

capital markets review

QUARTERLY

Beneath the Smoldering Ashes of Despair Lie the Seeds of Opportunity

In 1988 fires ravaged much of Yellowstone Park. Many naturally bemoaned the devastation to this national treasure. Yet within a couple of years green shoots of new life were springing up everywhere. Today one can hardly tell there had been a fire. Nature has a way of healing itself. The same can be said of American financial markets.

Chalking up the sharpest quarterly decline in the Dow since 1937, the three months ending September 30 viciously prolonged the agonizing 2½-year-old bear market for common stocks. The benchmark Dow Jones Industrial Average, though outmoded, closed out the third quarter having fallen for six straight months, a mournful pattern that has occurred only five other times in the history of the average.

The table to the right speaks volumes about the depth and breadth of financial carnage that has been sustained by shell-shocked investors, whose visions of riches have been blown to bits virtually overnight, with the erosion of wealth now exceeding \$8 trillion. While the clients of MCM have come through relatively unscathed so far, this mauling will go down as the most grisly bear attack since the early 1930s, shredding the longstanding mark of ignominy of the mid-'70s.

During the new-era heyday of just a few years ago, prognosticators shrilled (on nameless authority) that a 20% decline was the maximum mastication of the bear. What do they have to say today? Their silence is deafening, and those who listened are staggering around in disbelief. "Mr. Market's" advice should almost always go unheeded, but his often wildly emotional behavior occasionally provides the opportunity for independent thinkers to enhance, or at least preserve, their lot. For the victims of corporate fraud and for those who were swept up in the speculative contagion, we feel nothing but sympathy. For those who brazenly picked the pockets of shareholders or who knowingly preyed on the innocence or ignorance of others, we trust that justice will be served.

	<u>YTD</u>	<u>From Peak</u>
Dow	-24%	-35%
S&P 500	-29%	-47%
Nasdaq	-40%	-77%
MCM	-20%	+25%

What happened, in our judgment, is primarily the result of a universal human propensity to periodically fall victim to a pervasive speculative frenzy, to which we will turn in a moment. To be sure, it was far more about investor gullibility than American ingenuity and

MARTIN

CAPITAL MANAGEMENT, LLP
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perseverance. Lest in these troubled times we forget the entrepreneurial spirit that is our nation's distinctive economic attribute, upstarts Microsoft and Intel made their public debut as recently as March 1986 and November 1984, respectively. The Nasdaq first appeared in February 1971. Moreover, the American will and spirit are strong, as evidenced by the response to the 9-11 attack against the American character. The unprovoked assault revealed our moral strengths, not our weaknesses.

These woeful statistics give body and soul to two well-known (but oft-forgotten) and recurring forces at play here, likely interconnected but to what extent nobody knows. First, is the unwinding of a speculative mania about which we have often written. While no two episodes are identical, they have many characteristics in common. Graphically, an initial orderly and potentially sustainable advance in prices mutates inexplicably into an exponential rise, gradually liberated from the rational restraint of underlying value and fueled by the sheer force of more and more untutored money chasing the illusion of limitless wealth. Like any Ponzi scheme, all such manias feed on themselves and eventually collapse of their own weight. The magic that billions of dollars can create in the early going requires trillions of dollars to sustain as the legerdemain reaches full bloom. Not only is the supply of money finite, baby boomers notwithstanding, the speculative appetite is capricious, and contagion spreads like wildfire. Once the bugles sound retreat, an orderly exodus quickly becomes a stampede. The exponential explosion in prices, most noticeable in the speculative favorites, is invariably remedied by its polar opposite. Regression to the mean, like gravity, is not to be denied. Finally, and most dispiritingly, the propensity to take risks gives way, pendulum style, to a pervasive aversion to any risk, leaving the prices of good businesses to languish in the bargain basement as almost an expression of penance.

Despair distorts one's capacity for rational judgment and behavior. Moreover, patience, a virtue in most instances, is invariably in short supply when it's most needed. Strangely, it's often more difficult to say "yes" to the argument to buy when the only rationale is that businesses are desperately cheap than it is to say "no" to the case to sell when the sky seems to be the limit. Investors cannot see the opportunity to be found in the ruins so long as their eyes are glued to the rear-view mirror. Issues of terrorism, recession, and corporate malfeasance have dominated the

headlines and provide good alibis for inaction. The savvy investor knows one must sell into good news and buy into bad. There is no other way to live by the most productive of investment maxims: "Buy low, sell high."

