

capital QUARTERLY markets review

Keeping Our Eyes on the Ball — A Sequel

“Iraq.” Thus, with the name of a once-obscure but currently cover-story country, began the Quarterly Capital Markets Review that you received three months ago, shortly after the end of the first quarter 2003. Its title: “Keeping Your Eyes on the Ball.” Knowing that it is unlikely that you have the earlier review at your fingertips, we will stoop so low as to quote ourselves to make what we hope will be a lofty point. The following is the conclusion of the first paragraph of the first-quarter report:

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.

In the midst of the blinding-sandstorm battle for Baghdad, while all eyes were fixed on the mission of eradicating (any more descriptive and perhaps accurate word seems beneath the image we Americans have of ourselves) Saddam Hussein, the market, ever the discounting mechanism that it is, marched forward with equal ferocity, right through the cloud of confusion. As the winds of war began to wane, the market was found to be standing tall as noted in the table immediately below. This propensity, as history repeatedly teaches us, is the nature of markets.

Approximate Relative Performance

	Approx. 1st Qtr.	Approx. 2nd Qtr.	Approx. YTD
Dow	-4.2%	12.4%	7.7%
S&P 500	-3.6%	15.4%	11.8%
Nasdaq	0.4%	21.1%	21.8%
MCM*	-8.8%	24.3%	13.3%

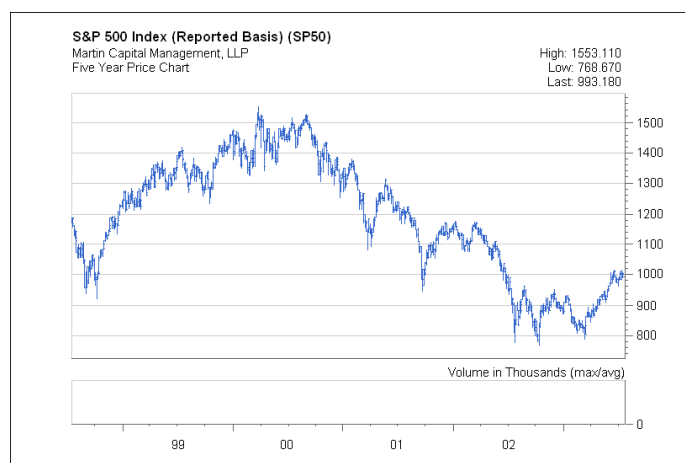
**Excluding Fees*

Sticking with our Baghdad metaphor, a battle has been won, but the investment war may be far from over. A short-term victory emerged from the conflict between reason and emotion. Reason had us looking beyond the turmoil that surrounded us, while emotion tempted us, albeit briefly, to take our eyes off the ball. If we’re to be rational, we have no choice but to look well beyond the moment.

MARTIN

CAPITAL MANAGEMENT, LLP
Registered Investment Advisor

As impressive as the second-quarter market statistics were — particularly when compared with those from the first quarter — we, as always, must put the goings-on in the larger historical context. To be sure, the five-year chart of the S&P 500 below makes abundantly clear that the recent rally doesn't look quite so impressive when measured against the backdrop of five years of market history. In point of historical fact, explosive rallies are indigenous to secular bear markets. The seemingly overnight reversal in crowd psychology from despair to at least temporary optimism is not without ample precedent. Whether what is going on represents the beginning of a new bull market or simply a cyclical rally within a secular bear market cannot be known with certainty until history renders its verdict. What is knowable is that unless the economy is in the early stages of a recovery and expansion, common stocks, in the main, do not appear to us to be cheap.



To shamelessly quote ourselves once again from last quarter's report:

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.

So today, as always, we stay within our circle of competence, we focus on what we believe is knowable, and we follow these simple rules:

1. Stick with easy-to-understand businesses with solid economic models.
2. Stick with businesses managed by people we respect and admire.
3. Stick with businesses that are financially strong.
4. Demand a margin of safety in the purchase price.

So Much for 'Trading Up'

Last quarter's "Capital Markets Review" discussed the potential for making some changes in an effort to increase the overall quality (as measured by our "wish list" of investment criteria) of our portfolio. As it turns out, we ended up sitting on our hands. You may recall that the stocks in our current portfolio that meet the fewest of our investment criteria are Emmis Communications, McDonald's, and Walt Disney. There is little doubt that the companies mentioned as potential investments (Fastenal, Factset, O'Reilly Corp., and FifthThird Bancorp) compare favorably to the above-listed companies. So why the reluctance to take the plunge?

