2005 levels. In the New York suburbs, though, values have fallen perhaps 10% or more since last year.

For many homeowners, of course, the decline doesn't much matter. They didn't really benefit from the run-up, and they won't suffer from the decline. And for renters hoping to buy a home, the fall in prices is downright good news. Unfortunately, there also are many

families who took on huge mortgage debts based on the ephemeral peak values of their properties. In effect, they cashed in on the housing boom without cashing out. As Ed Smith Jr., the chief executive of Plaza Financial Group, a mortgage brokerage firm near San Diego, said, “So many people picked up their homes, turned them upside down and shook them like a piggy bank.”

The withdrawals have been so big that members of the average household in Boston now have slightly less equity in their home than they did in 2000, according to analysis by Moody’s Economy.com that took inflation into account. And that analysis used the house prices reported by the National Association of Realtors, which appear to be more accurate than the government’s data—but are still too rosy, according to Leonhardt.

Then there are the benighted souls who bought their homes in the last couple of years and made almost no down payment. Many of them may now be underwater, owing more on their mortgages than their houses are worth.

Most worrisome, perhaps, is that growing numbers of these families are falling behind on their mortgage payments, and now they won’t be able to bail themselves out by refinancing or selling their homes. “We’re now going to combine a high amount of debt with falling home values,” said Mark Zandi, chief economist of Economy.com.

Believing we have seen only the tip of housing’s economic-effect iceberg, the numbers that approach \$1 trillion in interest-only mortgage resets in 2007 give us pause. For the many reasons cited in last year’s report, housing-induced economic slowdowns often range from two to four years in duration. Despite protestations to the contrary in the popular media, a rational individual would probably argue that the worst is yet to come ...

Greenspan’s Lagging, Looming Legacy

Alan Greenspan, another of the three wise men from the 2005 report, deferred to his successor and was conspicuous by his public absence in 2006. The words he uttered before departing from the Fed, however, still ring in my ears. He warned that hyper-inflating asset prices frequently have unavoidable attendant risks. Should the newly abundant liquidity (the fuel for asset price inflation) disappear as “readily” as it materialized, “any onset of increased investor caution elevates risk premiums and, as a consequence, lowers asset values and promotes the liquidation of the debt that supported higher asset prices. *This is the reason that history has not dealt kindly with the aftermath of*

protracted periods of low-risk premiums” [italics added]. While Greenspan identified incipient “irrational exuberance” in 1996 before it reached epidemic proportions, the final comeuppance, the bursting of the speculative Bubble, did not begin to dramatically implode until early 2000. Buffett, as you will remember, said much the same thing about Berkshire Hathaway stock that same year. In terms of personal-wealth consequences, each man proved, beyond a shadow of a doubt, that it’s far better to be early than late.

Capitalism: When ‘Financial’ Overwhelms ‘Commercial’

A significant explanation for the low equity risk premiums (as discussed in detail in the section The Equity Risk Premium: Passé?)—indigenous as they are to the “perfect storm” scenario—can be found in the global credit glut, about which my friend Doug Noland of David Tice & Associates, based in Dallas, was quoted at length in last year’s report. Based on recent conversations with Noland, as well as carefully reviewing his most recent written work, I would say the financial stimulus continues to grow unabated. Before returning to Noland and his latest musings on the unchecked growth of worldwide credit, let’s turn to an extraordinary economist known, I would surmise, to relatively few of you in order to put today’s happenings in the broader historical context.

Enter Hyman Minsky, a 20th-century American economist and prolific thinker and author whose genius, like that of Sir Isaac Newton, was exceeded only by his humility.¹¹ Neither man allowed egocentric preoccupations to stymie his precocious intellectual development. Two remarkably self-effacing insights were attributed to Newton: “If I have seen further [than certain other men] it is by standing upon the shoulders of giants” and “If I am anything, which I highly doubt, I have made myself so by hard work.” Similarly, Minsky was self-deprecating in assessing his far-reaching contributions to the world of economics and finance, admitting (in terms remarkably similar to Newton’s) that he stood taller because one foot was on the shoulder of John Maynard Keynes and the other on the shoulder of Keynes’ occasional ideological rival, Joseph Schumpeter.

In 1974 Minsky observed a fundamental characteristic of our economy that linked finance and economics: “The financial system

¹¹ Recall the reflections from Ernest Dimnet and Albert Einstein about the absence of independent thinking (see opening paragraph of the Introduction), to say nothing of Charlie Munger and the importance of vicarious learning (most of us fail to follow the following simple adage: “Life is too short not to make every effort to learn from the mistakes of others”).

swings between robustness and fragility, and these swings are an integral part of the process that generates business cycles.” Moreover, the prevailing financial structure is a central determinant of the behavior of the capitalist economy, according to Minsky. Likewise, the dynamism of profit-driven motives (which George Soros calls the “principle of reflexivity” in his book *Alchemy of Finance* and which sociologist Robert K. Merton, whom I have quoted regularly in the past, defined as a self-fulfilling prophecy) influence economic activity within the context of a given institutional structure in that the structure itself changes in response to profit seeking. Resonating with Schumpeter, Minsky emphasized that:

[F]inancial markets will not only respond to profit-driven demands of business leaders and individual investors but also as a result of the profit-seeking entrepreneurialism of financial firms. Nowhere are evolution, change, and Schumpeterian entrepreneurship more evident than in banking and finance, and nowhere is the drive for profits more clearly the factor making for change.

Think about Minsky’s prescience ...

The financial system takes on special significance in Minsky’s theory, not only because finance exerts a strong influence on business activity but also because this system is particularly open—or, as some might claim, prone—to innovation, as is abundantly evident today. Continues Minsky: “Since finance and industrial development are in a symbiotic relationship, financial evolution plays a crucial role in the dynamic patterns of the economy.”

In addition to emphasizing the relations between finance and business, Minsky identified progression through at least five distinct stages of capitalism. The five stages can be labeled as follows: merchant capitalism (1607–1813), industrial capitalism (1813–90), banker capitalism (1890–1933), managerial capitalism (1933–82), and money-manager capitalism (1982–present). Charles J. Whalen, introduced two pages hence, also refers to the latest iteration, “global finance capitalism,” beginning in 1994. The broad historical framework that Minsky developed in the last years of his life has gone almost unnoticed. According to Minsky, money-manager capitalism “became a reality in the 1980s as institutional investors, by then the largest repositories of savings in the country, began to exert their influence on financial markets and business enterprises.” The *raison d’être* for money managers, and basis by which they are held accountable, is the maximization of the value of the investments made

by fund holders. Not surprisingly, business executives became increasingly attuned to short-term profits and the stock-market valuation of their firm.

The growing role of institutional investors fostered continued financial-system evolution by providing a ready pool of buyers for securitized loans, structured finance products, and myriad other exotic innovations about which you will read presently. It also fueled the trend toward mergers, acquisitions, corporate restructurings, leveraged buyouts, and stock buybacks—since fund managers have a strong incentive to support whatever initiatives promise to boost near-term portfolio value. In the 1980s these managed-money funds often provided the resources that corporate raiders (remember T. Boone Pickens, Ivan Boesky, and all who followed?) needed to secure corporate control. Money-manager incentives—often in combination with the force exerted by growing international competition and rapid technological and product/market changes—also encouraged corporate downsizing and re-engineering. See Ben Stein’s observations in the footnote in the Introduction, and it’s clear that masters of the private economy left little to chance as they provided their own incestuous encouragement to the evolution of the financial system by removing many regulations imposed during the New Deal in the ’30s. Tax-law changes also have encouraged takeovers, buyouts, and other types of corporate restructuring. While the impact on labor varied considerably, the rise of the defined-contribution 401(k) plan that has systematically displaced the defined-benefit pension plan communicates volumes. Workers must now shoulder responsibilities for their own financial welfare for which they often are ill-prepared. The “age of empowerment” may prove to be a tragic mistake. Authority without responsibility is the equivalent of a handgun in the grasp of a minor.

A decade ago, Minsky prophesied that money-manager capitalism would become increasingly global and that further international economic integration would take place in the years ahead. Here’s a brief sampling of his comments on these matters: “Managed money capitalism is international in both the funds and the assets of the funds. *It has rendered obsolete the view that trade patterns determine the short-run movement of exchange rates*” [emphasis added]. *Voilà!* At last an explanation for the dollar’s stubborn, though perhaps temporary, resilience.

Minsky: a Prequel?

In what could be a prequel to that which may someday lie ahead, Minsky (who was only 10 years old in 1929) reflected on the years leading up to the Great Depression. The following excerpt [italics added at several points] is from a paper, “Hyman Minsky’s Theory of Capitalist Development,” by Charles J. Whalen, Institute for Industry Studies, Cornell University.

Although the years between 1908 and 1929 were not recession free, they were depression free and generally prosperous—a sharp contrast with the American experience from 1866 through 1908. Because the U.S. capital market was free from any significant policy constraints prior to 1933, any regulation had to come from within the financial community. But the relative stability and prosperity attracted not only new investors but also new investment bankers to the industry (many commercial banks, for example, formed investment banking affiliates in the 1920s). While the older firms were more conservative in their practices, the new firms were “aggressively engaged in expansion of their business.” Moreover, close ties between some investment companies and speculative interests meant that their policies contributed more to market instability than to stability.

According to Guilio Pontecorvo’s [another eclectic economist and a professor at Columbia] landmark study of the 1920s, investment-banking firms had become victims of their own success. Pontecorvo writes that the effect of entry into investment banking in the 1920s “was to reduce the relative importance and the leadership role of the original firms. Furthermore, the industry developed a large competitive fringe. This fringe of highly competitive firms had a considerable effect on the behavior of the industry.” He concludes: “The overall impact of these changes was the elimination of any internal controls that may have been present in the earlier period. The instability in the structure created by the rise of new firms was a factor in the *security inflation* that followed.” In classic Minskian fashion, success bred daring—and when the speculative bubble burst, not even the

nation's great investment banking houses could contain the collapse. It was at this point that Minsky turned to the insights of Schumpeter. In a 1986 essay, Minsky wrote: "The task confronting economics today may be characterized as a need to integrate Schumpeter's vision of a resilient intertemporal capitalist process with Keynes' hard insights into the fragility introduced into the capitalist accumulation process *by some inescapable properties of capitalist financial structures.*" Minsky believed that such integration was possible because Schumpeter and Keynes had a common perception of the task of economics: "they each define the problem that economic theory must explain as the path of development of an accumulating capitalist economy through historical time." From this perspective, the economy is a complex, time-dependent system. Society is an "evolutionary beast," changing in response to endogenous factors, not an equilibrium seeking and sustaining system.

The Depression made manifest the need for public action to stabilize economic activity in the face of business downturns. *Due to the divergence between individual and collective rationality,* it was nearly impossible for individual bankers, businessmen, and farmers to do anything except cut loans, slash prices, reduce employment, and increase agricultural yields—all of which made matters worse in the aggregate. Franklin Roosevelt's answer was the New Deal, a series of policies and reforms that ushered in the next stage of U.S. capitalist development.

On financial innovation, in 1993 Minsky wrote: "To understand the short-term dynamics of the business cycle and the longer-term evolution of economies it is necessary to understand *the financing relations that rule, and how the profit-seeking activities of businessmen, bankers, and portfolio managers lead to the evolution of financial structures ...* Consumer sovereignty is subordinated to the vision of entrepreneurs and the critical analysis of bankers in determining the path of the economy." Drawing on Schumpeter, Minsky noted that the banker/financier is the "ephor" (controlling figure) of a market economy, and that the central bank is

the ephor of the ephor. Since *policy interventions in the economy are the product of political processes*, Minsky stresses that the path through time of an economy is a “*political economy phenomenon*.”

