

# capital QUARTERLY

# markets review

## It's Time to Look at the Trees, Not the Forest

Thanks to the Internet, CNBC, Bloomberg and other notable pipelines direct to Wall Street, we as investment managers have no shortage of information conduits, especially when the contagion effect is strong. Along these avenues traveled a great cloud of billowing informational smoke, akin in consequence to the acrid soot that hampered the rescuers' efforts, following the September 11 attacks. After reading *Barron's*, *The Wall Street Journal*, and other Internet-provided periodicals over the weekend of September 29-30, we found the dense fog nearly impenetrable.

To be sure, our awareness of the history of financial markets makes it hard to argue against the proposition that the worst is yet to come. Reread if you will the 12-page appendix to the 2000 annual report, "The More Times Change, the More They Remain the Same: 1927-33 Through the Eyes of Benjamin Graham." In sum, it is the story of a pervasively contagious psychological epidemic in which mild-mannered investors were transformed to wild-eyed speculators, with the victims seemingly having little conscious awareness of the change until its devastating consequences left scars that were anything but fleeting. In today's world it is the cathartic process through which yesterday's Internet day traders, dot.com dreamers, or buy-at-any-price technology or telecom speculators are being shocked back to a harsh reality that

could be both long and painful. In large measure it is why the 1987-ish "back to the races" mentality holds little water for us. Sucker-pitch rallies like those in the spring of 1930 and October 1973 are usually a boon for traders but generally a bust for investors. We'll turn a deaf ear to the relentless clamor of the countless prognosticators whose abysmal records neither tie their tongues nor cause them to shrink in shame, but we will attempt to capitalize on their folly if that's what we believe it to be.

That having been said, one would surely find solace, as well as the vision to see through the fog, by reading Chapter 8 in Roger Lowenstein's *Buffett — The Making of an American Capitalist*. In the face of unrelenting pessimism in 1973-74, Buffett forged resolutely ahead, notwithstanding that, in the depths of the bear market in 1974, his net worth had fallen by half.

Wall Street wore the country's dismal mood for a mask. The nifty 50 stocks plunged by 80 percent [not unlike the recent devastation visited on the Nasdaq index]. Buffett chose to ignore this view [the widespread apocalyptic vision] and stay within "the realm of his specialty." He could not size up how the country's problems would influence the shares of *The Washington Post*. His

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genius was in not trying. Civilization was too variegated, its dynamics far too rich, for one to foresee its tides, let alone the waves and wavelets that affect security prices. Wars would be won and lost; prosperity would be hailed as everlasting and bemoaned as ne'er recurring as would politics, hemlines, and the weather enjoy their seasons. Analyzing them was Wall Street's great game — and its great distraction. In its floating salon, everything was interesting and nothing was certain — the president, the economy, the effect of OPEC on the sales of Pepsi-Cola.

None of these would substitute for critically evaluating an individual stock. When you purchased a share of *Washington Post* stock, ultimately you would not be rewarded on the basis of whether war broke out of the Middle East. You're buying nothing more, nothing less, then a share of the business — a claim on the future profits of its publishing and television assets. Yet if you knew what *The Post*, or any one business, was worth, it rang with the clarity of the single note. That was the sound Buffett strained for. Nothing else mattered, least of all the thousand cacophonous voices debating the future. As he had once told his partners, the future was never clear. What was very clear to him was that certain securities were available for less — far less — than the value of their assets. As the prices of great businesses got cheaper and cheaper, there was no "To Be or Not to Be," no equivocation. As [Buffett] said to *Forbes*, "Now is the time to invest and get rich."

And so it is with us. If we stay within our "realm of specialty" and keep our focus on businesses whose value we can reasonably approximate, lower prices are precisely what we have been (and are currently) looking for — and upon which we hope to capitalize. We trust the discussion that follows will bear that thesis out. We will not spend one moment lamenting our inability to buy anything at its lows. Rather, we will be thinking what the businesses we are purchasing today might be worth two or three years hence.

