

# Capital markets review

QUARTERLY

## The Times That Try ...

Depending on when you start counting, the grip of this bear market is at least 27 months in duration. Many observers cite March 10, 2000, as the pivotal date, when the Nasdaq composite peaked at over 5000. At this writing it languishes in ignominy at 1420, thwarted repeatedly as it has attempted to return to its glory of yesteryear and now trades at precisely the same level where it began its exponential flight to madness exactly five years ago. The much broader S&P 500 reached its zenith on March 24, 2000, at 1527. Today it is 35% lower, trading at 987. Your portfolios avoided

### Approximate Relative Performance

	Approximate 2nd Quarter	Approximate Year-to-Date
MCM Equities*	-5.2%	-0.5%
S&P 500	-13.7%	-13.8%
Dow	-11.2%	-7.8%
Nasdaq	-20.7%	-25.0%
<i>*Excluding Fees</i>		

that malaise until about five weeks ago. We have noted on several occasions in the past that it was becoming more and more difficult to swim upstream. During the last month or so of this second quarter the current became so swift and deep that few stocks were able to make headway. What progress we had made in the first five months the market has taken back. Such is the nature of short-term market fluctuations. In our last Quarterly Capital

Markets Review we mentioned that many of our holdings were fairly, and in some cases rather fully, priced. Because the declines were not uniform among all holdings, we have been able to add to certain positions recently. While we spend most of our time comparing market price with underlying value, it may be interesting to some to note that at the rate we are going this could be the third consecutive year of negative returns from the S&P 500. To put what may happen in perspective, the last time the S&P 500 declined three years in a row was 1939-41. Parenthetically, it swooned for four years consecutively during the Depression, 1929-32.

There is no shortage of disquieting news: international instability, eroding confidence in corporate governance (even the seemingly virtuous culinary capitalist, Martha Stewart, who now might be dubbed the Goddess of Greed, has been suspected of obstruction of justice, a far more serious crime than the original insider

### \*\* Website Update \*\*

We have updated our Website to include a "Clients Only" section. This section includes past Quarterly Capital Markets Reviews and internally produced research reports on the companies that currently populate the portfolio. As you might imagine, we consider this information highly confidential and, therefore, access requires a user name and password. This information, which will be changed quarterly, can be found on the last page of this and subsequent Quarterly Capital Markets Reviews.

MARTIN

CAPITAL MANAGEMENT, LLP  
Registered Investment Advisor

trading accusation, as noted in the *Wall Street Journal* during the last several days), the clear and present danger of further terrorist attacks, declining earnings trends and quality, a “W” rather than a “V” economic slump, the prospect for rising interest rates in part because of the falling dollar... While the risk of terrorist attacks is quite new to most Americans, the other risks we have seen before. Even if we are in a new age of terrorism, we would not advise business owners to sell their businesses. The same is true for your portfolio of businesses. We live with volatility — in fact, we embrace it because of the opportunities that it presents — but our focus and attention are on individual companies. We invested a lot of time with the leaders of some of our biggest holdings in the second quarter and spent almost no time watching the prices of their stocks. As the commentary below suggests, we are uniformly pleased with the business progress of our portfolio companies. For any one of these businesses, success or failure will be measured over a term of years, making the effects of current events momentarily unnerving for the casual observer but essentially irrelevant for the long-term investor.

Please don't misinterpret our attitude as nonchalant or devil-may-care. Nor do we (nor should you) think of ourselves as courageous, as mastering fear. Rather, think of us as having a deep respect for the unexpected. That's why we run a little scared, with a large amount of cash and short-term Treasuries at the ready reserve.

Our view is that the stock market's nemesis is still rich valuations as investors seem unwilling to capitulate after the speculative orgy that ushered in the new millennium. Investment-return expectations are still too high in the face of lackluster corporate earnings. In addition to these expectations, myriad other concerns plague investors, all of which are less important than the aforementioned valuation conundrum. Superimpose on all of the above factors the self-incrimination of a small but conspicuous group of prominent but ethically compromised corporate executives masquerading as capitalists and you have a witches' brew.

