

# capital QUARTERLY markets review

## First Quarter Capital Markets Review

Stalemate. That pretty much describes the performance of the financial markets during the first quarter. Terrorism and geopolitical worries once again raised the level of immediate concern for the markets, a condition that largely offset strong earnings growth and otherwise healthy economic indicators. The S&P 500 was up a little more than 1%, and the Dow Jones lost nearly 1%. Our equity portfolios were down roughly  $\frac{1}{2}$  of 1%.

From a longer-term perspective, we continue to believe that generally high valuations for stocks will weigh heavily on future market direction. To the extent the economy heats up and interest rates rise as a result, the bond market will be negatively impacted as the present value of future interest payments will be worth less. The negative influence associated with increasing interest rates applies to stocks, bonds, real estate, and every other income-producing asset. Risk-free rates of return are the "opportunity cost" for all alternative investments. Consequently, over the short to intermediate term, we would expect headwinds of one sort or another.

That said, we have more ongoing research projects than at any other time in our history, as we continue to refine our inventory of excellent businesses. We have little doubt that, in the short run, our returns will be determined primarily by the overall market ... for better or

for worse. As discussed below, however, the longer one's time frame, the more the portfolio results will be dictated by the business results of the companies in our portfolio. That will continue to be our major focus.

### Equity Review

We were generally quite pleased with the earnings progress of our portfolio companies during 2003. On a weighted average basis, "consolidated earnings" growth was slightly more than 20%. Much of the improvement can be attributed to an improved economy and meager profits for some of our companies during 2002 that make comparisons easy. As such, we don't believe the intrinsic value of our portfolio companies grew at the same rate of earnings. The growth of intrinsic value of the portfolio was more likely in the low double-digit range. We would expect more of the same during 2004. Indeed, we wouldn't be surprised if portfolio earnings growth surpasses last year's 21% performance. Once again, though, given the reality of the cyclical earnings patterns of several of our holdings, intrinsic value is likely to grow less than the rate of earnings growth. Conversely, we don't believe that the earnings declines for several of our holdings during the 2001-02 period were indicative of any erosion in intrinsic value.

MARTIN

CAPITAL MANAGEMENT, LLP  
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We're indifferent regarding two companies that grow over time at the same rate, irrespective of whether the earnings growth is steady or lumpy. Wall Street, on the other hand, has a strong preference for the former and is willing to pay significantly higher multiples for companies that can deliver good earnings growth every quarter. Indeed, it's easier to assess the growth of intrinsic value for non-cyclical companies. Several of our holdings (Dover, Hon, Leggett & Platt, Emmis, and Lamar) are sensitive to the business cycle, and it's impossible to grow earnings each and every quarter. The key to tracking growth of intrinsic value is whether or not the earnings achieve higher peaks and higher valleys with each economic cycle. We're willing to live with the quarter-to-quarter earnings uncertainty in exchange for lower multiples (prices). As the table below illustrates, the key is long-term earnings growth. In the long *run*, little else matters.

Before reviewing our portfolio companies, we'll make one final point. Recall from the 2003 annual report that our average equity portfolio increased more than 33% last year. It becomes rather obvious from the aforementioned discussion that the stocks outperformed the businesses during 2003. That, of course, is unsustainable. Our portfolio is not as cheap, generally speaking, as it was a year ago at this time. Unless the prices of our individual companies rise to a level where future expected returns are

less than satisfactory, we will maintain our current posture. Remember, two conditions necessitate an immediate sale: (1) The price rises to such a high level that the five-year expected return drops into the mid-single digits or less, or (2) we lose confidence in the business (we will sell at virtually any price if this condition occurs).

## Equity Holdings

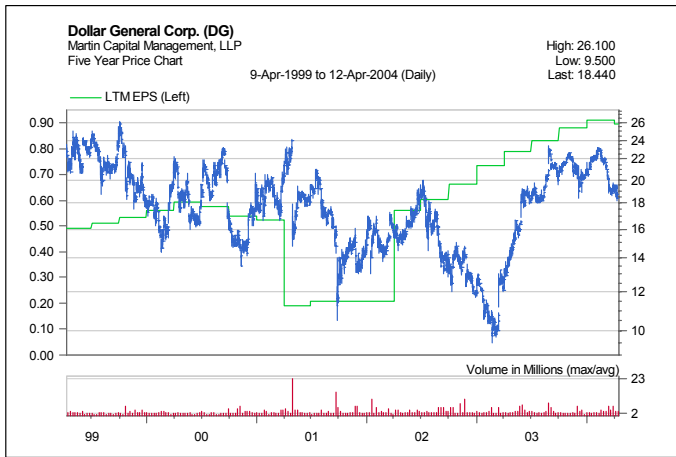
### *Dollar General (DG)*

DG is performing very well and continues to solidify its competitive position in the price/value retailing spectrum. DG is *not* a "dollar store." It has more in common with a 7-Eleven than a Dollar Tree store. It is more of a convenience store with expanded merchandise and much sharper pricing. Some retail concepts can compete purely on the basis of convenience (7-Eleven) and others on price (Wal-Mart), but the combination makes DG a very tough competitor. The company is growing its store count at a rate of 9-10%, which, when combined with same-store sales growth of 3-5%, gives it a very handsome core growth rate. As an added bonus, we believe that there's room for modest margin improvement over the next few years.