References to our famous mentor should in no way imply that we believe we are similarly endowed. To the contrary, the shadow that Warren Buffett casts is exceedingly long and has no contemporary equal. Accordingly, our pace will be more measured, our humility more obvious, and we will live by the adage of one of my dearest friends, "Measure twice, cut once."

## The Good Fortune of Great Clients

For those of us at MCM, perhaps the most rewarding fallout from all the havoc wreaked on many investors across the country and around the world over the last year and a half is the equanimity quietly and surely demonstrated by our clients. In place of the worry, angst and even anger other advisors are forced to face when their phones ring (or clients pay unexpected visits), the calls we receive reveal no irrational and destructive fears, but rather confidence, encouragement and even a sense of opportunity in the making. The business of business is hard enough without playing with one hand tied behind your back. We can't be effusive enough in expressing our gratitude for the freedom and support you have so consistently and generously provided us. Indeed, we are both humbled and pleased by the type of clients who have chosen us, and it remains our abiding goal to grow in competence and wisdom to maintain that trust.

To be sure, the appreciation in value of the companies we owned in 2000 in the face of the technology meltdown gave clients little cause for criticism. Even through the first half of 2001 the prices of our holdings defied gravity — a condition one must never see as permanent. However, all the gains of the first half, plus a little more, were surrendered in the third quarter. As indicated below, our year-to-date relative performance is quite impressive for those in the relative-performance

Relative Performance	
12/31/00 - 9/30/01	
MCM Equities*	-0.2%
S&P 500	-20.3%
Nasdaq	-39.1%
DJIA	-16.7%
* Represents average total return, after fees, of several representative portfolios.	

game. We, on the contrary, find nothing to cheer about when our absolute performance is flat — even when others are down 20-30% or more. You can't take flat absolute performance to the bank.

Moreover, that often overlooked provision in our performance-fees agreement — the "high watermark" — comes into play during times like these. We established a new high watermark for the quarter ending June 30 and so, while our year-to-date results may bring a modicum of comfort, we will be swimming upstream for some time before performance fees appear on your invoices. While neither of us will be particularly happy about the low fees you'll be paying for a spell (yes, that's what I meant!), brace yourself for the possibility of some whoppers down the road if we reap a bountiful harvest from the seeds we are sowing today!

## Getting Down to Business

As you can see from the accompanying charts and tables, the bear market in stocks now ranks as one of the worst in financial history. The percentage decline in the Nasdaq, whose daily trading volume regularly exceeds that of the New York Stock Exchange, equals the collapse of the "nifty 50" in the mid-'70s and beyond. For students of economic and market history, the only aspect of the collapse that was surprising was that it took so long. The bust, as busts are prone to do, followed the most explosive exponential advance in stock prices we've ever seen, culminating in the spectacular buying frenzy for anything related to the new Internet communications technology.

Clearly, the dramatic decline in equity prices over the last 18 months merely corrected excessive and unprecedented valuation levels that existed prior to the bursting of the bubble. Except perhaps during the infrequent periods of extreme over- or undervaluation, it's extremely difficult to gauge the overall attractiveness of the market given the unpredictability in interest rates, inflation expectations, equity-risk premiums, and corporate earnings. Indeed, while we no longer believe that extreme overvaluation exists in the stock market, we aren't convinced by any means that "the market" is undervalued. We find it much more feasible to make judgments about the long-term prospects of a select group of individual businesses that enjoy attractive

economics and are managed by people we trust and respect.

## Safety in Numbers?

Over the last several weeks we've heard countless financial commentators and advisors reminding investors of the virtues of diversification. As the air gushed from the technology bubble, the "pros" belatedly admonished all who would listen that you shouldn't have too much of your portfolio in technology stocks. The same was true after the tragic events of September 11 with regard to airlines and other travel-related businesses. Their advice, in effect, is to own a little of this and a little of that. Interestingly, given the universal nature of the current bear market, diversification has been a misunderstood and impotent defensive strategy for equity investors. The irony of diversification is that the more of it you do, the more certain it is that your portfolio will not — cannot — avoid the ravages of a pervasive bear market. Diversification protects you against company-specific risk, not market-specific risk. The unfortunate consequence of the growing popularity of index funds as the bull market wore on is that investors often unknowingly put their money in an investment that left them entirely unprotected against an ever-increasing bear-market risk. More on that in the annual report early next year ...

