

MARTIN
CAPITAL MANAGEMENT, LLP
Registered Investment Advisor

2008
ANNUAL REPORT

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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. Since then, Martin Capital has grown to serve 108 clients whose combined assets total approximately \$486 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 who 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. Also, all firm publications, as well as the SEC filings, including form ADV Part II and our Wrap Fee brochure, are available upon request. Please feel free to call or write us if you would like to receive more information. You also may visit us at www.mcmadvisors.com.

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Martin Capital Management’s 2008 annual report offers a new format. Section I, “The *Weekday Reader*,” is a 3½-page summary for the investor on the go. Beginning on page 7, Section II, “The *Weekend Reader*” caters to the investor who desires a more in-depth explanation of the “how” and the “why.”

SECTION I

‘THE WEEKDAY READER’

REPORTING INVESTMENT PERFORMANCE BY A WEALTH MANAGER

Every generation or two the true value of “wealth management” is revealed. Being aware that a single, big mistake can wipe out a lifetime of successes, a wealth manager must be hardwired to recognize and avoid grave risks, including those never experienced before. Fierce independence of thought and action, equanimity of temperament, abiding rationality and a keen understanding of human nature are essential. History doesn’t repeat itself but the passions of men do.¹

Most investment advisors are not wealth managers. Like greyhounds, they find themselves in a race with one another trying to catch an elusive rabbit. In the “relative return” performance derby, it’s all about who’s near the head of the pack chasing a benchmark index—such as the S&P 500. In a contest of swiftness, it is often forgotten that the symbolic rabbit is not reality itself—and that it might be headed in its haste toward a precipice and the abyss below.

By contrast, we at MCM proceed deliberately, like a tortoise, less interested in speed than in steadily and persistently pressing onward. As in Aesop’s fable, we generally arrive before the hare. The logic of trying to keep pace with a mindless index, as though markets are the indisputable arbiter of value, has escaped us. But then, so has the conventional wisdom that risk² is a constant regardless of the price of an asset. It is a focus on “absolute return,” the business-like approach to wealth management that differentiates Martin Capital Management from most of its peers. We are quite content to bide our time awaiting investments that offer reasonable certainty of being worth a dollar in five years for less than 50 cents today. If we can’t find enough³ to fill our coffers, we keep our clients’ money safely in cash until it can. Our fascination with owning fractional interests in businesses is exceeded only by our acute aversion to losing money. The simplicity of it all appeals to our long-term, value-oriented, and frugal nature.

The circumspect view is particularly valuable now, given the high leverage and focus on the short term, both by investment managers and company executives. It is the open, uncrowded field, but few investors are willing to trust such a long-term horizon—or they don’t know how to determine who will be good at it.

Our measured pace allows time for thoughtful observation of what’s going on in the world around us. Given what we believed⁴ was a looming financial day of reckoning, in the last few years it became more and more difficult to find investments that we were confident would be worth \$1 a few years hence. Uncertain about future values, we were stymied in trying to decide whether current prices were cheap or dear.

The minority is by definition small in number but not by definition wrongheaded. We were holding lots of cash when most others were of necessity fully invested, not wishing

to fall too far behind the relative-return rabbit. When the crisis hit in 2008, most others experienced great setbacks, and the trudging tortoise found itself ahead by not being behind. Since all shares of U.S. industry must be owned by someone all the time, there can only be liquidity for a few. Despite its near-universal popularity, broad diversification, as warned in the 2007 annual report, did not save the day. As underlying asset returns declined, hedge fund operatives and other managers had turned to the brinkmanship of financial leverage in hopes of making up the shortfall. Forced selling to unwind leveraged positions of what *might* be 50-cent pieces were sacrificed for a quarter or even a dime in the rush for the exits. In the mad scramble to exchange stocks for cash, market prices collapsed. Sometimes index chasing is antithetical to the goal of long-term investment success. If financial leverage is used, it can be disastrous.⁵

Human nature being what it is, the majority that forms a crowd, whose buying and selling move markets, is prone to occasional contagious waves of extreme euphoria and despair. Sometimes in its exhilaration the majority races so far ahead of reality that only a brick wall will stop it.

On page 7 you'll find the report card on both our short-term and long-term investment results. If you've studied the MCM annual reports the last several years, our 2008 investment results, as well as those for the last 10 years, should be of no surprise. If you read this report carefully, you may get a glimpse of how this tortoise plans to make its way, undeterred by what's going on around it, *in the future*. The absolute-return investor is rarely popular except among those who truly understand the magic of compound interest—and whose view toward wealth management is long term.

Lest there be any doubt, however, if we always got things right, if we were unfailingly prescient, there would be no need for this report! ☺ But since this journey is neither easy nor straightforward, hence the window into our thoughts.

ORIGINS OF A CRISIS: DECOUPLING RISK AND RETURN

That which cannot be seen is sometimes more powerful than that which can. After lurking in the shadows for several decades, mutating risk has finally made its fearsome presence known.

Risk is mysterious. It is intangible. Risk, aka danger of permanent capital loss, is that great investment unknown that connects the uncertain future with the known present. It is omnipresent, but it rarely makes its presence known until things don't turn out as expected, when it shows up wearing red. Because of the nature of risk, two independent parties are likely to perceive the same risk differently. Such divergences do not impede value-for-value exchanges. Not all parties are equally informed or rational: "One man's trash is another man's treasure."

But risk is not a constant, any more than the future is predictable. Attempts to quantify risk, to computer "model" it, are like trying to put a hat on a ghost. Worse yet, numbers give the illusion of precision, a false foundation that leads to trouble. Risk is also transferable, often without being noticed. Unchecked, it mutates.

Most of all, risk is fascinating. In this section we try to give it some shape, some form. Just maybe we can make it a little more recognizable to you?

STOCKDALE PARADOX: WHAT DO SURVIVORS HAVE IN COMMON?

The difference between investment victims and survivors can be most subtle. Especially today, there is a mindset that POWs and survivors of natural disasters share that current long-term investors would be advised to adopt.

Congressional Medal of Honor recipient Admiral James Stockdale turned his torturous ordeal as a Vietnam POW into the defining event in his life. Stockdale's paradox of accepting his brutal reality *while* never losing faith that he would *eventually* prevail may be analogous to what long-term investors must learn to endure. Prisoners who denied their reality, who clung to the fleeting hope that the horror would *soon* be over, were rarely among the survivors.

Stockdale's reality of torture was more tangible than threats to today's investor. Although the menace is opaque and abstract, its reality nonetheless must be accepted if one is to survive. In the comparatively civilized investment world, fear of the unknown is perhaps the most destructive of emotions. Warren Buffett's trademark rationality enables him to manage emotion to his advantage: "I am greedy when others are fearful and fearful when others are greedy." The average mutual fund investor, whose well-documented behavior typifies that of retail and institutional investors alike, is "harmoniously emotional": His feelings of greed and fear rise and fall with stock prices. Confronted with persistent fear, survivors, on the other hand, tend to be enduringly rational.

HARSH REALITIES AND THE SNOWBALL EFFECT

The harsh reality is snowballing down upon us. To survive we must know that the enemy is fear, the product of ignorance or denial, not the circumstances themselves.

The image of the formidable power of a giant snowball rolling⁶ down the mountainside conjures up a mental picture of the destructive force of the global avalanche in the financial markets. It took the better part of 25 years of exponential growth in financial muscle to push the snowball of financial innovation, which gradually mutated into a monster of financial excess, up the mountainside. As this gargantuan conglomeration of snow and ice surrenders to gravity the question heard is "Can it be stopped in its tracks, or will momentum cause it to run its course, flattening everything in its path?" The Stockdales, the harsh realists, have their doubts about suspending the law of gravity. The optimists, whose hope is vested in a quick fix based on opening wide the floodgates of monetary and fiscal stimulus, think otherwise. No matter how brutal the reality, those (like Adm. Stockdale) who will survive have a deep and abiding faith that "This too shall pass."

Should intervention fail to arrest the descent of the snowball, where might it stop? From our perspective as investors, we have approximated the level to which the S&P 500 must fall to represent a historically supported worst-case scenario. As for the economy, the work of respected scholars was surveyed regarding unemployment, production, debt, and deficits, under a similar scenario. While they were clearly more pessimistic than those who are paid to forecast, the clear and comforting message is all avalanches come to a stop.

BACK TO THE FUTURE

At Martin Capital Management, our long-term wealth management record affirms the efficacy of the belief that if you can't find a dollar for 50 cents you should pass. As our written record reveals, we have a keener nose than some for both danger and opportunity. In earlier missives, we warned of impending peril when it was largely invisible. With this report we are alerting the rational investor to opportunity, without yet being able to see to the other end of the tunnel of despair.

Always in search of the lessons history teaches, “Back to the Future” attempts to find predictive value in the repetitious history of finance and economics. Unlike technology, where today’s innovations stand on the shoulders of yesterday’s, the “dismal science” justly earns its nickname. Human nature doesn’t change. The investor’s ride through time is not on a rocket ship, it’s on a roller coaster, albeit with a long-term 10% upward bias. The pursuit of capital gains has come up empty-handed for the last decade, dashing the unrealistic expectations of those who see the future through the rearview mirror. Dividends—for a host of compelling reasons, including the corporate misallocation of capital and the abuse of stock options—will likely return to the fore as power gradually shifts back to the shareholders. Risk will become a four-letter word. Perhaps the biggest surprise of all is that regardless of the fate of the economy, short of social revolution, common stocks are likely to be by far the most profitable asset class while concurrently bearing the stain of the most reviled for years to come (see Exhibit 1 in the Appendix)...

SECTION II

‘THE WEEKEND READER’

REPORTING INVESTMENT PERFORMANCE BY A WEALTH MANAGER

MCM Investment Performance

Period Ending December 31, 2008	MCM		S&P 500 *
	MCM Equities *	Total Account *	
Ten Years	6.6%	5.2%	-1.4%
Five Years	-2.7%	-0.3%	-2.2%
Three Years	-5.8%	-1.4%	-8.4%
One Year	-21.5%	-7.8%	-37.0%

* *Disclosure: The MCM Equities Composite shows the performance of the equity investments in all discretionary fee-paying accounts managed by MCM. Historical returns include accounts that may no longer be under our management. The MCM Total Account Composite shows the performance of all assets held in fully discretionary fee-paying accounts who have given us authority to invest 100% of the account in equities and are managed per our model portfolio. Because this is the first year presenting the Total Account Composite, it contains only accounts that were actively managed as of 12/31/08. MCM believes that because the fully discretionary accounts are, and historically have been, so similarly managed in terms of types and proportions of securities, survivor bias—if any—is not material. Both MCM composites are net of all management fees and include the reinvestment of all income but do not reflect the effect of taxes. The composites are compared with the S&P 500, an unmanaged market capitalization-weighted index of 500 common stocks chosen for market size, liquidity, and industry group representation to represent U.S. equity performance. S&P 500 returns do not include consideration for fees or taxes.*

*Due to client nuances including equity allocation constraints, start date, and cash flow differentials, derivatives constraints, tax issues, etc., an individual's account performance may differ materially from the composite. **Past performance is no guarantee of future results.***

A wealth manager represents a relatively small subset of the universe of investment managers. Most investment managers are geared to besting a particular benchmark index. Their performance is measured in relative terms. If their performance for 2008 was -30%, and their measurement standard was the S&P 500, -37%, they would consider the year a success. As one stretches out the time horizon, the exclusive focus on relative return can occasionally lead one to miss the forest for the trees, as was true when surveying the past from the vantage point of year-end 2008. Using data from the preceding table, \$5 million invested in the S&P 500 ten years ago would be worth only \$4.34 million, including dividends, at year end. (Using the same metrics, MCM Equities would be worth \$9.47 million and MCM Total Account, \$8.30 million.) Of course, stretch the horizon out long enough and returns regress to the mean. John Maynard Keynes had the last word on infinitely extending the horizon: “In the long run, we are all dead.”