The second force is not nearly so predictable, making it the forecasting wild card. We are in an economic contraction, the nature of which won't be known until the next expansion. The period of decreased business activity could be cyclical and therefore will be called a recession, which is the hope of everyone — or it could be secular and exhibit all the symptoms of a depression. Part of our admitted uncertainty is related to the effect of diminished stock market wealth on economic activity. There is little precedence for making informed judgments on that causal connection. Moreover, ever-increasing global economic and financial interdependence has complicated the process of predicting U.S. economic activity, the historical record of which is evidence enough to discredit the whole exercise.

Strategically, we are both placing our bets (as well as hedging them) on companies we think can weather almost any storm — and by holding a large portion of uncommitted cash safe-harbored in short-term U.S. treasury securities or in the highest-grade tax-exempt bonds. We don't pretend to be able to foresee the twists and turns of the economy. Recession or depression — however future historians characterize the economic malaise at the dawn of the new millennium — stock prices tend to reach their nadir relatively early in a contraction. In either case, well-capitalized, well-managed businesses with essential products or services that can be purchased at prudent and competitive prices ought to be part of one's portfolio of assets. We are less sanguine about the prospects for several tangible asset classes.

As counterintuitive as the following may appear, in the event of what might be defined as a depression with the benefit of hindsight, investors (based on a very limited historical experience, to be sure) could be staring intermediate-term opportunity squarely in the face. Yes, that affirming, uplifting statement is what we meant. Despite MCM's clients' generally positive experience — both relative and absolute — throughout the present siege on wealth, most investors are mired in the crippling emotional misery of watching their nest eggs relentlessly shrink, seemingly with no end in sight. From that

emotional vantage point it is very difficult to think beyond the pessimism of the moment, to look beyond the image of Armageddon.

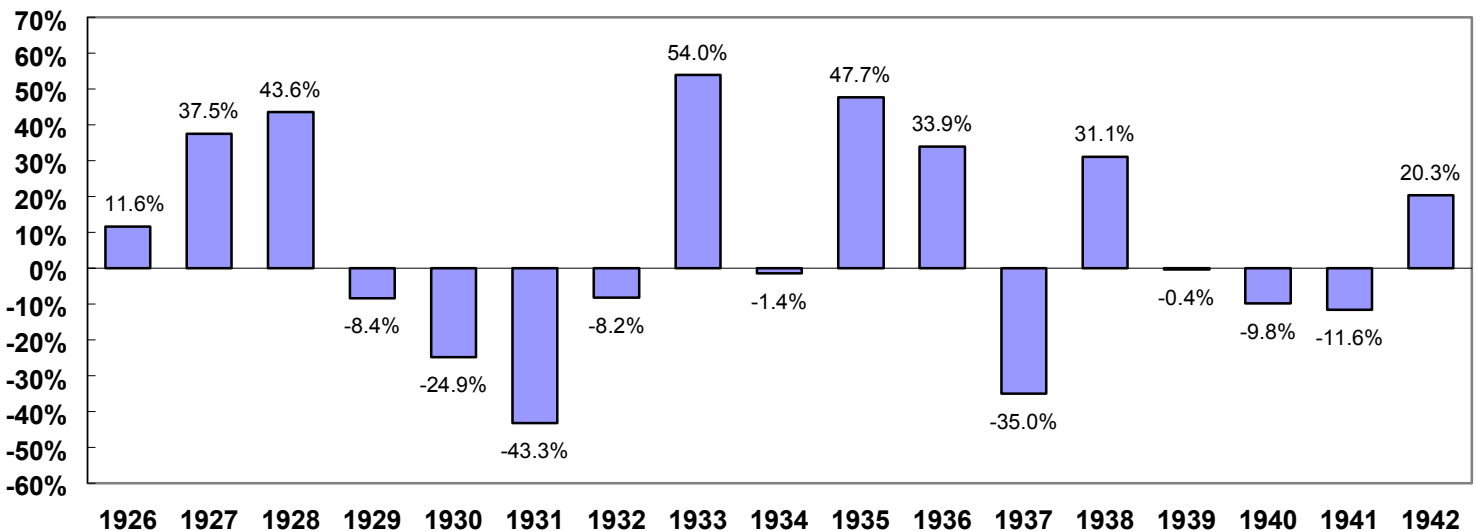
Whereas others may shrink from the specter of ruin, we allow for the likelihood of outsized opportunity. Between January 1, 1933, and December 31, 1936, the S&P 500 or its predecessor advanced threefold for the four years, by an average 32% compounded annual rate — smack-dab in the middle of the Great Depression. Who would have been able to anticipate that surprising windfall? Of course, if the resilience of the U.S. economy and the economic process of natural selection work their wonders as they seem to be doing and a prolonged business slump is averted, the returns to equity investors over the next five years could eclipse other asset classes by a wide margin. Moreover, hard-asset deflation, should it occur, will make any upward move in stock prices that much more impressive in terms of purchasing power gained.