We acknowledge that there will be unforeseen exogenous shocks that can change the dynamics of given businesses and industries. That is why some diversification is prudent. However, many of the worst investment results, while not precisely knowable, were generally predictable. In too many cases investors become overly diversified due to concern that the future cannot be known with precision. Often it is adequately prudent, especially if you allow yourself a margin of safety in the purchase price, to be generally correct in the assessment of a handful of businesses. If investors would approach investing in marketable securities with the same thoughtfulness and diligence as they do private businesses (or perhaps the purchase of a home), their portfolios would be inherently more secure and, in all likelihood, more productive.

## Portfolio Management Implications

This has been a year of extraordinary activity from a portfolio management perspective. It's especially noteworthy, given our longer-term approach to investing in equity securities. Part of the explanation lies in the distinction of being *prepared* to own a stock for a long period of time. We will never buy a stock with the idea of making a quick buck. Sometimes, however, that is the outcome we experience. When a stock price climbs substantially faster than business value, the economics of the investment change. At the same time, we have seen stock prices of other companies crumble in recent weeks. The end result is a period of substantial change for our portfolios.

There is one final general thought we'd like to share regarding portfolio turnover. You are no doubt aware that high portfolio turnover is quite costly to the partners at Martin Capital. Since our portfolios mirror yours, we too are paying capital-gains taxes this year. While we don't like paying taxes any more than anyone else, if we must pay them, the 20% capital-gains tax is the one we find least offensive. **We may be realizing additional long-term capital gains in the days or weeks ahead. Should you wish to donate appreciated shares to your favorite charities, please bring your intentions to our attention as soon as possible.** Second, our firm pays for all commissions on behalf of our clients, and those costs are not immaterial. Indeed, our trading expenses in all likelihood will exceed our revenue during the third quarter. Sympathy cards may be sent to my attention!

## Buy Low, Sell High

You no doubt remember the last sentence in our most recent communiqué: "Buy low, sell high." Each quarter we encourage you to carefully examine the charts (below) of our most recent purchases and sales. If they don't give compelling evidence that we are living by that adage, don't waste any time in calling the apparent lack of discipline to our attention. To the best of our knowledge, Wabash National is the only recent exception to that rule. When we initially started buying shares in the company, it was well capitalized. Unfortunately, the capital structure deteriorated concurrently with the

decline in the stock price. While the worst operating scenario may be already imputed in the stock price, apocalyptic financial risk rarely is fully discounted. Accordingly, if we perceive that risk to be unacceptably high, we will have no choice but to act pre-emptively. We learned much from our long tenure with Wabash — at considerable cost to you and us. If that kind of knowledge is truly cumulative and transferable, the cost may eventually be justified.

Many of the general comments above, while reflecting unanimity of thinking within the firm, were composed by the managing partner. The company-specific analytical commentary below was written by Research Director Dennis Blyly, by Todd Martin, and by Drew Wilson and is but a quarterly thumbnail sketch of the painstaking initial and ongoing research conducted by this extraordinary group of analysts/portfolio managers. These are the fellows who make things happen. Like a movie or book critic, who himself can neither produce nor write, I am relegated to the rather loathsome role of devil's advocate.

In the meantime, gird your loins. My perennial promise to downsize the annual report is likely to be deferred yet another year. The last 18 months have been so historically extraordinary, as well as instructive, and the opportunities that lie ahead so compelling that to sacrifice the fruits of postmortem analysis on the altar of brevity would be a grave injustice. (Why do I sense some eyes rolling at this point?!) Hang in there; the following pages make for really good reading!

## New Holdings

The next several months are bound to be noted for their market-price volatility and economic uncertainty. We hope that you find comfort in the quality of businesses you own, and we encourage you to take some time getting to know the businesses. We are in the process of completing research reports on some of the newer companies purchased, and we will send them out as they are finished. If you are not receiving research reports but would like to, please give us a call.