Minsky calls merchant capitalism and banker capitalism “commercial capitalism” and “financial capitalism,” respectively. Marc Faber, my friend mentioned above who calls Hong Kong home, refers to the same phenomenon but by more prosaic names: the “real” economy and the “financial” economy, as described in the 2004 and 2005 annual reports.

Back to the Present

With a possible theoretical framework in place, we return to year-end 2006 and the observations of Doug Noland, upon whom the “mark of Minsky” is indelible. While what follows is long and (dare I say it?) laborious—certainly not fare for the faint of heart—much of it is quoted verbatim to avoid diluting the message through paraphrasing. Noland, by his own admission, has cast his lot with the Jim Grants and Marc Fabers of the world—and obviously believes that the weight of the evidence is so compelling that the search for disconfirming evidence is superfluous. Once you climb out onto that limb, it’s hard to find your way back. So ... read on with the realization that Doug Noland has charted his course and that much of what he looks for is to confirm that he’s on track. Before you skip over the 10 pages that follow, reflect on these words from Pierre-Simon Laplace, the 16th-century French mathematician, astronomer, and philosopher to whom Charlie Munger saw fit to make reference in *Poor Charlie’s Almanack*. Laplace is credited with key discoveries relating to inductive reasoning and probability, as well as causal determinism. In what is considered his greatest work, *A Philosophical Essay on Probabilities*, Laplace reveals one of his distinctive ideas: “We may regard the present state of the universe as the effect of its past and the cause of its future.” Noland begins:

A rapidly weakening housing market, to this point, has been perceived by the stock and bond markets as a net positive. The slowdown has at least temporarily restrained GDP growth, while market sentiment has shifted to the view that current heightened inflationary pressures will prove fleeting. Expectations now have the Federal Reserve commencing a loosening cycle early next year. This prospect has enlivened bullish notions of perpetual economic expansion, robust

corporate profits, and low interest rates. Conventional market analysts have been quick to ratchet up expectations for future stock market gains. In a replay of familiar bubble dynamics, liquidity overabundance begets exuberance that incites only greater financial excess.

Noland laments our escalating dependency on foreign investors, echoing Warren Buffett's concerns, although Noland, unlike Buffett, speaks in gross, not net, terms.

The "Rest of World" (ROW) accumulation of U.S. financial obligations is unlike anything ever experienced in the long history of finance. Foreign holdings of U.S. financial assets expanded, amazingly, at an almost \$1.4 trillion annual pace during the first half of 2006. For perspective, ROW holdings increased an average \$393 billion per annum during the nineties, and didn't surpass \$1 trillion for the first time until 2004. The ROW stockpile of U.S. financial assets has ballooned 50% in just three years to \$11.6 trillion. During this period, total holdings of U.S. credit market instruments jumped 63% to \$6 trillion, as Treasuries holdings increased \$636 billion (46%) to \$2 trillion; agencies rose \$400 billion (59%) to \$1.1 trillion; and corporate bonds including ABS surged \$1.2 trillion (80%) to \$2.5 trillion. ROW's \$800 billion annualized first-half credit market instrument purchases accounted for a large percentage of total Treasury and agency issuance.

It is worth noting that U.S. trade deficits have more than doubled since the dollar's early 2002 peak. Total foreign central bank reserves have swelled an incredible \$1.3 trillion, or 38%, over just the past two years and will soon surpass \$5 trillion. China's reserves are up 366% since 2002 to about \$1 trillion, now outranking Japan as our largest creditor. Look no further than massive U.S. current account deficits and the dollar balances gushing to the rest of the world to largely explain the destabilizing global liquidity glut.

The "recycling" of dollar liquidity back through U.S. securities markets has over time severely distorted our credit system. For one, this process has created enormous artificial demand for top-

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rated U.S. securities, as foreign central banks and others direct the global flow of dollar balances to the perceived safest and most liquid dollar-denominated instruments. Think of this dynamic in terms of a massive credit system expansion—comprising the banks, Wall Street, securitizations, finance companies, securities finance, etc.—generating purchasing power that propagates mushrooming current account deficits. This global flood of dollar balances is then funneled back to a limited supply of requisite securities.

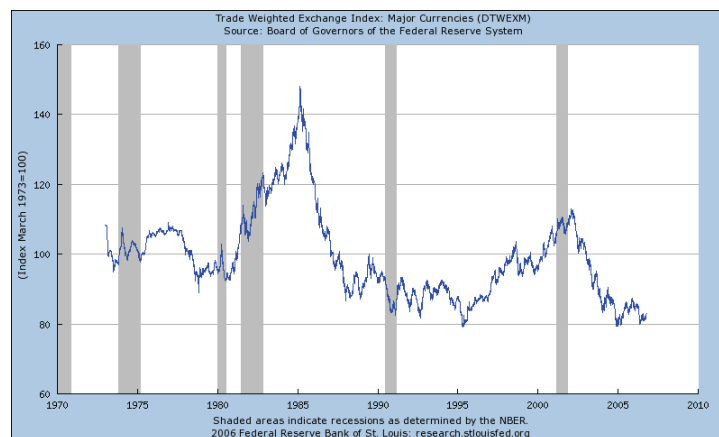
This unparalleled market intervention has not gone unnoticed by the enterprising speculator community. Ramifications include the markets' perception of uninterrupted liquidity and prevailing price support, breeding only more emboldened leveraged speculation. The resulting tight supply of Treasuries and agencies creates further price distortion, including a mischief-making propensity for short squeezes. And with the Treasury market anchoring market yields generally, the process of dollar "recycling" has placed significant downward pressure on yields across the board. Deficient real interest rates, then, promote only greater credit excess, resultant trade deficit expansion and a more unwieldy "liquidity glut." We always thought "conundrum" a misnomer. "Bubble effect" would be more explanatory.

Noland, like a bulldog whose jaws are locked on your trouser leg, continues with a passion.

Importantly, this has squeezed the ballooning leveraged speculating community only deeper into the higher-yielding debt universe, while shifting the "structured finance" apparatus into high gear. The resulting pronounced boost to credit availability and surge in liquidity throughout the corporate sector have been self-reinforcing, nurturing a resurgent corporate debt boom and a credit derivatives bubble. These speculative bubble dynamics explain the insatiable demand for corporate debt that has provided a major impetus for the commercial lending, junk bond, syndicated bank "leveraged lending," and global M&A [mergers and acquisitions] booms.

Where Goeth the Dollar?

With the final breakdown of the Bretton Woods system in 1971 (see “Nixon Shock” on pages 91–92), exchange rates of the major currencies floated, thus becoming persistently variable against each other for the first time in history. Viewing the dollar from the perspective of a foreign holder of U.S. currency, the dollar’s ascent in the early 1980s was largely precipitated by the record-high interest rates in the U.S. Its less-spectacular rise and fall from 1995 to 2005, when the CPI (consumer price index) was comparatively subdued, was probably influenced in some meaningful measure by returns being earned in the U.S. capital markets. For example, the rising dollar from 1985 through 2000 was in part the product of competitive interest rates, rising stock prices, and a general antipathy toward chronic U.S. trade deficits. The opposite was true subsequently. As noted in this section, the number of dollars piling up overseas is beginning to raise an eyebrow or two. Who knows what will happen if and when the droves of dollars come home to roost.



And while speculator flows from low-yielding currencies are today lending support to the dollar, only foreign central bank accumulations of dollar reserves on a massive, unprecedented scale could have forestalled a dollar crisis. The consequences of this ongoing endeavor, however, are becoming increasingly dire. Credit bubble excesses—at home and abroad—are left unchecked to run to only more perilous extremes. We do not believe it is hyperbole to warn that consequences include economic maladjustments and financial instability beyond compare. Yet, credit bubble effects include

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seductive “fundamentals” such as booming corporate profits, robust financial markets, and economic resiliency, altogether presenting a convincing aura of soundness and sustainability.

Noland raises the inevitable question for which no easy answer exists:

A major dilemma today, as we see it, is that massive positions are being accumulated in dollar securities perceived as sound and liquid as “money.” Confidence that foreign central bank operations will interminably support both U.S. securities markets and our currency promotes huge dollar instrument “carry trades” and other speculations. In reality, “official” dollar buying exacerbates excesses, dollar vulnerability and the risk of future speculator de-leveraging and illiquidity. To be sure, irrepressible credit inflation, non-productive debt growth, and unmanageable current account deficits guarantee that the perception of “moneyness” (with regard to U.S. financial assets) is an illusion to be shattered at some future date. Our fear is that the unavoidable dollar crisis will now likely coincide with a crisis in market confidence at the very heart of the U.S. credit system.

Both Noland and I agree with Minsky: “The economy is an ‘evolutionary beast,’ changing in response to endogenous factors, not an equilibrium seeking and sustaining system.”

Manifestly, U.S. and global systems retain little capacity for adjustment or self-correction. Our housing slowdown only incites heightened excess throughout the credit system. The prospect for slower growth encourages an intense flurry of mergers, acquisitions, and leveraged buyouts incorporating progressively more leverage. The prospect of the reversal of Fed “tightening” has equities speculation raging in markets across the globe. Meanwhile, speculator mishaps in energy and commodities trading only empower players operating in the fixed-income and credit “arbitrage” arenas, in the process promoting only more destabilizing system credit and liquidity excess.

Recently, markets have prospered from the view that the Fed's next move will be a rate cut. Through 17 rate increases, the bond market always took solace in housing bubble fragility. Surely, Chairman Bernanke would today prefer not to apply added pressure on faltering housing markets. At 5.25%, the Fed funds rate is agreeable to the financial sector and markets. As bullish analysts see it, the current rate structure would seem to procure double-digit corporate earnings growth for as far as the eye can see. Even savers are offered respectable nominal returns, while borrowers continue to enjoy free-flowing credit at minimal real rates. The rate environment is today creating nothing in the way of headwinds for asset markets or for the real economy.

There is, however, something quite askew with this glowing picture: The Fed has willfully orchestrated the most transparent and agreeable "tightening" cycle, yet without having ever actually tightened financial conditions. This experiment in New Age central banking has suited market participants just fine, as illustrated by the broker/dealer and NYSE Financial indices having surged 84% and 37%, respectively, since rates were first nudged upward back in June of 2004. This does not, however, alter the harsh reality that credit and speculative excesses have emerged more forceful and unwieldy with each passing year. U.S. and global imbalances have been left to accumulate exponentially, ensuring a dreadfully formidable adjustment period. In the final analysis, what's askew is the Fed's misguided determination to avoid popping bubbles, an irresponsible policy stance that has tacitly accommodated runaway excess. No matter how you slice it, there is an incredible amount of debt outstanding in this financial economy.

Charlie Munger warns that too little attention is paid in the design of incentive systems to second- and higher-order effects. For all we know, the global financial system is spinning out of control because those in charge (to the best of our knowledge, *no one* is in charge, as there is no captain on this ship) don't take into account the second- and third-order effects of what's going on.

Examining the landscape, we are anything but dissuaded from our dire credit bubble thesis. In

fact, there is today ample evidence of the type of instability and volatility—especially with regard to perceptions and market prices—that are hallmarks of a boom’s capricious finale. And this is the most unsound boom imaginable, fueled by a degree of credit and speculative excess that even our careful reading of financial history had left us less than fully prepared to fathom.

