

# capital markets review

QUARTERLY

## Business as Usual

Continuous improvement processes, though they go by various names, have become widespread throughout American industry as we struggle to maintain competitiveness with other countries that have lower labor costs. Beyond the ongoing and aggressive investment in advanced education, another form of continuous improvement at Martin Capital takes the form of calibration. Synonyms for calibrate include *synchronize, standardize, adjust, align, balance, condition, correct, and fix*. Our process works by asking our analysts to be specific in regard to forecasts of profitability and growth for the companies we continuously monitor.

Over time, as the data accumulate, we can gain a sense of whether we are systematically too conservative or, generally worse, too optimistic as it relates a particular company or industry. The process of calibration demands that we consciously think about what we know or, more importantly, don't know regarding the future prospects of the many businesses we follow on a regular basis. As you are not a participant at our research meetings, you might find it helpful, as we do, to reread prior Quarterly Capital Markets Reviews to look for evidence of an ongoing effort to calibrate our thinking.

One of the problems with making market or macroeconomic forecasts is that it's difficult to

arrange the data in a way that makes the process of calibration meaningful. There tend to be too many moving parts that prevent the accumulation of data, with regard to a particular circumstance or scenario, to make the process useful. For example, the idea of "don't fight the Fed" once led people to believe that as long as the Federal Reserve was accommodative, the stock market would keep going up. After all, it certainly worked in the 1980s. It hasn't worked in the 2000s. Thus, the idea of calibration begins to break down with the profusion of sometimes-extraneous and sometimes-relevant data as it relates to market and macroeconomic forecasts. Every period of time tends to have a number of circumstances unique to that period that makes "rules of thumb" judgments unreliable.

As a result, we're inclined to ignore market-related forecasts and concerns. We avoided the Internet and high-tech hype in the late 1990s because we didn't feel we understood the economics of the related industries. Of particular note, we didn't understand the valuations. On the flip side of the coin, during the height of apprehension over the impending Iraqi war, investor concern was reflected in lower stock prices. While we didn't have any special insight into the conflict's eventual resolution, our approach of buying high-quality

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companies at good prices led us to purchase stocks in the face of adversity without feeling compelled to know the future outcome of the concerns of the day. In short, we won't disregard what we believe to know something about (e.g., that a company like Dollar General is very likely to keep growing for several years) because of unknowable shorter-term concerns about the market, economies, and geopolitical events.

## The Markets

A blistering start to the quarter turned into a frosty end, leaving indices modestly positive for the quarter. The market was encouraged by clear signs of economic recovery in July and August, but by the end of September concern about stock market valuation and the less than ebullient pace of the resurgent economy dominated the investor psyche. We have no idea how the year will end, but we're encouraged by the improvement in the earnings we have seen in most of our portfolio companies. Our general view is that the stock prices of many of our holdings reflect a reasonable approximation of intrinsic value, so we'll need to see continued improvement in the earnings of our portfolio holdings if we're to achieve reasonable investment returns. We own outstanding companies and, absent a prolonged economic slump, we consider it highly likely that our companies will deliver.

|            | <u>Qtr.</u> | <u>Year</u>  | <u>5-years</u> |
|------------|-------------|--------------|----------------|
| S&P 500    | 2.6%        | 24.4%        | 1.0%           |
| Nasdaq     | 10.2%       | 53.1%        | 1.4%           |
| <b>MCM</b> | <b>3.1%</b> | <b>23.8%</b> | <b>21.2%</b>   |

The equity performance for our portfolios mirrored the market during the quarter, leaving us with good gains for the year, which are modestly in excess of the S&P 500. The table above illustrates our results for the quarter, year, and last five years. We think you should know that, at least for the foreseeable future, the opportunity to outperform the equity market pales in comparison to what we achieved over the past five years. Those last five years were a unique period that incorporated a bubble of historic proportions. The valuation gap between the types of companies we're naturally attracted to and those that dominate the performance of the S&P is no longer conspicuously large. As such, we would be surprised to see consistent year-in, year-out performance that exceeds

the popular indexes. Over time we strongly believe that outstanding companies bought at reasonable prices should produce superior results, but there will likely be periods in-between that will be less favorable. Forewarned is forearmed.