A word of admonition for “market timers” is warranted here. Those who think they have the perspicacity to enter the market at its lows might also scrutinize the following table. (For the mathematically challenged, when dealing with percentages please recall that it takes a 100% gain to offset a 50% decline.) The stock market crash began in October of 1929, and the economy began to pull out of its

extended slump with the buildup for World War II. Knowledge of the often perplexing relationship between economic activity and stock prices can be an investor’s best friend. Make no mistake about it, making acceptable returns as an investor in a languid economy is in one sense very difficult and yet in another relatively safe. The difficulty comes from fighting the prevailing economic headwinds, while battered prices often provide a (frequently under-appreciated) margin of safety.

As for the here and now, the third quarter of 2002 will go down as the three-month span that sent the stocks of many companies to the bargain basement, similar to the first quarter of 2000 and the fourth quarter of 2001. Because we committed so much money to what we believe were superior businesses at giveaway prices on those earlier occasions, we have less money to invest now. Moreover, money already invested is at risk of the market’s vagaries. As the summary table early in the report illustrates, the prices of the companies we own were not immune from the general malaise, declining roughly 20% during the quarter. The large amounts of cash held in reserve moderated the overall portfolio impact. Of course, if that cash is not ultimately put to work, it will also mitigate the extent to which we participate in the next advance. As long-term investors we have no choice but to ride out the squalls, or on very rare occasion, hurricanes. If our

The Stock Market and the Great Depression



commitments were made at prudent prices, as thus far the record would suggest they were, the experience should not be torturous. If we remain rational and listen to logic and not lamentations, we should weather the storm with minimal anxiety and manage to capitalize on the good that may dwell within the trauma.

Over the last 60 years, the stock market has provided an average (though admittedly non-linear) total return of roughly 12% per year. During that period we have had the second war to end all wars, forgetfully followed by Korea, Vietnam and the Gulf War; oil shortages; rampant inflation; interest rates that have ranged from 1% to an unprecedented 20%; wage and price controls; Watergate; the political and economic destruction of a superpower; a presidential impeachment; a meltdown in Asia-Pacific markets; and a one-day drop in the U.S. stock market of 23%. Uncertainty is indigenous to the world in which we live. We won't be able to predict times of trouble, but we may be able to profit from them if we see through the smoke to the nub of the matter: Low prices relative to good value are at the root of all investment success.

At current prices we believe a margin of safety has been re-established with many of our holdings, meaning they're selling in the marketplace at prices comfortably below what we think they're worth. While we have no idea what market surprises the next few months (perhaps years) will bring, we expect the businesses in our portfolios to become more valuable over time, which we are confident will lead to very acceptable returns over the long term.

Times like these provide propitious moments to trumpet the virtue of performance-based fees. Our brethren whose fixed fees are assessed on total assets suffer modestly during bear markets, but certainly not proportionally, compared to their clients. Despite having negotiated our way through the minefields comparatively well, our sustenance of bread and water for some time to come will pale in nutritional value vis-à-vis theirs. For purposes of our performance-based fee calculation, a high-water mark was established on March 31, 2002. Until we eclipse that standard, you will be assessed our bare-bones maintenance fee. For your sake and ours, let's hope you see those big fees again soon!

The High Price of a Smooth Ride

On occasion, Wall Street's characteristic short-term orientation creates stellar openings in the marketplace. When Wall Street completely ignored fundamentally solid "Main Street" businesses in the spring of 2000 in its quest to capitalize on what later would be termed the "technology bubble," a "fishing from a stocked pond" moment presented itself for long-term investors like us. We believe there is another opportunity in the making, albeit more subtle.