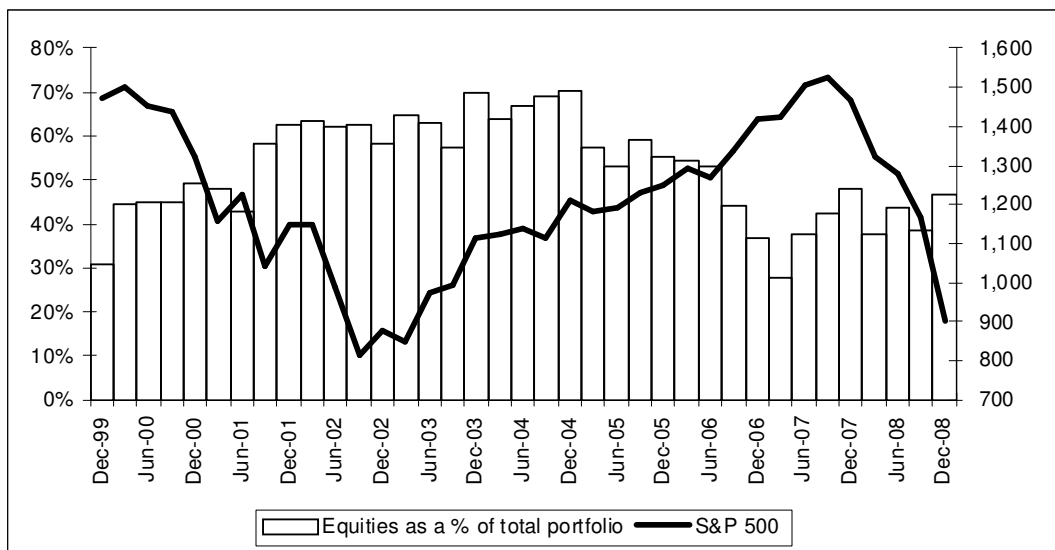
The clients of a wealth manager are predominantly “wealthy” individuals and affiliated entities like private foundations. As these individuals often are the creators of their

own wealth, it's foreign to most of them to reconcile a 30% plunge in the market value of their portfolio over the course of a year with investment "success." Moreover, they tend to view investment performance over the long term, just as they would as businessmen. Seeing their portfolio shrink in value over a 10-year span, before inflation and taxes, might give them second thoughts about why they ever sold their business.

Rationalism, patience, competence, and confidence were hallmarks of many of their business careers. Nonetheless, wealthy individuals are still human. Thrust into the often unfamiliar world of marketable securities, where time is measured in hours or days and not years, they often lack confidence and question their own competence. Not having the old lampposts on which to lean for support, they unwittingly but quite normally let emotions override their rational cognitive capabilities. Crowd-inspired behaviors, subliminally nudged by envy or propelled by fear, are among those proclivities with which a wealth manager must empathetically cope if he is to serve each client's best interests. Emotion-driven behaviors are generally counterproductive to investment success.

Businessmen-turned-investors often forget the patience that saw them through many trials while creating their wealth. Seeing the prices of their securities fluctuating on a daily basis is like the upper that comes from drinking coffee for the first time. It's not uncommon for investors (and wealth managers!) to fall under the spell of the "institutional imperative"; the strong impulse to always be *doing* something serves to validate some convoluted law of value creation. Einstein saw motive behind the imperative: "People love chopping wood. In this activity one immediately sees results." As for the counter viewpoint, Abraham Lincoln took all of 272 meticulously chosen words to write the Gettysburg address. In so doing, he indirectly legitimized the primacy of thought as a value-added proposition. After all, it was Lincoln who, in the most basic of metaphors, argued for pre-eminence of thought over action: "If I had eight hours to chop down a tree, I'd spend six hours sharpening my ax." As the following bar chart indicates, with the S&P 500 approaching its peak, we simply could not find equity investments from which five-year expected returns compensated adequately for the burgeoning financial risks we saw (and wrote about) looming on the horizon.

Aggregate Allocation of Client Capital



Investment advisors will continue to chop wood with a dull ax so long as the industry's reward structure remains as it is. Since a "rank" of wood is measurable and thought is not immediately visible, the ranks of the thinkers will never be crowded, a competitive edge that we need not fear losing anytime soon.

Businessmen are generally as much "means" as "ends" oriented, as interested in how something was accomplished as in what was accomplished. With the above performance data as the end, one must read the last several annual reports to find the means. Likewise, the report you're holding in your hands is designed to shed light on what we envision as the means for which the performance results years hence will be the ends.

Confluence of Wealth Management and Investment Management

With this report as the "means," the journey over the next 20 pages should lead you to the end implied by the above title. If, for the first time since the early 1980s, risk and return are "recoupled," we need not fear another 2008 until memories of the current episode fade. Then we'll likely have more low-risk, high-expected-return ideas than we have cash. A wealth management portfolio will be largely indistinguishable from one that features equities only. Few developments are without irony. When good ideas were scarce, the institutional imperative was in full force. When they become plentiful, our clients won't be pushing us, we'll be pushing them!

Toward that end, the preceding performance table now includes both the performance of our equity securities alone within a portfolio and total account performance. The total account includes all the assets in a portfolio, mostly funds safe-harbored in cash and equivalents but also options used as a hedge against market risk, as well as those used to enhance portfolio cash earnings. In evaluating total account results, it helps to view performance by comparing the performance table with the bar chart that shows the percentage of assets committed to equities. If the recoupling of risk and return takes place, we would expect the results in each column to converge. We also expect the bar on the second chart, by default, to approach 100%.

What Are We Looking for in New Clients?

Our documented investment reasoning over the last several years, along with the investment performance that resulted, has not gone entirely unnoticed. Receiving inquiries as a result, we thought it appropriate to include this section. Prospective clients are sure to know much more about us than we know about them. Our website (www.mcmadvisors.com) gives our history of thought and action in greater, even excruciating, detail. While our long-term focus has been on serving wealthy individuals, the environment we envision in the future will likely make it possible for us to cater to equity-only investors as well. Relative-return and absolute-return investment styles will naturally merge.

As always, relationships take precedence over dollars in our understanding of the wealth management business. Although our minimum relationship size is \$5 million in order to avoid overtaxing our human resources, a \$10 million relationship based on mutual trust, admiration and respect easily trumps one that is two or three times larger yet lacks those qualities. We hope that our relationships with those investors for whom we manage only a portion of their money will be equally enjoyable in their own way.

If you know of someone for whom a relationship with MCM might be mutually beneficial in all the right ways, we'd be grateful for a kind word. A caveat: Inviting new clients into the fold is a process that is both time-consuming and exceedingly pleasant. The pace of one new client each quarter would be ideal.

ORIGINS OF A CRISIS: DECOUPLING RISK AND RETURN

In the beginning, risk and return were coupled...

There was a time when your local bank's mortgage lender from whom you nervously borrowed money to buy your first home had a vested interest in its repayment. The incentives were properly aligned to encourage the long view: Actions, we were told from our earliest days, have consequences. If your coat-and-tie mortgage lender made enough bad loans, you might see him next wearing a hairnet, flipping burgers at McDonald's.

Over the last 20 years, risk and return have progressively decoupled. Financial innovation was to become the forbidden fruit.

"Securitization" was among the watershed developments in financial innovation. "Commercial" banks of old made loans judiciously, the dollar amount put on their books limited by regulatory capital adequacy ratios. Bundling loans and selling them to "investment" banks that marketed them as *negotiable* asset-backed *securities* (ABS), the process of securitization linked lender and investor for the first time. Like technology, no breakthrough is without its unintended repercussions. Accountability for risk got lost in the shuffle. Because the Federal Reserve did not have authority over investment banks, it soon lost control over the creation of credit as the "shadow banking system" usurped its power. Securitization enabled the credit explosion. Glass-Steagall, R.I.P., or so it was thought when Bill Clinton laid it to rest in 1999...

Risk associated with a mortgage loan becomes increasingly opaque as it leaves the originating bank and disappears into the investment banker's sausage grinder of complexity and comes out the other end as a "structured finance product" known as a CMO, CDO, RMBS, CMBS, or some other confusing acronym. By design, as risk and return move up the credit food chain, they decouple. A CMO (collateralized mortgage obligation) is a legal entity wholly separate from the investment bank that created it. By slicing and dicing mortgage loans into a hierarchy of tranches, or classes, risk is parceled, ostensibly enabling investors to choose their own degree of exposure.

The rating agencies of Moody's and Standard & Poor's were no bit players in this unfolding drama. Driven by the most basic of incentives, they showered AAA-ratings like a priest sprinkles holy water after lingering a bit too long at the communion rail. To the discriminating eye, the assumptions in their models didn't hold water, but no one seemed to care at the time. Everybody was drinking the same Kool-Aid and minting money. Moody's and Standard & Poor's charged into the unknown on the backs of credit default risk models that didn't compute if house prices started falling, spurred on by the dubious assumption that a slightly over-collateralized portfolio composed largely of subprime toad-like loans could, by some miracle of financial alchemy, morph into a prince. Bingo. The game was over, and the meltdown that started in the mortgage markets on a single faulty premise began its migration throughout the financial system...and then on to the real economy. Nobody is minting money nowadays...except the U.S. Treasury, but that's tomorrow's problem.

Wall Street, the epicenter of the crisis, convulsed into a money-making, risk-taking and, most importantly, risk-creating colossus by an alteration so simple and subtle that it

went largely unnoticed. For generations, investment banks were partnerships where risk-conscious owners played with their own chips. Then in 1980 industry bellwether Salomon Brothers transformed itself into a publicly owned corporation. Salomon made the trade of its lifetime: It sold off responsibility for its actions to its new shareholders for a relative pittance in dividends. The Pandora's box of risk shuttling was opened wide. The incentives and penalties of the game changed with the stroke of a pen, and investment bankers of every stripe jumped aboard the gravy train. OPM, which sounds and acts like opium, is a crude Wall Street acronym for "other people's money." OPM forever shifted the culpability for risk. Not so many years later, when risk untrammelled by accountability finally brought the Street to its knees, the former partners had the loot and the shareholders the loss.

The devil once again is in the details. Hank Paulson, whose brief tenure as Secretary of the Treasury will not likely mark him as the Alexander Hamilton of the 21st century, was nonetheless *Time* magazine's runner-up for its Person of the Year in 2008. In September '08 *Newsweek* dubbed him King Henry in a cover story. Paulson's earlier, less visible work included serving as chairman and CEO (not senior partner) of Goldman Sachs. In 2004 the SEC bowed to the powers that be,⁷ unanimously agreeing to release the major investment houses from the net capital rule, the requirement that their brokerages hold reserve capital that limited their leverage and risk exposure. Goldman Sachs, then headed by Paulson, was among them. Is there reason to wonder just how Paulson was able to amass a nest egg estimated at \$700 million? Thus the rich irony of Paulson self-righteously thrashing the very shareholders who bore the risks supporting his own great wealth accumulation. If asked to define a conservative, Paulson might have responded, *When you have something to conserve, you'll know*. According to that definition, if the shareholders were conservatives several years ago, they no longer are. As so often happens, pride goeth before a fall. Amid the rubble Goldman Sachs and Morgan Stanley are the two majors still standing, but on shaky legs. Paulson helped raise the golden goose and then offered its head. King Henry VIII?!

An 'HDS' Fable

The alien world of a state-of-the-art financial innovation leaves many a layperson befuddled. After a brief introduction, the "HDS Fable" that follows may help you move on to the rest of the report feeling a little more in the know about risk.

In the last several annual reports, reference was made to a number of the instruments of financial esoterica. As noted, formerly conservative balance sheets exploded with these exotic and increasingly toxic assets, leveraged up to 30 times with OPM. Derivatives (leverage by another name) morphed from a means of hedging risk to a mysterious "black box" for creating and trading risk. Credit default swaps (CDS), conceived as a means for an owner to insure a bond against default. Then they exploded in popularity to become one of the greatest speculative bubbles. AIG was brought to its knees by CDS. Approximately 500 traders in its derivatives department were able to humble the once proud insurance giant that employed almost 120,000 workers.

A \$10 million bond position might have an "open interest" of 50 times that much. The first position was purchased as insurance. The rest were speculative, synthetic risks created among the two counterparties to a contract. Although it is estimated that the number has shrunk by half since then, the notional value of credit default swaps outstanding in the early months of 2008, as noted in the 2007 MCM annual report, was more than \$60 trillion (yes, trillion). Still no trifling matter. As corporate defaults rise and recovery rates fall, the exercise of outstanding CDS contracts could theoretically consume all of the capital

in the global banking system, several times over, according to some sources. The actual dollar amount of the debt outstanding against which those contracts were written is a tiny fraction of that number. While the variety of derivatives outstanding is only limited by the imagination of their creators, CDS, as noted in the fable following, have the beguiling capacity to create synthetic risk.

Flash back to 2006 and engage your imagination regarding a particular house. Suppose, if you will, that 50 neighbors have become infected by the speculative virus. The ingenious neighbors concoct what becomes an active market in HDS (home destruction swaps), buying and selling contracts, essentially taking both sides of the bet that the house will go up in flames. Those who think an accident is likely pay insurance-like annual premiums to those willing to hold the opposite view. For a contract to come into existence there must be both a buyer of risk insurance and a seller who is willing to underwrite the risk. Although there is only one house at risk, the number of contracts outstanding is limited only by the number of parties willing to enter into a swap agreement related to that particular house. Unlike a conventional homeowner's insurance policy with a limit of one per house, these synthetic policies have no such limits. When the speculative appetite is well nigh insatiable, they multiply like rabbits (but it's hare today, gone tomorrow).