On that final point, and how it might best be addressed, we have some strong beliefs — particularly as they relate to financial accounting standards. History leaves no doubt that increased governmental regulation is not

the solution. Furthermore, such regulation has proven to create addition problems. We think Arthur Andersen was a whipping boy. To be sure, the venerable icon was not without egregious sins, but the solution is not likely to be found in the disorderly dismantling of this once proud firm. The scourge is more deeply seated. The mad scramble of Arthur Andersen's accountants to find work at the surviving firms is the equivalent of rearranging the deck chairs on the Titanic. Accountants have followed lawyers down the path that leads from the garden of professionalism to the racetrack of competition. Few now remember when accountants considered themselves to be members of a financial priesthood, responsible to a higher authority than the client's checkbook. Getting tough with accountants, however, will not make them responsible for their own actions. The accounting profession must be responsible for its own standards, and its standards must be effective and satisfactory both to its direct clients, the corporations it audits, and to its indirect clients, the shareholders and creditors of the corporations. Shareholders and creditors should not have to look to the government to set or enforce accounting standards; they must have faith in the accountants themselves.

There is an old aphorism that can be rephrased to make it apply here: “A country gets the government it deserves.” If investors had been on their guard and acted rationally, the Enrons and WorldComs of this sorry epoch never would have made it through grammar school. But, alas, the markets have already served notice to Corporate America. Companies that employ Enron-like Special Purpose Entities are getting penalized in the marketplace. On the other hand, companies with transparent financial statements and straight talk are being rewarded. We will predict that stock options will be the next target for naturally disgruntled investors. Companies with abusive stock option programs that are the equivalent of picking the pockets of shareholders will feel the anger of disenfranchised shareholders who will vote with their feet. The stock prices of such companies will manifest the widespread disaffection, weakening stock options as a tool for the future. As with all manias, investors invariably dropped their guard as they embraced the absurdity of new-era thinking (for lack of a more descriptive word). No legislation exists to protect us against gullibility, stupidity, and lemming-like behavior. These characteristics of human nature are as old as time

and will, in befuddling iterations, repeat themselves over and over again *in the future*. Now chastised with fire, investors will go a long time before being burned in like fashion again. No amount of legislation will equal the siren song for the return of fundamental analysis, the very message of perhaps the best book ever written on investing: *Security Analysis*. This book was penned by a remorseful Benjamin Graham and published in 1934 as both an after-the-fact account of the speculative excesses of the late '20s and a warning against similar scourges in the future. This message was heeded in the early years when it was irrelevant, and forgotten decades later when it was poignantly pertinent. If not dead, speculation of the '90s is in the process of dying. In the place of speculation, grind-it-out due diligence, like blocking and tackling in football, will rise once again. Sometimes the markets anticipate, and at other times they react. It is our conviction that fast-and-loose corporate management is passé. Washington, take note: The market will serve up its own justice ...

In the meantime, there is a discernible hesitancy for investors to commit to stocks, largely because there's no general sense of "upside risk." That is, two years of bear-market conditioning and abortive rallies have depleted the reservoir of belief that the market might run higher and leave noncommittal investors behind.

Such a lack of concern with the opportunity cost of shunning stocks is overlaid by a broadening belief that the best one can hope for now is several years of mid-single-digit equity returns. Warren Buffett and others have been saying this for more than a year [as noted in the 2000 and 2001 MCM annual reports ...], and many have since taken this view to heart. A new Credit Suisse First Boston survey of institutional investors shows two-thirds believe the S&P will deliver 0-10% annually over the next 3-5 years.

The odd thing about such talk is that it is always presented as a sober return to reality, a profound adjustment to investors' experience of the markets. Yet, as implied earlier, we've been in a single-digit return environment for years now, since before the bubble days began. Indeed, the annualized total return of S&P 500 index funds in the five years through Wednesday, July 3 was a measly 1.65% (yes, including dividends).

This simply throws into vivid relief the fact that single-digit annual returns can result from wildly varied up-and-down phases, rather than calm, annuity-like regularity. Simply positing historically modest annual gains, in other words, says little about whether stocks are a good buy or a sucker's bet at this moment. We hope to capitalize on the opportunities presented by this environment because of our bottoms-up approach to stock selection.

## Equity Holdings

The recent downturn in the market and several of our portfolio companies presented us with two opportunities. First, we added to some of our existing positions. Secondly, we were able to initiate positions for newer clients who missed out on the first round. Consequently, client portfolios under our management are beginning to homogenize.