Wall Street, having been once bitten, is now twice shy. In stark contrast to the days when pipe dream companies were a welcome addition to many portfolios, there is little tolerance today for venturesome investments, where disappointments and uncertainty are far too common. Indeed, when stocks crater 25% in a day for what we consider to be nothing more than "business noise" (when earnings fail, by a penny or two, to meet Wall Street expectations), who can blame them? Today's investors are hungry for earnings consistency, and companies that have a business model that lends itself to steady earnings growth have clearly charmed the stock market. These "dependable 10 and 15% growers" now boast P/E ratios of 25-30. We too admire many of these businesses, but we aren't willing to pay premium prices for short-term consistency. Sampling Wall Street's "flavor of the day" almost always leads to indigestion.

We have found a different group of companies with similar long-term growth prospects, but whose earnings are more volatile, typically as a result of the ups and downs of the business cycle. These stocks are now deemed "risky" by Wall Street, merely because it's nearly impossible to forecast what their earnings are going to be next quarter, not to mention when their earnings are going to enjoy a sustained recovery. Their stock prices reflect Wall Street's revulsion over earnings uncertainty. A number of these types of companies now populate our portfolios.

Our view of risk (either stock market risk or business risk) has little to do with short-term certainty. We are looking for long-term reliability. We want to own companies that enjoy dominant competitive positions in their respective industries and that are managed by able and trustworthy executives. The fact that these businesses are

economically sensitive — and therefore offer less earnings predictability — is of little consequence to us. We're simply trying to buy as much present value of future earnings as possible for as little money as we can. The fact that a business can earn considerably more in some years than others is essentially irrelevant. The following "Let's Make a Deal" analogy may help develop the idea.

Suppose you were given a choice of games. In the first game, you could lose \$20,000, win \$10,000 or win \$30,000, depending on which of three doors you choose. In the second game, behind one door you have to pay \$30,000 to Monty Hall, behind another door there is zero payoff, but behind the third door you could win \$70,000. Now suppose further that you must pay to play. What amount would you be willing to pay for each game? Mathematically, both games have equal pay-offs (a little over \$13,000). However, there is more stability in Game One. Indeed, for a risk-averse player, Game 1 might be more valuable *if you could only play one time*. Suppose, however, that you could play the game over and over. Then, the variability of the second game becomes irrelevant. The payoffs between Game 1 and Game 2 are going to be equal over a long period of time.

What we often see in the stock market is a profound tendency for Wall Street to pay twice as much for the right to play Game 1, even though there is no more economic value over the long term. In effect, Wall Street plays as if it has only one turn. We assume we are playing the game over and over and will nearly always opt for Game Two, if the price to play is less than Game One.

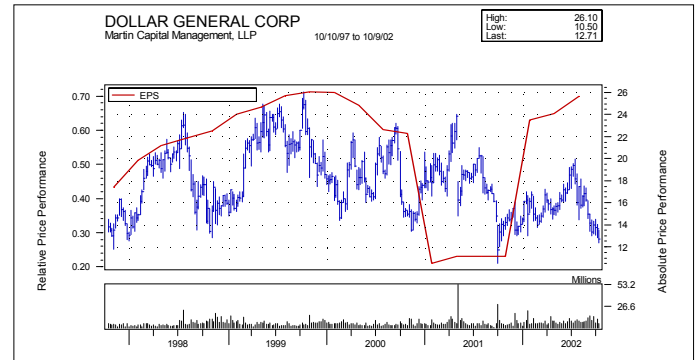
Equity Holdings

Dollar General (DG)

Fundamentally, it would be difficult to find a retailer that is performing better than Dollar General. Same-store sales have been growing at over 7% for more than a year. The company also has improved its systems and store-level profitability. This was evidenced by a 17% sales increase with 3% less inventory during its most recent quarter.

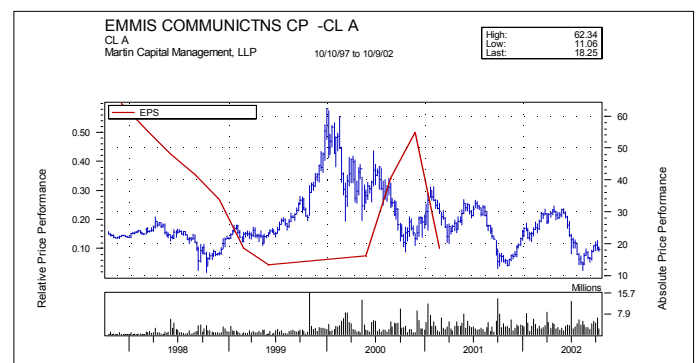
Nonetheless, the company did not meet Wall Street's EPS and margin expectations, and the stock price has retraced the gains made earlier in the year. The retail sector in general has not performed particularly well over the last

several months as consumers have grown more concerned about the economy. Interestingly, we can hardly think of a better-positioned retailer to withstand recessionary forces than Dollar General. Overall, the business continues to improve and, sooner or later, Wall Street will notice.

