

capital markets review

QUARTERLY

Keeping Our Eyes on the Ball

Iraq. We made little mention of this perennial Middle East hotspot in the October 2002 Quarterly Capital Markets Review and our Annual Report that followed in January 2003. Notwithstanding the fact that the assault on Baghdad has become the preoccupation of the nation (including commentators on and speculators in the capital markets), we will once again turn our attention elsewhere. Despite the seriousness and potential consequences of the U.S.-led offensive — economically, diplomatically, militarily and so forth — its longer-term effects are unknowable. Thus to speculate about outcomes is little more productive than a dog chasing its tail. What we do know is history, and its lessons tell us that economies and markets somehow survive conflicts such as the one in which we're now engaged. We also know that the odds are very high that we will enjoy respectable long-term returns by sticking to our "all seasons" investment strategy of buying superior businesses at reasonable prices.

Of far greater importance to us as stewards of your capital is to avoid becoming excessively concerned with extraneous factors, which may impact our investment decision making much less than generally perceived. Regardless of the incessant drone of the television in the

background, we must not be distracted from the task at hand.

Our approach to our role as analysts always has been "bottoms up." We focus our attention on specific businesses and are currently attempting to envision how they will fare in what remains a lethargic economic environment. Few companies are immune to a slowdown that is as pervasive as the one in which we now find ourselves. And yet in such times those businesses that are conservatively financed and managed — and opportunistic rather than fearful in their outlook — are likely to strengthen their competitive position in the marketplace.

Take the manufactured housing industry as an example. While most competitors are taking extreme measures (with potentially devastating long-term competitive consequences) in an effort simply to survive, others like Skyline and Clayton are positioning themselves to take full advantage of their disciplined and rational approach to the business, so that once the recovery in demand returns they will be in the catbird's seat. This is true in many industries. While giant United Airlines struggles in bankruptcy, Southwest Airlines continues to take actions to strengthen its position. And so the story goes, industry after industry.

MARTIN

CAPITAL MANAGEMENT, LLP
Registered Investment Advisor

Even in our own profession, most firms are consumed with damage control, loathing the prospect of having to meet with clients and restructuring portfolios from offensive to defensive postures. Through a combination of ample good fortune and limited foresight, our view toward what lies ahead is heavily biased toward capitalizing on the opportunities that misfortune always presents. We have no way of knowing what will happen in the near future, but the long term is more knowable for the kinds of businesses we own. For example, it's highly predictable that Disney's ESPN will remain the No. 1 sports network throughout the world and that lots of people, especially men, will continue to watch it. If we stick to our basic game plan — and we intend to do so — we should be able to weather whatever storm comes our way.

	<u>YTD</u>	<u>From Peak</u>
Dow	-4.2%	-30.5%
S&P 500	-3.6%	-43.5%
Nasdaq	0.4%	-72.9%
MCM	-8.8%	17.0%

Short-Term Equity Performance

As you can see from the table above, our performance for the quarter was worse than the poor performance of the benchmark indices. We figure this will be the case nearly 50% of the time. Moreover, because our portfolios are purposely concentrated in fewer holdings, our absolute and relative performance is likely to be quite variable in the short run. We nonetheless strongly believe our strategy is much less “long-term risky” than conventional portfolios.

Our portfolios, as often is the case, are made up of terrific companies that are experiencing what we believe to be a temporary hiccup in their long-term growth. At this time, overall economic weakness is the primary culprit that is holding back earnings growth for many of our companies (see Dover discussion that follows). This is a temporary issue. In any event, because of the economic sensitivity of our portfolio, the short-term performance of the portfolio will generally be determined by the change in perception regarding the economy. In the first quarter, as concern about the war and its effect on the economy escalated, it was reflected in our performance. Once again, unless our economy is now in an extended funk, always a possibility but we think a relatively low probability, Wall Street will

eventually come around to our way of thinking with regard to our portfolio holdings.

Bottoms-Up Wish List

As everyone should understand by now, we at Martin Capital have a fairly narrow universe of companies that fit our criteria for investment. While few businesses enjoy all of the following “wish list” characteristics, you will find that all of our companies possess many of them. Anecdotally, very few companies meet these criteria, which is (at least in part) why our portfolios tend to be more concentrated than industry convention.