Always thinking of new ways to make their money work harder, the swap sellers, those willing to underwrite the risk that the house will be destroyed, put their proceeds to work in the rising stock market. Likewise disposed, buyers pay their premiums with money borrowed at the local bank. Everyone knows that financial leverage amplifies returns (although they conveniently forget that it has the same effect on risk).

Suddenly circumstances change. The house is sold and immediately a rumor spreads that the new owner is building a potentially explosive meth lab in the basement.

As the perception of risk of fire rises sharply, the protection sellers are taking huge paper losses, while the buyers are racking up big gains. The buyers naturally want to cash in their gains and reduce their debt. But the sellers can't close out their positions at the new price. And since this is a small and transparent market, other potential buyers have no interest, because the sellers are too weak a "counterparty." And bankers are making collateral calls on their loans. Thus the buyers of the HDS contracts discover to their dismay the meaning of "counterparty risk."

Now, suppose there's a modest stock market downturn, just as the HDS buyers' banks are haircutting the nominal paper gains on their HDS. The bankers will start calling for more collateral for their margin loans, which many buyers can't meet. The sellers, of course, are in even worse shape; they're taking paper losses, and their stockbrokers have adopted much more aggressive tones. Both buyers and sellers may end up bankrupt.

And so the fable ends with the meth lab madman in jail, the innocuous little house, the object of so much reckless risk taking, still standing. Though the structure didn't collapse as expected, it was in a very real sense a house of cards—as the 50 speculators discovered to their chagrin. Left in the wake of the massive speculative episode where risk was created out of thin air are 50 financially and otherwise devastated families. The inebriate who insisted on smoking in bed, source of the comparatively insignificant original "risk" upon which the mania took root, never had a hint of what was going on in the neighborhood around him.

An Epilogue

From the earliest securitizations to the mythical HDS, the hot potato of risk has been tossed everywhere. The commercial banks thought they were flipping it to investment banks who thought they had offloaded it to their customers, with the rating agencies looking a lot like thus-far-unindicted co-conspirators. For reasons too intertwined to attempt to unravel in this relatively brief report, suffice it to say: “What goes around comes around.” When the music stopped, the shareholders of the commercial and investment banks, along with the investors who had purchased toxic products, were the first to fall. While many individual investors suffered, the heaviest toll was taken by the mutual funds, pension plans, endowment funds, hedge funds and others.⁸ You know, those financial intermediaries who oversee what is, directly or indirectly, our money. In case no one asks, conspicuous by its absence is the name of a single executive of any of the failed institutions who shared a similar personal financial fate. Of course, if failing means a reduced bonus or dramatically reduced net worth, there finally were a few. And no, Bernie Madoff, a smoke-and-mirrors charlatan who reportedly “made off” with an almost unfathomable \$50 billion, was not overlooked.

Back to the Age of Innocence?

There is hope for “re-pairing” risk and return. Left solely to the monetary and fiscal devices of government intervention, the intention of which is to ameliorate the consequences of excessive risk taking, recoupling is unlikely. Counterintuitively, the reality that no government edict, policy, or infusion of money has thus far brought a stop to snowball declines in asset prices or economies does bode well for the process of recoupling. Few lasting lessons are learned when the law that actions have consequences is circumvented.

The much-maligned free capital markets are doing their job, thank you, in downsizing the demon of risk despite the countervailing force of macro policy intervention. If risk is indeed not a constant but rather a function of the relationship between the price of something and its underlying value, what holds for individual investors might apply to investment markets as a whole. The decoupling of risk from the risktaker enabled the creation of hugely disproportionate amounts of synthetic and ultimately systemic risk. The flight from risk also exhibits the characteristics of a very large snowball. In the process, about \$7 trillion of shareholders’ notional (paper) wealth in U.S. companies—the gains of the last six years—was wiped out in a year of violent market swings. Globally, including the U.S., stocks lost 42% of their value in 2008, as calculated by the MSCI (Morgan Stanley Capital International) world index, erasing more than \$29 trillion in value and all of the gains made since 2003. What the interventionists are trying to cover up with a few trillion dollars of taxpayer money, the thus-far-free capital markets are exposing with nominal losses of tens of trillions of dollars in shareholder wealth. Just for good measure, tack on another 10% decline in the S&P 500 during first three weeks of 2009.

Since we often think of risk in terms of the likelihood of loss, it stands to reason that an asset priced at zero is risk-free to the buyer. It logically follows then that, relative to the recent past, worldwide the risk of loss has been reduced by \$29 trillion. Though many risks persist, the risk of loss in the capital markets around the globe is at least nominally much lower than it was a year ago. While exacting much pain and bucking interventionism, the capital markets sure as shootin’ are relentlessly pushing prices down toward realignment of risk and return. Markets are, lest we forget, little more than scoreboards. They flash the

ever-changing prices at which buyers and sellers exchange liquidity for shares of stock. Market participants are sometimes extremely emotional, exhibiting bouts of manic-depressive behavior. Indeed, the pendulum alternates between despair and euphoria—and every emotion in between.

Although the world's stock markets fell dramatically last year, in some measure they reflected the temporary or permanent impairment of the underlying assets themselves. Not surprisingly, the free market process of purging financial risk is nearly impossible to contain and compartmentalize. It is contagious. It has infected the economy. Economic output is declining at the cost of 2.6-plus million jobs lost last year and many more likely this year.

The Question on Which the Future of Investment Hangs

Will the migrating financial and economic consequences of the decoupling of risk and responsibility prove to be so traumatic that the current risk aversion exhibited by consumers, lenders, investors, and others will become as deeply embedded in our psyches as it was following the Great Depression? Or will it all subside soon after the crisis atmosphere abates, as more optimistic pundits believe? Momentous social issues notwithstanding, *the future of investment for a generation hangs in the balance*. If the former, “bubbles” will become a distant memory, and the foundation for low-risk, long-term investment will be laid. If the latter, instability and crises will persist, and speculation will continue to displace investment.

Like it or not, the momentum of the snowball effect is huge. The absence of either credit or confidence can precipitate an economic collapse. Recovery, to paraphrase John Maynard Keynes⁹ as he wrote in 1936, requires the revival of both. In the current episode, the credit crisis preceded the crisis in non-financial sector confidence. Quite different, it should be noted, from the experience of the 1930s. As Ben Bernanke has ruefully discovered, low-priced credit hasn't been sufficient palliative to jump-start the credit machine. Once risk crashes to the fore, like Godzilla before a terrified crowd, the legs of confidence get wobbly. Perish the thought, but if recoupling risk and return are prerequisites for renewing the confidence of true investors, the *long road*, the one Washington will likely spend trillions of dollars to avoid, may be the only route back to innocence...

If indeed it is to be the long road, it will be arduous. Period. We, however, have been preparing for the journey. Read on to see what it takes to survive. Also, take heart: Thinking in terms of rainbows, we expect to find a pot of gold-en opportunities along the way.

STOCKDALE PARADOX: WHAT DO SURVIVORS HAVE IN COMMON?

Jim Collins, in his best seller *Good to Great*, described what is known as the Stockdale Paradox, recounting the courage of Vietnam POWs who survived deprivation, uncertainty, and loneliness while in captivity. According to Stockdale, these prisoners of war were able to accept the brutal facts of their reality while maintaining an unwavering faith in the endgame.

When Collins asked Stockdale which prisoners didn't make it out of the “Hanoi Hilton” alive, the admiral gave a quick and surprising response: “The optimists.” They were the prisoners who refused to accept their reality, clinging to the hope that they would soon be released. When those hopes were dashed, they eventually died, many of broken hearts.

What separates those who persevere until the end and those who do not, according to Stockdale, is not the presence or absence of adversity but how one deals with the

inevitable misfortunes of life. Unremitting optimism that doesn't lend full credence to the harsh realities is likely to give way to eventual despair.

The analogy to the uncertain financial times ahead, of course, breaks down in relation to what POWs suffer in times of war. Short of social disorder, we are not likely to be in any physical danger, nor be deprived of the basic comforts of life.

Know Thyself

Before you become too sure of your capacity to endure, consider Laurence Gonzales¹⁰ and his best-seller *Deep Survival: Who Lives, Who Dies, and Why*. Gonzales recounts stories of those who actually went looking for risk. The book's appendix, "The Rules of Adventure," is a misnomer. Gonzales' message between the lines is really about developing survival skills applicable to any threatening situation that might be unexpectedly encountered—from fighter pilots who find themselves involuntary guests at the "Hanoi Hilton" to investors trapped in roiling financial markets like whitewater kayakers in a narrow chute.

Ever vigilant, Gonzales' first rule is to stay out of trouble. So far we at Martin Capital Management have managed to avoid making wealth-threatening choices during this adventure. Investing is a journey fraught with temptations for the overconfident or ill-prepared. As we envision the difficult road ahead, the greatest risk to be encountered in getting from here to investment Nirvana will not be determined by the threats from events and circumstances in the world around us but rather from the *insidious enemy within*.

In an earlier age fear was the emotion essential for the survival. The "fight or flight" reflex determined who survived and who didn't. The reflexive flight instinct has made the lowly cockroach distinct—and not extinct—among all living creatures. However, the brains of (most!) humans are not hardwired like those of cockroaches. We (ostensibly) have a higher order of cerebral function than all other animals.

And yet in modern times much of brain functioning is still reptilian when it comes to money. Money is symbolic. As a store of value, it is proxy for the most basic of risks and rewards that are important to our survival in the modern world. Recall your state of mind from 2003 to 2007. Making money has the same euphoric effect as a mood-enhancing narcotic. As 2008 evolved, notice how quickly euphoria gave way to fear. The threat of loss of money evokes immediate responses from the emotional centers of the brain. Emotional responses were the tools of survival eons ago. They are antithetical to deep investment survival in the 21st century.

The vast majority of investors actually think risk won't bother them until they feel the pain of loss. Having observed market participants for more than 40 years, I must conclude that myopia can be as counterproductive as fear. Gonzales' book is chock full of stories of adventurers whose confidence was untested. Although the sound is the same, real bullets evoke a different response than blanks. James Montier, like Jason Zweig,¹¹ has studied the irrational behaviors of investors when the emotion of fear of loss dominates the cognitive process. Montier discovered that even when the odds are 50-50, past losses diminish the willingness to take current risks. Paradoxically, instead of learning from their mistakes, additional losses, expected with such odds, caused participants to become increasingly risk-averse over time.¹²

Warren Buffett is often asked, "What's the secret of your investment success?" The investment genius invariably responds to this effect: "I'm rational." In terms of brain functioning, his simple answer explains much about how his mind responds to external

stimuli. Buffett's discipline ensures that his higher-order cognitive capabilities dominate the more reptilian responses. It prepares him for the demands of the modern world by allowing his higher-order skills to prevail where emotions would fail. Investors like Buffett tend to emanate calmness, an imperturbability that transcends the crises of the moment. They exist in a state of not being bothered by things that bother most people. Of course, eons ago Buffett would have been some prehistoric creature's lunch.

It's not that Buffett and fellow iconoclasts are without emotion. Zweig coined the term "inversely emotional," giving academic credence to Buffett's aphorism: "I am greedy when others are fearful—and fearful when others are greedy." Almost sociopathic in his response to what others see as threatening, Buffett actually feels better the farther prices fall. Decades of observation have led me to conclude that most people are proportionately emotional: The fear factor declines as prices rise and increases as prices fall. Think of that as a rhetorical statement and not a question. ☺

Zweig came across another intuitive and complementary insight. The emotional part of the brain is highly active in short-term decision making, understandable if one thinks in terms of pain avoidance. Many people experiencing disturbing symptoms still avoid a trip to the doctor because of fear of pain or uncertainty. Case in point: A thirtysomething attorney practicing in my county of residence several years ago died of heart failure. A few days prior to the heart attack that killed him he had told a colleague about a recurrence of chest pains. His friend said, "You need to see a doctor." The lawyer replied, "I know, but if I go, I probably won't like what I hear."

To be sure, the future is very abstract and provides little in the form of near-term emotional rewards. I've spent 40 years surrounded by people who watch the prices of the stocks they own as they fluctuate on a daily or, heaven forbid, on the intraday basis. Trudging through time on a roller-coaster emotional treadmill is like envy: Nothing good comes from the expenditure of enormous energy.