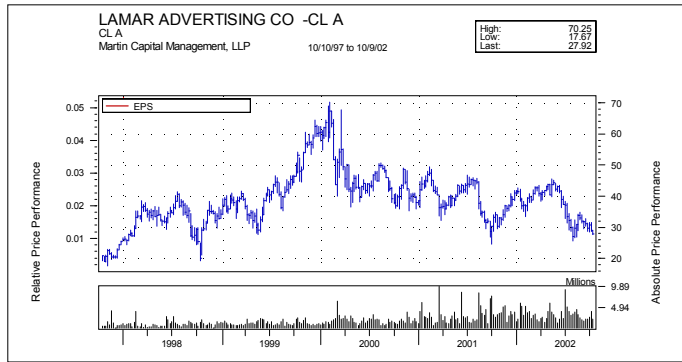


Emmis Communications & Lamar Advertising (EMMS & LAMR)

The valuations of media companies have significantly eroded over the past few years — and for good reason. In some cases, valuations had simply become too stretched. In others, investors had allowed themselves to be taken in by misleading "pro forma" earnings figures. But, as we've said before, one person's disaster is another's opportunity. This valuation collapse has given us the chance to buy two terrific local media businesses. Both radio (Emmis) and billboard (Lamar) are predominantly local in character where service and relationships still matter. The Emmis radio and television businesses have seen some good improvement, but the billboard business, which didn't fall as much as other media, has been a little slower to recover.



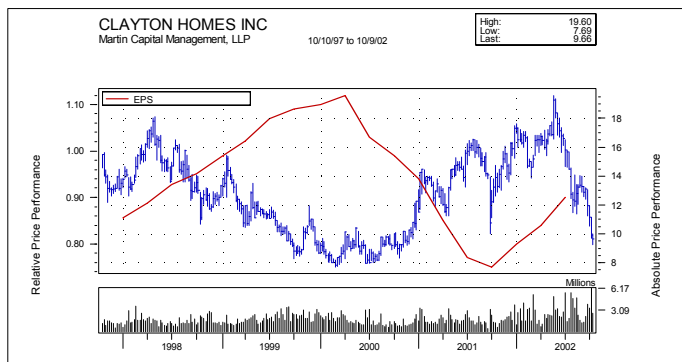
Both companies have great franchises that are very indicative of the long-term-reliability argument made above. Both companies also have a large component of fixed costs, which will allow earnings (or free cash flow) to recover quickly when the economy improves.



Clayton Homes (CMH)

Just when you think it can't get any worse in the manufactured housing industry, another major source of financing (retail and floor plan) announces its intent to leave the business. Industry shipments are now estimated to be in the 170,000-unit range for 2002. For some perspective, the industry shipped more than 300,000 units in each of the six years from 1994 through 1999. Shipments peaked at 372,000 units in 1998.

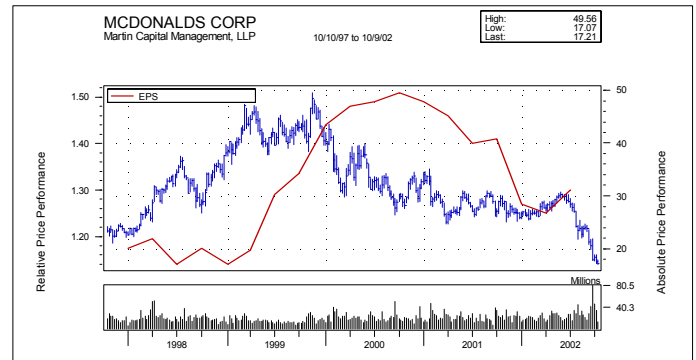
Even in this depressed environment, CMH has maintained a pristine balance sheet and earned an ROE of 10%. Indeed, CMH earned more than \$100 million, while its three larger competitors were losing hundreds of millions. More importantly, from an earnings recovery standpoint, the company's market share has increased from 7-8% to 14%.