Disconcertingly, the economy’s recent downshift has only incited a pedal-to-the-metal mentality throughout the financial sector. It is worth noting that non-financial debt growth has slackened somewhat this year as nominal GDP has slowed markedly. Meanwhile, financial sector borrowings have actually accelerated to a 10% annualized rate. The upshot of financial sector expansion significantly beyond the funding needs of the real economy is easily recognizable.

According to Noland, global credit growth continues unabated, despite the U.S. housing slowdown.

Through the year’s first nine months, global investment grade debt issuance of \$1.3 trillion was running 16% ahead of 2005’s pace, led by a 22% increase from the U.S. Record global new “leveraged finance” surpassed \$1 trillion, 14% ahead of last year’s pace, with U.S. leveraged lending increasing 19%. Leveraged buyouts (LBOs), along with high-yield and “leveraged” lending, are on a record pace. Global M&A volume, already having surpassed \$3 trillion, should easily set a record. Global private equity is on track to raise an unprecedented \$400 billion this year. Syndicated bank lending is on pace to reach a five-year high—going back to the fateful telecom debt bubble. And despite the third quarter slowdown, 2006 will post the strongest year of global IPO issuance since the bubble year 2000. At the same time, inflated cash flows and loose corporate debt market conditions have spurred record corporate share repurchases.

“Everybody” is getting in the hedge-fund game. Noland talks about people in high political places, but we’re also seeing it in academia, such as with Roger Ibbotson and Robert Schiller, both at

Yale, who have hung out their shingles like so many kids selling lemonade in the neighborhood on a hot summer day.

Despite some earlier market and industry tumult, the hedge fund community raised \$44.5 billion during the third quarter, a three-year high. Year-to-date inflows of \$110 billion have already exceeded 2002's record \$99.4 billion. Hedge fund assets are said to have surpassed \$1.4 trillion. And in a sign of the times, former Treasury Secretary John Snow recently became chairman of Cerberus Capital Management, a \$16 billion hedge fund group. Clinton Treasury Secretary Lawrence Summers accepted a managing director position at D.E. Shaw, while Paul O'Neill is now an advisor to the Blackstone Group.

Bankers are pulling out all the stops in their rush to pile on profits. Charlie Munger minces no words: "I hate with a passion GAAP (generally accepted accounting principles) as applied to derivatives and swaps. J.P. Morgan sold out for this type of accounting to front-end revenues. I think it's a disgrace." He considers the accounting for derivatives "disgusting" and believes there will be "hell to pay" in due course. He warns, "All of you will have to be prepared to deal with a blowup of derivative books." Continuing with Noland:

To be sure, global credit systems continue firing all cylinders. Here at home, total bank credit has been expanding this year at a 10% pace. Commercial and industrial loans have expanded 15% annualized. Housing slowdown notwithstanding, bank real estate loans have been growing at a 15% year-to-date rate. Total system mortgage debt expanded 10.1% annualized during the first half, with 12.7% growth in commercial mortgages helping to offset a somewhat slower 9.8% increase in household mortgage debt.

Citigroup, our nation's largest financial institution, expanded total assets by \$119 billion, or 30% annualized, during the third quarter. Citi's balance sheet ballooned \$275 billion, or almost 19%, during the past year to \$1.75 trillion. Bank of America is enjoying double-digit growth in both consumer and business loans, with assets expanding 16% over the past year to almost \$1.5 trillion. JPMorgan Chase has posted 11% year-over-year commercial loan growth, with total

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assets also up 11% the past year to \$1.3 trillion. The bank's third quarter investment banking fees increased 44% from a year earlier to a record \$1.4 billion. Though first mortgage originations have been somewhat below last year's level, Wells Fargo has continued to achieve 10% growth in both consumer and commercial loans. Total assets were up 15% from a year ago. And throughout the U.S. banking system, intense competition and narrowing lending margins have pressed bankers to press for greater loan volume.

In response to the industry-wide mortgage origination slowdown, almost without exception the major financial institutions have moved aggressively to ensure double-digit growth in home equity and commercial real estate loans. Yet likely expending even greater influence upon the real economy, lenders have adopted strategies to focus more intensively on small business and commercial lending. And, today, the surest way to rapid lending growth is achieved through financing mergers and acquisitions.

If the highly competitive lending business cannot secure adequate profits, the focus then turns to the capital markets, trading, derivatives and investment management. Never has pressure to meet Wall Street's elevated expectations been as overwhelming, and rarely have financial conditions remained sufficiently loose to emboldened institutions trying to exceed those expectations—in one manner or another. Citigroup, Bank of America and JPMorgan Chase combined to repurchase 120.5 million of their shares during the third quarter, increasing year-to-date buybacks to an astounding 427.6 million.

Hearken back to the Introduction and the executive compensation packages for the top dogs at Goldman Sachs and Morgan Stanley as you read the following from Noland:

Never to be outdone, the rapid expansion of bank credit is bettered by Wall Street and its incredible securities-based credit apparatus. Broker/dealer assets expanded 18% over the past year, with two-year growth of an astonishing 46%. The "big five" securities firms—Goldman Sachs, Merrill Lynch,

Morgan Stanley, Lehman Brothers and Bear Stearns—posted combined net revenue growth during the first nine months of the year of \$93.6 billion, up 33% from comparable 2005. Compensation expense increased 36% during this period to \$48.3 billion. And despite the marked slowdown in home sales, an irrepressible mortgage-backed securities (MBS) and asset-backed securities (ABS) marketplace lends support for another year of double-digit mortgage debt growth. Insatiable demand for high-yielding instruments ensures that “private label” MBS will post another year of heady growth. One of this year’s hottest products, the collateralized debt obligation (CDO) marketplace, is on pace for issuance of \$400 billion, double last year.

Derivatives are the “black hole” of finance. Alan Greenspan, who has stated that derivatives actually reduce systemic risk, would probably place the fears that derivatives conjure up in the same category as the apprehensions about Y2K. The term “notional” refers to the total value of the derivative’s underlying asset. Market-traded derivatives, like stock options or futures contracts, are the most easily understood and help us to define *notional*. For example, if a speculator buys a common-variety derivative, say, a call option, on 100 shares of XYZ that sells for \$30, for \$500, the notional value is \$3,000, and the money at risk is \$500. One of the mysteries of derivatives is that the relationship between notional value and the much smaller capital at risk varies considerably from derivative to derivative and is, therefore, impossible to quantify. Unlike the purchase of common stock that can be owned by only one person at a time, there are two parties to a derivative contract, each effectively placing an opposing bet that the price of an underlying asset will move in a direction that will favor his or her “investment.” The buyer of a call option expects the underlying stock’s price to rise, whereas the seller of the option expects the stock’s price to remain unchanged or fall during the contract period. The potential loss on buying options contracts is typically limited to the capital committed—in this case the \$500. When you move on to exchange-traded futures contracts, potential losses are theoretically unlimited. The over-the-counter derivatives market is dominated by interest-rate swaps. Here’s a simple example. Suppose a small bank has a portfolio of fixed-rate loans, so that the interest payments remain the same each period. The bank wants to convert these fixed-interest payments to floating, or variable, rate payments, so that they fluctuate with market interest rates. That way, if rates rise and the bank has to

pay higher rates on its liabilities, the interest it receives on the loan portfolio also will rise, thereby preserving the bank's profit margin.

The small bank can go to a dealer, typically a large bank, to swap the fixed rate on its portfolio for a variable rate. The small bank promises to pay the dealer the fixed rate, while the dealer promises to pay the small bank the variable rate.

If the small bank extends \$100 million in fixed-rate loans, the notional value of the derivative is recorded as \$100 million on the dealer bank's books. Suppose that when the swap contract was written, the variable rate and fixed rate were both 5%, so the annual interest payment is \$5 million, and the payments cancel each other out. On net, the small bank owes the dealer nothing, and the dealer owes the small bank nothing. Of course, the variable rate often deviates from the fixed rate. Suppose the variable rate drops from 5% to 4%. In this case, the small bank owes the dealer 1%. If we assume there is only one period left in the contract, that amounts to \$1 million. Because the small bank owes the dealer \$1 million, that is the amount of the dealer bank's credit exposure.

In this Goldilocks scenario, Greenspan's *laissez faire* attitude seems to be justified. But in the wild-and-woolly, over-the-counter world of derivatives trading, outside the standard, plain-vanilla, interest-rate swaps, life is not so serene. New mutations of yet exceedingly more complex and intertwined derivatives contracts on seemingly any kind of asset appear almost daily. Unimaginable multiples of financial leverage compound the risks to an alarming extent. Very few people have any experience in "unwinding a derivatives book," and thus the risk remains a hypothetical, an abstract concept. Not so with Warren Buffett, however. While the following block quotation from the Berkshire Hathaway 2005 report is long, the message is surely worth the effort. As you'll see, paraphrasing would not do the subject, nor Buffett's humor, justice.

Long ago, Mark Twain said: "A man who tries to carry a cat home by its tail will learn a lesson that can be learned in no other way." If Twain were around now, he might try winding up a derivatives business. After a few days, he would opt for cats.

We lost \$104 million pre-tax last year in our continuing attempt to exit Gen Re's derivative operation. Our aggregate losses since we began this endeavor total \$404 million.

Originally we had 23,218 contracts outstanding. By the start of 2005 we were down to 2,890. You

might expect that our losses would have been stemmed by this point, but the blood has kept flowing. Reducing our inventory to 741 contracts last year cost us the \$104 million mentioned above.

Remember that the rationale for establishing this unit in 1990 was Gen Re's wish to meet the needs of insurance clients. Yet one of the contracts we liquidated in 2005 had a term of 100 years! It's difficult to imagine what "need" such a contract could fulfill except, perhaps, the need of a compensation conscious trader to have a long-dated contract on his books. Long contracts, or alternatively those with multiple variables, are the most difficult to mark to market (the standard procedure used in accounting for derivatives) and provide the most opportunity for "imagination" when traders are estimating their value. Small wonder that traders promote them.

A business in which huge amounts of compensation flow from assumed numbers is obviously fraught with danger. When two traders execute a transaction that has several, sometimes esoteric, variables and a far-off settlement date, their respective firms must subsequently value these contracts whenever they calculate their earnings. A given contract may be valued at one price by Firm A and at another by Firm B. You can bet that the valuation differences—and I'm personally familiar with several that were huge—tend to be tilted in a direction favoring higher earnings at each firm. It's a strange world in which two parties can carry out a paper transaction that each can promptly report as profitable.

I dwell on our experience in derivatives each year for two reasons. One is personal and unpleasant. The hard fact is that I have cost you a lot of money by not moving immediately to close down Gen Re's trading operation. Both Charlie and I knew at the time of the Gen Re purchase that it was a problem and told its management that we wanted to exit the business. It was my responsibility to make sure that happened. Rather than address the situation head on, however, I wasted several years while we attempted to sell the operation. That was a doomed endeavor because

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no realistic solution could have extricated us from the maze of liabilities that was going to exist for decades. Our obligations were particularly worrisome because their potential to explode could not be measured. Moreover, if severe trouble occurred, we knew it was likely to correlate with problems elsewhere in financial markets.

So I failed in my attempt to exit painlessly, and in the meantime more trades were put on the books. Fault me for dithering. (Charlie calls it thumb-sucking.) When a problem exists, whether in personnel or in business operations, the time to act is now.

The second reason I regularly describe our problems in this area lies in the hope that our experiences may prove instructive for managers, auditors and regulators. In a sense, we are a canary in this business coal mine and should sing a song of warning as we expire. The number and value of derivative contracts outstanding in the world continue to mushroom and are now a multiple of what existed in 1998, the last time that financial chaos erupted.