The uncrowded thinking space in the time dimension is the future. Once focused on that space, the short-term, pain-avoidance syndrome is kept at bay. The harsh reality is that we will be destined to be average if we think and act like everyone else.

The Evidence That Indicts

Who is "everyone else"? It is with some reticence that I turn to the class of investors whose decisions are most predictably irrational. Thanks to the massive database of the Investment Company Institute, tracking the behaviors of the average, open-ended, equity mutual fund investor is easy. While there are very sophisticated investors who use equity mutual funds, the middle of the bell curve tells a sorry story. In the aggregate, equity mutual fund investors are the last to arrive at the party and the last to leave. They are proportionately emotional: greedy when they should be fearful and fearful when they should be greedy. Let the facts do the talking.

The last great opportunity to buy common stocks when everyone else was fearful occurred in the early 1980s, several years after the cover of *Business Week* proclaimed the "Death of Equities" in an August 1975 edition. Not liking what they were seeing in the rearview mirror, twice-burned (1973–74 and 1980–81) mutual fund investors resisted common stocks in the main until the fear of missing the bandwagon finally spurred them to action. Only 5.7% of U.S. households owned mutual funds in 1980; a whopping 44.5% had discovered them by 2000.

Net new cash flow into equity mutual funds did not begin in earnest until 1993, more than a decade after the secular up cycle began. It peaked in 2000, just as the grand cycle was cresting. After repentant selling during the final two years of the 2000–02 bear market, rising prices drew mutual fund investors back into equity funds, and net new cash inflows returned to levels comparable to those of the mid-'90s. True to form, inflows dropped off to \$93 billion in 2007. Net outflows for 2008 are estimated to be a (predictably irrational) stunning \$320 billion.

From 2005 to 2007 between 80% and 90% of new money flowing into equity funds were allocated to global funds. It probably goes without saying that global equity funds dramatically underperformed all other major asset classes in 2008. Exchange traded funds (ETFs) are a popular new iteration of closed-end funds. While nothing more than an educated guess owing to the scarcity of data, it's very likely that much retail investor money was squandered purchasing leveraged ETFs, which had placed bets on oil and other commodity markets.

Equity funds as a percentage of total mutual fund assets peaked at 59% in 1999, only to fall to 42% at the end of the bear market in 2002. The percentage subsequently rose to 57% in 2006 and, by October 2008, had sunk to 41%. Sadly true to the pattern of being the last to leave the party, following the bear market of 1973–74 outflows from equity funds set records from 1977 through 1979, exceeding 10% of assets each year. While certain to chase the rabbit of any meaningful rallies, the mutual fund investor is likely to take his leave in a long and drawn-out fashion.

The ubiquitous 401(k) plan, a cornerstone of the much-heralded “ownership society,” was predictably overrated as a retirement plan alternative because the previously described “harmoniously emotional” mutual fund investor found himself uncomfortably behind the steering wheel. About 50 million Americans have 401(k) plans, which had \$2.5 trillion in total assets. In the 12 months following the stock market's peak in October 2007, more than \$1 trillion worth of stock value held in 401(k)s and other “defined contribution” plans was wiped out. If individual retirement accounts, which consist largely of money rolled over from 401(k)s, are taken into account, about \$2 trillion of stock value evaporated.

As the mutual fund investors' record makes abundantly clear, following the crowd will lead to only one investment destination: mediocrity. We must be rational and fiercely independent if we expect to land well on the positive side of the bell curve. We must forswear the security of the crowd.

‘All We Have to Fear Is Fear Itself’

The FDR-styled “Fireside Chats” posted to our website during the course of 2008 had two purposes. First, we sought to keep you apprised of the emerging harsh realities. Second, thus forewarned you could be emotionally forearmed, forestalling the emergence of the insidious fear of the unknown. In this writer's judgment myriad risks still loom on the horizon, risks that few investors have encountered before. As alluded to above, the most threatening are not external. They are cerebral, the tricks our minds play on us. Notwithstanding all the physical threats, Stockdale's greatest enemy was not his Vietcong captors. It was the only facet of the experience over which he had any control—his attitude. The Hanoi Hilton was really a test of his perseverance, his mental toughness. “I never doubted not only that I would get out, but also that I would prevail in the end and turn the experience into the defining event of my life, which, in retrospect, I would not trade.” Stockdale was remarkably victorious in the battle of mind over matter. While on a far lesser

scale, will we be able to rise above the harsh realities and ultimately echo the sentiments of the only naval officer ever to wear both aviator wings and the Congressional Medal of Honor? Fear will test us like we've never been tested before. That's why the dais will not be crowded... We expect to remain standing...if we have the courage to accept the harsh realities.

HARSH REALITIES AND THE SNOWBALL EFFECT

It is no mean feat to look harsh realities full in the face. Few people do.

We humans are hardwired to avoid discomfort and pain. Thus the foolish reward the courtiers who tell them what they want to hear; the wise bestow their gratitude on those who struggle, however futilely, to reach them with the truth.

The following observation bears the stamp of humility on the diploma from the school of hard knocks: People who are fascinated by complexity and intrigued by uncertainty are likely to be the ones who have something worthwhile to say about the future.

As you try to understand the scope and breadth of the harsh realities in which we find ourselves mired, remember the famous retort from Jack Nicholson in the movie "A Few Good Men" as he responded to the entreaty from the military prosecutor played by Tom Cruise. Cruise: "I want the truth!" Nicholson: "*You can't handle the truth!*" My assumption is that you desire the truth; my hope is that *we* can handle it. It is unlikely that it will be found in the mindless reassurances of the Hank Paulsons of the world.

In one of his last interviews before leaving office, Treasury Secretary Paulson elucidated as only he can:¹³ "We've done all this without all of the authorities that a major nation like the U.S. needs." Is the reader to accept "We've done all of this" as self-affirming or self-condemning? It sadly appears the secretary still sees himself as Superman overcoming the insurmountable. "We're dealing with something that is really historic and we haven't had a playbook," he continued. "The reason it has been difficult is first of all, these excesses have been building up for many, many years. Secondly, we had a hopelessly outdated global architecture and regulatory authorities ... in the U.S." Paulson concluded by saying any future regulatory overhaul should emphasize "better and more effective" regulation. It also "needed to make sure that infrastructures and powers were robust enough to allow large institutions to fail."

The formidable avalanche-like power of a giant snowball rolling down the mountainside conjures up a graphic mental image of the destructive force of the global meltdown in the financial markets. As is the nature of such events, no one can ever predict with precision when the increasingly daunting efforts to push the ever-larger ball of snow up the incline will eventually prove no match for its burgeoning mass. What one can say with some certainty is that when the spherical mound of snow is thundering down the mountainside it will flatten everything in its path. The bigger the snowball, the broader and longer is the swath of destruction. Even though its pace has slowed somewhat, the financial snowball thus far has been unstoppable despite heretofore unprecedented efforts by the Treasury and the Federal Reserve. Through the process of contagion it has migrated from the financial system to the real economy. Virtually all contemporaneous and leading indicators of economic activity are in a state of free fall. It's no surprise that conditions have forced President Barack Obama to frantically package an estimated \$1 trillion economic stimulus program, which he launched soon after taking office January 20.

The imponderables are endless in this no man's land. There's at least a kernel of truth expressed in the earlier lamentations of Paulson. We are floundering in uncharted

waters. Although it's widely presumed that a Keynesian demand-pull fiscal stimulus program is the most appropriate remedial action, there is room for doubt among reasonable men. Even Keynes observed that consumers are far from Pavlovian in their response to stimuli. As one of the pre-eminent scholars of the Great Depression, Keynes posited that an investment spending cycle generally begins with "spontaneous optimism" and "animal spirits." But now consumer confidence is snowballing downward in conjunction with a dysfunctional financial system and a slumping global economy. Is it logical and responsible to expect that throwing money in its path will be sufficient to rekindle spontaneous optimism and animal spirits?

It should be noted that the proposed massive fiscal stimulation program is the chosen strategy by default. With Fed funds rates near 0%, monetary policy may have played its last trump card.

A rational concern regarding when the tide might turn is the future of securitization, a key mechanism of modern banking that enables banks to bundle loans and bonds into securities for sale to investors (as discussed in detail earlier). This crucial market is moribund now that many of its creations are selling for a fraction of their carrying value. Three decades ago, banks supplied \$3 out of every \$4 of credit worldwide. Today, because of securitization and the "shadow banking system," that share has dropped to about \$1 in \$3. Unless what remains of the investment banking industry is able to securitize—which, in turn, depends on investors' willingness to buy the bundled loans—credit will remain tight, even if banks resume lending.

Households, whose spending constitutes 70% of GDP, have thus far not answered the bell, refusing to step back in the ring. Consumers have become more circumspect about their spending and saving decisions. They no longer view them casually in the gristmill of the new harsh reality. Such behavior has a name. It is called the "thrift paradox." What is prudent behavior for the individual may be antithetical for the economy at large. Referring once again to Paulson's remarks, one of the long-expanding excesses to which he referred is America's gradual emergence as the world's largest debtor nation. As if to pour salt on the wound, research¹⁴ has shown that when the ratio of public debt to GDP is already high, the multiplier effect of fiscal stimulus is likely to be low. Even more worrisome, in extreme cases fiscal expansion can be counterproductive. Not surprisingly, the sheer size of the combined monetary and fiscal stimulus programs—reflected in the mirror of a worldwide loss of confidence in the dollar—may have the unintended side effect of further depressing consumer confidence.

Adding to the malaise, the thus-far-cheap financing of ballooning budget deficits should not be taken for granted. It will not bode well for the prospects of recovery if what consumers have learned about the limits to their indebtedness proves to be applicable to governments as well. If the U.S. runs short on foreign creditors willing to finance the budget and trade deficits at less than confiscatory interest rates, our policy options begin to narrow dangerously. A ruinous inflation or even heretofore unthinkable currency devaluation should not be ruled out.

In realistic summary, it is little more than restating the obvious when I note that the restorative efforts that have been and will be employed by the new administration are figuratively "robbing Peter to pay Paul." Apart from the looming long-term consequences of Band-Aid therapy, the process will surely be remembered as one tarnished by wastefulness, bureaucratic bungling, political patronage, and (yes) corruption. Even deeper down in the behavioral realm are F.A. Hayek's contentions—namely that social science, including economics, has been built up on the pretense that it's possible to gain "scientific"

mastery over complicated social problems. Such intellectual ambition (hubris?) is inherently Icarus-like, he argued. It is “the fatal conceit.”¹⁵ Sadly, a fiscal stimulus program that defers the burden on the taxpayer at the cost of higher marginal tax rates in the future does little to instill long-term incentives to work, invest, and innovate. The financial crisis has been blamed on deficient risk management. The proposals for a large fiscal stimulus suffer from the same weakness.¹⁶

Those, dear readers, could be the harsh realities of the snowball effect. Do not give up hope. The process is cathartic and, as you’ll read in “Back to the Future,” the wisdom of “This too shall pass” is universal in its application.

The Counterargument

Perhaps the most plausible case made in opposition to the snowball scenario is the impact the information revolution has on the speed with which both speculative contagions are formed, as their countervailing forces cause them to vanish. A credible intuitive presumption is that the faster a mania spreads the quicker it will dissipate. If information availability is instantaneous and ubiquitous, it also may be reasonable to assume that the thoughts or ideas themselves have no momentum or “flywheel effect” and are therefore subject to immediate change. Anecdotal evidence abounds. Since Lehman Brothers sank into bankruptcy on September 15, the S&P 500 has moved more than 5 percent in either direction on 18 different days (more than half of the 32 such occurrences in the last 30 years). The very persistence of yo-yo volatility may run counter to the “quick to dissipate” contention. The unprecedented extremes to which the waves of volatility have extended in either direction could easily be made into a case that the information revolution may actually help to sustain rather than contain the lingering episodes of high uncertainty and risk aversion. Worldwide instantaneous communications constitute a new variant in the current crisis. It makes possible global synthetic crowds and exacerbates the tendency to panic *en masse*, no matter how big or little the event to which speculators and investors are responding.

Despite the speed of technology and its ubiquity, it still takes 24 hours to complete a day and sometimes forever to forget a loss. Does anyone think the psychological damage inflicted on a not insignificant community of investors by one Bernie Madoff will be repaired in a fortnight? Restoring trust is a gradual and interpersonal process. If anything, nanosecond technology impedes the reprogramming of the necessary but antiquated processor—the human brain.

Can Harsh Realities Be Quantified?