CMH's finance subsidiary, Vanderbilt Mortgage, has played a stabilizing role from an earnings perspective over the last few years. It is also the part of CMH that we watch quite closely, especially as other finance companies experience credit quality deterioration. Delinquent and non-performing loans (as a percentage of the servicing portfolio) have actually improved over the past 12 months. We will continue to look for opportunities to add to Clayton's already large position in our portfolios.

McDonald's (MCD)

The improvement we referred to in the second quarter proved to be short-lived. The United States and Europe have both struggled in the third quarter, and much of the rest of world is mired in recession. The problems in the U.S and Europe, representing 68% of worldwide sales, are looking more and more intractable. The acquisition of new chains, throwing more money at franchisees for cooking systems and remodeling costs, and price cuts are indicative of problems without a good solution.



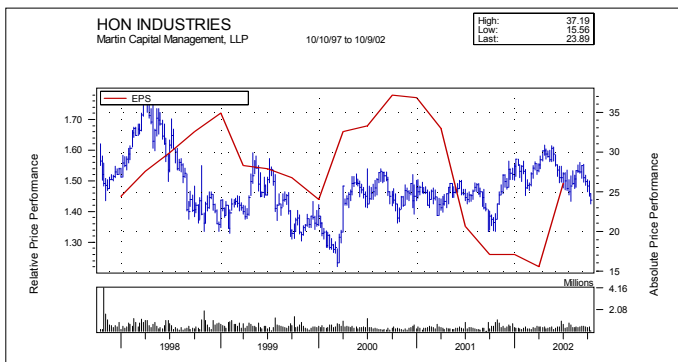
McDonald's is a terrific franchise. Even with the reduced levels of earnings, it is one of the most profitable franchise systems in the country. The business will remain a good one for a long time, but we're much less confident about the company's growth potential and its ability to respond to competitive threats. We'll look for opportunities to sell our stock in rallies.

Hon Industries (HNI)

Business isn't getting any better in the office furniture industry. But given the continued strength in the housing industry, the company hearth business seems to be holding up reasonably well. Hon has made significant

improvements in its cost structure during the last 18 months of tough industry conditions. This is evidenced by more than 200 basis points improvement in gross margin, even in the midst of declining sales.

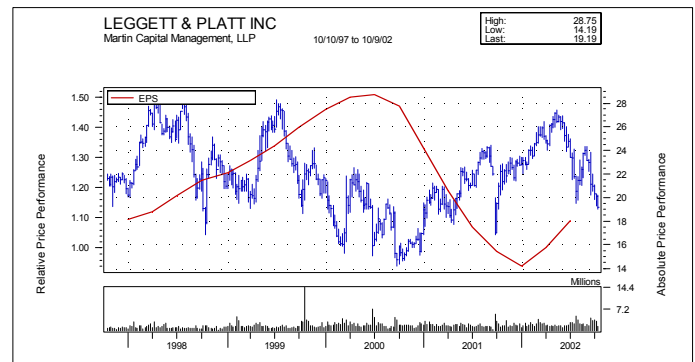
Hon's biggest problem is finding reinvestment opportunities. The company is largely debt-free and generates considerable cash flow from operations. While there are acquisition candidates available in both of its businesses, they are not of sufficient size to satisfy the company's appetite over the next several years. Hon is considering an additional business platform to go along with office furniture and hearth technologies. We also are encouraging the company to consider share repurchases as an ongoing use of retained earnings.



Leggett & Platt (LEG)

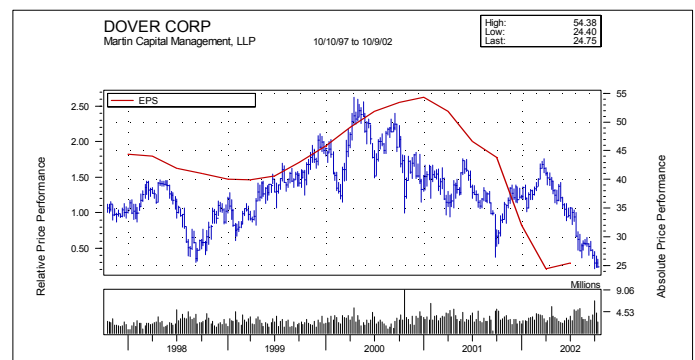
LEG has roughly 40 business units, some of which enjoy very large market shares. Like any other well-managed company, LEG has used this downturn to improve virtually every aspect of its business. With working capital as a percentage of sales lower, the company has consolidated 20 plants and reduced head count by more than 10% as the company adjusted to lower levels of business. The changes implemented, however, are permanent cost reductions that could not have been made without unwelcome disruptions when volumes were much higher.