Our experience should be particularly sobering because we were a better-than-average candidate to exit gracefully. Gen Re was a relatively minor operator in the derivatives field. It has had the good fortune to unwind its supposedly liquid positions in a benign market, all the while free of financial or other pressures that might have forced it to conduct the liquidation in a less-than-efficient manner. Our accounting in the past was conventional and actually thought to be conservative. Additionally, we know of no bad behavior by anyone involved.

It could be a different story for others in the future. Imagine, if you will, one or more firms (troubles often spread) with positions that are many multiples of ours attempting to liquidate in chaotic markets and under extreme, and well-publicized, pressures. This is a scenario to which much attention should be given now rather than after the fact. The time to have considered—and improved—the reliability of New Orleans' levees was before Katrina.

When we finally wind up Gen Re Securities, my feelings about its departure will be akin to those expressed in a country song, “My wife ran away with my best friend, and I sure miss him a lot.”

Back to Doug Noland and the proliferation of derivatives, with the words of warning from Warren Buffett still ringing in our ears.

Yet when it comes to awe-inspiring growth, derivatives these days have no match. Expanding unremittingly at double-digit rates, global derivatives markets have reached nearly \$300 trillion in notional value. Amazingly, positions have tripled in size since 2000 to surpass four times the total combined market value of the world’s equity and bond markets. Globally, the notional value of interest-rate swaps jumped 25% over the past year to \$250 trillion. U.S. commercial bank derivative positions were up 24% over the past year to \$119 billion. Interest-rate derivatives jumped 21% year over year to \$98.7 billion, with U.S. banks’ credit derivative contracts ballooning 60% to \$6.6 trillion.

Alarmingly, the global credit derivatives market has doubled over the past year to \$26 trillion, in the process demonstrating all the signs of problematic excess. There is sound basis for presuming the mania that’s enveloped the credit default swap arena has been a primary driving force for this year’s insatiable demand for new corporate debt. With credit so readily available and marketplace liquidity in surplus, writing corporate credit protection has been as alluringly profitable as selling flood insurance in the midst of a long drought. The only limiting factor is finding enough buyers of insurance. This quandary has been at least partially ameliorated by the proliferation of Wall Street structures incorporating highly leveraged pools of corporate credits that then acquire hedging protection in the credit derivatives marketplace.

Meanwhile, this year’s setbacks in energy and commodities trading have buoyed “credit arbitrage” funds to the top of the global performance leader board. And with success in

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this environment comes the bounty of huge investor inflows—that then must be put to work. Ironically, heightened uncertainty and overall global financial market volatility have only fanned the burgeoning bubble in corporate debt. This manic backdrop has the Wall Street “structured finance” mega-machine burning the midnight oil, with recent new products incorporating as much as 15:1 underlying leverage in corporate credits.

The globalization of finance has fostered a credit Bubble pandemic, as will be obvious as you read on.

To be sure, bubble excesses are no longer confined to the U.S. credit system. Throughout the Eurozone, the pace of private credit growth has accelerated to better than 11%. Credit systems around the world today flourish with unequalled leeway, posting double-digit growth across a wide spectrum of economies, including the United Kingdom, Scandinavia, Eastern Europe, Russia, Australia, New Zealand, India, China, and throughout much of non-Japan Asia. Mirroring the U.S., the Chinese economy has attained the status of one of history’s spectacular credit booms. Also luxuriating in the miraculous global liquidity backdrop, India has set its sights on following in China’s footsteps. And all the while fanning the global boom, America’s captivation with leveraged speculation, derivatives, MBS, ABS, CDOs, CLOs (collateralized loan obligations), LBOs, “repos,” and who knows what else, has taken the world by storm.

Little wonder global markets are these days characterized by such phenomenal price volatility and, increasingly, severe price distortions and divergences. Credit conditions and liquidity creation have remained too loose for too long, with each year of excess adding to the cumulative supply of international “finance” focused intently on generating a rousing return. This amassing global pool of “hot money”—absolutely unparalleled in scope and dynamism—now revels in its freedom to rampage about. For the past several years, this dynamic has imparted a stubborn upward price bias upon the vast majority of global asset and commodity markets. Lately,

however, a conflux of heightened speculative excess, “crowded trades,” and derivatives-related leveraging has nurtured susceptibility to abrupt price reversals, sizable market pullbacks, and some rather exceptional trading anomalies (i.e., natural gas versus the industrial metals).

The abundantly liquid and highly speculative U.S. and global market backdrop has proceeded to the point where any real or perceived scarcity risks foment panic buying and spectacular price spikes. This has been the circumstance throughout the energy and commodities complex and is even a recurring factor for securities markets around the world. Seemingly, myriad marketplaces share a similar propensity for wild speculative runs on the upside, only to leave them susceptible to equally dramatic price collapses and speculative routs on the downside.

Earlier in the year, a liquidity-fueled speculative run propelled a synchronized skyward lunge in global stocks, energy and commodities, and emerging debt and equities markets, only to abruptly reverse in May and plummet collectively as well. The nature of global market instability has been disconcerting, but so far the vast sea of global liquidity has succeeded in keeping things afloat. Fear that the Bank of Japan was removing global liquidity has dissipated, as have notions of concerted global central bank “tightening.” The bottom line is that global credit systems are firing on all cylinders. Liquidity has stayed readily abundant, which has ensured that bullishness perseveres; that speculators have become only more emboldened; and that global economies have remained resilient. Even Iceland and New Zealand, notable examples of susceptibility to the whims of global finance, have defied predictions of financial and economic hardship.

Sound the global system is not. This year’s backdrop exudes instability and uncertainty, characterized by wild volatility and some notable divergences among various markets and asset classes. Importantly, there has been no letup in upward price pressure for commodities in limited supply. Copper has posted a better than 60% rise

so far this year. The industrial metals nickel, tin, zinc and lead have spiked to multi-year or record highs. Global drought conditions and weather uncertainty have wheat prices up 50% to a 10-year high and corn rising 50% to a multi-year high. Cotton, orange juice, sugar, coffee and other staples have traded with significant volatility.

Take a deep breath and watch out below, however, when a presumed shortage fails to materialize. An unexpectedly placid hurricane season and relative calm in the Middle East tipped the energy markets where, in hindsight, an anomalous throng of investors, speculators, and derivative traders were all loaded onto the same side of the boat. A major liquidation of speculative positions surely played a key role as the price of crude oil sank about 25% in the two months following July's record \$81 a barrel. And, of course, natural gas collapsed better than 50%, in the process taking down the \$6 billion Amaranth hedge fund.¹² With a segment of the leveraged speculator community rushing to stop the bleeding, a contagious commodities rout saw the Goldman Sachs Commodity Index drop 20% in two months from its August record high.

¹² Amaranth once sent chess sets to its investors as year-end gifts, inscribed with a quotation from the late grandmaster Alexander Kotov: "It often happens that a player carries out a deep and complicated calculation, but fails to spot something elementary right at the first move." The universality of the above quotation began with Amaranth ... Parenthetically, at the first scent of blood the piranhas gorged on the prey. JPMorgan Chase, Amaranth's natural-gas clearing broker gobbled up \$725 million in the feeding frenzy, making it the big winner in the dismemberment of the hedge fund. In the perverse "dog eat dog" world of big and fast money, the deal with Amaranth helped build JPMorgan Chase's ignominious profile as a commodities player. In January 2007 a magazine called *Risk* named the firm "Energy Derivatives House of the Year." Another hedge fund, Chicago-based Citadel, about which you read earlier, as well as notables such as Goldman Sachs, Merrill Lynch, and Morgan Stanley, were in for the kill. While it's likely that Amaranth investors will receive something more than 25% of their original carcass after the voracious feeding of the piranhas, it should be obvious by now where the customer stands in the food chain. Small wonder why there are more herbivores than carnivores. *Caveat emptor*: If you're not a flesh-eating predator, *you* could be somebody's lunch if you venture into the hedge-fund jungle ...

The index, however, remains about double the level from 2003.

Global market booms and self-reinforcing liquidity abundance have become reliant upon—and beholden to—pervasive leveraged speculation. Such a predicament eventually manifests as erratic market behavior. We've reached such a point, and there's today no escaping chronic susceptibility to the whims of a highly speculative and leveraged marketplace. Bubbles inflating, and others aged and endangered, now emerge as a primary market focus. Moreover, there is a nagging disquiet that the liquidity gala must at some point be interrupted or perhaps even abruptly dissolved, a backdrop sure to intimidate the indecisive and challenge even those of us with the strongest convictions. At this stage of the cycle, we likely have little alternative than to become accustomed to formidable speculative runs that set the stage for unsettling downdrafts.

With regard to the U.S. bubble economy, it is these days on notably less sure footing. Of course, the onset of a major housing downturn is the most noteworthy economic development. Unsustainable price inflation, gross overbuilding and mounting inventories finally punctured grossly unrealistic expectations. Home prices can and will decline. The major national homebuilders—having previously taken full advantage of the speculative bubble—now find themselves in the forefront of cancelled orders, evaporating waiting lists, and costly price concessions. It was estimated that speculators accounted for upwards of 25% to 30% of last year's home transactions. Speculative buying has all but evaporated in many of the frothiest markets, leaving bloated inventories and sharply diminished demand.

It was clearly constructive for the marketplace that yields responded promptly to the prospect of economic moderation. Benchmark 30-year mortgage rates have dropped 50 basis points from this summer's highs. And while I can write with confidence that air has begun exiting local housing bubbles around the country, the same cannot yet be said for the national mortgage finance bubble.

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Credit availability has slackened little, if at all. Importantly, borrowers facing potentially problematic adjustable- and teaser-rate mortgage payment resets are being actively accommodated. Ongoing loose marketplace conditions empower aggressive lenders with the capacity to offer mortgage terms favorable to borrowers desperate to refinance, and at the same time appealing to booming ABS and CDO marketplaces clamoring for higher-yielding fodder. The bottom line is that, despite the housing downturn, total mortgage credit is on track for the sixth consecutive year of double-digit growth and the ninth uninterrupted year of at least 9% annual growth.

Not one to make light of the ultimate consequences, Noland points out the “perilous predicament” in which the central banks find themselves.

There is a particular scenario worthy of the title “A central bank’s most perilous predicament”: Follow the error of indulging credit, asset inflation and speculative excess with a cycle of policy acquiescence and accommodation. In the process, fashion a New Age policy doctrine readily endorsed by a highly speculative marketplace, firmly locking the central bank into a perpetually accommodative stance. This clinches acute system fragility—always inherent to runaway financial and economic bubbles—that will further extort promises of “asymmetrical” policy responses. The marketplace comes to perceive that already loose financial conditions will be loosened aggressively at the first sign of trouble. And, lastly, the most perilous predicament would have a central bank resolutely circumventing the business cycle, precluding recessions while convincing everyone that they’re merely nuisances that can and should be avoided. Most regrettably, this is precisely the predicament now facing the Bernanke Fed.

It may have appeared logical for the Federal Reserve to tread ever so gingerly in an environment fraught with asset and economic bubble vulnerability, while financial fragility seemed to beckon for a degree of policy forbearance. And, of course, no one welcomes the

hardship and uncertainty that accompany bursting bubbles.

There is, however, no escaping the reality that bubbles, along with their innate frailty, are very much an outgrowth of an underlying financial structure, credit infrastructure and monetary environment. It is also true that epic credit bubbles are creatures fashioned especially by all-powerful dynamics and atypical monetary backdrops, usually associated with the interplay of extraordinary financial and economic phenomena. Once ingrained, they will categorically exhibit every inclination to avoid simply rolling over and obligingly exhausting themselves. Characteristically, they will defy the hopes and prayers of central bankers.