MCM ‘WISH LIST’

1. Core business must be easy to understand.
2. The management team must be competent and honest.
3. The underlying business economics must be above average and sustainable.
4. There must be ample reinvestment opportunities in the existing business.
5. The company must be conservatively financed.
6. The accounting must be aboveboard and transparent.
7. Insider ownership should be substantial.
8. Executive pay should be rational.
9. There must be a reasonable margin of safety implied by the purchase price.

It's important to note that our list excludes the very characteristic on which Wall Street is most fixated: namely, a company's ability to meet or exceed earnings per share (EPS) estimates. We believe this gives us a considerable advantage, which we will illustrate by using Dover as a case study.

Dover has been an outstanding company for more than 30 years, and it meets almost all of the above-listed investment criteria. The chart below illustrates the stock price in relation to its EPS. When the stock price was near its peak in the spring of 2000, its EPS was somewhere between \$2.00 and \$2.50, so the P/E multiple was roughly 20x earnings.

Today the story is dramatically different. With EPS estimated at \$1.25 this year and a stock price at \$25 (half of its peak), the P/E multiple is still roughly 20x earnings. In Wall Street's paradigm, the stock is no more attractive at \$25 per share than it was at \$55. Our view is very different. First of all, intrinsic value is the present value of *all* future cash flows, so a year or two of dismal earnings has little impact on intrinsic value. Moreover, we have always focused on "normalized" EPS, which takes into account the fundamental earnings power of the company in a "normal" economic environment. While we acknowledge a lack of precision in estimating normal EPS, we'd much rather be roughly right in our "normal" EPS calculation than precisely wrong by focusing too much attention on a precise annual calculation. In our view, Dover was selling at roughly 25x EPS when the stock price was \$55, while now (@ \$25 per share) it's selling at roughly 11x normal EPS of \$2.20. Clearly we don't know when the company will return to the \$2.20 number, but when it does, Wall Street will value the company based on EPS of \$2.20 vs. the current estimate of \$1.25. We should profit handsomely as Wall Street gradually comes around to our way of thinking about this company. In effect, we are arbitraging the difference between short- and long-term thinking.

Trading Up?

Generally speaking, because of the quality of our "wish list" companies, seldom do they sell at bargain-basement prices. For those companies that grow irregularly, most of the opportunities occur when the business cycle is temporarily depressed (exemplified by Dover). Sometimes high-quality companies can be purchased at reasonable prices simply because of the stock market environment (read "bear market"). While we still aren't ready to pronounce the stock market as a whole as "cheap," after three years of declining prices, we are beginning to see a few more of our "wish list" companies showing up in the "reasonably priced" category.

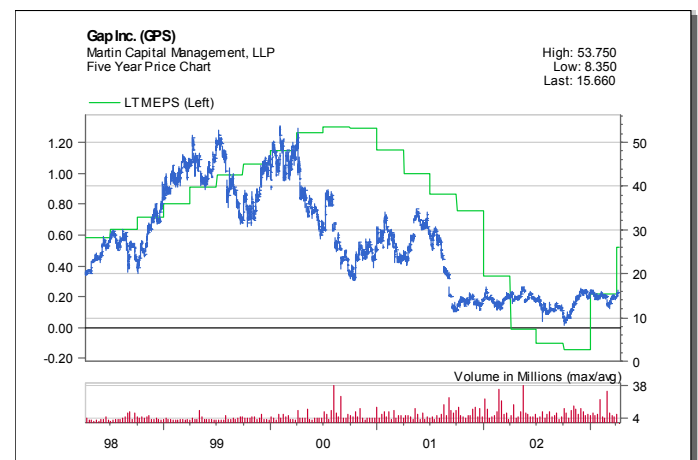
It was mentioned earlier that some of our "wish list" companies possess a higher proportion of desirable traits than others. As such, we have begun to vigorously discuss the possibility of "trading up" in our portfolios. While we don't think the expected return of the portfolio would be enhanced (indeed, it might modestly erode), we believe

that the collective long-term certainty of our portfolio could be improved with some changes. We haven't yet made any final decisions (except for The Gap), but we'd encourage you to read the following business profiles from that perspective.