Not to leave those hungering for the tangible hanging on a clothesline of dangling prepositions and metaphors, I’ve attempted to put a little meat on the bones of conjecture. In the Appendix, Exhibits 2–5,¹⁷ you’ll find reasonably understandable explanations of four different methodologies for roughly valuing common stocks in the aggregate—and over many decades. The first compares the total market value of all U.S.-domiciled companies annually with GDP. It has been featured in a number of earlier annual reports. The second, a model originated by Ben Graham and updated by Bob Shiller, traces the 10-year trailing deflated price-earnings ratio from the early 1920s. The third, Tobin’s q-ratio, compares the market value to the replacement value of corporate assets over the same time frame. Finally, a name out of the past, Edson Gould, attempts to use dividend yield as a measure of

valuation. Gould's work is more relevant to the case made below regarding dividends returning to prominence.

These four different ways of looking at the same thing provided not only similar conclusions as to when major market lows occurred but, with reasonable accuracy, how depressed valuations were on those occasions. Common stocks were most out of favor in the early 1920s, the early '30s, and the early '80s, the last episode being the only instance of double-digit inflation and interest rates. If the current malaise continues, and those same low valuations are eventually realized, the S&P 500 could decline farther to somewhere between 400 and 550, the Dow Jones industrial average, 4000 to 5500. From year-end prices the further erosion in total market value could range between 30% and 50%.

You'll be making a big mistake if you take the above to be a forecast. As indicated in the preceding section, you'll be making even a bigger mistake if you do not make adequate mental provision for what could be a worst-case scenario.

I'm even more hesitant to opine with specifics on the real economy. First, anything I might offer is little more than the warmed-over forecast from someone else. Moreover, forecasters seem to come from two camps. First are those who draw their paychecks from a for-profit enterprise. Given the obvious incentives, there must be a presumption that if they have a bias it will most likely lean toward the optimistic side. The other cohort comes largely from the academic community. The work of these folks has its own biases. Of all the many opinions I have read over recent months, one from Martin Wolf of the *Financial Times*¹⁸ seemed the least infected with common biases and was based, for better or worse, on the antecedents of other banking crises in advanced economies since World War II—in addition to two prewar developed country episodes: the Great Depression in the United States in the 1930s and in Norway in 1989.

The academic sources Wolf quoted¹⁹ from a year ago showed that standard indicators for the United States, such as asset price inflation, rising leverage, large sustained current account deficits, and a slowing trajectory of economic growth “exhibited virtually all the signs of a country on the verge of a financial crisis—indeed, a severe one.” So far, on point. In a January 2009 paper, the academics cited by Wolf focused on the comparative historical analysis of the aftermath of systemic banking crises.²⁰ According to them, such crises tend to be protracted affairs, with three characteristics in common.

- First, asset market collapses are deep and prolonged, with real housing price declines averaging 35% and stretched over six years. On average equity prices took 3½ years to fall 55%.
- Second, the crises were followed by profound declines in output and employment. Unemployment rose on average by 7 percentage points over the contraction phase of the cycle, which averaged more than four years in duration. Peak-to-trough declines in output averaged 9%, although the duration was two years, half that for unemployment.
- Third, the real value of government debt exploded, rising an average of 86%. Interestingly, the bailout spending related to recapitalizing the banking sector was not the main driver of the mushrooming debt. Rather, the culprit was the inevitable collapse in tax receipts resulting from the contraction in economic output, as well as the countercyclical fiscal policies aimed at mitigating the downturn.

No matter what course the financial and economic crisis takes, the not-so-harsh reality is that, as stated, “This too shall pass.” By exposing you to hypothetical worst-case

scenarios based on the repetitious nature of human behavior, along with somewhat similar episodes from the past, we hope we have helped you form the kind of expectations that will set you up to be a survivor, not a victim. One point bears repeating, however. Long-term stability is predicated on recoupling risk and return. Government macro policies are, in the name of social stability, aimed almost exclusively at stopping the bleeding. To the extent that the consequences of risk indulgence are thereby ameliorated, long-term stability is in jeopardy.

BACK TO THE FUTURE

“Where we’re going, we don’t need roads.”

—President Ronald Reagan, quoting from the movie
“Back to the Future” in his 1986 State of the Union
Address

By Populist Demand: Return of the Dividend

In 1958 a theretofore unimagined change occurred: The dividend yield on the S&P 500 “permanently” fell below the yield on 10-year U.S. Treasury bonds and remained that way until the record was broken late in 2008. Then with a little help from the Fed and short-term rates nudging zero, the 10-year note fell below 3.5%.

Two explanations later emerged for the 1958 reversal of fortunes. The economy’s recovery from the 1957–58 recession showed investors could finally put to rest the widely held expectation of an imminent return to the Great Depression. Second, as those fears receded, investing in “growth stocks” gained in popularity. In order to fund growth—and in the inflationary 1970s to compensate for the inadequacy of depreciation expense based on historical cost²¹—the dividend payout ratio from growth companies (the percentage of earnings distributed to shareholders in the form of quarterly cash dividends) was reduced out of necessity (see Exhibit 1 in the Appendix). Warren Buffett, the ultimate capital allocator, legitimized the concept. Berkshire Hathaway has never paid a dividend since he christened it his flagship in 1965. Buffett has argued that so long as he can reinvest Berkshire’s copious cash flow at rates comparable to what Berkshire shareholders can do on their own, he’ll retain all of the company’s earnings.

With the S&P 500 at year end trading 39% below the highs of 1999—to the instant-gratification speculators nine years is an “eternity”—the argument for owning stocks for price appreciation has weakened among the rank-and-file who see the future through the rearview mirror. Even for those who look through the windshield, visibility for sustained economic growth is the foggiest in decades. The so-called “equity risk premium”—the excess return over and above U.S. Treasury securities historically demanded by investors as compensation for the greater risks of owning equities—will likely take the form of investors demanding a higher current yield from stocks vis-à-vis bonds. This can be accomplished two ways: falling stock prices and rising dividends. The worst collapse in stock prices since the early ’30s, coupled with the gradual increase in the S&P dividend over the years, has pushed the dividend yield to around 3.5%, up from 1.0% in 2000.

The wild card in thinking about what will make dividend yields appealing is the future course of the yield on U.S. Treasury securities. Everything is relative. In one of the most unsettled times in U.S. financial history, arguments in favor of both the specter of deflation or disturbing price inflation have credibility. A 3.5% dividend yield may be competitive today when U.S. Treasury bills yield next to nothing. If inflation and/or a

declining dollar drive interest rates higher, stock prices must ratchet downward for dividend yields to remain above those earned on U.S. Treasury securities.

It should come as no surprise that dividend-paying companies outperform non-dividend-paying companies over time. It all seems to be linked to financial responsibility and accountability. With more income being distributed to shareholders, CEOs may make what cash is left work harder. They will have strong incentive to instill a culture of financial discipline to ensure that the dividends are safe and growing. What's good for a company may also be good for the economy...

The Slow but Steady Dividend: A Likely Winner by a Hare

Unfortunately there are few Warren Buffetts wearing the CEO's hat in the executive suites of corporate America. On December 10, Standard & Poor's provided some telling data. "Since the buyback boom began during the fourth quarter of 2004, S&P 500 companies have spent about \$1.73 trillion on stock buybacks, compared with \$1.87 trillion on capital expenditures and the \$907 billion on dividends." Not unlike the mutual fund investors' behavior profiled earlier, the average company is prone to buy aggressively when prices are relatively high and forgo expending shareholder capital when prices are comparatively low. Of no surprise whatsoever, during the third quarter of 2008 share repurchases declined 48% from the prior year.

Long opposed to share repurchase programs—except in those rare instances where they inure conspicuously to the benefit of the long-term investors who choose to stand pat—I view the payout of \$1.73 trillion of shareholder cash to departing shareholders as a travesty in corporate capital allocation. While there are wonderful examples to which the pull toward mediocrity does not apply, many buyback programs (with the benefit of hindsight) were nothing short of a counterintuitive strategy of paying departing shareholders a huge exit premium to invest their money elsewhere under the guise of "rightsizing" capital structures, euphemistically known as "financial engineering." These same companies spent egregious sums in time and money courting institutional shareholders,²² providing earnings guidance to make the analysts' jobs easier and to contain the risk of an unexpected earnings hiccup, along with "road shows" to trumpet their stories in the financial centers. I suppose if you're paying shareholders to leave, you've got to hit the road to find their replacements. Go figure.

The Oracle of Omaha is no lemming. Refusing to buy out departing Berkshire Hathaway shareholders at high prices, Buffett squirreled away cash so that he could be...greedy when others are fearful. Even though corporate cash levels were near record highs in the third quarter, the standard response of corporate execs was "We are choosing to hold onto the cash, unsure of what the near term will bring." By loosening restrictions, regulators sought to encourage companies to buy back shares during the massive selloff. Though led to water, the horse mostly refused to drink. Parenthetically, might there be inferences we can make about consumers' likely response to stimulus measures based on the behaviors of presumably more enlightened corporate boards and CEOs? History doesn't repeat itself, but the passions of men do.

Why Dividends Went the Way of the Buffalo

To be sure, many companies repurchase shares to offset the dilution from their stock option programs. As stated, Buffett is neither a lemming...nor a fool. His "rate busting" salary noted a couple of paragraphs hence has not stood in the way of his ascent to the bully

pulpit as the wealthiest man in the world. In many respects it has actually helped. While I'm on a rant, most readers will recall the old Smith Barney ads featuring the famous line from the late John Houseman. The actor help turn a slogan into a catch phrase with his deliberately haughty delivery, echoing his performance as the curmudgeonly Professor Kingsfield in the movie and TV series "The Paper Chase": "We make money the old-fashioned way. We *earn* it."²³

One of the salutary effects of the great unwinding just could be a new way of looking at executive compensation. Instead of providing the "free ride"²⁴ of stock options, boards of directors might pay their executives "the old-fashioned way" and propose the novel idea that executives buy company shares in the open market. That puts them at true parity with the rest of us common folk. And that's what Buffett did in the early days at Berkshire. Of course, most moribund businesses are not going to perform like Berkshire has. Let's not forget Berkshire's less than auspicious beginnings. When Buffett bought Berkshire it was a threadbare dying textile company. Buffett proved to be a rare exception to his own rule: "When a management with a reputation for brilliance tackles a business with a reputation for bad economics, it is the reputation of the business that remains intact." Maybe it's the lack of direct feet-to-the-fire personal accountability that explains why stock options have been so popular. Managers are paid to have foresight, so it doesn't appear unreasonable to hold them accountable with the benefit of hindsight.

Buffett's salary at Berkshire is \$100,000. If that's an acceptable benchmark, with which I won't quibble based on my own salary, the multimillion dollar executives jetting around the country appear to be somewhat overpaid—unless they atypically exhibit the foresight mentioned immediately above. Parenthetically, we don't need a host of new laws and regulations to repair the obvious. A few conscientious boards of directors should do the trick. If they need a little boost, it might be suggested by shareholders that they take the premiums previously spent on directors' and officers' liability insurance as additional compensation. They will have "earn[ed] it." ☺

The Future of Risk Aversion

There are profoundly positive consequences from the harsh lessons investors and consumers are in the process of learning. The significance cannot be overstated. As observed on page 14, "[T]he future of investment for a generation hangs in the balance." The wisdom to be gleaned from older men is a sure way to steepen the DIY (do it yourself) learning curve. Peter Bernstein, 90-year-old author of the Christmas book of 1996 *Against the Gods: The Remarkable Story of Risk*, is wisdom personified. He lived the history about which he writes.²⁵

Based on Bernstein's shared recollections and our mutual belief in the predictable irrationality of human behavior, we envision a future that closely parallels the acute risk aversion mindset that framed the attitudes of investors turned savers²⁶ for several decades after the Great Depression. The man who has seen so much and who has reflected endlessly on what he has observed says:

The new environment will be slow to develop excesses, especially in the credit area, and this result will last for a long time. So, we can be patient, seek out opportunities calmly and quietly, and not worry because nobody will be in a hurry. Secondly, liquidity derived from trust and not from the central banks will not be in unlimited supply because trust itself will be limited in supply for a long time. The Word awash will vanish from the

vocabulary. This result means that if you have liquidity, you have a precious asset and can achieve high returns.

There will be a revolution in expectations and priorities. Savers were so risk-averse after the war that most business school graduates went into business instead of off to Wall Street to make their fortunes. Bernstein recalls that only two of his fellow 1947 graduates from Harvard migrated to Wall Street, and one of them was named J.P. Morgan III.²⁷ After graduation Bernstein began teaching money and banking at Williams College in Massachusetts. Bernstein had his students study the financial statements of a local bank—Williamstown National Bank—where most had deposited their money. He pointed out with apparent dismay that 75–80% of the bank’s assets were invested in bonds and only a small amount in loans. Soon the bank president summoned the greenhorn, admonishing him: “Bernstein, you don’t understand a thing about running a bank. We have all these depositors who could ask for their money at any time, and I have to remain liquid.” The Williamstown bank president’s preoccupation with risk aversion was an apt proxy for the cautious outlook of bankers in the late 1940s and beyond, a convex rear-view mirror perspective on the future in which the image of the Depression was magnified out of proportion with reality.