The stakes inevitably become too high. Years of financial sector expansion, innovation and evolution work to embed a systemic propensity for ever-expanding excess. Speculators, elemental to bubbles, develop a predilection for increasingly audacious risk-taking (and leveraging), emboldened after persevering and prospering through years of mostly ups and a few downs and close calls. Eventually, limitless liquidity is presumed. And the greater the scope of bubble excess the more assured the marketplace is of unconditional central bank benevolence. Meanwhile, the maladjusted bubble economy is sustained only by ever-larger doses of credit and asset inflation.

Until a catalyst [with teeth!] coerces a change in behavior, lenders will go on lending, borrowers will keep on borrowing; and speculators will relish in speculating. An increasingly commanding Wall Street today stops at nothing when it comes to creating and unloading securities, as well as inventing new products and creative vehicles for financing more and larger deals. And, quite naturally, uninterrupted growth becomes the imperative—for financier, lender, borrower, businessperson, central banker and politician—growth that, not coincidentally, is essential for avoiding the scourge of deflating bubbles.

So the Fed is forced to choose between two unattractive options: Administer sufficient pain to

exact a bubble-terminating change in conduct, or acquiesce to ever-more-destabilizing degrees of excess, distortion and maladjustment. Unfortunately, it is the nature of commanding credit bubbles—as we’ve been witnessing—to provide absolutely no policymaking middle ground.

The Evolving History of Economics, Finance: Reflections

The current liquidity-induced stock market rally should be of interest only to those whose perspective is short-term. Not drifting from our investment mandate, our ever-evolving portfolio posture continues to run counter to the prevailing sentiment. We’ve become especially focused on liquidity, as ready access to cash in what may be a radically different and profoundly attractive opportunity set ahead is of paramount concern.

Regular readers of the MCM annual reports have no doubt committed two charts, which appeared in 2004 (page 17) and 2005 (pages 23 and 24), to memory(!), so they will not reappear this year. It’s easy to download either report as a PDF file from the library section of our website (www.mcmadvisors.com). The first chart, the historical trend in the ratio of the market value of all publicly traded U.S. equities to GDP, serves as a rough measure for the ebb and flow of the valuation of common stocks in general. The second chart displays the trend in the ratio between total debt and GDP.

Updated information on both charts is calculated as follows. The data for the aggregate market cap to GDP ratio uses the Wilshire 5000 index (actually 6,300 publicly traded, domestically domiciled companies) as the numerator and the trendline estimate of GDP for 2006 based on actual 2005 data. The numerator is \$17.7 trillion (including \$1.6 trillion owned by “insiders”), and the denominator is \$13.2 trillion, indicating a ratio of 134%. We consider this information to have a high degree of accuracy. The range for the 70 years ending in 1995 was from our market lows of below 30% to bull-market highs around 80%. The average is 60%. By this crude measure, domestic common stocks, in the aggregate, are selling at more than twice the 80-year average.

Equally problematic is the ratio of total debt to GDP. We do not believe that a precise number can be provided because of the existence of the double counting of real-estate-related debt when viewed at a point in time. Rather than repeat ourselves, please refer to the 2005 annual report beginning on page 26. We estimate the Total Credit Market Debt to GDP ratio to be 330%. The ratio reached

270% in the depths of the Great Depression, only to fall back to between 120% and 140% for the almost 50 years leading up to the early 1980s, where once again it began its long ascent to record highs. The comparatively low ratios following the Depression are explained in detail in the section A Tale of Two Americas Rethought that discusses the establishment of the FDIC (Federal Deposit Insurance Corp.) and the ultra-conservative lending practices that characterized banking throughout the 1930s and beyond.

No matter how generous you are in interpreting the above big-picture data, it corroborates the details that Doug Noland and others have provided. Fred Sheehan Jr., whom I introduce in the following paragraph, adds his own interpretation of the growing debt relative to GDP. “Between 1920 and 1980, every dollar of growth was supported by about \$1.40 of new debt. The ratio is \$7 of borrowing to a dollar of growth today. This,” he notes with a touch of sarcasm, “is economically unproductive but financially remunerative.” The connection between the financial and the real economies, as Faber or Minsky would avow, is ultimately inseparable. Either a greater share of GDP is dedicated to servicing the burgeoning debt, or the assets (phantom or otherwise) are liquidated in distress—and the creditors end up using the then worthless “certificates of confiscation” to paper their crumbling walls.

According to my aforementioned Bostonian friend and collaborator Mr. Sheehan, who often writes erudite essays for Faber’s publication *The Gloom, Boom & Doom Report*, the “financial markets owe much to illusion.” In a December 2006 historical essay, “War of the Nerds,” Sheehan laments the complacency toward risk among most investors and the attendant nonchalance toward the possible consequences. In a particularly compelling story, Sheehan recounts the several unheeded warnings by a prominent central banker who described the economy as “living on the edge of an abyss if taxes and spending were not addressed. [The banker] then observed that if nothing were done, the first trouble would be some basic questions about convertibility of the dollar ... the government will be forced to consider imposing direct controls over wages, prices and credit.” Federal Reserve chairman William McChesney Martin issued these and similar warnings in speeches in 1965 and later in 1968. Martin’s warnings came to fruition on that fateful day in August 1971 (not to be confused with the fateful August day three years later, the culmination of Watergate) when President Nixon opted off the gold standard and

imposed temporary wage and price controls.¹³ Parenthetically, it was in the evening following that Sunday afternoon presidential announcement that, in utter disgust, I took pen in hand and began writing essays on the capital markets and the economy. It must've been the tipping point! I've kept on writing for 35 years. So feel free to blame my penchant for purple prose on Nixon!

Sheehan's essay begins (and this essay concludes) with a repeat-for-emphasis reiteration of the thought-provoking quote from George Eliot's tragic story, *Silas Marner*, first noted in the Executive Summary.

The sense of security more frequently springs from habit than from conviction, and for this reason it often subsists after such a change in the conditions as might have been expected to suggest alarm. The lapse of time during which a given event has not happened is, in this logic of habit, constantly alleged as a reason why the event should never happen, even when the lapse of time is precisely the added condition which makes the event imminent.

If the logic of that short vignette on the peculiarities of human behavior didn't immediately resonate, please return immediately to the section titled Rationality.

¹³ By the early 1970s, as the Vietnam War accelerated inflation, the United States as a whole began running a trade deficit for the first time in the 20th century. The critical turning point was 1970, which saw U.S. gold coverage deteriorate from 55% to 22%. This, in the view of neoclassical economists, represented the point where holders of the dollar had lost faith in the ability of the U.S. to manage its budget and trade deficits.

In 1971 more and more dollars were being printed in Washington, then being shipped overseas to pay for government expenditures on the military and social programs. In the first six months of 1971, \$22 billion fled the U.S. In response, on August 15, 1971, Nixon unilaterally imposed 90-day wage and price controls, a 10% import surcharge, and most importantly "closed the gold window," making the dollar inconvertible to gold directly, except on the open market. Unusually, this decision was made without consulting members of the international monetary system or even his own State Department and was soon dubbed the "Nixon Shock."

A TALE OF TWO AMERICAS RETHOUGHT

John Edwards, the Democratic vice-presidential candidate in 2004, and, most recently, among the first (December 27, 2006) to throw his populist hat in the ring for 2008, gained a lot of media attention with his tale of “two Americas.” Mr. Edwards observed that “one America is for the rich and one for the rest; one privileged, the other burdened; one that does the work, another that reaps the reward; and one that pays the taxes, the other that gets the tax breaks ...” While Edwards had some success stirring the pot of class politics, the heat of discontent from voters who grumble about the economy did not rise to enough of a boil to achieve an electoral victory for the Kerry-Edwards ticket. Instead, red-state, working-class voters paved the way for another four years of Bush-Cheney.

As long as the economy remains relatively stable, the voting public doesn’t seem to be particularly interested in pursuing a political platform that promises a sweeping redistribution of wealth. Most people are willing to sacrifice the modest gains in income and the more egalitarian society that would ensue in order to preserve the dream of striking it rich. How else can we explain the fact that, according to *The Economist*, more than 70% of Americans support the abolition of the estate tax (inheritance tax), even though only one household in 100 will pay it? The American spirit, it seems, is characterized by a steadfast belief that wealth—whether acquired through hard work and business acumen, a blossoming career as an entertainer, a child’s athletic or intellectual prowess, or a sudden lottery windfall—is just around the corner. The unfathomable executive compensation packages that are doled out in the nosebleed suites of Manhattan skyscrapers—and are about as far from the reality of most businesses as Donald Trump is from the role of a Buffett-like capitalist icon—may incite moral outrage in some quarters. In general, though, they are seen as a negative externality rather than a fatal flaw in the system. Such wretched excess is the price to be paid for a system that holds out the hope of prosperity and security.

That isn’t to say the working class doesn’t care about the economy; it does. But these folks worry less about what’s going on at the top rungs of the ladder than about what’s happening on their own rung. Dreams of the future aside, in their day-to-day life they are interested in maintaining the status quo or perhaps in taking a modest step or two up the ladder. Accordingly, issues like the cost of energy, hourly wages, the price of healthcare, and job security tend to have the greatest sway over their political affections. A recent poll by *Foreign Affairs* indicates that 90% of workers worry about their jobs going

overseas, while 60% are skeptical of free trade. Small wonder that some politicians are turning to protectionism.

Is America's brand of capitalism too unequal? I think it depends on whom you ask. Endless research is produced on the disparity in incomes in America, but do any more than a small handful of the 105 million families in this country read *The Economist*, *BusinessWeek*, or the *Wall Street Journal*? The trends often referred to are very long-term, and the changes are so incremental that they frequently go unnoticed by those on the bottom rungs of Abraham Maslow's hierarchical-needs ladder. While many families live from paycheck to paycheck, the unemployment rate, at less than 5%, has not approached kindling temperature. Easy credit, forgetting for the moment about the consequences, makes the American Dream seem more accessible for the masses. Optimism is a relative term. For manifold reasons, the bottom quintile of America's workers has not yet taken to the streets to protest the supposed inequity of the system.

While it's an insult to the disenfranchised to deny the existence of inequality in incomes in America, I think there are certain dangers in oversimplified generalizations, and care should be taken before deciding whose ox deserves to be "gored." So, before we go off on a rant about the extent of "gross inequity" (about which you received a hint in the Introduction), let's examine the U.S. Census Bureau's income-distribution figures that are at the statistical foundation of most class-warfare rhetoric. Keep in mind, in this instance we are referring entirely to the distribution of income as distinct from the distribution of wealth, which refers to income saved and invested from prior years, inherited assets, etc. At first blush, these annual income figures show a high level of inequality. According to Census Bureau data, the top one-fifth of households have \$14.30 of income for every \$1 in the bottom one-fifth. So that the reader will know our source and its potential biases, we lean heavily for the substance of the discussion that follows on the conservative Heritage Foundation think tank, the board of which includes Steve Forbes, J. William Middendorf II, and a host of other notable conservatives who advocate the principles of free enterprise, limited government, individual freedom, traditional American values, and a strong national defense.