Equities Sold

The Gap

There could not be a better example of our desire to trade up for longer-term certainty than our decision to sell The Gap. In the short term, the company's fundamentals are improving dramatically, more or less as we expected. Of all our portfolio holdings, however, The Gap clearly has the fewest elements included on our "wish list." In short, we decided to upgrade to long-term certainty of our portfolio by redeploying the capital invested in The Gap into other names. Our investment return for The Gap in most of our accounts was a modest 11% during our holding period. However, the market declined 11% during the same period. It's important to note that The Gap may be a terrific investment from current prices. We simply aren't sufficiently sure, and that is the point!



Equity Holdings

Clayton Homes

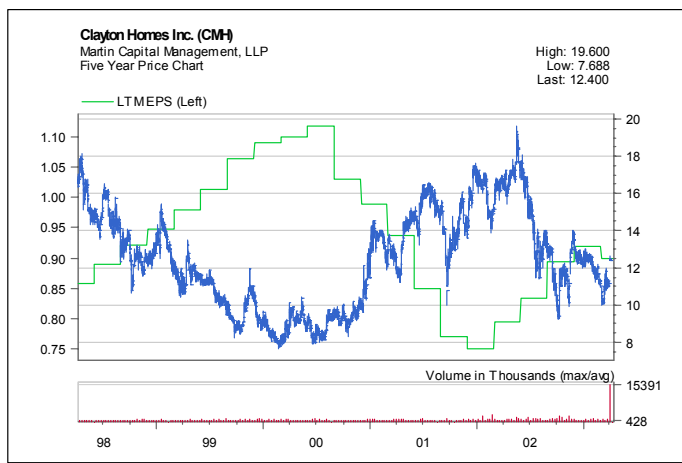
On April 1, 2003, the night before we sent this piece to our editor, Berkshire Hathaway announced that it had reached a definitive agreement to acquire Clayton Homes for \$1.7

billion in cash, or \$12.50 per share. Apparently, Warren Buffett agreed with our original comments below.

While we understand the management team's decision (the Clayton family owns 30% of the stock), we are disappointed with the outcome of our investment. Clayton is our largest investment, which underscores our confidence in both the company's future prospects and the margin of safety we enjoyed in the stock price. In the short-term, it will be difficult to replace this holding with another that gives us the same magical characteristics of high long-term potential and low long-term risks.

Parenthetically, it also illustrates an often-overlooked competitive advantage that Berkshire Hathaway enjoys as a first-choice home for great businesses that have owners who care deeply about the ultimate destination of their business. Buffet's reputation for integrity and his record of keeping his commitment never to sell a business, irrespective of circumstances, is serving him very well. In this case, regrettably, he took a little from our hide, assuming the deal closes.

Bad weather, continued tough competition with discounted reposessions, and a continued shortage of consumer financing availability will aggravate what is already a seasonably slow first quarter. Nonetheless, Clayton's solid balance sheet, discipline, and vertically integrated business model continue to allow the company to pile on market-share increases.

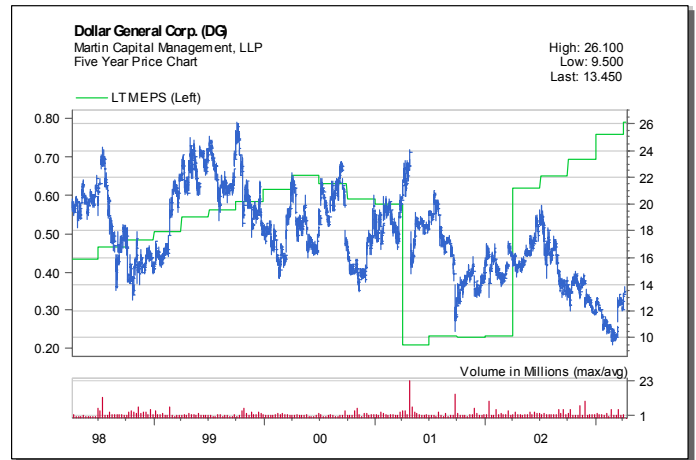


Clayton Homes is one of those special companies that meet all of the criteria on our "wish list." Indeed, it would

be difficult to find another industry where the industry leader has such a clear advantage over the rest of the competition. What's more, it serves a highly cyclical industry that gives us periodic opportunities to purchase the stock at bargain prices when Wall Street sours on the industry. We believe that Clayton's normalized earnings power is substantially higher than indicated by its current earnings reports. Our strategy is simply to sit back, wait for the industry to recover, and watch the earnings roll in.