As we stated last quarter, the margin of safety in most of our companies had largely been dissipated due to stock-price appreciation. Well... it's back — in some cases. We feel our portfolio, as a whole, is no longer fully valued. As you know, our target positions are substantially a function of expected return, which is inversely related to stock price. If the market continues to punish our stocks for crimes committed by others, you may receive more buy confirmations with familiar tickers.

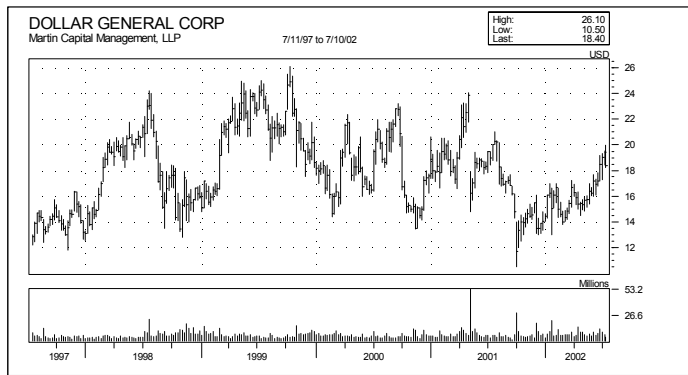
We mention below in the "New Ideas" section that the pace of research has never been greater. Depending on the breadth, depth and length of the market's bout of lethargy, there could be considerable changes to the make-up of our portfolios. We make changes whenever we can increase (1) certainty (i.e., confidence in a company's prospects or its management), and/or (2) expected return. Tax ramifications, of course, will always be a consideration.

### *Dollar General (DG)*

As expected, a settlement of \$160 million has been reached regarding the class-action lawsuit concerning fraudulent accounting. Investors are still awaiting any

SEC (Securities and Exchange Commission) penalty, if any, which may be assessed against the company. The management team has described the SEC's current posture as relatively passive. It would appear, understandably, that the SEC has bigger fish to fry.

Dollar General's business has notably picked up steam. Over the last several months comparable store sales have been the best in the discount-store industry, averaging in the high single digits. Clearly, the company's fundamentals are back on track. The company has several initiatives under way that will keep the momentum going, the most exciting of which is broadening the merchandising mix to include perishables (primarily cooler items). Early testing in 800 stores has been very encouraging, as the average ticket and the frequency of customer visits has increased.



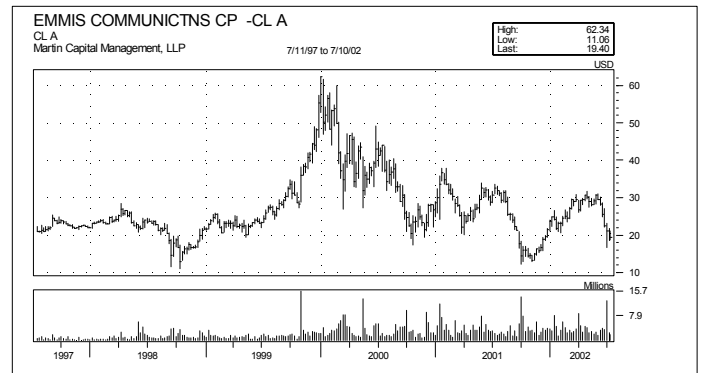
DG has had its problems over the last 18 months, but the core strategy and positioning of the company have not changed. Small-store convenience with competitive prices is a legitimate market niche that still has considerable room to grow.

**Emmis Communications (EMMS)**

Media properties (EMMS, LAMR, and Disney) have taken their lumps over the last several weeks as investors have understandably had enough of the "proforma earnings" that became the basis for earnings manipulation. Media companies have long since used their own "proforma earnings" (called broadcast cash flow) as the basis for establishing valuation benchmarks. Broadcast cash flow, however, is a reasonable approximation for real operating earnings for media companies, which is why this methodology has stood the

test of time. However, with goodwill amortization going the way of the buffalo, investors may choose a different benchmark. Irrespective of the turmoil in media stocks, we believe we have a pretty good idea of the true earnings power of media portfolio holdings.