First, like the favorites at a pari-mutuel horse racing track, the "better" horses are typically handicapped accordingly. Likewise with equities, the "better" companies often sport higher (sometimes much higher) P/E ratios. This was the dilemma we faced during the previous quarter. How much more should we pay for the companies that meet more of our investment criteria? Second, while Emmis, McDonald's, and Disney sell relatively low valuations, we expect their business prospects to improve markedly in the months ahead. Thus, we chose to leave the portfolios largely unchanged during the second quarter. So far, in the aggregate, this decision has worked out well, as the stocks we kept have appreciated more than those we chose not to buy. In reality, though, the wisdom of our decision won't be known until well into the future.

Unseen Errors

The fact that we elected not to “trade up” has the potential to be an “unseen error.” Over the course of time, to be sure, we will make many mistakes, some more visible than others. Of course, the more visible errors are those stocks that are purchased but whose business fundamentals never live up to expectations. Even though we try to employ a margin of safety, we will have situations where we might suffer permanent capital losses.

Our experience, however, is that less visible mistakes are likely to be far more expensive (in the form of lost opportunities). These types of mistakes fall into two categories: (1) not buying an attractively priced stock that meets our investment criteria and (2) selling a stock too soon. Someday we may overcome our embarrassment and share with you the first category of unseen errors, but for now we’ll simply confess the mistakes of the second category. Please refer to Exhibit A (Progressive Corp.) and Exhibit B (Heartland Express). In both cases we sold the stock after a relatively short period of time (beyond a year, of course) for roughly twice what we paid for it. However, had we held onto our shares, today we would be looking at a “four-bagger,” to paraphrase Peter Lynch.

We find this instructive for a couple of reasons. First, enough time has elapsed, and the earnings performance of Progressive and Heartland has improved to the extent that it’s obvious that we, in fact, made a mistake. Understand that just because a stock moves higher after a sale does not necessarily mean we made an error in judgment. In an environment of uncertainty there are many times we must distinguish between the quality of an outcome and the quality of a judgment. For example, we may have “swapped” into a more attractive company. Second, the stock may be bid up to uneconomical prices, which we would never be able to anticipate. Finally, if we grow uncomfortable about our conviction regarding the company’s future potential, it is prudent to sell our holding and move on, taking our eyes off the rearview mirror.

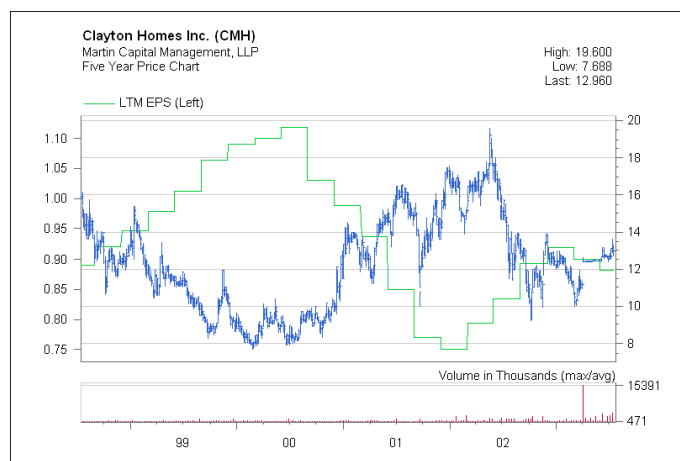
In the cases of PGR and HTLD, while we knew that the fundamentals would recover and earnings would grow significantly into the future, we underestimated the magnitude and timing of the improvement. We sold because the stock was no longer cheap and, indeed, based on the earnings at the time, seemed expensive. Given the

current earnings power of those two businesses and the continued prospects for growth, clearly those stocks were far less expensive than they appeared. As you read some of the profiles of the companies you own, please note the potential for significantly improved earnings. Prospects for significantly improved earnings are what prompted us, at least in part, to hold onto McDonald’s, Emmis Communications, and Walt Disney — for now anyway.