Dollar General

Dollar General has delivered a compounded EPS growth rate of more than 15% over the last 30 years. Even over the last five years, a period that has included more than a few stumbles (including an earnings restatement), the compounded growth rate has been 15%. The convenient, small, discount-store model is performing very well relative to other retail formats and has very good growth potential.



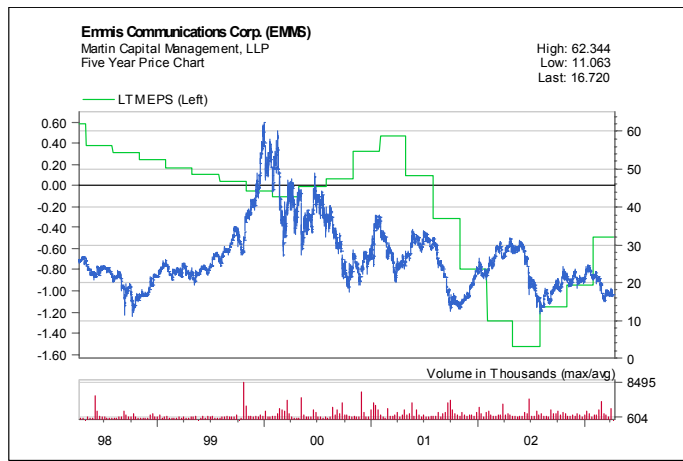
Long the innovator in the small-store format, this company has dramatically increased the number of consumable items in the stores (resulting in higher traffic) and has begun to add coolers (milk, ice cream, eggs, meats, etc.) to about 1,000 of the company's 6,000 stores, with outstanding initial results.

To be sure, Dollar General has been behind the curve technologically, which has contributed to a higher-than-industry-average "shrink" (consumer/employee theft) and perhaps to some elements of the restatement charges taken

in 2000. The company has rapidly begun to address this issue and is reaping some of the results. For example, in 2002 the company actually reduced inventory levels despite 10% more stores and a 15% increase in sales. Naturally, significant improvement in return on investment was the result. We continue to be optimistic about the potential of Dollar General.

Emmis Communications

The company’s operations are performing very well. Ratings, which translate into market share of advertising dollars, have improved in virtually all of Emmis Communication’s markets. Especially important are the company’s New York City and Los Angeles radio stations, which have gained momentum in recent quarters. Combined with a more robust advertising market (at least up to the launch of the Iraq war), these factors have led to fairly dramatic improvements in profitability.



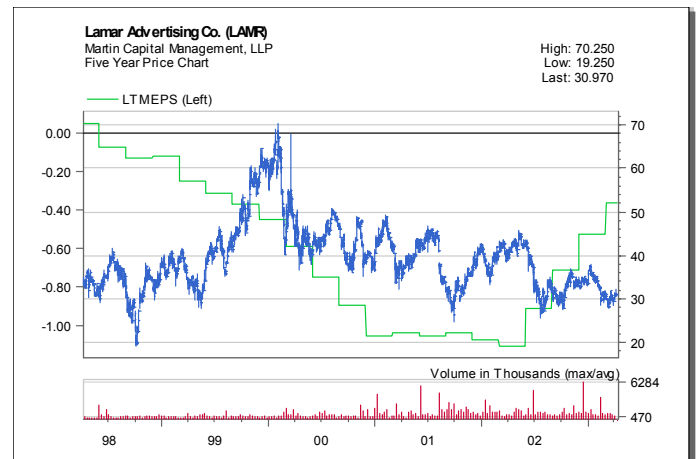
The “wish list” elements at Emmis, however, are more mixed. The company enjoys the many advantages of being No. 1 in large media markets, and the general managers at the radio and TV stations are second to none. Given the increased ratings and the operating leverage inherent in the media business, the potential for significantly increased earnings is very good. The company, though, has too much financial leverage, made worse by another recent acquisition. In addition, while we don’t detect anything wrong with the company’s accounting, we don’t agree with the management team’s assessment of “*pro forma earnings.*” Finally, given the

consolidation of media properties over the last decade, many of the remaining “independent” properties tend to sell at “trophy” prices. Thus, if Emmis is intent on continuing to purchase media assets at existing prices, the return on capital will keep eroding. We would have strongly preferred the continued reduction in leverage over the continued purchase of media properties at existing valuations.