If the Census Bureau income data are adjusted for those items not included, the tenor of the implication about inequality changes. First, capital gains and losses are added to the Census Bureau data. Offsetting by a factor of two for the lowest quintile are employee health benefits, which tend to benefit the upper quintiles (i.e., those who have salaried jobs) and government non-cash transfers—such as

the earned-income tax credit, food stamps, school lunch programs, public housing, Medicaid, and Medicare—which tend to benefit the lower quintiles. All of these benefits, in other words, when counted at their insurance or market value, promote income parity. Finally, the effects of federal income taxes, state income taxes, and Social Security taxes reduces annual total income by an amount almost two times the benefits listed above that accrue largely to the lowest quintile and markedly decreases inequality, as the top quintile shoulders a disproportionate share of the tax burden. The folks at the Heritage Foundation (specifically Robert E. Rector, co-author of the paper in question, whom we interviewed for the better part of an hour), call the data as adjusted above “comprehensive post-tax income.” Inclusion of taxes and non-cash aid substantially reduces economic inequality. As a result the bottom quintile’s share of total income rises from 3.5% to 5.3%, and the top quintile falls from 49.6% to 46.2%. The \$14.30-to-\$1 advantage that the top quintile enjoys drops to \$8.60 to \$1.

The overlooked number of people in each quintile is where income inequality is most affected and, often times, least noticed by the casual observer. The Census Bureau quintiles are unequal in size because they are based on a count of households rather than individuals. A household is defined as a person or group of persons living in a single housing unit. In the United States, high-income households tend to be married couples with many members and earners. Low-income households tend to be single persons with little or no earnings. Thus, the superficial reader of this data may be surprised to learn that the average household in the Census Bureau’s top quintile contains 3.2 persons, while the average household in the bottom quintile contains 1.8 persons.

Thus, for every person in the lowest quintile there are 1.7 persons in the top quintile. That is a whopping difference. If one adjusts the quintiles so that each actually contains 20% of the population, the income share of the bottom quintile rises to 9.4% of total income, and the share of the top quintile falls to 39.6%; the income disparity of the top to the bottom quintiles would fall to \$4.21 to \$1.

Finally, it is worth noting that, in many respects the economic inequalities between the quintiles are a direct reflection of disparities in work performed. If we revert to the conventional Census quintiles with unequal numbers of persons and examine the total annual hours of paid labor in each quintile we find that in 2002 (admittedly somewhat dated, but arguably still relevant) individuals in the bottom quintile performed 4.3% of all the work in the U.S. economy, while those in the top quintile performed 33.9%. Thus the top quintile

performed almost eight times as much labor as did the bottom quintile.

In part, the low levels of paid employment in the bottom quintile reflect the low numbers of working-age adults (ages 18 to 64) within the group, with the bottom containing only 11.2% of all working-age adults, while the top quintile represents 27.6%. Not only does the bottom quintile contain fewer adults of working age, but each adult, on average, works fewer hours during the year than does his counterpart in the higher-income quintiles, averaging half as many hours. The combination of relatively few working-age adults and low levels of work per adult contributes significantly to the low income levels in the bottom quintile.

Most people, regardless of political persuasion, will agree that the Heritage Foundation research makes three important points.

- The first is that the income differences between quintiles are not as extreme as the census data present them to be, though here individuals to the left of center may quibble that the aggregation of data into quintiles minimizes the extent of the difference, pointing out that if one compares the median income in highest and lowest quintiles, which would be another means of representing comparative wealth, the discrepancy is a factor of 7.40 (\$111,310 vs. \$15,040) not 4.21.
- The second is that the tax system and the government programs that it funds are effecting a significant redistribution of the wealth.
- The third is that individuals in the lowest quintile would benefit from greater opportunities to work.

From this point forward, however, the discussion gets cloudier. Liberals might see the redistribution of wealth as the alleviation of suffering and the foundation of a humane society. Conservatives might see it as a form of moral hazard: an injustice to hardworking Americans and a self-fulfilling prophecy that promotes dependence and stifles initiative across the entire economic spectrum. Liberals might argue for further narrowing of the gaps through the creation of new redistributive economic programs or the revision of old ones. Conservatives might suggest that the existence of gaps in income has created a strong incentive for acquiring an education,

which has led to a better trained, more productive workforce.¹⁴ Last, conservatives might argue for caps on the amount of money an individual can receive from welfare and stronger incentives for returning to work. Liberals might use this opportunity to push for government contributions to daycare. Our purpose here is not to take a position on any of these issues. Rather, it is to note that income discrepancies for the vast majority of Americans are not as large as they initially seem and to suggest that there is enough common ground for a rational and hopefully productive discussion about how to best improve the standard of living for everyone in the United States. Unfortunately, there are few absolutes in the study of demographic data, and the result is often dueling data sets. You'll get scant comfort—but perhaps some amusement!—from these closing witticisms, both of which are commonly attributed to Mark Twain:

Figures don't lie, but liars figure.

There are three kinds of liars: liars, damn liars, and then there are statisticians.

The Law of Small Numbers

It is my hope that the foregoing section has helped bring a new perspective to the discussion of income distribution in the United States. It hasn't touched, however, the nagging issue of the outrageous salaries that comprise the top end of the highest quintile. In the name of "fair" play, I thought I'd present some data about executive compensation, as published by the liberal research groups *United for a Fair Economy* and the *Institute for Policy Studies*. According to their jointly published recent "Executive Excess" report, in 2004 the ratio of average CEO pay to the average pay of a production (i.e., non-management) worker was 431:1, up from 301:1 in 2003. That's not the highest ever though. In 2001 the ratio of CEO-to-worker pay hit a peak of 525:1. Today's compensation numbers rank on the high end historically. In 1990, for instance, CEOs made about 107 times more than the average worker, while in 1982 the average CEO made only 42 times more. "Pay" in this case refers to total compensation—including salary, bonuses, restricted stock awards, payouts on long-term incentives, and the value of options exercised during the year.

The report indicated that average CEO pay was \$11.8 million in 2004. Remember my early warnings about dueling data sets. The

¹⁴ There is strong anecdotal evidence that would support such a claim. The share of U.S. workers with a college degree, which was 20% in 1980, is in excess of 30% today.

folks at United for a Fair Economy might have provided a slightly more realistic picture of executive compensation had they used the median salary of executives included in the data set. The median salary, which was \$6,855,000, would have been a more appropriate metric since it would have avoided the skewing effect of the huge pay packages that a handful of executives receive. In fairness to the authors, however, the source from which they derive their research, *BusinessWeek's* annual survey of the 367 wealthiest corporations, also uses the mean to report average compensation, as do similar surveys, including the one at *Forbes*.

Probably most people, whether conservative or liberal, would agree that executive compensation schemes that result in \$50 million, \$100 million, even \$200 million payouts are obscenely divorced from reality. The populace at large may see this chicanery as a potent symbol, an embodiment of greed and selfishness that can become a rallying cry for revising and, from their perspective, improving the system. Such a symbol in the hands of a radical demagogue, a modern-day Huey Long, might become the basis for social upheaval.

In reality, such compensation schemes represent a comparative drop in the bucket of the entire economy¹⁵ and would have very little impact on overall well-being if they were distributed downward. The number of excessive CEO salaries will never be statistically significant when comparisons are made with 105 million households. According to *Forbes*, only five of the CEOs of the United States' 500 wealthiest corporations had compensation packages in excess of \$100 million. Thirteen were north of \$50 million, 40 were above \$25 million, and 140 were more than \$10 million. This list, of course, omits the thousands of highly paid Wall Streeters and the specialty bankers who are making (mountains of) hay so long as the sun shines on the credit-glut epidemic. It also omits the pay that CEOs of smaller and private companies receive. The compensation of the latter is not made public because they aren't required to file annual reports to the Federal Trade Commission. Unlike the CEOs of public companies, the nuances of whose pecuniary benefit packages are explained in revealing detail in the annual proxy statements mailed to all shareholders, most of whom don't seem to mind reading unembellished factual material devoid of color, graphics (with one exception), and pictures, the CEOs of privately capitalized companies are able to work in virtual anonymity. Regardless of what one defines

¹⁵ Admittedly, when aggregated the numbers become large enough to be worthy of Illinois Sen. Everett Dirksen's well-remembered observation, "A billion here, a billion there, and pretty soon you're talking about real money."

as excessive and how one expands the data pool, the results don't rise to the level of statistical significance. We may be talking about extremely high compensation, but we're not talking about amounts of money that could result in a substantial redistribution of the wealth.

Perception, however, is not always linked to reality. Perception is the process of acquiring, interpreting, selecting, and organizing what we observe through all our senses. Sometimes the intensity of the sensory stimulus influences our perception of the effects of events. While perception can be rational, most of the time it isn't. Emotions often rule the mind. Under conditions of extreme and widespread emotional angst, the rational case presented above may never be heard above the noise. Crowd psychology, congealed only by the simplest of suggestions, is in no way amenable to persuasion by logical arguments.

What If?

As for now the "law of small numbers" scenario—a corruption of the "law of large numbers" (the precocious Bernoullis were cited in last year's report; this principle of mathematics is attributed to James) coined shamelessly by the undersigned—remains unrealized. But it may not be permanently suspended. While some readers will dismiss the following as poppycock, I urge you not to be too quick to turn the page.

What if the national unemployment rate were to defy those anchored in the present and skyrocket to 10% or even 15%? What if the floodwaters of economic hardship begin to rise again, as they did in earlier times of economic distress, and the social safety net fails? Impossible, you say, because of the safeguards enacted during the Great Depression. Reflect on this thought for a moment. Virtually every program in the safety net, as I will detail in a moment, is logically and substantially *underfunded* and therefore dependent on transfer payments to deliver on its promises. In political science and economics, a transfer payment is a payment of money from a government to an individual for which no goods or services are required in return. In economics, government transfer payments can be considered a negative tax, since in the case of a tax, people pay the government without getting any goods or services in direct exchange. While it certainly hasn't been tested, there may be a negative tax limit beyond which taxpayers will revolt. What happens then?

No matter what the tax rate, taxpayers simply cannot fund a systemic failure, particularly one that results from an overstretched and

risk-indifferent financial system that has been dissected elsewhere in this report.

If you consider chaos and whatever might follow impossible due to myriad “fail safe” programs instituted in the 1930s, please ponder two simple but telling examples of grossly *underfunded* institutional safety-net programs: the Pension Benefit Guaranty Corporation (PBGC) for pensioners and the FDIC for savers. In July 2006 Congress addressed pensions for the first time since ERISA (Employee Retirement Income Security Act) was enacted in 1974. As recently as November 2006 the *Chicago Tribune* reported that the PBGC “is running a long-term \$22.8 billion deficit,” and “the system is underfunded by an estimated \$450 billion.” Of course, defined-contribution plans [401(k) plans and others] have rapidly supplanted pensions as the retirement plan *du jour*. By contrast and by definition, these plans are always “fully funded.” Parenthetically, “fully funded” is a misnomer. To be sure, from the employer’s perspective there is no future funding liability. But if the assets in the account are decimated because of uninformed investment choices or pervasive bear markets, the participants would hardly think of them as “fully funded.” As we’ve discussed in earlier annual reports (e.g., *The Great Abdication of Fiduciary Responsibility*, 2003), vesting responsibility for management of defined-contribution assets with the employee is a flagrant delegation of responsibility without commensurate authority. Known as the “imperious immediacy of interest,” the employers want the intended consequences of the action (shirking the responsibility of providing *income security* for their employees *during retirement*) so much that they purposely choose to ignore unintended effects. The unintended effect is surely to be a great percentage of underfunded or even unfunded 401(k) plans after the next market meltdown. This willful ignorance is far more pernicious than “true ignorance.” In addition, the euphemism “empowerment” is little more than a time-intensive intrusion on the after-hours lives of the participants if they hope to have any chance of learning enough to keep their 401(k) heads above water. So far the results are not encouraging. According to AMG Data Services, approximately 90% of new money invested in mutual funds in 2006 was deployed in non-domestic funds. Always chasing the last best idea ...