## The Value of Growth

Longtime clients understand that value and growth are, as Warren Buffett likes to say, "joined at the hip." In other words, growth is an important component (if not the key component) in any calculation of intrinsic value. When we think about growth, we're concerned not only with the rate of growth but also the duration of growth. Without going through the math, we know that a company that can grow at a good rate for a long time is very valuable. Indeed, in this context, a P/E multiple of 20x could represent good value.

The problem is that there are very few companies that we believe are capable of growing at solid double-digit rates for long periods of time (in excess of 10 years). With the benefit of hindsight, we know the companies that have a long history of solid growth. The problem is we're not sure how many of those we would have predicted. We suspect there are a few. In like vein, while there will be a reasonable number of such companies in the future, there are but a few where we would be willing to bet on such an outcome. These companies display two key characteristics: (1) a growing market, a very large and highly fragmented market, or some combination thereof and (2) a durable competitive advantage. If, at some point, you see company in your portfolio that sports a higher P/E than is customary for MCM, remember that high growth comes at a price that we are sometimes willing to pay if our confidence in the outcome is high.

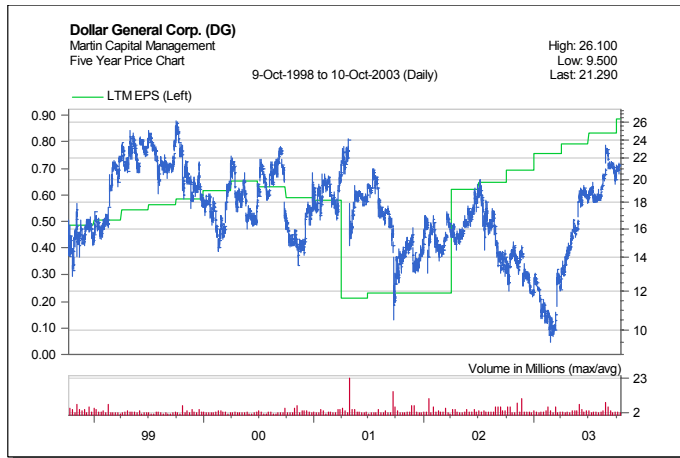
## Equity Portfolio

### *Dollar General*

DG competes on the basis of price and convenience, and that combination continues to deliver good results. The company reported an increase in EPS of 53% for its latest quarter. The company was aided by an unusual improvement in gross margin, at least in part due to an

accounting quirk, that will be reversed in DG's third and fourth quarter. Fundamentally, when you get below the surface, the company continues to grow at a low-to-mid teens rate, which we believe will be sustainable for several more years.

The top three management positions at DG have changed since the retirement of founder Cal Turner approximately six months ago. Our initial impressions of the new CEO, David Perdue, are favorable, but we'll know more when we visit the company in mid-November. Within the last few weeks, Perdue has named a new president and executive vice president from outside the company. Needless to say, we're monitoring developments closely, but we strongly believe that Dollar General has built-in momentum working in its favor.