In short, while we continue to believe there is much to like at Emmis, there may be more to like elsewhere. “Stay tuned.”

Lamar Advertising

The billboard business has been a little slower out of the gate than the radio and TV businesses. This is not atypical, as billboards are traditionally slower going into the downturn and slower coming out. We have great confidence in the management team, however, and one could hardly find a simpler business. On the other hand, the prices of billboard acquisitions have gone up the last few years (until recently), and the return on capital at Lamar also has eroded. Of course, the higher-than-normal vacancy rates resulting from a slack economy is also a big factor.

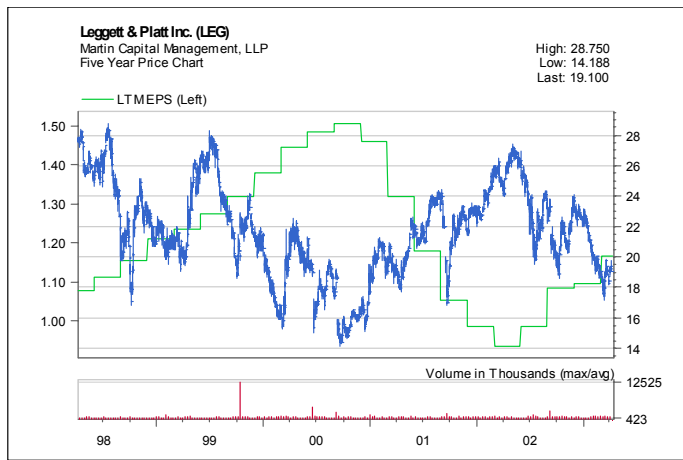
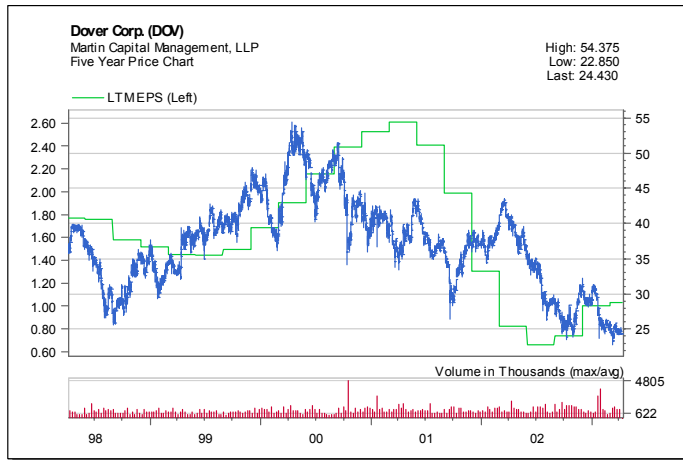


The rate of industry consolidation has slowed and, as a result, we are focusing more on the reinvestment opportunities left in the billboard business. This is not a huge concern if management, unlike what we’ve seen at Emmis, is willing to shrink the capital structure through

reduced leverage and share repurchases. We'll continue to monitor the company's strategy and wait for the earnings leverage to kick in when bulletin and poster occupancy levels pick up over the next two years.