The time to embrace opportunity is when everyone else is focused on shunning risk. There were two risks that experience had told Depression-era Americans to avoid: market and business (or credit) risk. The stock market crash-induced trauma was seared into investors’ psyches for a generation. The business depression that followed sealed the demise of confidence, obliterating the Keynesian urge toward “spontaneous optimism” and “animal spirits.” With the propensity to recklessly embrace risk in pursuit of return (that marked the 1920s) purged from the minds of all those who bore the scars of the Depression, assets sold at prices that were stripped of “blue sky.” Although the Depression lingered through the ’30s, the give-away prices at which businesses sold reflected the sorry state of affairs. It was the exogenous stimulus from the Lend-Lease program that began in March 1941, more than 18 months after the outbreak of war in Europe that began to slowly stoke the fires of recovery.

Two critical concepts introduced at the outset of the report are worthy of repetition: Risk is not a constant, nor can it be avoided. Investors often fail to realize what modern portfolio theory dogma refuses to embrace is that risk is variable, that it is functionally related to the price paid for an asset. A junk bond portfolio, to use an extreme example, is less risky at a yield of 20% than at a yield of 4%. In the last 18 months junk bonds traded at both extremes. To use a hypothetical example, if 10% of the portfolio defaults and the recovery rate on the defaulted bonds is 50%, the current yield falls to 12–17%. If the default rate turns out to be 20%, the yield is still 7–12%.

Investment risk can never be avoided because the very act requires a capital outlay in the present with the expectation that more than what has been ventured will flow back in the sometimes capricious future. The greater the apprehensions about the vagaries of tomorrow, the smaller the capital outlay an investor is likely to make for a given asset. When the perception of uncertainty is profoundly influenced by past experience (where assuming risk resulted in losses), the price investors are willing to pay for an asset is likely to be more influenced by fear of risk of loss than opportunity for gain. The antithesis of investors’ irrational willingness to be undercompensated for the risks assumed in euphoric times—the equally unreasonable insistence by “once burned, twice shy” investors that they be overcompensated for the risks assumed in troubled times—is manna from heaven for the

courageous, value-driven, long-term investor who is not without fear but is not controlled by it either.

The Great Depression Bear Market Myth

The legacy of common stocks as the cause of so much misery in the 1930s has been made all the more emphatic by historians who have felt compelled to finish the story by reminding readers that *it took the once mighty Dow Jones industrial average until 1954—a lost generation it would seem—to claw its way back to the summit reached in 1929*. The image is teeming with innuendo.

The implication is that those who acquiesced to their greedy impulses in the late '20s, which by all appearances included just about everybody, served penance for a quarter of a century thereafter. To be sure, most who speculated and lost never purchased another stock for the rest of their lives. Even today, the universal mental image of the era begins with the wealth-destroying stock market crash, followed by the demoralizing and seemingly endless economic depression—and culminating with the manifold uncertainties of World War II. Fear and remorse sounded the death knell for investment in what everyone had come to believe was the riskiest of all asset classes: common stocks. That perception stubbornly clings to the collective psyche as one of the great investment myths when talk turns to the Depression and its aftermath.

Facts Tell a Dramatically Different Story

Using annual data²⁸ from the beginning of 1930 until the end of 1954, here are the plain facts, presented dispassionately. For openers, if one includes reinvested dividends, as clearly one should, *\$1 invested on January 1, 1930, in the S&P 500 was made whole during 1936*. That's less than seven years to break even, not the much-ballyhooed quarter of a century.

As for the so-called “lost generation” from January 1, 1930, to December 31, 1954, the average annual total return (including dividends) for the more broadly based S&P 500 was 8.1%. Starting three years later in the depths of the Depression, on January 1, 1933, the average annual total return jumped to 14% for the 22 years. Sadly, the greater loss for a generation was opportunity, not money.

What about the so-called safe alternatives? The average compounded annual return from Treasury bills was virtually identical for the 25- or 22-year periods: 0.7% versus 0.8%. The same was true for intermediate-term Government bonds: 2.6% versus 2.4%.

Moving from percentages to dollars, the ensuing table displays the results of investing \$1,000,000 in each of the three asset classes January 1, 1930, or January 1, 1933.

	Treasury Bills	Government Bonds	S&P 500
1930–1954	\$1,200,000	\$1,900,000	\$7,000,000
1933–1954	\$1,200,000	\$1,700,000	\$17,900,000

The unleveraged and unflappable long-term investor (of whom there were undoubtedly precious few) who failed to see the crash coming but still clung, like Adm. Stockdale, to his steadfast belief that this country would persevere during what proved to be the most trying of times, was handsomely rewarded, seeing his money multiply sevenfold.

The patient value investor who left the market in the late '20s because of the scarcity of conservatively priced businesses—and returned because of their abundance three or more years later during the despair that followed the crash—prospered mightily, turning \$1 into

\$18 over the next 22 years. As was previously stated in the weekday edition—and is reiterated here for emphasis:

Every generation or two the true value of “wealth management” is revealed. Being aware that a single, big mistake can wipe out a lifetime of successes, a wealth manager must be hardwired to recognize and avoid grave risks, including those never experienced before. Fierce independence of thought and action, equanimity of temperament, abiding rationality, and a keen understanding of human nature are essential. History doesn’t repeat itself but the passions of men do.

Having sampled the headlines in national newspapers from 1930 to 1945, I don’t want to even imagine a future scenario that would be the equal of the endless stream of dispiriting news that inundated readers day after day. People feared Armageddon and stocks were priced accordingly. The value investor, who inferred from the awful headlines that stocks must therefore be cheap, ventured forth without seeing any light at the end of the tunnel of despair. Value investing is not for the faint of heart.

The best of returns from common stocks are invariably germinated in the worst of times. The popularity of common stocks and the returns they produce are inversely proportional. That simple truth has applied from time immemorial. I will boldly forecast that the inverse relationship will be as applicable in the future as it has been in the past.

Dividends represented a significant part of the return from common stocks during both historical periods, as Exhibit 5 in the Appendix indicates. Dividend yields hovered close to 6% until the mid-1950s, greatly exceeding the return from either Treasury bills or Government bonds.

Any discussion of long-term historical investment returns would be incomplete without addressing the erosion in purchasing power due to inflation. The average compounded rate of inflation was 1.8% from 1930 to 1954 and 3.2% from 1933 to 1954. The difference is fully explained by the deflation in the early years of the Depression: In 1930 prices declined by 6%; 1931, by 9.5%; and 1932, by 10.3%.

The following table shows the inflation-adjusted value of \$1,000,000 invested in the three asset classes, before personal income taxes.

	Treasury Bills	Government Bonds	S&P 500
1930–1954	\$760,000	\$1,220,000	\$4,600,000
1933–1954	\$730,000	\$840,000	\$9,500,000

Fearful investors, reeling from losses in the stock market and facing a collapsing banking system and economy, sought safety in Treasury bills and Government bonds. As is obvious, in their emotional state they paid a high price for the *illusion of security*. Even intermediate-term Government bonds barely kept pace with inflation. Unmanaged fear and long-term investment success simply cannot coexist. *Those who believed in the great bear market myth because they lost part or all of their savings during the great Crash of 1929 lost something far greater: the willingness to venture, to win it back many times over in the years that followed.*

President Reagan prefaced the reference to “Back to the Future” at the outset of this section with the following: “Never has there been a more exciting time to be alive...” Adm. Stockdale might have phrased it differently, but he, like Reagan during the difficult times in his life, kept digging, knowing that someday he would find “the pony in the dung heap.”

FINAL THOUGHTS...

To begin “lite” and finish sober, this may be the first annual report from the undersigned that does not send the reader to the dictionary, trigger a migraine, or induce sleep—or all of the above. During a December Kitchen Cabinet meeting, John (Houseman) Dille, looked across the table and asked as only Professor Kingsfield (see page 24) could: “Frank, for whom are you writing the report this year? Yourself or your clients?” The truest of friends, John’s gentle nudging throughout this effort will never be forgotten. I doubt that I need to ask you to join me in thanking John.

President of Federated Media, John Dille is one of six contemporaries and clients who constitute the MCM “Kitchen Cabinet.” The other five are:

- John Collins, former CEO and founder of Leer
- Bob Deputy, former CEO of Godfrey Marine
- Andy Frech, chairman of board of Ancon Construction Co.
- Scott Welch, chairman and CEO of Welch Packaging
- Wally Wells, former president and CEO of Schult Homes

Although the Kitchen Cabinet has no formal authority, its informal power can move mountains. See following paragraph.

Everybody reports to someone; I can’t think of any greater privilege than to be accountable to this remarkable group. If the boards of directors across corporate America were half as good as this crackerjack crew, capitalism would not be on trial today. I once asked for a raise, and the cabinet referred me to the aforementioned Smith Barney ad (page 24).

The privilege to develop relationships from occasional to collegial with thinkers and authors like Peter Bernstein, Jack Bogle, Rick Bookstaber, Warren Buffett, Laurence Gonzales, Charles Morris, Dennis Rocheleau,²⁹ Kate Welling, and many others has been invaluable and to them I extend my heartfelt thanks. A few of them were gracious enough to provide editorial assistance.³⁰ To my partners, associates, and staff, to whom I’m also deeply indebted, I can’t think of a finer assemblage of solid, bright, and hard-working professionals with whom to share our common mission. My wife, Marsha, who has had a steady diet of breakfast buffet banter for years from the undersigned, was an enlightened taskmaster and critic throughout the project. My able assistant, Kristen Smith-Myers, ages in excellence as I age in years. Dan Shenk of CopyProof and I have been working together for so many years that he is considered as adjunct faculty.

My role is to continue living mentally in the sparsely populated thinking space of the future. Our defensive posture was conceived in the good times, but it anticipated what might lie ahead. It was founded on the belief that “to win, first you must not lose.” As many of our bloodied relative-returns peers retreat from the field of battle, the spoils are there for the taking by tried-and-true value investors. The opportunity set of the future looks more and more promising. Our top-drawer team of analysts, whose primary focus is on becoming intensely familiar with individual businesses like a general knows his best soldiers, are going up and down the ranks in the search. The task is time-intensive and requires great skill. Todd (managing partner), Dennis, Drew, and I are the point men. Aaron, who does double duty as chief trader and analyst, and Clint fill out our in-house cohort.

The year just past is perhaps the midpoint during a span of time in history best described by the adage “There’s no rest for the weary.” Going against the grain of conventional wisdom is as taxing as it is rewarding. I wouldn’t have it any other way.

Finally, to you, our loyal clients, I joyfully tip my hat each year. Serving you is a rare honor and privilege. Indeed, it is the reason I awake each day with enthusiasm for what lies ahead. Each of you is unique—a blessing in my life that, like the sunrise of each new day, illuminates, warms, and inspires.

Frank K. Martin, CFA, Senior Partner

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, each partner’s personal portfolio is 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 seek to 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. We may, from time to time, take positions in exchange-traded options for hedging existing positions or the market in general. Any one option may, and often will, expire worthless. Unlike any individual business in which we invest, we view the potential loss on any individual option position in the context of the total portfolio.

- Consistent with our attitude toward catastrophic risk, we have little interest in the use of leverage. We do not margin portfolios and usually avoid making investments in businesses that themselves labor under a heavy burden of debt.
- When we purchase common stocks, we approach the transaction as if we are buying into a private business. We insist on a purchase price that represents a “compelling discount” from intrinsic value. Once a purchase is made, we focus the bulk of our attention on tracking the business itself and ignoring short-term price fluctuations. We are quite content to hold onto our investment in a good business so long as (1) the prospective return on equity capital is expected to be satisfactory, (2) the management continues to conduct itself with competence and honesty, and (3) the market does not become excessively enthusiastic about the future outlook for the business.
- We believe that intrinsic value is in essence the central tendency in the price of an asset. It is the investment concept at the core of our analytical methodology. While intrinsic value is an elusive notion, “earnings power” has become the driving force in fixing a range for intrinsic value. Earnings power allows for the existence of an intangible asset known as “economic goodwill” that can be aggregated with tangible assets to arrive at intrinsic business value. Without such a fundamental benchmark, however vague, one is at risk of becoming awash in the occasional tides of euphoria and pessimism that flood the security markets.
- We generally limit the number of companies we own in any individual portfolio to fewer than 20. Contrary to popular opinion, exceptional investment ideas are uncommon indeed. We do not want to dilute the performance of outstanding investments with potentially mediocre ones purchased solely for the sake of additional, and often redundant, diversification. Despite the intuitive appeal of the broad spreading of your risks, extensive computer-backed testing has demonstrated that 90–95% of all the benefits to be gained from diversification can be achieved with a well-selected portfolio of fewer than 20 businesses.