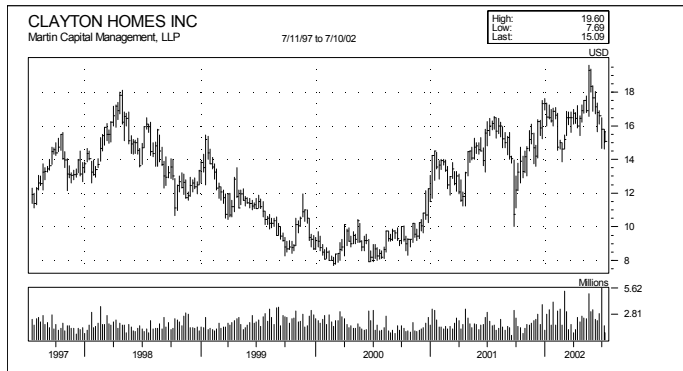
Business, with the exception of its important New York City radio market, also improved at Emmis. Not only are the radio and television markets firming, the company also is picking up market share via ratings increases. In the meantime management continues to look for ways to shed its television business. In that regard the company adopted FASB 142 (relating to goodwill and intangibles) and reported a \$160 million charge for goodwill impairment, mostly attributable to the television station acquisitions in the late 1990s. We knew a write-off was in the works. All one has to do is look at the company's below-average return on capital to understand that management paid too much for its television properties. Of course, as the stock price has fallen from \$60 to the teens, we believe our return on investment will be satisfactory. While there are few better in managing radio properties, management's record of reinvesting capital is spotty at best. We will analyze future acquisitions (and they will come) with great care in assessing this company's potential for profitable growth.



**Clayton Homes (CMH)**

The company is now firing on three of its four major cylinders. Sales at Clayton's retail centers have been increasing at a 20% plus rate and, as you would expect, origination volume at the company's finance subsidiary has followed. The community division also continues to post good results. Only the manufacturing division, still suffering from the lack of financing through the

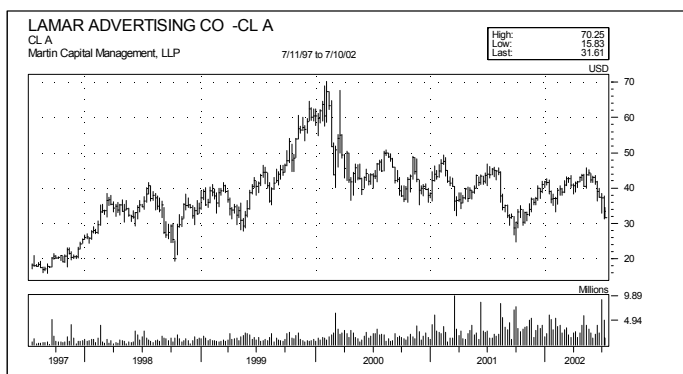
independent dealer channel, is experiencing lackluster results.



As the industry recovers, the company is in an excellent position to resume its primary growth strategy: expansion of its company-owned dealer network. CMH has little business in the Midwest, and it seems like a logical market in which to resume expansion.

### **Lamar Advertising (LAMR)**

Lamar has managed extremely well through the advertising recession. Local advertising tends to be more stable than national advertising, so the company did better in the downturn, and its recovery has been a little slower than the broadcasting media.

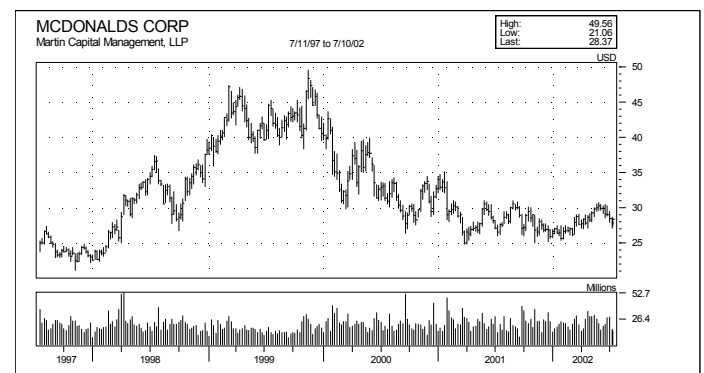


The company's billboard business is highly profitable, and the acquisition model for this business works pretty well given that acquisition multiples tend to be less than broadcasting media, especially radio. The sports and entertainment business (including media) are filled with big egos and unique personalities. In this context it is sometimes hard to find a management team that shows

much concern for shareholder value. Self-aggrandizement tends to be the order of the day. Lamar, no doubt in part because the managing and founding family still owns a large amount of stock, has a long history of delivering value to shareholders.