Dover/Leggett & Platt

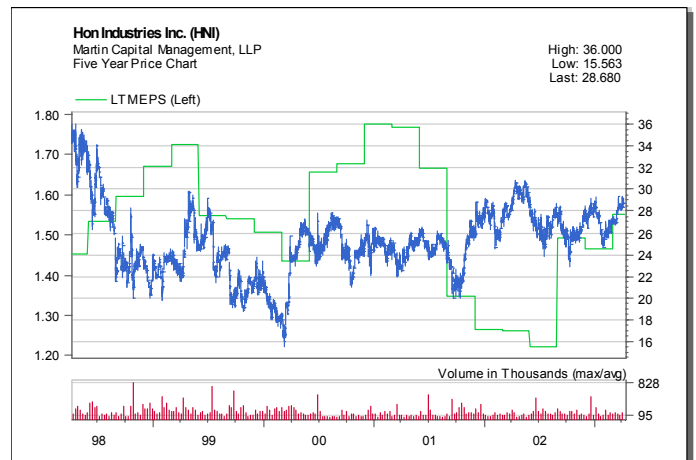
There are many similarities between DOV and LEG. They are roughly the same size, they have highly decentralized organizational structures, they both have four major business platforms, both businesses are highly sensitive to industrial/commercial capital spending, and they both grow by acquisitions. We also would say they both meet nearly all of our "wish list" elements. Whatever was said above about Dover, we now ditto for LEG.



Hon Industries

Like LEG and DOV, this company has experienced significant softness in its largest markets, namely office furniture. Industry shipments have declined nearly 40% from their peak. Even so, Hon's culture of continuous improvement and new-product development has allowed operating margins to expand, and its market share has increased from 12% to 14% the last 12 months.

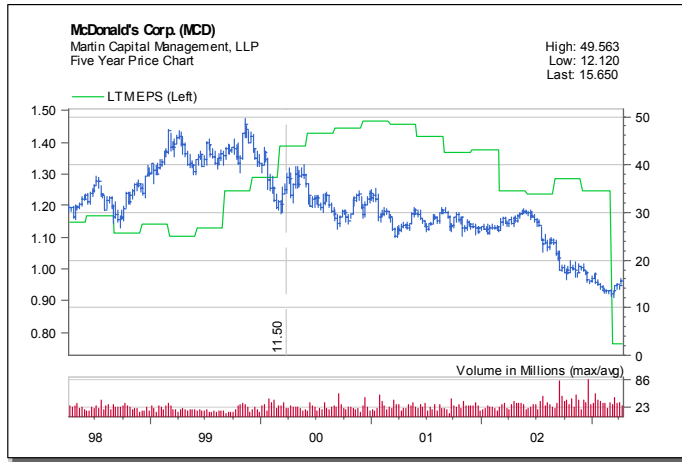
Hon is building a cash hoard as it assesses the reinvestment opportunities available in its existing markets. Hon's return on investment is one of the highest we've seen for manufacturing companies and, as a result, it generates a significant amount of cash. While it's a nice problem to have, in the absence of significant share repurchases, it's likely that the company will need to expand into a new business at some point. Thus, the company doesn't meet one of our "wish list" characteristics. Nonetheless, Hon is a terrific company with a first-rate management team. We expect to continue to hold onto this stock.



McDonald's

During our last update on McDonald's we admitted we were too optimistic about the company's long-term potential, but we felt that the stock price had overreacted to negative news. We still believe that to be the case, but we're perhaps more prone to use this holding to upgrade the long-term potential of our portfolio. We aren't concerned about the company's finances or ability to recover from its current funk. We are, however, more

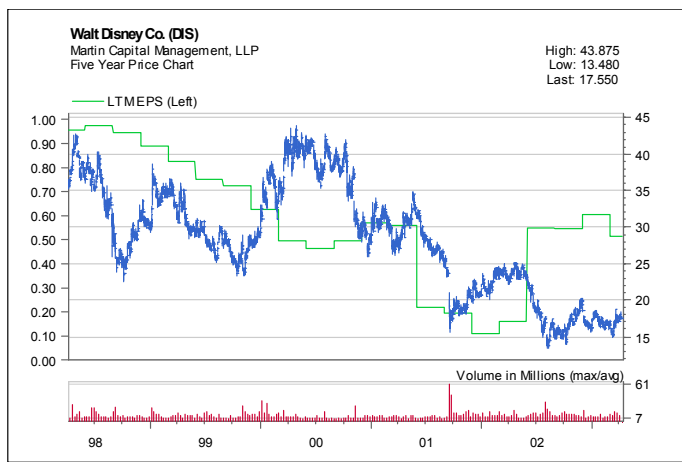
doubtful about the company's long-term growth potential. We continue to view MCD as a source of funds.



Walt Disney

Disney's results have improved nicely over the last several quarters, albeit from an unacceptably low base. Ratings at ABC are recovering, the consumer products division is performing much better and, until the beginning of the war with Iraq, the theme-park business was recovering.