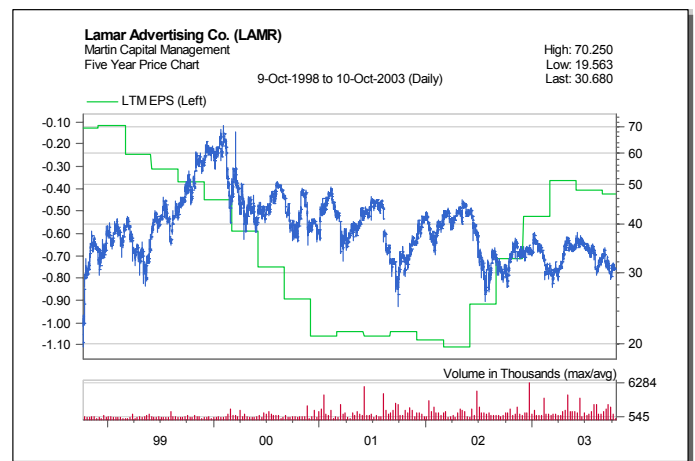
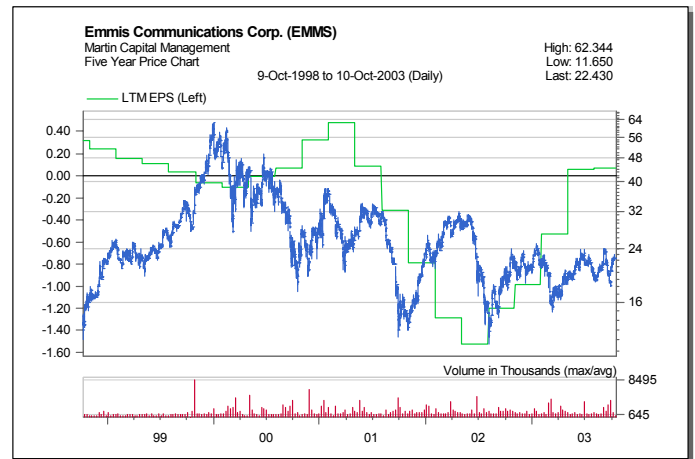


**Media (Emmis and Lamar)**

Continued sluggishness in local advertising has slowed the recovery in earnings for Emmis and Lamar. Though it isn't uncommon for local advertising to emerge from a recession later than its national advertising counterpart, patience appears to be wearing thin on the part of investors. Overall, we hold fast to the belief that radio and outdoor (billboard) media will gain share at the expense of newspapers and television.

Lamar is the dominant billboard company in many small and medium-sized media markets. In some cases, it's the *only* billboard alternative. Thus, the company boasts handsome margins and terrific cash flow. Cash-flow margins in the last quarter were above 45%, and that's even before an industry recovery.

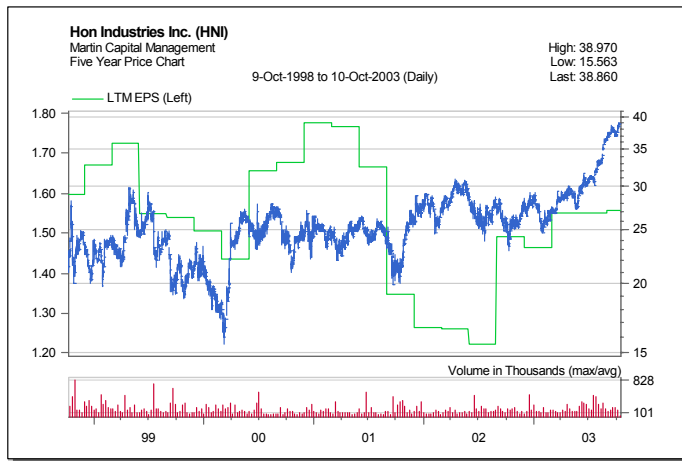
While the overall trends for Lamar have been consistently lackluster, the trends at EMMS are much more favorable due to exceptional operational performance. Ratings improvement at almost all of the Emmis radio and television stations are driving superior results and bode well for earnings over the next several quarters. Therefore, in making the case for both EMMS and LAMR, we think it's simply a matter of time — along with sustained economic recovery — before the earnings results become more exciting.



**Manufacturing (Hon Industries, Leggett & Platt and Dover)**

Most manufacturers have become a bit more optimistic of late. While channel inventories continue to drop, order patterns have begun to rebound. Indeed, this combination strikes us as a recipe for a more vigorous recovery in the industrial sector.