Just as importantly, LEG has the financial capability to continue making strategic acquisitions. So far this year the company has acquired companies with more than \$500 million in sales at prices that should result in very good returns over time. In sum, we believe that we will see a healthy "snapback" in earnings as the economy recovers.



Dover Corporation (DOV)

Dover, more than any of our other businesses, has been directly affected by the collapse in technology spending, which accounts for roughly 40% of the company's sales. Like LEG, the company has permanently lowered its cost structure for many of its businesses during this downturn in business. Significantly, LEG and DOV do not "set aside" the expenses associated with such activity in the form of a "restructuring charge."



The rate of acquisitions has slowed at Dover, albeit not for lack of resources. The company has never been stronger financially. Dover's acquisition program has been well nurtured over many years. Like Martin Capital, it has a large wish list of terrific companies it would be willing to buy and has had plenty of conversations with their owners over time. DOV, however, has not been able to find an owner who wants to sell his business in the current depressed environment. In other words, Dover hasn't been able to find high-quality bargains, yet is unwilling to pay high prices that prove to be dilutive. In short, Dover is well positioned to participate in an economic rebound.

The Gap (GPS)

The new merchandise is in the stores, and we're waiting to see if the new duds can spark a rebound in the company's earnings. Early indicators are mixed. Comparable-store sales are still down from last year, but only marginally so. Perhaps more importantly, given the unusually long and hot summer (which affected fall apparel sales for the entire industry), the company appeared to outperform other specialty apparel retailers for the first time in a few years during August. While we hardly consider ourselves fashion experts, clearly the look of the stores has changed dramatically over the last several weeks. Like McDonald's, we will use The Gap as a source of funds, ideally as the business and stock price improves.



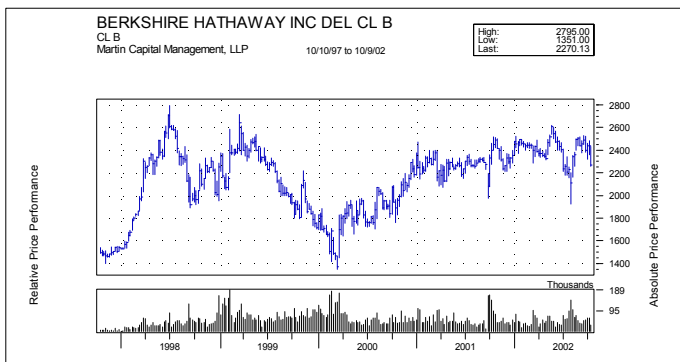
Walt Disney (DIS)

Not much has changed since our last update on Disney. The media markets (ESPN, Disney Channel, etc.) seem to have modestly recovered, and there is a little more optimism for improved ratings at ABC, but attendance at theme parks continues to be soft. Moreover, a major hit from its animation business is still missing. As a result, we aren't sure when earnings growth will be restored at this multi-faceted company. The good news is that we believe current stock price incorporates much of the bad news. Indeed, the stock seems priced at a level that assumes that the current state of business is a permanent condition. We are more optimistic and consider the business worth much more than its current price.



Berkshire Hathaway

It's a great time to have an abundance of liquid capital. It's also a great time to be in the insurance business. Put both of them together, and you have a wonderful business outlook for Berkshire Hathaway. In spite of Warren Buffett's attempts to lower expectations for future long-term returns, the outlook over the next few years is bright indeed!



Mercury General (MCY)

Despite a recent \$30 million loss (on a portfolio of nearly \$2 billion) on telecommunications industry bonds, this auto insurance company has made fundamental operating improvements. The company grew more than 27% during the quarter, with improved margins. The stage is set for Mercury General to continue growing quickly the next few years. How quickly is the major question. The answer hinges on whether the company is able to replicate its successful California business model in other states. Florida is showing encouraging signs, but other markets are taking longer to develop. To justify our holding at current prices, the company needs to develop new markets rapidly in order to take advantage of the current cycle for auto insurance. As always, we'll be watching closely.