Disney has a few good businesses, along with two outstanding businesses in cable (ESPN and Disney Channel) and its resorts. These are the businesses that will have the most impact on the future performance of the company. Hit movies, while important, simply add to the "lumpiness" of the company's growth rate.



Many of our clients have wondered aloud how the ongoing threat of terrorism might impact Disney's theme parks, the company's most visible "crown jewels." The theme-park business, depending on the year, accounts for 30-45% of Disney's earnings, so it is a significant business. We don't dismiss the concern out of hand. However, we think the question is broader in scope and must include all entertainment venues. Will the terrorism threat shrink or slow the large-venue entertainment business, an industry that has enjoyed very steady above-average growth? Our view is that the threat is real enough that we would be unlikely to own Disney at high valuation levels but remote enough to own it when valuations are on the low side.

How does Disney fare on our "wish list"? While some folks would give the company poor marks for executive compensation (Eisner's past pay packages) and managerial performance (not as bad as it may appear), we are more inclined to worry about the reinvestment opportunities relative to the company's existing size. The theme-park business can clearly continue to grow, but the growth is likely to accelerate internationally where the company doesn't invest much capital. Acquisition multiples in many of its businesses are unattractive, so once again the management has a "problem" of what to do with reinvested earnings. Debt reduction and share repurchases will likely rule the day in the short run. Disney meets fewer of our "wish list" criteria than most of our other portfolio holdings, but we're content to own it at current prices in the absence of other opportunities.

Portfolio Additions

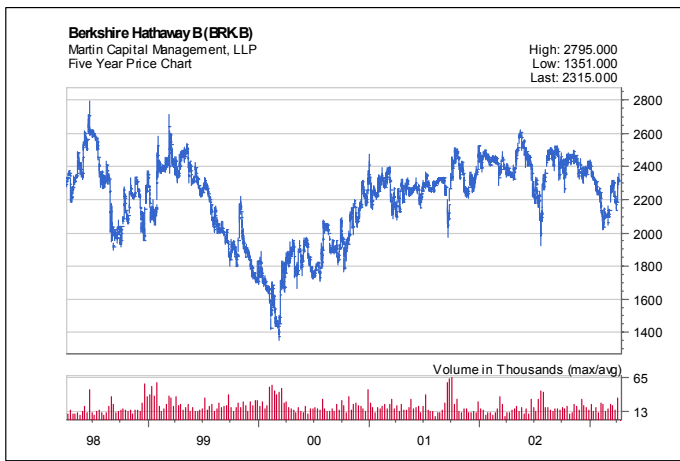
For many of our longstanding clients the recent purchases of Berkshire Hathaway and Mercury General simply add to existing positions. For some of our newer clients, they are new positions. As such, we will take a little more time explaining the rationale behind these investments.

Berkshire Hathaway

Berkshire Hathaway (BRK) is the holding company run by famed investor Warren Buffett. In the past BRK was often inappropriately considered to be a closed-end investment fund managed by Buffett. In fact, it was more of an insurance company that used low-cost float (money held to

be paid out in future claims) to build a large investment portfolio. Over time, BRK has built some powerful competitive advantages, in no small part due to its AAA financial and claims-paying-ability ratings.

BRK has roughly \$80 billion in cash and securities as a result of stellar historical investment returns and increased amounts of float generated by its insurance companies. More recently BRK's earnings from its non-insurance wholly owned businesses have exploded. During the last six years the net operating income from BRK's non-insurance businesses has exploded from \$234 million to nearly \$2.2 billion (a nine-fold increase), even as the investment portfolio has continued to grow.



Today BRK is more appropriately viewed as a holding company made up of myriad first-rate businesses run by a coterie of managers who, like Buffett himself, continue to work for the love of it. BRK also has an \$80 billion investment portfolio that is somewhat of a wild card in terms of its potential future contribution to BRK's future growth.

BRK has grown its book value at an annual rate of more than 23% for nearly 40 years. Today, due to its large size, we'd settle for half of that in the long run. In the intermediate term, we suspect that Buffett, aided by a strong tailwind in the insurance industry, could continue to surprise us on the high side.