Equity Holdings

Clayton Homes

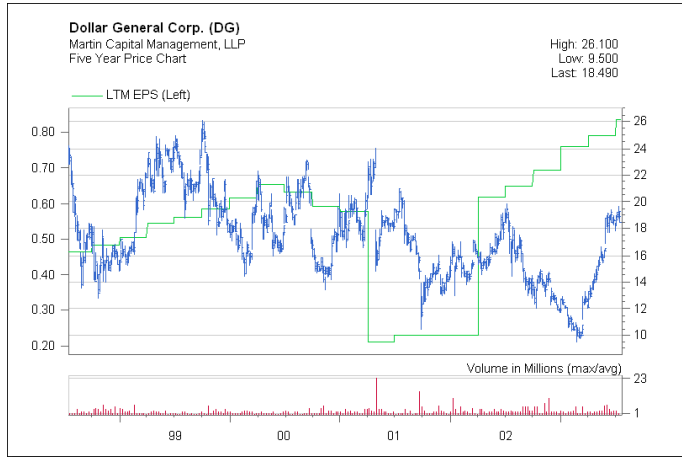
On July 16 Clayton shareholders will decide the fate of the company. If the company is sold to Berkshire Hathaway, a major holding will be turned to cash. Given the difficulty of finding attractive opportunities, it may remain in short-term, fixed-income securities for a period of time. If shareholders vote for the company to remain independent, we will resume our normal reporting on how the company is coping in a very difficult manufactured housing environment.



Dollar General

DG is now our largest holding, in part due to a 50% increase in its stock price since our last quarterly report. The company is moving past some of the execution issues that plagued it over the last few years and is now in a better situation to favorably position itself in what is otherwise an “over-stored” retail industry. DG is competing on the basis of convenience and price. Its easily accessible small-store format is much more

convenient than traditional supermarkets and, especially, large discount stores. Furthermore, prices at DG are much more competitive than other convenience-oriented retail formats, including drug stores and convenience stores.



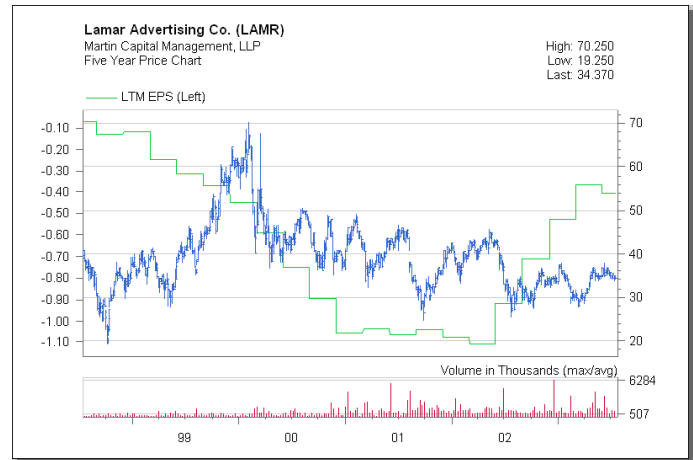
Too, there's ample room for additional growth and margin improvement at DG. Family Dollar (DG's most similar competitor) and DG combined have sales of only \$11 billion, which equals a little more than two weeks of sales at Wal-Mart. Further market penetration, good same-store sales potential, and ample room for geographic expansion should continue to drive sales, and we expect earnings to grow faster than sales for the next several quarters. As DG earnings continue to grow, we expect (over time) that the stock price will continue to advance.

Lamar Advertising

As is common in the advertising industry, the local advertising market (newspapers and billboards) has lagged behind the recovery of the larger national markets. We continue to like the billboard business due to high barriers to entry, terrific margins, and the opportunity for billboards to grow overall share of advertising expenditures. We especially like Lamar's positioning in small and mid-sized markets where media alternatives are fewer in number.

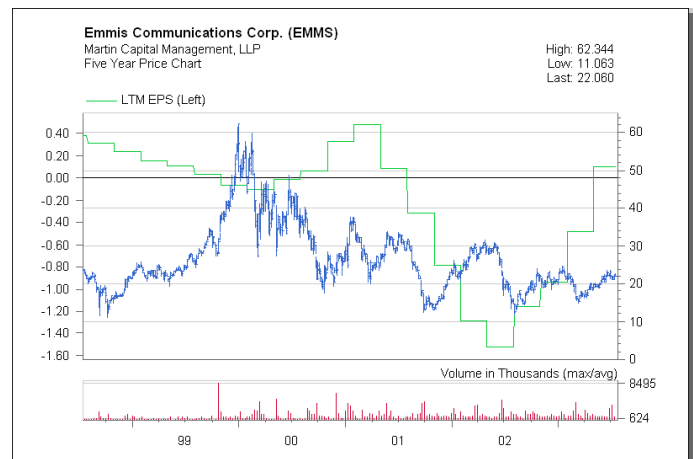
Lamar's management recently noted some improvement in occupancy trends and rates in the poster (vs. highway directional billboards) business, which traditionally is a good sign of a pickup in local advertising. There is enormous operating leverage in this business, and the combination of increased occupancy and higher