Therefore, Congress, in its infinite wisdom, thought that there was no need to protect participants in defined-contribution plans. Then along came the Enron scandal in 2001, bringing to the surface one potential problem with defined-contribution plans; the company had strongly encouraged its workers to invest their 401(k) plans in their employer itself, violating primary investment guidelines about

diversification. When Enron went bankrupt, many workers lost not just their jobs but also most of the value of their retirement plans. Congress inserted trust-law fiduciary liability upon employers who didn't prudently diversify plan assets to avoid the chance of large losses inside ERISA. But if the fiduciaries go broke when the plan fails, there are no deep pockets to make the employees whole. As noted above, Congress protected defined-contribution-plan participants from some isolated risks but not from the big, systemic one. But, you say, "You are only selecting a subset of the population at large, those Americans who have defined-benefit or defined-contribution plans."

In response, let's move on to commercial banking and the FDIC (and presumably a much larger subset). Suffice it to say, your grandfather's banking system is almost an anachronism today. As if it were mocking commercial bankers in general, as well as indicating the redundant billions available for rent, in late November 2006 Citadel Investment Group, the Chicago-based hedge-fund manager, "announced plans to borrow \$2 billion in the public markets," according to my ideological cohort Jim Grant. Citadel, which manages \$12 billion of investors' capital (leveraged, net, at the ratio of 7.8:1, as disclosed in the offering circular) aspires to be less beholden to "Wall Street prime brokers for funding, especially during times of stress." Observes Grant: "Of course, if the prime brokers, who know Citadel's positions, were unwilling to extend accommodation in a crisis, it begs the question of why a bondholder, with far less information, would want to be on the hook." What's amazing about the above credit-generating scheme is that, aside from the reference in the second line, the word "bank" is conspicuous by its absence.

Nonetheless, let's give commercial banking and the FDIC their due. In a September 2006 letter to the FDIC from the senior economist of the American Bankers Association (which represents 2.2 million bankers), Robert W. Strand pronounced the banking system sound. In arguing for a reduction in the Deposit Reserve Ratio (DRR) from the current and long-standing 1.25% of total domestic insured deposits (the statutorily permitted range is 1.15% to 1.50%), he asks and answers his own question.

It is natural to ask whether the risk has remained the same as it was in 1991. *The answer is clearly no* [italics added]. First, Congress enacted significant regulatory powers in the early 1990s—including prompt corrective action, depositor preference and cross guarantee measures—that make it less likely that a bank will fail and less costly to resolve those

that do. Enhancements under development in risk-based premiums and risk-based capital, if done correctly, should further encourage sound banking and reduce the risk of loss to the DIF [Deposit Insurance Fund].

The unmistakable motive behind the appeal was to reduce, as well as stabilize, the premium expense that banks pay for the insurance so as to minimize the impact on bank earnings. As Charlie Munger would surely say, “The bankers have gone bonkers.” To suggest that banking, or the amorphous worldwide credit-generating machine whose clutches (in crisis) the commercial banks cannot escape, is “sound” goes beyond the incredulous. John Dugan, comptroller of the U.S. Currency, is on the stump constantly imploring his run-and-gun wards to rein in their reckless and feckless lending practices. If the bankers are more worried about tweaking their earnings by lobbying the FDIC to reduce the premiums paid to protect their increasingly at-risk depositors, who, we’re inclined to ask, is the depositors’ advocate—if not the bankers?

As you read excerpts in the block quotation below from *A Brief History of Deposit Insurance in the United States*, published on the 50th anniversary of the FDIC’s enactment through the second Glass-Steagall Act (and signed into law in 1933 on the June day that nine years later would become my birthday), perhaps you can sense the needlessness of such laws for a banking community that was already overwrought and nearly crippled with contrition. (Ironically, and emblematic of the perverse cyclicity of finance, Glass-Steagall was repealed in 1999, precisely when, in this observer’s view, it should’ve been enacted for the first time. Glass-Steagall attempted to limit ruinous competition among banks by placing ceilings on interest paid on certain types of accounts—and by separating the activities of commercial banks and securities firms and prohibited commercial banks from owning brokerages, among other provisions.) In any event, please reflect on this flashback to the 1930s, compare the message of conservatism couched in these words, and muse on the relaxation of standards that 70 generally crisis-free years have surreptitiously enabled. Quoting from *A Brief History* ...

The early years of the FDIC’s existence, following banking laws enacted from 1933 to 1935, were not a period of risk-taking by banks. Caution marked the attitudes of both the supervisory agencies and the industry itself. For their part, the supervisory agencies viewed the events that culminated in the nationwide bank holiday as a banking rather than a

monetary phenomenon. The prevailing philosophy was that unfettered competition in the past had resulted in excesses and abuses in banking. Consequently, the supervisory agencies followed what the FDIC later termed as a policy of keeping banks and banking practices within the bounds of rightful competition.

The attitude of bankers was similarly circumspect. Those who survived the Depression were chastened by that experience. The effect of the Depression experience on the industry was reflected in the subsequent massive liquidity buildup undertaken by banks. By 1937, for example, cash and holdings of U.S. government securities comprised about 52% of the industry's total assets, or more than twice the proportion held in 1929. [Today's ratio, 17%, is provided with reluctance to avoid precipitating adverse health effects for those who are faint of heart.] To the dismay of would-be borrowers, banks continued to stress liquidity for many more years. While the effects of a still-depressed economy also engendered caution on the part of bankers and regulators, conditions improved from the low point reached in 1933.

Unemployment declined significantly, real GNP increased at an average annual compound growth rate of 9.5% between 1933 and 1937, and price increases were moderate. The recession of 1937–38 interrupted this pattern of economic expansion. Owing to the continuous improvement in the banking system that had occurred since the bank holiday of 1933, however, banks were able to meet without difficulty the strains resulting from the decline in business activity that ensued. Following the recession, economic conditions improved once again as real GNP rose and unemployment abated.

When the Law of Small Numbers and Rising Angst Converge

Can the “robber barons” of today forever live in opulent obscurity in their mansions in gated communities or New York City

penthouses?¹⁶ Perhaps ... unless a credit, derivatives, housing, employment, or other economic or financial crisis ensues that causes great angst among the populace—and someone in high political office sees fit to use the small number of the super-rich to galvanize public discontent by directing it toward the most visible and deserving of scapegoats, namely, the leaders of big business and finance, as a convenient means to bring about necessary change.¹⁷ John Edwards, bide your time—and the opportunity may be yours. Scapegoat icon Donald Trump, of course, is little more than a caricature, a satirical and ludicrous imitation of today’s “capitalist”: a man who is both loathsome and an object of envy. Under different circumstance, however, he might be perceived as a symbol embodying something far

¹⁶ Modern scholars, such as Robert Heilbroner, a professor of economics, describe the robber barons of a century ago. In his book *The Worldly Philosophers* Heilbroner claims that robber barons used extraordinary dishonesty to gain economic power and industrial supremacy. In the fields of finance and banking, the names Jay Cooke, Daniel Drew, James Fisk, Jay Gould, and J.P. Morgan are among the most ignominious of the lot. Although J.P. Morgan was sometimes noted for such misanthropic statements as “I owe the public nothing,” he nevertheless made significant contributions to the arts and universities. J.P. Morgan Jr. took over the business at his father’s death 1913, but he never was as influential. As required by the 1933 Glass-Steagall Act, the concentration of power in “House of Morgan” was splintered into (1) J.P. Morgan and Co. and its bank, Morgan Guaranty Trust; (2) Morgan Stanley, an investment house; and (3) Morgan Grenfell in London, an overseas securities house, acquired by Deutsche Bank AG in 1990. Like the legendary phoenix rising from the ashes, J.P. Morgan again reigns supreme as the powerhouse in the murky world of derivatives. Will it too fall victim to its own “success”?

¹⁷ Among these are the 173,000 employees of Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers, and Bear Stearns. According to Bloomberg, “Never in the history of Wall Street have so many earned [“been paid” would’ve been more appropriate] so much in so little time.” Bonuses for the privileged few will exceed \$36 billion in 2006, Bloomberg says. This number does not include the additional billions that will be paid out to Citigroup, Bank of America, and JPMorgan Chase, as well as to the hundreds of smaller brokerage firms, hedge funds, and private equity firms that make up the financial sector. Anecdotally, is it any wonder that in November 2006 nearly half a billion dollars’ worth of impressionist and modern art changed hands at a 2½-hour Christie’s auction in New York, shattering the previous record by \$200 million? Auctioneer and honorary chairman of Christie’s, Christopher Burge, concluded: “Certainly the most amazing sale I’ve ever taken.”

more sinister. Remember the aforementioned importance of the simplicity of suggestions in molding public sentiment.

I think we need to entertain the possibility that we might we someday, once again, hear these words of disgrace and reproach? They were uttered more than 60 years ago ...

Plenty is at our doorstep, but a generous use of it languishes in the very sight of the supply. *Primarily this is because rulers of the exchange of mankind's goods have failed through their own stubbornness and their own incompetence [italics added throughout], have admitted their failure, and have abdicated. Practices of the unscrupulous moneychangers stand indicted in the court of public opinion, rejected by the hearts and minds of men.*

True they have tried, but their efforts have been cast in the pattern of an outworn tradition. *Faced by failure of credit they have proposed only the lending of more money. Stripped of the lure or a profit by which to induce our people to follow their false leadership, they have resorted to exhortations, pleading tearfully for restored confidence. They know only the rules of a generation of self-seekers. They have no vision, and when they have no vision the people perish.*

The moneychangers have fled from their high seats in the temple of our civilization. We may now restore the temple to the ancient truths. The measure of the restoration lies in the extent to which we apply social values more noble than mere monetary profit.

Happiness lies not in the mere possession of money; it lies in the joy of achievement, in the thrill of creative effort. *The joy and moral stimulation of work no longer must be forgotten in the mad chase for evanescent profits. These dark days will be worth all they cost us if they teach us that our true destiny is not to be ministered unto but to minister to ourselves and to our fellow men.*

Recognition of the falsity of material wealth as the standard of success goes hand-in-hand with the abandonment of the false belief that public office and high political position are to be valued only by the standards of pride of place and personal profit; and there must be an end to a conduct in banking and in business which too often has given to a sacred trust the likeness of callous and selfish wrongdoing. Small wonder

that confidence languishes, for it thrives only on honesty, on honor, on the sacredness of obligations, on faithful protection, on unselfish performance, without them it cannot live. Restoration calls, however, not for changes in ethics alone. This Nation asks for action, and action now.

... Finally, in our progress toward a resumption of work *we require safeguards against a return of the evils of the old order:* there must be a strict supervision of all banking and credits and investments, so that *there will be an end to speculation with other people's money;* and there must be provision for an adequate but sound currency.¹⁸

FINAL THOUGHTS ...

After concluding perhaps the most arduous year-end research and writing exercise in my career (excluding double dipping with *Speculative Contagion* last year), I must, in a levelheaded way, if that's even possible, ask the obvious question: "Is it all worth it?" Based on the wide range of responses I've received over the years—from glowing tributes to polite platitudes to more than a few "no shows"—I conclude that it *is* worth the effort. I admit that on occasion I muse about the unknowable thoughts of the non-responders, but what's on their minds "stays in Vegas." That's OK. No writer can ever know the full impact of his or her work. All that notwithstanding, the words of encouragement from people I respect are always inspiration enough to anticipate the annual year-end labors with enthusiasm.