THE MARTIN CAPITAL MANAGEMENT TEAM

Frank K. Martin, CFA, Senior Partner

Frank has 41 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 South Bend in 1978. From 1964 to 1966 Frank served as an officer in the U.S. Navy. He is a Chartered Financial Analyst. Frank has served on the board of directors of several manufacturing companies, as well as a variety of social service organizations. He is currently a member of the boards of the Elkhart General Hospital Foundation; Fourth Freedom Forum, Goshen; Sauder Stewardship Foundation, Inc., Archbold, Ohio; 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. Frank published a biography of his father, William F. Martin, in 2000. In December 2005 Frank published the book *Speculative Contagion*. In 2009 Frank plans to continue work on a proposed book, *In Temporary Trust*.

Todd B. Martin, CFA, Managing Partner

Todd has 20 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 an MBA from the University of Notre Dame in 1997, graduating *magna cum laude* with membership in *Beta Gamma Sigma*. He remains affiliated with Notre Dame 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 Elkhart General Hospital Board of Trustees and an advisory board member of Old National Bank.

Dennis D. Blyly, CFA, Partner

Dennis has 23 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 Hertzler Systems, Goshen, and Pleasant Street Homes, LLC.

Andrew P. Wilson, CFA, Partner

Drew has 13 years of investment industry experience. He was admitted to the partnership on January 1, 2004. Prior to joining Martin Capital in 1995, Drew was an employee benefits consultant with Watson Wyatt Worldwide, Chicago, 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. He completed the MBA program at Northwestern University's Kellogg School of Management

in the spring of 2004. Drew sits on the Indiana University South Bend School of Business Advisory Board and is Chairman-Elect on the board of directors of the Center for Hospice and Palliative Care, Inc. in South Bend, Indiana.

Aaron J. Kindig, CFA

Aaron joined MCM in December 2002 as a financial analyst. He earned a BA in accounting and business administration from Bluffton College (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.

Clint S. Leman

Clint joined Martin Capital in May 2008 as a junior research analyst. He recently graduated with a BS in business and economics and major in finance from Indiana University South Bend. Clint also earned membership in *Beta Gamma Sigma* and the Financial Management Association International National Honorary Society, from which he received the Finance Award.

Karman L. Eash

Martin Capital recruited Karman in January 2007 as the firm's operations manager. She earned a BS with high distinction in accounting from Manchester College in 1990 and obtained her CPA license in 1993. Karman began her career in public accounting, spending five years with Coopers & Lybrand and then a short period of time with McGladrey & Pullen immediately prior to coming to Martin Capital. Karman also held the division controller position with Accuride International, gaining six years of experience in manufacturing before returning to her alma mater, Manchester College, as controller at the college for four years. Karman is a member of the Indiana CPA Society and the AICPA.

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, Kristin was employed by Northern Trust Bank, Chicago, as a senior representative in the investment managers liaison group.

Karen M. Sherer

Karen has more than 21 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.

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-Myers

Kristen joined Martin Capital in 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 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.

Sue K. Massey

Sue joined the Martin Capital team in 2005. She earned her associates degree and paralegal studies certificate from Indiana University 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.

Kellie L. Doemer

The most recent addition to the operations team, Kellie joined the firm in June 2008 as the business office coordinator. She graduated from Elkhart Central High School. Prior to Martin Capital, Kellie was employed for seven years at Innovations Hair Design where she held the position of salon manager.

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 its 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:

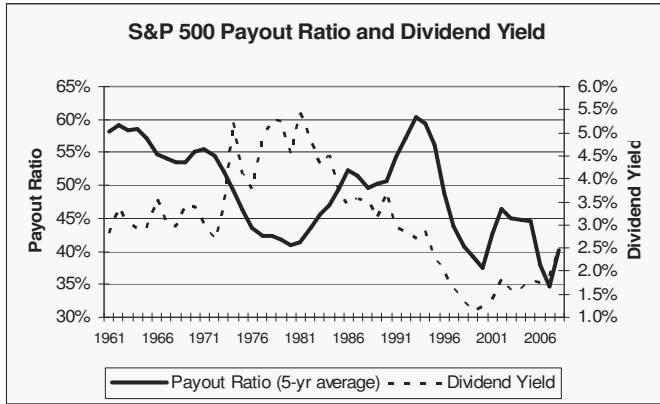
- Help MCM better serve the client’s investment and financial needs.
- Suggest services or other materials that may be of interest to the client.
- Fulfill our regulatory obligations.
- Administer MCM’s business.

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.

APPENDIX

Exhibit 1: Payout Ratio & Dividend Yield



The chart at left shows the volatile but downward trend in both payout ratio and dividend yield over time. In recent years, managements have, for various reasons, favored share repurchases rather than dividends. Given the dismal returns on such “investments,” investors may begin to demand that discretionary capital be used to enrich them rather than the exiting shareholders. A bird in the hand...

Exhibit 2: Market Capitalization-to-GDP

One useful measure of aggregate market value is the market capitalization of all publicly traded stocks as a percentage of gross domestic product (GDP). The November 24, 2008, *Barron's* article, from which the graphic at right was taken, reveals that the capitalization of the stock market was 59% of GDP. This is below the long-term average of 79% but well above the lows, which, if achieved, would result in a 550 level on the S&P 500.

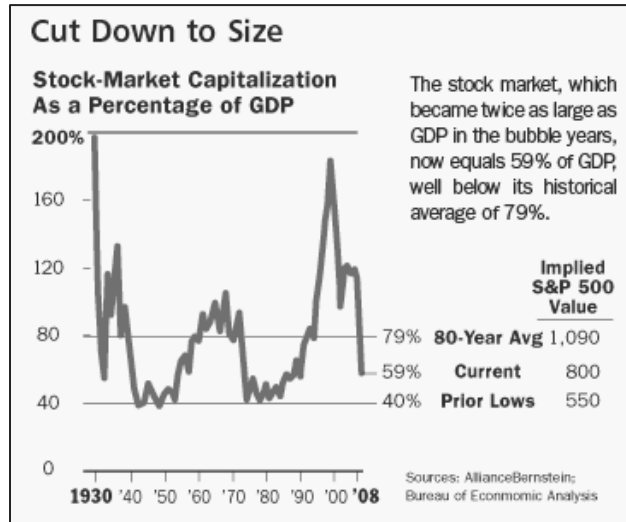
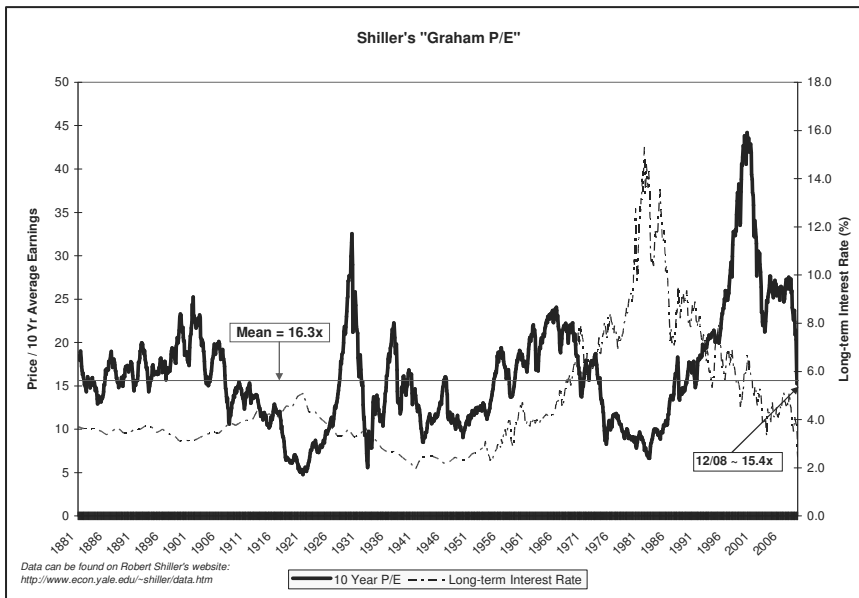


Exhibit 3: Shiller’s Graham P/E

When calculating price-to-earnings ratios (P/E), most investors divide the stock’s price by last year’s earnings per share (or estimated current-year earnings per share). Legendary investor Ben Graham, however, suggested that P/E ratios be calculated using the average earnings of the last 7–10 years as the denominator. Such a methodology smooths yearly earnings gyrations and gives the investor a better sense of price paid relative to a business’s earning power over a full business cycle.



The chart at left was created using data generously provided to the public by Yale economist and noted author Robert Shiller. It can be accessed at his site: <http://www.econ.yale.edu/~shiller/data.htm>. The price component of the adjusted P/E is the S&P 500 index value adjusted for inflation. The earnings component of the calculation is the average of the

preceding 10 years earnings on the S&P 500, again adjusted for inflation.

As of the end of 2008, the market was trading at a “Graham P/E” of 15.5 times earnings, close to the long-term average of 16.3 times earnings. However, if we swing pendulum-like through the average and reach the lows of about 6.5 times as we did in '21, '32, and '82, the S&P would fall to 350–400. Even a more reasonable downside of 9 times equates to a 500–550 level on the S&P 500.

Exhibit 4: Tobin's Q-ratio

Tobin's q-ratio, named for economist James Tobin, is conceptually a measure of the market price of a firm's assets relative to their replacement value (market value of capital/replacement cost of assets). A q ratio greater than 1 means the market is valuing the firm's assets for more than it costs to replace them. In other words, you can buy a business for less than you can build that business. The converse is true



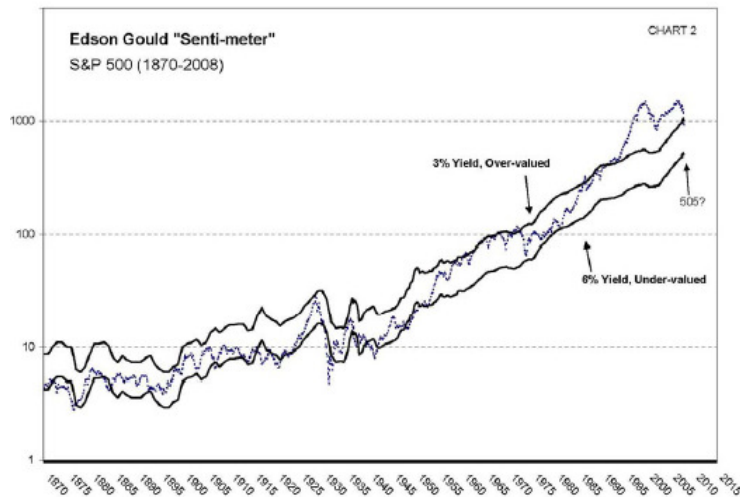
for q ratios below 1. Among the many versions and approximations of Tobin's q is the equity-market q—or the market value of publicly traded equities divided by their book value. The chart above shows that as of December, the market was valuing aggregate net assets at about 75 cents on the dollar, which is approximately the long-term average. However, it's obviously a very volatile measure. In four previous bear markets ('21, '32, '49, and '82) the q ratio dipped below 0.3, which, if revisited, would equate to a 400–450 level on the S&P 500.

Source: *The Way Forward*, http://www.deanlebaron.com/misc/CFA_LeBARON_WAYFORWARD_2008_1130.pdf

Exhibit 5: Gould's Senti-meter

Famed technician Edson Gould hypothesized that the market's dividend yield was a reasonable indicator of investor psychology. His theory was that dividend yields less than 3% signified an optimistic bias in investor sentiment and portended a market decline, while a dividend yield greater than 6% foretold the opposite.

The chart below depicts the dividend yield on the S&P 500—or the ratio of the prices of the stocks in the S&P 500 to the cash dividends that owners of those stocks receive. The solid lines represent Gould's 3% and 6% yield channel as approximations of whether the stocks in the S&P 500 were cheap or dear. According to Mark Ungewitter, vice president and portfolio manager at Charter Trust Company, if dividend payout ratios remain unchanged, a 6% yield would equate to about 500 on the S&P 500.



Endnotes

¹ Throughout this report many references are made to the lessons learned from history. The following quotation, found on page 40 of the 2006 annual report, attempts to build a bridge of understanding between the events of which history is the effect and the human behaviors that are often their cause. “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.’”