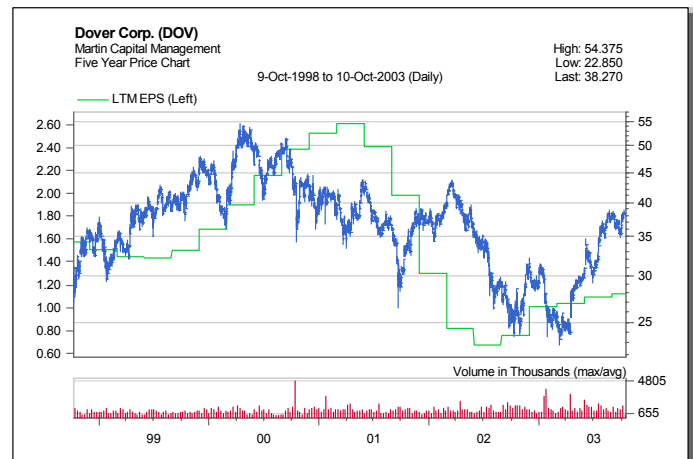
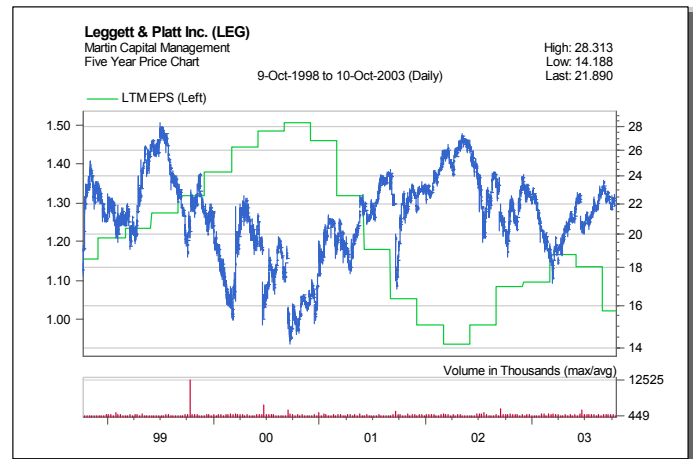
We own three outstanding manufacturing companies, as evidenced by stellar long-term track records. All three companies enjoy strong balance sheets and plenty of experience in executing acquisition-driven growth strategies. We are, however, paying close attention to (1) what we perceive to be a slowing in the pace of acquisitions and (2) competitive issues related to China. We believe the pace of acquisitions has slowed because of the extended downturn in the manufacturing sector. Entrepreneurs are understandably reluctant to sell their companies in such a depressed state. The China question demands a little more explanation because it doesn't apply uniformly to our companies.



China can affect U.S. manufacturers in multiple ways. China enjoys a number of advantages besides its seemingly endless supply of cheap labor. Chinese manufacturers are largely free of regulatory constraints and, because of certain U.S. tariffs (notably steel), raw materials can be purchased more cheaply in China. However, some product categories are largely insulated from international competition due to size/volume considerations relating to shipping, just-in-time delivery requirements, and/or products that have low labor content. Many of the products manufactured by Hon and Leggett & Platt (office furniture and box springs, for example) in varying degrees fall into that category. Hon and Leggett also source complete products and component parts from international sources when it's cheaper to do so.

Of the companies we own, Dover is by far the most affected by the boom in Chinese manufacturing. Much of the final assembly of electronics (PDAs, cell phones, etc.)