To be sure, the task each year is enormous, particularly when anticipating the project. Moreover, I'm sure I have many biases, some of which are subconscious, and I never know the extent to which they compromise the rationality of my reasoning process. Even my principles, which I hold inviolate, may be impacted if influenced by forces other than the product of the pure application of my rational mind. While of little concern to me, what appears on these pages will be my documented legacy—of ignorance or insight, as only the future will reveal. Plato sets the scene: "Wise men speak because they have something to say, fools because they have to say something." I don't

¹⁸ Excerpts from Franklin Delano Roosevelt's first inaugural address delivered to the nation on March 4, 1933, at the nadir of the country's financial and economic crisis.

fear being wrong, but I'm terrified of not giving the effort the very best that I have. I read and listen with insatiable curiosity to become wiser, but in the process of gaining at least a modicum of wisdom I'm often reminded of the irony that the wiser one becomes the more one realizes how much there still is to learn. (The more you know, the more you know that you don't know.) And, alas, as knowledge and wisdom seem to grow geometrically—or even exponentially—some of us find ourselves plodding along arithmetically. Einstein provides a glimmer of hope in his definition of discernment: “To recognize the significant in the factual is wisdom.”

On a similar line, when people ask me why I keep working such long hours, my answer is as quick as it is unequivocal: “If this were work, I wouldn't do it!” When 87-year-old friend Peter Bernstein was asked why he keeps going, his simple answer: “How else do you find out how much work you can handle?”

Serving clients is easier during some periods than others. As stated elsewhere in the report, on occasions like the present, when we have been giving up some ground running counter to the pack (see cartoon on page 15), a few clients are bound to become restive. Most everyone has an opinion about the future, and the future has a funny way of making fools of us all from time to time. What I can promise clients is educated and independent judgment, constancy of purpose, and unyielding commitment to principle, all of which is carefully documented. In addition, recognizing the damaging effects of yielding to emotions, I work hard to truncate both my lows and highs. Unfortunately, as noted above, only the future will tell whether wisdom and equanimity were my touchstone—or whether some other qualities were my millstone.

Given their objectives, Warren Buffett and Charlie Munger were wise to extricate themselves from the position of always being “second-guessed.” From my perspective as the now senior partner of a purposely small boutique investment advisory firm tucked away in Elkhart, Indiana, the wonderful personal relationships that have made my life so rich in the important ways transcend those moments when everything is not “hugs and kisses.” Finally, like what followed the last period of “great temptation,” the expressions on the faces of those clients who hung in there with us were priceless in their affirmation, if not their relief. Come hell or high water, we are here to do what is opportunistically conservative, which may not be the same as what is conventional.

A simple analogy will suffice in revealing the independent cuss that I am perceived as being, with a sometimes idiosyncratic contrarian streak. Most people have a preference, if they have the urge at all, to

savor sunsets rather than sunrises. Marsha and I, on the other hand, are “sunrise addicts,” so much so that we positioned our home and its windows so that we can see the sunrise throughout the seasons. For the curious, at 42° latitude the sun rises at 60° true at the winter solstice and then swings southward to 120° true at the summer solstice. On days that are partially overcast, the majesty of the sunrise as it refracts through the clouds is unequalled in its display of ever-changing colors—from pinks to reds to purples, manifesting a variety of form and grandeur during a span of time that rarely exceeds 15 minutes. Moreover, we’re almost always at home when the sun rises, which is hardly the case with sunsets. Finally, and perhaps most importantly, in giving full witness to the indescribable beauty of God’s creativity, the new day dawns in magnificence and hope.

At the end of the day’s labors I ponder the following thoughts of Alex Noble: “If I have been of service, if I have glimpsed more of the nature and essence of ultimate good, if I am inspired to reach wider horizons of thought and action, if I am at peace with myself, it has been a successful day.”

Harking back to sunrises, I’d like to conclude by deferring to the wisdom of the Hindu Sanskrit poet and lyricist from antiquity, Kalidasa, mixing the metaphorical with the practical. We believe that the sun is setting on a bull market that’s long in the tooth and wonder if the night that follows will be deep and dark. Optimism, however, springs eternal—in my home and, I trust, in yours. Already we are preparing for the new Dawn.

Listen to the Exhortation of the Dawn!
Look to this Day!
For it is Life, the very Life of Life.
In its brief course lie all the
Verities and Realities of your Existence.
The Bliss of Growth,
The Glory of Action,
The Splendor of Beauty;
For Yesterday is but a Dream,
And To-morrow is only a Vision;
But To-day well lived makes
Every Yesterday a Dream of Happiness,
And every Tomorrow a Vision of Hope.
Look well therefore to this Day!
Such is the Salutation of the Dawn!

Frank K. Martin, Senior Partner

A Changing of the Guard

While in Washington, D.C., a little over a year ago, I watched the changing of the guard at the Tomb of the Unknowns at Arlington National Cemetery. The symbolic ceremony brought to mind a plan that had been germinating for some years. In June 2007 I reach the age of 65 which, for a fellow who thinks his work is fun, is no milestone ... beyond the prospect of becoming eligible for Medicare! However, after 40 years—most served as point man—it's only fair to let my highly qualified understudy take the lead. The energy, endurance, intelligence, and engaging personality of a 40-year-old, particularly in the person of my son, Todd Martin, is something to behold. Accordingly, on January 1, 2007, and by acclamation, Todd assumed the responsibilities of managing partner of Martin Capital Management. He is now shouldering most of the duties and responsibilities held by the undersigned since the firm's founding in 1987.

I am moving on to the role of senior partner and will continue to pursue my passion(s) with the same vigor as always, so long as I am able. My duties are comparable to those of a chairman of the board but also include overseeing the investment-management process; recruiting, training, and motivating members of our professional team; serving as chief investment strategist; and, to prove that I actually am strategizing, this annual missive will continue to carry my signature. Having introduced a six-page executive summary for the first time this year, I wonder what (someday) may become of the other 100 pages! I'm afraid to ask.

One duty I don't have is to micromanage the managing partner! My perspective has been shaped by observing Warren Buffett relate to his managers over the years. If Todd wants my opinion on some issue, I will make myself available. If he doesn't, I'll be too busy to notice.

THE MARTIN CAPITAL MANAGEMENT TEAM

Frank K. Martin, CFA, Senior Partner

Frank has 39 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. He 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 Frank served as an officer in the US 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; Western Reserve Partners, LLC, Ohio; and the Frank Martin Family Foundation. He is founder and chairman of the board of DreamsWork, a mentoring and scholarship program for inner-city children. In 2000 Frank published a biography of his father, William F. Martin, who died in December 2006. In December 2005 Frank published the book *Speculative Contagion*. In 2007 Frank plans to continue work on a proposed book, *In Temporary Trust*. Frank assumed the responsibilities of senior partner on January 1, 2007.

Todd B. Martin, CFA, Managing Partner

Todd has 18 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 CFA 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 has served on the boards of several social service organizations and is currently a member of the boards of the United Way of Elkhart County and St. Joseph Capital Corporation and Bank as Chairman of the Audit and Corporate Governance

Committee, Mishawaka. Todd was appointed managing partner on January 1, 2007.

Dennis D. Blyly, CFA, Partner

Dennis has 21 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 has served on the boards of several social service organizations and is currently a member of the boards of ADEC, Inc., Bristol; Hertzler Systems, Goshen; Pleasant Street Homes, LLC; and the Elkhart Chamber of Commerce.

Andrew P. Wilson, CFA, Partner

Drew has more than 11 years of investment industry experience. He was admitted to the partnership in 2004. Prior to joining Martin Capital in 1995, Drew was an employee benefits consultant with Watson Wyatt Worldwide, specializing in qualified retirement plans. He graduated *magna cum laude*, with membership in *Beta Gamma Sigma*, from Loyola University, Chicago, where he majored in finance. Drew earned his CFA in 1998. Drew completed the top-ranked Executive MBA program at Northwestern University's Kellogg School of Management in the spring of this year. Drew sits on the board of the Child and Parent Services (CAPS) of Elkhart County; the Center for Hospice and Palliative Care, Inc.; and is Chairman of a United Way of Elkhart County allocation panel.

Aaron J. Kindig, CFA

Aaron joined MCM in 2002 as a financial analyst. He earned a BA in accounting and business administration from Bluffton College in Ohio 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 almost five years in investment services. Aaron earned the CFA designation in 2003 and is a member of LaCasa Lending Advisory Committee, Goshen; and a mentor for DreamsWork.

Thomas W. Dugan

Tom joined Martin Capital in 2004 as a research analyst. Prior to that time he spent two years with the Sprint Corporation as a financial analyst and was a summer associate in the research department of Waddell & Reed Mutual Funds during graduate school. He graduated *summa cum laude* from Rockhurst University with a major in finance and economics. He earned an MBA, with membership in *Beta Gamma Sigma* from Indiana University's Kelley School of Business in 2004. He has passed three levels of the CFA Program and will be eligible for the CFA charter upon completion of the required work experience. Tom is a volunteer with Habitat for Humanity and DreamsWork.

Charles R. Kirk

Charlie's contribution to our research effort is part-time. Given his impressive and varied background in business and his ability to cut the core of an issue, it is much more valuable than the hours would suggest. He has 28 years of experience in plastics manufacturing. He was employed by Industrial Plastics Corporation for 18 years, the last ten of which he served as president. The next four years he worked for operating units of Trinova Corp., IPCs acquirer, as general manager of the IPC division and as group vice president. From 1993 to 1995 he was president of Elkhart Plastics, Inc. Charlie received a BA in 1963 and an MA in 1964, both from the University of Akron, and in 1968 his PhD from Temple University.

Ann T. Frantz

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 membership in *Beta Gamma Sigma* from Indiana University. She earned her CPA designation in 1986. She is a member of the Indiana CPA Society.

Kristin A. Antalavits

Martin Capital recruited Kristin in 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 2001, she was employed by Compass Financial Advisors as a registered representative. Karen was also employed for 16 years with Bank One/Chase 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.

Stephanie A. Malcom

Stephanie joined Martin Capital in 2000 as the Business Office Coordinator. 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. She began volunteering as a mentor for the DreamsWork program in 2005.

Christine L. Broadbent

Christine joined the firm in 2004 as an executive assistant to three of the four partners. She attended both Indiana University's Bloomington and South Bend campus' studying anthropology and history. Prior to Martin Capital, Christine worked for the University of Notre Dame for 12 years, beginning in the Undergraduate Admissions office, served as Marketing Coordinator for MBA Admissions as well as Assistant Director of Pre-College Programs, a high-talent summer program for rising high school seniors. She spent the last three years with the University's MBA Program as Assistant Director of Student Services.

Kristen R. Smith

Kristen began with Martin Capital in July 2005. She earned her BA with high distinction in general studies, with minors in anthropology and sociology, while also obtaining an International Studies Certificate from Indiana University at South Bend. Prior to Martin Capital, Kristen spent seven years working for ADEC (Association for the Disabled of Elkhart County) as a residential trainer. She also worked as a writing consultant in the Writing Center at IUSB for two years. Kristen began volunteering as a mentor for the DreamsWork program in 2005.

Martin Capital Management

Sue K. Massey

Sue is the newest addition to the Martin Capital team, beginning her duties in October 2005. She earned her associates degree and paralegal studies certificate from Indiana University at South Bend. Sue was employed for 12 years at Bank One/Chase, the last three working as an administrative assistant in the trust department. Sue currently serves as a mentor for DreamsWork.