### **McDonald's (MCD)**

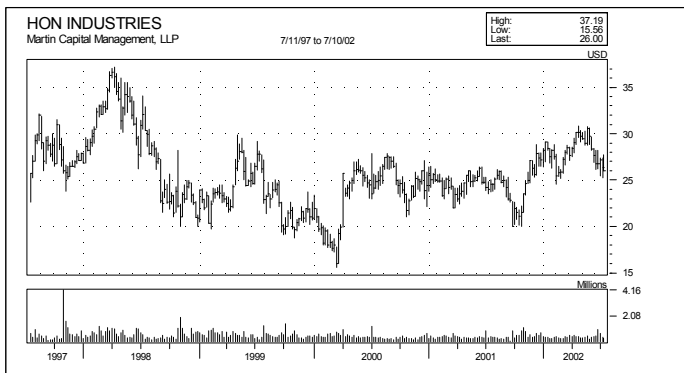
Things are slowly improving at McDonald's. Sales are modestly rising in the U.S. market, and Europe is performing very well, having recovered from the Mad Cow scare. The Asian (Japan has its own Mad Cow scare) and Latin American markets (experiencing recessions) are still struggling.



Wall Street has, understandably, grown increasingly skeptical about the potential for long-term growth at McDonald's. With the aid of share repurchases, international growth, and the growth of partner brands, we see no reason why the company cannot grow at 9-11% rate for a period of time. A steady growth rate of 9-11% was once sneered at by Wall Street, but with overall corporate earnings expectations slowly becoming more realistic, investors may again warm to this relatively steady company with moderate growth prospects.

### **Hon Industries (HNI)**

The unprecedented decline in the office furniture business deepened in the last quarter. Dealer-dependent distribution channels have been especially hard hit. While Hon's Allsteel line competes in this channel, the wholesale and retail channels have held up a little better. Still, Hon's office furniture sales have been down in the double-digit range the last few quarters.



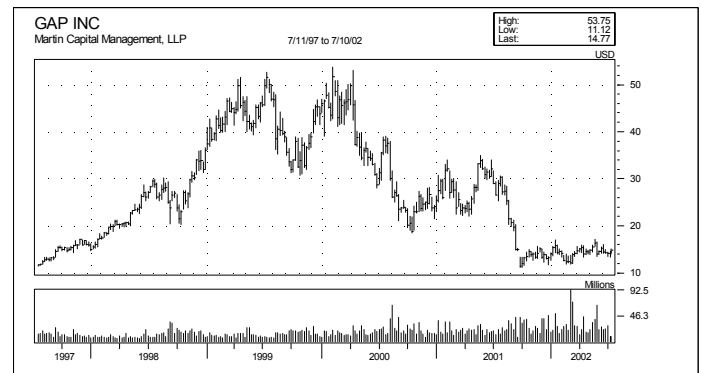
The most plausible explanation for the dramatic decline in the industry is that this recession was caused by a dramatic decline in capital investment (especially in computing and telecommunications). Indirectly, Hon has been affected by the spillover effects of the bubble.

Even so, due to continued productivity improvements and excellent performance in the company's health technology business, earnings have held steady this year. Hon is truly an undiscovered diamond in the rough. The downturn in the office furniture business has masked significant improvements in the company's cost structure and increased market share. A recent visit to our office by CEO Jack Michaels and his team only reinforced what we already knew: outstanding management is a hallmark of this company.

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

One really must be an optimist to say that things are improving at this company. At best, things are not as bad as they were (comp store sales are now only down in the single digits!). Moreover, since our last quarterly update, The Gap's legendary CEO, Mickey Drexler, announced he would be stepping down as soon as a replacement is found.

The core businesses are tracking along more or less as expected. Inventories are in very good shape, and there has already been some improvement in gross margin. The merchandising changes should be fully implemented with the launch of the fall selling season (now only weeks away), so we will soon have a better basis for assessing the durability of the flagship brands.