## **Media**

The media business is often associated with large, highly visible national media companies that tend to have CEO's with a big egos, leveraged balance sheets, and economic sensitivity. Media businesses also tend to be highly profitable, especially at the local level. With Lamar Advertising and Emmis Broadcasting, we now own two of the best media companies in the industry. Lamar, headquartered in Baton Rouge, Louisiana, is the largest pure-play outdoor advertising (mostly billboards) company in the country. Emmis is headquartered in Indianapolis but has radio stations in New York City, Los Angeles, Chicago, Denver, Phoenix, St. Louis, and Indianapolis.

Worth noting is the fact that Emmis has the No. 1 station in both New York City and Los Angeles, the only company ever to achieve such a feat in those two lucrative markets. The company also owns several television stations in small to mid-sized markets. In an age when reaching potential customers is getting more difficult and costly, radio and outdoor advertising are well positioned to continue to take market share from more expensive newspaper, magazine, and television alternatives.

Media businesses enjoy more pricing flexibility than many businesses, partly because some media properties enjoy near monopoly status. The other reason is the structural dynamics of the industry, where unit growth is often limited. Local, state, and federal laws prevent the construction of new billboards in most markets, so it's quite difficult to grow by expanding the number of billboards. Likewise, the Federal Communications Commission governs the number of radio and television licenses in any given market. Broadcasters can't simply add units of commercial time at the expense of programming for fear of alienating listeners or viewers. Thus, as demand for advertising grows, the price of a fixed amount of commercial inventory goes up. This, at least in part, explains some of the attractive economics of this industry.

Naturally, advertising is a cyclical business. Over the short run, advertising is among the easiest expenses to cut. The reality of recession has Wall Street abandoning media companies, much to our delight. Both Emmis and

Lamar are largely dependent on local advertising, which is much less cyclical than national advertising. Further, billboard and radio are the least expensive of all forms of advertising (with the possible exception of direct mail), which also ameliorates the cyclicity of their businesses. While both companies carry a fair amount of leverage — as is common to that industry — cash-flow coverage is generous, and the quality of their media properties is superb.

## **Walt Disney (DIS)**

Disney is obviously one of the all-time-great franchises in the world. Most people associate Disney with theme parks and animated movies, which represent roughly 50% of Disney's cash flow. The theme park and animation businesses are truly unique. Competitors have long built parks in close proximity to take advantage of the traffic generated by Disney's destination resorts, which can now be found not only in the U.S. but in Japan, France, and (soon) Hong Kong. Likewise, Disney's animation business is one of a kind with the ability to re-release classic Disney movies at virtually no cost. The film library alone is worth many billions of dollars, and the ongoing strength of the Disney brand continues to deliver new hits to add to its list of 40 classic films.

Disney is also one of the largest cable programming and broadcasting companies in the country. Cable networks include ESPN, ESPN II, The Disney Channel, The Disney Family Channel (formerly Fox Family), and SOAPNET. Disney also owns the ABC network and several of the affiliate stations located in large markets. ESPN, with its well-targeted audience, reaches 80 million viewers and is by far the most valuable cable property in the industry. The Disney Channel, also with a highly defined target market, reaches 70 million homes, an increase of 9 million over the previous year.

All of the above notwithstanding, it has been a difficult time for Disney over the last few years. The company has not capitalized on its powerful animation franchise, finding itself unable to create a hit movie that rivals previous releases like *The Lion King* and *Beauty and the Beast*. The firm is also in various stages of transition in

its Disney Store and licensing divisions. The studio division has changed the schedule of library releases as the company awaits the launch of its new DVD strategy. Finally, as with Lamar and Emmis, the media and theme park businesses will undoubtedly soften in the months ahead. There is plenty of room for improvement. In the meantime, "Mr. Market" has given us an opportunity to buy one of the true "storied" franchises in America at valuation levels not seen in two decades.

### ***The Gap (GPS)***

The fashion-apparel business is not one of our favorite industries. We don't need our wives to confirm that we are more or less clueless when it comes to notions of style. Thus, we have not based our investment decision on any review of upcoming merchandising schemes and assortments. We don't know *when* The Gap will again find favor with the nation's thirtysomething and under crowd, only that it is highly probable that it *will*. In the meantime, it would appear that Wall Street has totally given up on the family of brands of The Gap, which include Old Navy and Banana Republic, in addition to its flagship brand.