advertising rates has the potential to drive earnings and cash flow dramatically higher.



Emmis Communications

On a comparative basis, Emmis is performing quite well. Ratings improvements and aggressive sales effort have allowed the company to grow twice as fast as the markets in which it participates. Even better, like Lamar, the company is beginning to see more favorable trends in the ad markets.



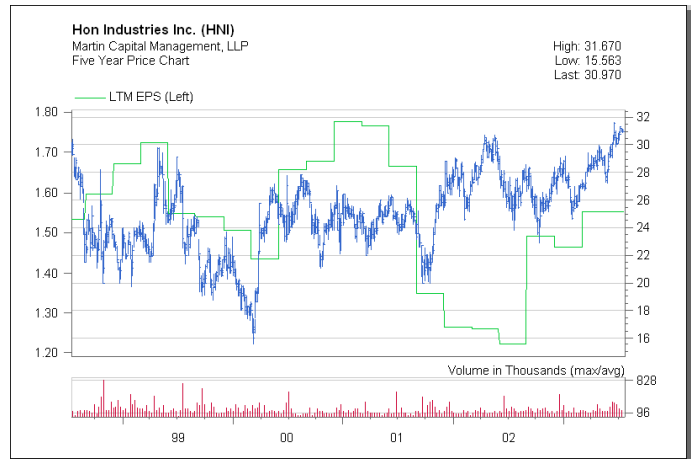
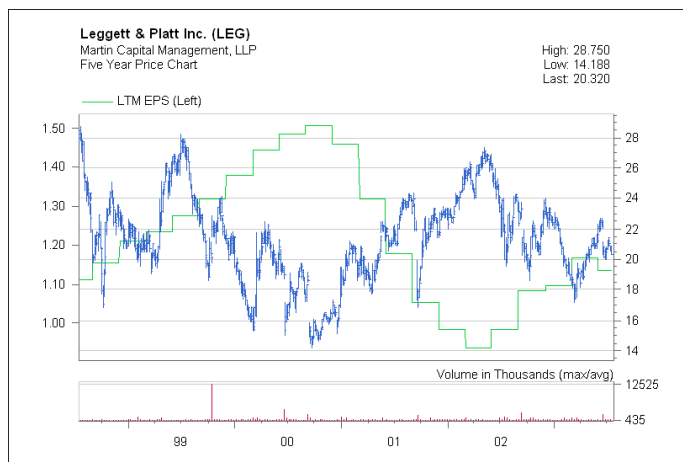
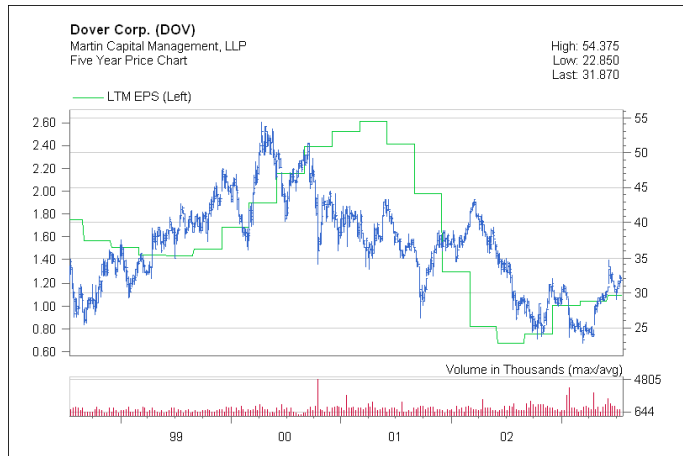
As Emmis has often done in the past, and to Wall Street's mild disappointment, the company plans to increase its promotional budget during its fiscal second quarter. This "investment spending," as the company likes to call it, is intended to continue building on and exploiting the ratings momentum the company has enjoyed over the last few quarters. We have commented in the past that it would be

hard to find better radio properties managed by more capable executives than what we've found at Emmis. We think Wall Street is far too shortsighted, and we continue to expect a healthy earnings growth rate for Emmis as the advertising market recovers.