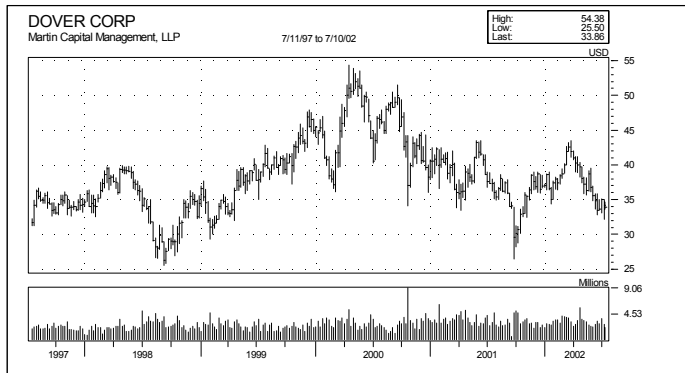


The departure of Drexler, though unexpected, may end up being the right thing for the company. While we acknowledge that the company needs his merchandising skill to effect a turnaround, given the extended lead times, the merchandising has already been determined, probably at least through next summer. Thus, whatever Drexler would have been able to contribute to the turnaround is already a done deal. Finally, it is probably time for the company to hire a CEO who is more interested in managing the flagship brands than selecting color palettes and determining hemlines.

We are closely monitoring the progress of this company, and we will likely have a quick trigger finger. If The Gap doesn't close the gap soon, we will sell the stock. Conversely, we will probably make an early exit if the business does begin to improve, assuming that Wall Street begins discounting a full recovery at The Gap.

### ***Dover Corporation (DOV)***

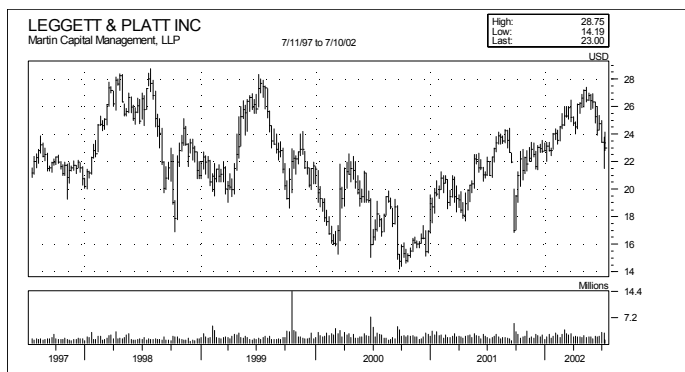
Dover, at this point, is the only company in our portfolios that is directly affected by the meltdown in the high-tech world. Approximately 30-35% of its business is supplying capital goods to that industry. The company has made excellent progress in downsizing its high-tech related businesses while maintaining the R&D required to introduce new products and technology.



Most of Dover’s businesses also are lackluster, reflecting the rather dour mood of Corporate America at the moment. We would advise everyone to look beyond the current earnings malaise at this company and focus on what we refer to as “core earnings power.” Intrinsic value is the present value of *all* future cash flows, and we’re confident that earnings growth will quickly return to this company as the economy improves.

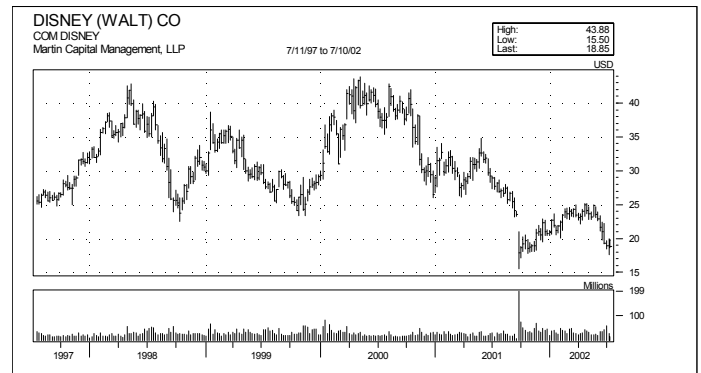
**Leggett & Platt (LEG)**

Like other companies in our portfolio, earnings at LEG are suffering from depressed business conditions throughout the company’s business segments. LEG has taken the downturn as an opportunity to reduce debt (cash flow is at record levels due to reduction in working capital) and consolidate operations. Our hope, (and the same idea applies to Dover, Hon, and a few of our other portfolio holdings) is that the business downturn has made acquisition targets more realistic about the value of their businesses. We are confident LEG will come out of this economic malaise stronger and more profitable than when it entered.