The Gap does enjoy some advantages. Like Land's End, which many of you may remember, The Gap enjoys the benefits of vertical integration and its own private brand. The vertical integration gives it a level of coordination within its supply chain that allows the company to turn its inventory up to eight times per year. In particular, control over the distribution channel (the firm's own stores) is a great advantage that enjoys some economies of scale. The brands themselves are also a differentiating feature. The Gap brands are not associated with any particular fad or trend. Indeed, brands like The Gap and Old Navy are more associated with the American lifestyle in general than faddish trends that come and go.

The Gap is one of America's most successful and profitable retail chains. Few companies have been able to duplicate The Gap's store-level returns on investment. The company has demonstrated an ability to add new retail concepts (Banana Republic and Old Navy), in addition to successfully replicating its flagship franchise internationally. The outcome of our investment,

however, will be largely dependent on a recovery of the core franchise. The company has temporarily stumbled several times in the past, but the strength of the brand as a destination store has always allowed The Gap plenty of time to recover from the inevitable merchandising miscues that seem inherent to the business. If the past is any guide, our patience and willingness to go against convention will be amply rewarded.

### ***Dollar General (DG)***

DG is a discount store chain of more than 5,000 stores, which until recently was renowned for its extraordinary growth and profitability. Lately, well-publicized accounting "irregularities" have appropriately become the focus of most investors. We are not indifferent to the potential problems that have led to the firing of DG's auditor. After all, the company is in the process of restating three years' worth of earnings, and we have only general ideas regarding current levels of profitability.

The public record would suggest that so far the focus is on the classification of synthetic leases and the method of recording the deferred state-tax liability. The public record also indicates that there may be additional accounting issues for which there has been no official comment. There are a few things we know for sure. First, this company has been growing its store count at a rate of 15% for several years, with no need for external financing. Internal cash generation has been strong enough to grow the store count, in addition to repurchasing stock. While there can be earnings without cash generation, it is tough to have cash generation without earnings. This has been an important distinction in virtually all the cases where accounting irregularities materially misstated the health of a company. Second, we know that the CEO, Cal Turner, and his family own 15% of the company. We also consider Mr. Turner to be a man of integrity.

Even if the accounting problems are honest mistakes and, as we suspect, turn out to be more or less immaterial from a financial sense, management clearly has made some gaffes. There is little doubt that the company's "weakest link" has been in the area of implementing technology, particularly with regard to financial controls.

These are being addressed and should be balanced with other strengths in the company — including human-resource management, strategic focus on an underserved market, and logistics (moving lots of merchandise through a large number of small stores).

### ***Manufacturing***

We have added to our holdings of Dover, Hon Industries, and Leggett & Platt — and we've nibbled at Kaydon. All of these businesses are experiencing anemic demand, as will no doubt be reflected in reduced earnings in the months ahead. On the other side of the ledger, these companies have strong balance sheets, which will enable them to take advantage of acquisition opportunities and/or share repurchases.

A little less than two years ago we began buying auto insurance stocks, businesses that also are notoriously cyclical. We bought them with a clear understanding that margins in the insurance industry were getting worse, and growth was slowing, if not turning negative. By then Wall Street had gone negative on the entire industry, and the stocks had fallen 60-70% from their peak, a time that coincided with robust industry conditions. Today, the auto insurance industry — Mercury General and Progressive in particular — are just beginning to enjoy a strong turn in the operating cycle, and their stock prices have already doubled.

The same has been true historically for manufacturing companies. If you wait until it's apparent to everyone that the economy is beginning to improve, it will be too late. Strong manufacturers use economic downturns to consolidate their industries and take costs out of their operations. In Dover, Hon, and Leggett & Platt you have three of the best.