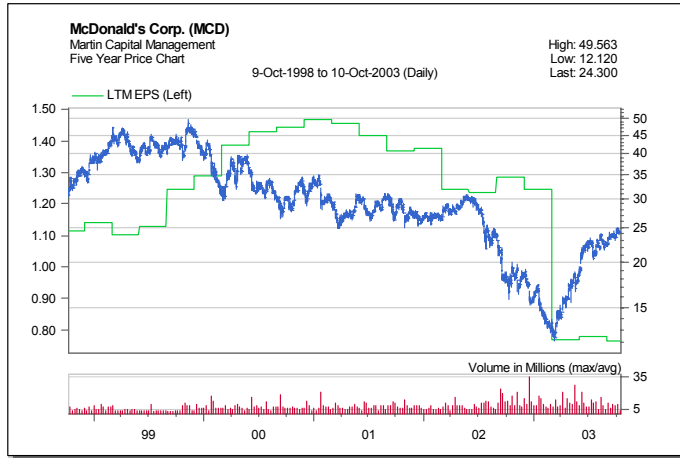
has moved to China, and component suppliers have set up shop to stay close to their customers. Dover Technologies (the division represents 25-30% of sales), as a supplier of specialized capital equipment and materials to this industry, has followed suit by moving a significant portion of its production to China. Approximately 40% of Dover Technologies' production now originates in China. This is in stark contrast to its negligible presence there just 2-3 years ago.



**McDonald's**

The new management team at McDonald's has communicated several months of very positive business performance. We attribute greatly enhanced same-store sales to a "beefed up" menu, some discounting, and more accountability, all of which have bettered a variety of execution issues. We'll get our first hint of whether the improved top-line performance has been converted to

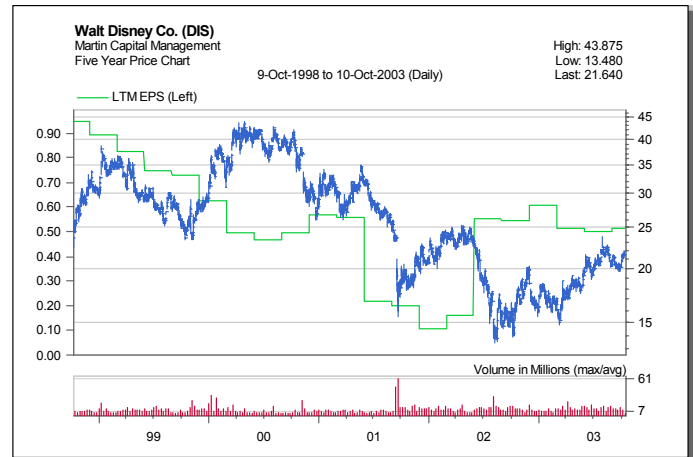
bottom-line results when the company reports its third quarter earnings in October.



While we're impressed with the turnaround at McDonald's, we're still concerned about the company's long-term growth prospects. Therefore, we're much less willing to hold the stock at higher P/E ratios. Once we get a peek at what we expect will be an improved earnings outlook, we'll be in a much better position to evaluate the price relative to the company's earnings potential.