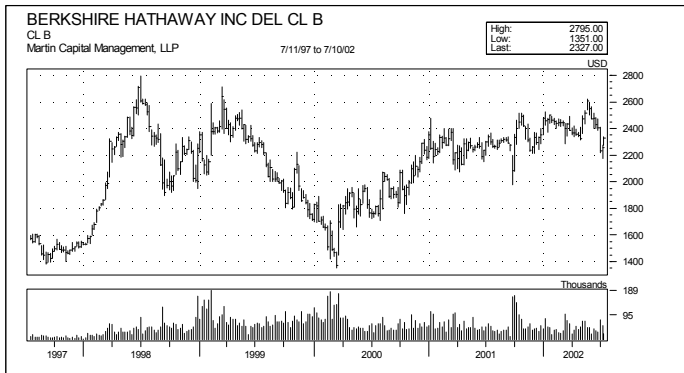
**Walt Disney (DIS)**

Disney has a few wonderful businesses (theme parks, cable networks, animated theatrical production, licensing) and a few mediocre businesses (ABC, retail, live action film). None of these businesses are performing particularly well for various reasons. While it has led some to question Michael Eisner’s tenure as CEO, the main effect has been on its stock price. Disney is by far the cheapest stock among the major media companies. It is a little more difficult to estimate a “normal earnings” figure because the recovery potential of its businesses is difficult to estimate. But there will be a recovery, and we would expect to the stock to react favorably when the intrinsic earnings power becomes more visible.



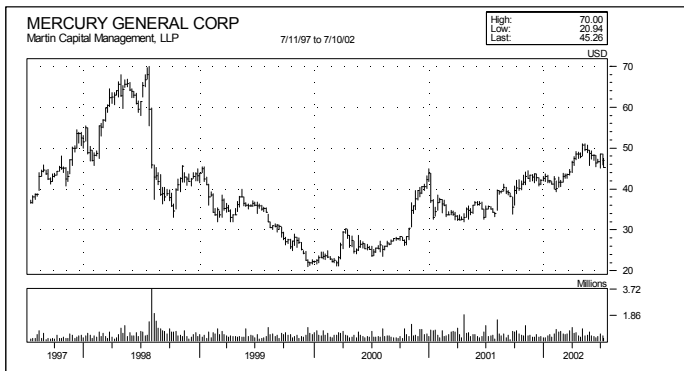
**Berkshire Hathaway (BRK)**

All is well at Berkshire Hathaway. Insurance capacity is currently in short supply, so demand for BRK’s abundant capital and inherent stability is rising. Thus, the company’s float is growing very nicely, while the cost of the float is likely to plummet. If only common-stock prices were more reasonably valued, the stars would truly be aligned for this most unusual of companies.



### ***Mercury General (MCY)***

The earnings snapback we anticipated many months ago has come to fruition, and the turn in the auto insurance market is in full bloom. The company is experiencing very good growth (20%+), and margins are increasing. The stock, of course, reflects at least some of the expected improvement. We may use MCY as a source of funds if we find more compelling values in the future.



### **New Ideas**

We have been searching amid the high-tech and communications debris. What we found was somewhat surprising. At the peak of the hype we understood that expectations were way out of line and that there were numerous accounting problems that became endemic in those industries. As we started looking for opportunities in these areas, however, we gained a new appreciation for the scope of the mania and accounting abuses. Even after a 70% decline in the Nasdaq, many companies still sell for 5-10x revenues. Many other companies in these industries either have precarious business models or such

manipulative accounting practices that we find management credibility to be a deal breaker. We have found a few companies regarding which we are continuing our due diligence, but don't hold your breath! If we ultimately choose to venture forth into this heretofore forbidden territory, rest assured it will be by owning a "basket" of companies, or we will simply restrict our commitment to the industry.

The pace of new-idea generation is accelerating at MCM, and we hope to share more new ideas with you as the year unfolds. Whether or not they find their way into your (and our) portfolios will depend on Mr. Market.

### **Website Information**

Address: [www.mcmadvisors.com](http://www.mcmadvisors.com)  
User Name: mcmcapital  
Password: mcmcapital