### **Common-Stock Sales**

#### ***Gillette/McDonald's (G/MCD)***

Both Gillette and McDonald's stock prices have held up well over the last several months as investors have

increasingly sought out companies that have more stability in their business models. Stability, however, comes at a high relative cost. As the stock market has declined over the last several months, we have found other opportunities that appear far more attractive than Gillette in particular. Thus, we have sold our entire holding in Gillette and very well may use McDonald's as a source of funds. Both companies are making substantial progress in addressing some of the mistakes of the past. Furthermore, we believe that both companies will continue to dominate and grow their businesses around the world for the foreseeable future. But we can buy \$1 worth of future earnings for a lot less capital with some of our other holdings. While Gillette is no longer in our portfolios, it is still on our radar screen.

We have not made the decision to sell McDonald's, although it may have been trimmed back in certain portfolios. Much will depend on what happens to the expended returns (which in turn depends on fluctuations in the stock price) of McDonald's and other alternatives.

#### ***Wabash National (WNC)***

There have been no new fundamental developments since our last update. The company's markets are still declining, the company is trying to "right size" the business, and the search for a new CEO continues. What has changed is the number of other more compelling investment opportunities. More importantly, WNC is the only company we own that carries significant balance-sheet risk. It also can provide some tax relief for those of us who have realized capital gains during the year. This is a long way of saying that the days are numbered for what has been a very disappointing and humbling investment.

### **Other Holdings**

#### ***Insurance***

The collapse of the World Trade Center towers has tragically changed many lives. It has also changed, at least for a while, the dynamics of the property/casualty

insurance industry. The bill for the insurance industry will probably be in the \$40 billion to \$60 billion range, a record catastrophe that far surpasses Hurricane Andrew in 1992. Berkshire Hathaway expects that the event will cost its insurance companies a little over \$2 billion. It also has raised abundant concerns about the reliability and availability of reinsurance (insurance for insurance companies). We have commented in the past that Berkshire Hathaway is positioned in such a way (with hordes of capital available to write insurance and \$30 billion in cash) that the worse things get for the insurance industry and capital markets, the better things are for Berkshire Hathaway.

Primary insurance carriers typically buy reinsurance in an effort to spread their risks. Contractually, however, the primary carrier is on the hook in the event that the reinsurance company is unable to perform. Thus, when reinsurance gets scarce, primary carriers flock to Berkshire Hathaway, which stands ready to write an enormous amount of premiums at the right price. Moreover, with the stock market cratering, Buffett should be able to opportunistically increase the expected return from Berkshire's \$70 billion investment portfolio.

Rising prices for property/casualty insurance is a foregone conclusion. Even for auto insurance, there should be some spillover effects as insurance companies refocus on underwriting profitability. Mercury General, which already was witnessing a strong recovery in premium growth, will likely see further acceleration in its growth rate.

### ***Clayton Homes (CMH)***

We are nearing the end of the downturn for manufactured housing. Before detailing the good news, however, a little background: There was a predictable chain of events that caused the latest downturn in this industry. Relaxed credit standards in the late 1990s artificially stimulated demand for manufactured housing. The number of dealers (also taking advantage of abundant wholesale financing) exploded to accommodate the new level of demand. The effects of the loose credit standards in the late '90s led to a spike in defaults and repossessions (which compete with new sales) over the

last 18 months. The combination of much-needed tighter credit standards, the working off of repossessed inventory, and a 25-30% reduction in dealer inventory has caused the severe industry slump that has persisted since late 1999.

The good news is that the default rate will naturally decline with the aging of the bad loans made in the late '90s. Combined with the lower repossessed and new-model inventories that exist today, the industry is poised for renewed growth over the next few quarters. Clayton Homes has held its dealer network together extremely well during this downturn. Combined with a nearly debt-free balance sheet, this leaves the company very well positioned to take advantage of the impending recovery.

### ***Heartland Express (HTLD)***

HTLD keeps on trucking! In a sense the company is in the same position as Berkshire Hathaway. The worse things get in the trucking industry, which may very well temporarily depress HTLD's earnings (not unlike BRK's claims for the World Trade Center towers), the easier it is for the company to execute its acquisition strategy. Given Heartland's \$140 million-plus in cash and no debt, we may not have to wait much longer for the company to grow substantially.