Manufacturing (Dover, Leggett & Platt, Hon Industries)

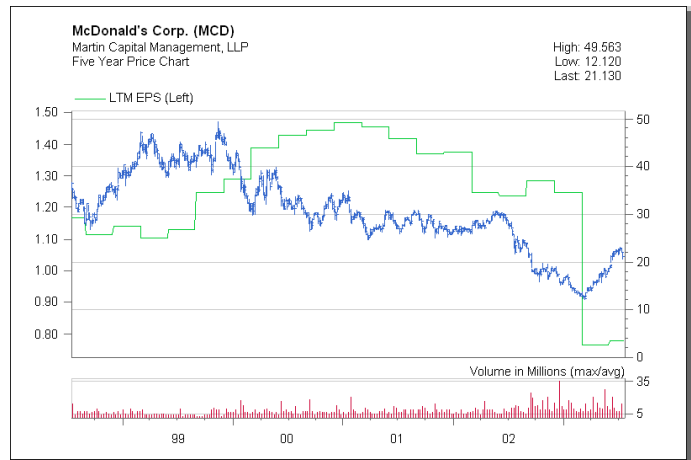
Our manufacturing businesses have yet to experience much of a business recovery. Even so, earnings have been improving due to cost-cutting initiatives that all of these companies have undertaken over the last few years.

The good news is that these companies enjoy strong balance sheets and have ample capital available for acquisitions just at the time when multiples are coming down. As such, a recovery in capital equipment purchases, along with a few choice acquisitions, can produce significant growth in earnings and cash flow. Patient investors are likely to be handsomely rewarded.



McDonald's

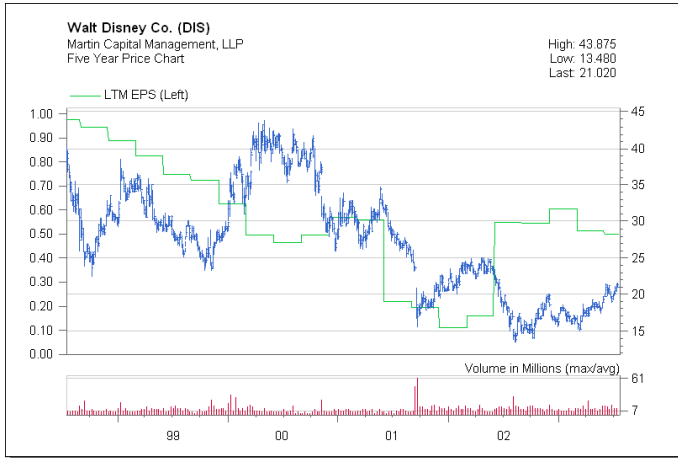
To say the new management team is shaking things up is an understatement. Significant changes in the menu, advertising, growth strategy, and accountability have taken root at the golden arches. While it's too early to know how effective the changes will be, it was a relief to see a 6% improvement in May comp-store sales, the best performance in more than four years. We will continue to closely monitor the turnaround effort, still with an eye toward selling our position. We would simply like to get a better price, given the improved fundamentals.



Walt Disney

Disney has a multitude of businesses, and none of them has been doing especially well. The three largest and most important businesses (ESPN, animation, theme parks), however, have a reasonably good chance to show substantial improvement in the quarters ahead. "Finding

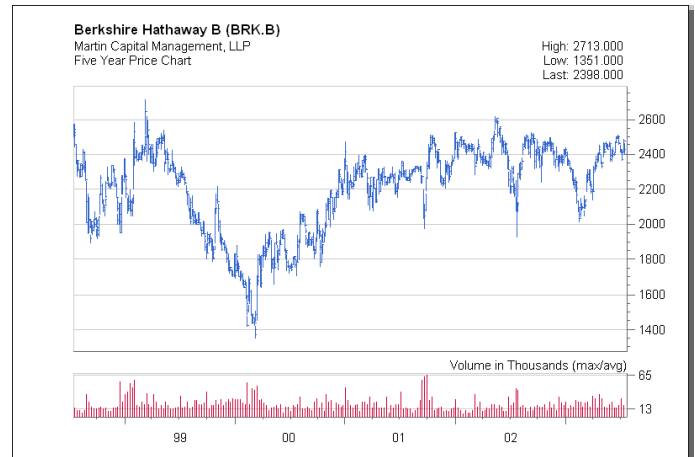
Nemo” may become the best-selling animated hit of all time, which will produce a big bounce at the company’s studio division. At ESPN the price of purchasing sports programming has peaked and should allow margins over the course of the next year. Finally, a recovery in travel expenditures, along with significant updates and new attractions, should fuel a recovery at the Disney theme parks.