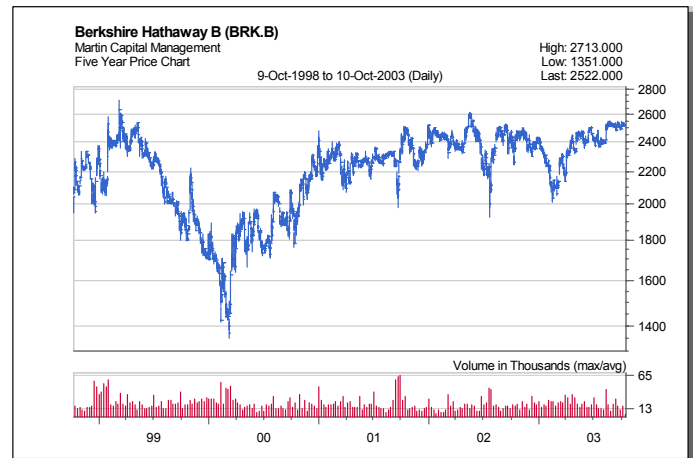
**Walt Disney**

Disney finally scored some hits in this summer's box office competition. We can only hope that the company will begin hitting on a few more cylinders during the next few quarters. Movies are important to Disney, but the results of the cable properties (especially ESPN and the Disney Channel) and the resort business are the real drivers of earnings. They're also among Disney's most unique businesses, making it difficult for competitors to stay in the ballgame. Imagine trying to compete with Disney in the theme park business! Indeed, rivals locate in Orlando in hopes of feasting on table scraps. Likewise, the competitive positioning and growth prospects for Disney's cable properties are impressive. Eventually, we believe the media and travel markets will recover, and with them, Disney's earnings.



**Berkshire Hathaway**

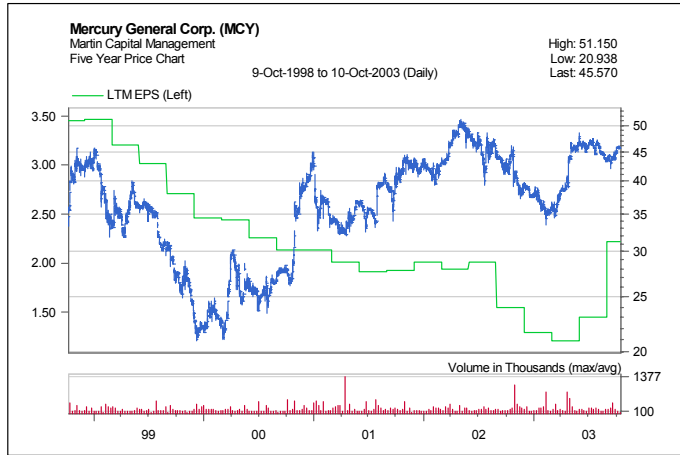
There's nothing new to report at Berkshire. The transaction with Clayton Homes has been completed, which continues the long-term transformation of Berkshire from an "insurance company with a large investment portfolio" to a company that is an unusual conglomeration of good businesses. Oh, yes, BRK still has a very large investment portfolio (nearly \$90 billion).



**Mercury General**

MCY is in the sweet spot in the auto insurance underwriting cycle. EPS increased more than 30% in the latest quarter due to revenue growth in excess of 25%, along with long-expected improvement in operating margin. The industry-wide premium rate increases that have been responsible for the growth of MCY and Progressive (consumers shop more when premiums go up) are beginning to moderate, so we would expect revenue

growth to slow to something closer to 10-15% for a period of time. It's always difficult to predict margin trends, but it would surprise us if we saw any deterioration in margin for the next several quarters.



We also have become more optimistic about Mercury General's growth prospects beyond its core California market. After a few years of struggling in Texas and Florida, both the growth rate and profitability in those markets have demonstrated significant improvement. MCY's plan is to continue, over time, a methodical expansion into many other states. This development has caused us to raise our estimates of the long-term growth potential of the company.

## New Ideas

There are many companies that, at any given point in time, exhibit wonderful economics. The challenge is to find companies that we believe are likely to deliver outstanding results well into the future. There are significantly fewer companies that fall into the latter category because many businesses eventually falter with the slightest headwind — or they fall victim to changes in the competitive dynamics of the industry. Walgreen is one of those special companies that we believe can grow at a good rate well into the future. It is no accident that we mention Walgreen in the same report as the discussion on the price of growth. These growth companies rarely sell at bargain-basement prices, so our return will more likely come from a growing earnings trend that makes the company more valuable over time.

Correspondingly, the idea of margin of safety differs somewhat from the more familiar “discount to intrinsic value” thesis. In some situations, the economic characteristics of the business lead to stable competitive dynamics, which can be equally compelling from a margin-of-safety perspective to a business with a less certain outlook purchased at what we believe to be a discount. Don't be surprised if, over time, you see what appears to be a high-priced stock in the portfolio. Simply know that our conclusion is that it's worth every penny!

## Website Information

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\*Updated October 2003