² Risk is a word that appears more than 50 times in this report. Risk management is, after all, a core concept in value investing. Although modern portfolio theory (MPT) quantifies risk as *beta*, the volatility of the stock vis-à-vis an index, that is not how value investors define it. Benjamin Graham, the patron saint of value investors, suggested long before MPT that the focus be on the dangers of “permanent loss of capital.” Such risk might be divided into three broad categories. First, there is valuation risk, buying a stock at a price that is not sufficiently low to provide a margin of safety in the event it is revalued downward due to internal or external developments. The more stock prices fall, the lower the level of valuation risk. In a relative sense, that risk has declined over the past year. Second, in business or earnings risk, the danger is in a loss of earnings quality and power “through economic changes or deterioration in management.” Currently that risk is high and rising. Third, balance sheets/financing risk is related to how a company’s assets are financed. Periods of financial crisis in all but the most conservative debt levels will likely detract from the investment merit of the issue. While clearly throwing into question the investment merits of the financial services industry, the presence of the second and third risks is beginning to interact and impact the investment merit of companies in the non-financial sectors of the economy.

³ “Enough” may include stock options, index options, various quality grades of fixed-income securities, as well as common stocks.

⁴ It has become fashionable to say, “I said this would happen.” It is particularly true for those pundits who conveniently lack a paper trail. Of course, our record of opinions and actions is so long that one easily gets lost along the way. To make the process cleaner, several excerpts are provided below from prior 10 annual reports. For those who have the time and the inclination, they can be found in the library section of our website by Googling “Martin Capital Management.” Don’t take our word for it; please find out for yourself.

From the 1999 annual report, page 21: “It is to state the obvious that prices, particularly those of companies probing the frontiers of the new tech-based information age, have long been detached from traditional benchmarks of value. But it’s not just concerns about the relationship between price and value that put a traditionalist on edge. Rather, it’s also about how investors attempt to capitalize on what is taking place.” [MCM did not own a single technology or dot.com company from 1998 through 2002.]

As stated in the 2004 annual report, page 18: “We have no idea how much debt the economy can service... What we do know is that the purveyors of financial service products, including those financial institutions that deal in the black-box world of derivative products whose notional totals don’t appear in the above figures, have seen their earnings skyrocket, along with the debt outstanding. To be sure, money greases the skids of commerce, and easy money lubricates the engine of excess. In simple terms, financial bubbles, driven as they are by human folly, are often the result of too much money chasing too few worthy ideas, leading to overinvestment and excess

supply.” [MCM had minimal exposure to stocks in the financial services industry until late January 2009.]

In the 2005 annual report, pages 54 and 55: “The 2005 annual report will reach beyond its traditional grasp by thinking outside the box, which means thinking about the “(housing) box,” to dissect what appears to be a housing price anomaly. Of what relevance are levitating real estate prices, or the schemes to finance the boom in housing, to a firm that does not invest in other than marketable securities? We believe that the argument we will propose forthwith is an essential part of an interdependent larger mosaic that requires some familiarity with multiple disciplines—and feel we would be remiss in not disclosing housing’s role in this increasingly interconnected financial and economic world.”

And in the 2007 annual report, page 13: “While a recession would almost certainly knock the CDS market into a cocked hat, this feat of financial legerdemain is so ill-constructed, with only the slimmest margins for error, that it may fall of its own weight even without the help of a stumbling economy.” [The “skeleton in the closet” throughout the financial meltdown has been, and will likely continue to be, the mysterious credit default swaps (CDS). See the HDS fable on page 11.]

⁵ In mid-January 2009 Wells Fargo revealed a new way for financial firms to get battered by Bernie Madoff’s alleged \$50 billion Ponzi scheme. Up to that point, financial firms have been hit with losses when they reimbursed clients who themselves suffered losses (1) as a result of the bank’s trust department’s direct investments with Madoff or (2) or because the bank had recommended the Madoff firm to its clients. In this latest iteration, clients of the San Francisco bank were engaged in the “carry trade,” using low-cost borrowed money from the bank to leverage their purchase of the higher-yielding Madoff funds. Wells Fargo announced that it took permanent losses of \$294 million in loans made to Madoff clients who are now no longer able to repay the debt. According to the *Wall Street Journal*, when asked if their banks were experiencing similar problems with loans made to Madoff clients, spokespersons for Bank of America Corp., Citigroup Inc., and JPMorgan Chase & Co. did not immediately respond.

⁶ Not to be confused with the title of Alice Schroeder’s biography of Warren Buffett, *Snowball*. As used in earlier annual reports, the metaphor is analogous to the pendulum (in the horizontal plane). As the mass increases, it takes more force to push it up the mountainside. When gravity takes over, its momentum is unstoppable until the mass dissipates as it rolls down the mountainside.

⁷ Ben Stein—lawyer, actor, critic, and son of economist Herb Stein—once called Goldman Sachs the “real government of the United States.”

⁸ Overlaps occur. Endowment and pension funds own hedge funds as do fund-of-funds and so on.

⁹ *The General Theory of Employment, Interest, and Money*, 1936, John Maynard Keynes. Keynes was a pioneer in the theory of full employment and made his reputation in the 1930s by encouraging fiscal stimulus. He had a great deal of influence on Franklin Roosevelt. Keynesian economics has been used frequently in the post-World War II period and is being embraced by President Obama. Were Keynes alive today, I wonder if he would be employing the strategies associated with his name. Long an advocate of letting circumstances dictate responses, his spend-your-way-out-of-trouble prescription, used repeatedly in the post-WW II era, may not be the shoe that fits in 2009.

¹⁰ *Deep Survival* is among the growing collection of books in my library that focus on behavioral economics. A topically organized reading list will be sent to anyone expressing interest.

¹¹ Jason Zweig is author of *Your Money and Your Brain* and writes a weekend column for the *Wall Street Journal*. A convenient source for some of the material in this report was a May 2007 interview Zweig

had with my friend Kate Welling, whose subscription-only website, Welling@Weeden, is a treasure trove of interviews with the *crème de la crème* of the investment community.

¹² James Montier, a gifted strategist who writes a bimonthly essay under the title “Mind Matters” for the French bank Société Générale (and, at the risk you’ll lose respect for him, also penned one of only two reviews of my *Speculative Contagion*, 2006, on Amazon’s website!) devised a simple, sequential, coin-tossing experiment with rewards that were conspicuously biased to encourage the participants to bet on every toss. That notwithstanding, when participants experienced loss after a flip of the coin, they were less likely to bet on the next toss. Moreover, what he learned from the process, as illogical as it may seem, is that the aversion to uncertainty actually increased over the course of the experiment. If players were rational and learned from their experience, the longer the game progressed, the more they would have been expected to figure it out. Surprisingly, or perhaps unfortunately, the greater their experience the less they decided to invest. They were getting worse at the game as time went on. By contrast, a control group that had a very specific form of brain damage that limited their capacity to feel fear significantly outperformed the group of normal brain functioning participants.

¹³ *Financial Times* interview with Hank Paulson, the outgoing U.S. Treasury Secretary, December 30, 2008.

¹⁴ Reinhart, Carmen M., and Kenneth S. Rogoff. 2008. “Banking Crises: An Equal Opportunity Menace.” National Bureau of Economic Research Working Paper 14587. Draft dated December 19, 2007.

¹⁵ *The Road to Serfdom* is listed among the 25 books the *Washington Monthly* proposed as a reading list for President Barack Obama. Author Friedrich Hayek, of the Austrian school, won a Nobel Prize in economics.

¹⁶ The idea that boom causes bust—and that great busts are self-reinforcing—originated in the Austrian school of economics, with its chief protagonists being Friedrich Hayek and Ludwig von Mises. “The main tenets of Austrian business-cycle theory can be summarized as follows: (1) the boom causes the bust; (2) the bust is proportionate to the boom; (3) major intervention is likely to cause major unintended consequences; and (4) sound money is the best policy in all environments.” [Let there be no mistake, Austrian business-cycle theory has been harshly criticized by such influential economists as John Maynard Keynes and Milton Friedman. Of no minor significance, Hayek and Mises both predicted the upcoming crisis in 1929. [Source: “A Way Forward” by Walter Deemer et al.]

¹⁷ In Appendix, Exhibits 2–5, are charts of the ratios, as well as brief and understandable explanations.

¹⁸ “Choices Made in 2009 Will Shape the Globe’s Destiny” by Martin Wolf. Published January 6, 2009, *Financial Times*.

¹⁹ Reinhart, Carmen M., and Kenneth S. Rogoff. See earlier endnote by same authors.

²⁰ While I thought the research was sound, the statistical support could’ve been much better—e.g., simple use of standard deviations with averages.

²¹ Something to think about as we anticipate the potentially long-term inflationary consequences of the macro policy initiatives under way...

²² Fifty years ago individuals owned 92% of all stocks; financial institutions owned 8%. Today, individuals own only 24% of all stocks; institutions own 76%. “I think a central problem is that these institutions have not behaved in an appropriate manner,” chastised Jack Bogle in the January/February 2009 *Financial Analysts Journal*. A pet peeve of Bogle and the undersigned is the breakdown in the agent/principal relationship and the abdication of responsibility and accountability that resulted (see endnote 27 below). In this writer’s opinion, the phenomena are tightly linked and interdependent.

²³ “The Paper Chase,” 1973 movie and later TV series, featured actor John Houseman as the curmudgeonly Professor Kingsfield, Harvard Law School.

²⁴ One of the more disingenuous phrases found in proxy statements to justify executive stock options is the following: “To align the interests of management with those of the shareholders.” There are admittedly a number of responsible justifications for stock options. That just doesn’t happen to be one of them.

²⁵ “How Far Away Is the Past? How Near Is the Future?” Peter Bernstein (December 2008, CFA Institute, *Conference Proceedings Quarterly*, page 3).

²⁶ Not finding a suitable definition of the difference between savings and investment, I’ll offer my own. Savings is the conscious act of deferring consumption, of setting aside a portion of one’s disposable income so that it might be expended in the future. Investment is what you do with the money set aside. There is no place one can put money that has been set aside that is entirely immune from risk (money tucked away in a lockbox as a store of value may buy less in the future because of inflation in the price of goods it will be used to purchase). Cautious investors may seek out the asset classes that have historically been the safest: savings accounts at banks: CDs, U.S. Treasury bills, and so forth. More enterprising investors will assume greater uncertainty in terms of future payback. They may invest in real estate, mutual funds, etc. Intelligent investors (which is also the title of one of the greatest books written on the subject) attempt to reconcile expected return with risks incurred.

²⁷ Two Harvard economists, Lawrence F. Katz and Claudia Goldin, have long studied the career choices of Harvard undergraduates. In recent years 23% have entered banking and finance, six times the percentage of the 1960s. Money has been the lure. Compensation was triple that of their non-finance contemporaries. Far more significant in terms of recoupling risk and reward, a National Bureau of Economic Research working paper by Thomas Philippon of New York University and Ariell Reshef of the University of Virginia found that the difference in pay between finance and the rest of U.S. industry was slight, if any, *except in the late 1920s and then again from the mid-1990s to 2006*. With total bonus payments on Wall Street reaching \$18.4 billion last year, a sea change could be in the offing. The harsh reality is that high pay on Wall Street is an episodic phenomenon. If history repeats, the pay for top bankers could fall into line with pay for other professions, like doctors and lawyers. Maybe the best minds will once again be employed creating things of lasting value?

Wall Street also set the tone for other industries, as the compensation of senior managers rose far faster than for most workers. In 2007 the total compensation of chief executives in large U.S. corporations was 275 times that of the salary of the average worker, estimates the Economic Policy Institute in Washington. In the late 1970s CEO pay was 35 times that of the average U.S. worker. Overdue compensation restitution, as appears to be occurring in 2009, reduces the risk of social revolution.

²⁸ The Ibbotson® SBBI® Classic Yearbook is the definitive study of historical capital markets data in the United States.

²⁹ Dennis Rocheleau, former Northwestern fraternity brother/roommate, deserves special mention for his careful review of the entire document. Dennis, who may well have studied under a Professor Kingsfield while at Harvard Law School, plied his considerable skills at GE where he was labor relations manager/chief negotiator for more workers than the entire population of Elkhart County, Indiana. When he pointed out to his daughter Shana that this report was the only instance when his name appeared in the same sentence with the Oracle of Omaha, she sardonically replied, “Dad, you’re no Warren Buffett!” ☺

³⁰ Rick Bookstaber and Charles Morris provided valuable editorial commentary on various sections of the report. Morris’s just-released sequel, *The Two Trillion Dollar Meltdown*, was just released and will be distributed to clients.