Disney has a number of businesses of the “no-brainer” variety. It would be very hard for competitors to damage Disney’s synergistic combination of theme parks and animation. That’s why Universal and others chose to follow Disney to Orlando a number of years ago in hopes of catching a few crumbs from the table. Likewise, it just doesn’t make any sense to take on ESPN “head to head.” This is a chicken/egg problem. One would need billions of dollars to purchase the programming required to attract an audience, but you need an audience to justify the expenditures to pay for the programming. Once again, we believe that patience will be rewarded.

Berkshire Hathaway

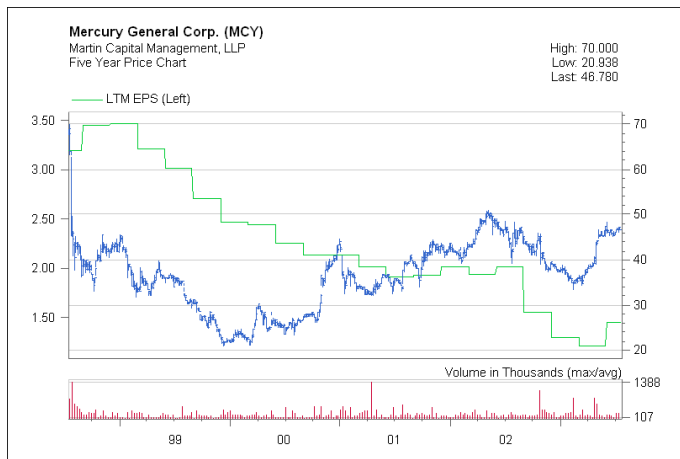
We concluded last quarter’s commentary on BRK with the idea that this company is the closest we can find to being indestructible. This may sound strange for a company that has a very large insurance business. Indeed, it is a foregone conclusion that the company will take a \$1 billion loss (or more) someday for a California earthquake or a hurricane that strikes Long Island. However, unlike other insurance companies that depend on the ability of reinsurers to pay their bills, BRK knows exactly the nature of its exposure to various catastrophic events.



What’s more, the company has become increasingly diversified. Seven years ago non-insurance operating companies produced a few hundred million in earnings. Now they represent in excess of \$4 billion in earnings ... and counting. Finally, BRK has an \$80 billion investment portfolio with nearly \$35 billion in cash. In a sense, the worse things get, the better the outlook for Berkshire. This is the type of company where a substantial position would not make us nervous in the least. We’ll see if the stock gives us an opportunity.

Mercury General

This auto insurance company is really beginning to roll. The company reported sales and earnings up 28% and 47%, respectively, in 2002. Perhaps more importantly, every MCY market (except for the recently entered markets of New York and Virginia) reported underwriting profits. Eventually, the profitability of the auto industry will allow even the high-cost competitors to make a little money. Soon after, premium rates become a lot more competitive, and we will begin to look for signs of the end of the underwriting up-cycle. However, we believe it’s way too soon to begin worrying about that. Therefore, sit back and enjoy watching the earnings roll in.



New Ideas

We continue our analysis of myriad businesses, of which only a few make it through our filters. Our research team is becoming better calibrated all the time, able to more quickly discern the types of businesses about which we can more confidently make long-term forecasts. We have found what we believe to be a plentiful supply of good to great businesses, but (with the recent recovery in stock prices) most of these businesses have asking prices above what we consider to offer a reasonable margin of safety. If the market continues to recover into the third quarter, you may see us take some profits without any immediate plans for reinvestment. In that case, instead of “trading up” we’ll be “trading out.” Our experience tells us that patience is usually rewarded in waiting for opportunities, as well as in exploiting them.

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