Allow us to offer one more thought on BRK: This company is built to last. It is the closest thing we could

ever hope to find in terms of being indestructible. Indeed, it has the characteristic that the worse things get in the short run (economy, markets, geopolitical climate, etc.), the better they get for BRK in the long run. No company in America is better situated than BRK, should a worst-case scenario become a reality. What's more, the company will undoubtedly do just fine if things return to business as usual. How's that for "risk management"?!

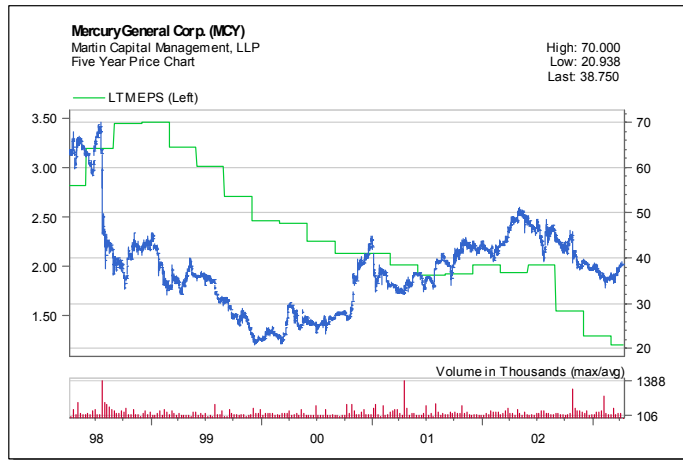
Mercury General

Mercury General (MCY) is an automobile insurance company that has its roots in the California marketplace, which still accounts for 85% of premiums written. The company has built a wonderful franchise in the independent-agent distribution channel. MCY has become a low-cost producer of auto insurance by exploiting its advantages in this channel of distribution.

MCY has built effective systems for claims (especially fraud prevention) and administration, but what makes the company a low-cost producer is its approach to underwriting and agent compensation. The company pays its agents on a floating-commission schedule determined by the quality of the business produced by the agent. For example, an agent who produces an underwriting margin of 10% may get a 20% commission rate, while an agent who produces an underwriting loss may get only a 10% commission rate. This is very important in the auto insurance business, because inaccurate policy applications and fraud are huge issues. If an agent suspects that an individual is a poor risk, he or she will likely send the policy to a different carrier, not wanting to lower the underwriting results for the business written by MCY. Thus MCY achieves low-cost status by virtue of favorable client selection that is built into its agency-based business model. There's more to it than that, but chronicling those factors would go beyond the scope of this summary.

Mercury General is enjoying the "sweet spot" of the underwriting cycle for the auto insurance market. Premium rates are going up, prompting more and more customers to shop their insurance. As a low-cost producer, along with Progressive and Geico, MCY is enjoying tremendous growth (32% last quarter). This premium growth should continue for some time and eventually is expected to be accompanied by expanding margins.

Earnings per share could very easily be 50% higher within two years.



Here are two more quick points on MCY:

1) Only recently has MCY's business model been proven effective outside of California. The company is now growing rapidly in Florida and Texas — and is opening markets in New York and Virginia, with other states to follow. There's a great deal of growth potential at MCY.

2) It wasn't long ago that the independent agent was thought to be an endangered species, as direct marketing (especially over the Internet) took over. In fact, at least for the foreseeable future, the independent agent is in the driver's seat. For a long time many insurance carriers (State Farm, Farmer's, Allstate) found it advantageous to bundle homeowners and auto insurance policies. Often they used homeowners insurance as a loss leader. But huge losses and the growing threat of mold litigation have many insurance officials rethinking the issue of bundling. As such, the independent agent, with access to many insurance carriers, is providing a service that is increasingly value-added — and that bodes well for MCY.

New Ideas

Since we told you that we're considering upgrading our portfolio, we thought we should at least mention some of the new names being considered for purchase. Some of these are companies we've mentioned in the past that have become more reasonably priced the past few months.

These companies have two things in common. First, each is a small player in a very large market. Second, each has a proven business model that allows it to profitably increase market share year after year. Without getting into any specifics, we have stepped up our research activity on the following names: Factset, Fastenal, O'Reilly Corp., and Fifth-Third Bancorp.

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User Name: mcmpw*

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