### EARNINGS GROWTH

### STOCK PRICE APPRECIATION

Company	1988 EPS	2003 EPS	Annual Growth Rate	Avg. Price 1988	Avg. Price 2003	Annual Growth Rate
General Motors	\$ 6.82	\$ 5.10	-1.9%	37	38	0.2%
Cooper Industries	\$ 2.20	\$ 2.80	1.6%	28	40	2.4%
Sears	\$ 3.84	\$ 4.80	1.5%	38	39	0.2%
Louisiana Pacific	\$ 1.18	\$ 1.95	3.4%	10	13	1.8%
Wisconsin Energy	\$ 1.94	\$ 2.25	1.0%	17	28	3.4%
Ryder System	\$ 2.27	\$ 2.05	-0.7%	28	26	-0.5%
<b>Average</b>			<b>0.8%</b>			<b>1.2%</b>
Fifth-Third Bancorp	\$ 0.35	\$ 3.00	15.4%	4	50	18.3%
Walgreen	\$ 0.13	\$ 1.12	15.4%	2	30	19.8%
Johnson & Johnson	\$ 0.36	\$ 2.65	14.2%	6	50	15.2%
Expeditors	\$ 0.08	\$ 1.10	19.1%	1	32	26.0%
Fastenal	\$ 0.04	\$ 1.10	24.7%	1	34	26.5%
Coca-Cola	\$ 0.36	\$ 1.94	11.9%	6	42	13.9%
<b>Average</b>			<b>16.8%</b>			<b>19.9%</b>



DG has a solid balance sheet and ended the year with more cash than debt. The company generates more than enough cash to fund its growth. Indeed, DG is in the enviable position of being able to grow the business at a healthy clip *and* repurchase shares. The management team has cautioned investors that a number of new programs and initiatives are under way at the company that could cause a hiccup in earnings growth during the coming quarters. We are relatively unconcerned about these cautionary statements and remain enthusiastic about DG's long-term prospects.

### **Dover (DOV)**

DOV has had a tough ride the last few years. Earnings for 2003 were 40% lower than the peak in 2000 (a level we viewed then as unsustainably high). While it's difficult to see the progress the company has made, we believe that the long-term earnings power has been enhanced. The company, which grows by acquisition, has always used downturns to improve its businesses, especially those acquired during the upswings. For example, the company has consolidated facilities, and, in the case of its high-tech equipment/component businesses, moved production to China. The company has reduced its headcount by 20% since 2000 and will emerge from the recession with a radically lower cost structure. Just as important, though earnings have been depressed, DOV has set records for cash flow, which will allow the company to continue to execute the acquisition aspect of its growth strategy. The market for businesses has been sparse during the downturn because many owners are reluctant to sell as business valuations are falling. However, there are signs that, coincident with the bottoming of the industrial capital

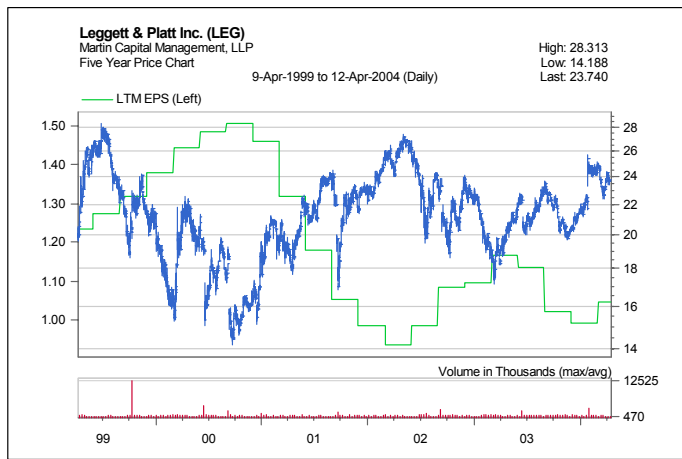


goods market cycle, acquisition opportunities are beginning to surface.

### **Leggett & Platt (LEG)**

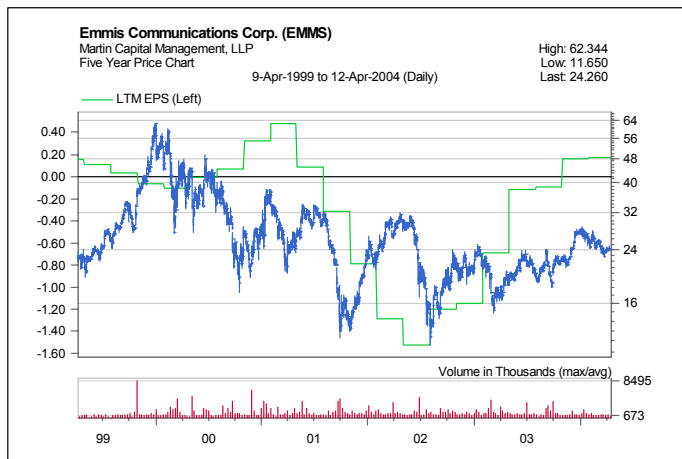
LEG had a disappointing year in 2003. Steel is the primary raw material in many of LEG's products, and for a number of months the company was reluctant to raise prices due to an original perception that high steel prices were merely transitory. Finally signaling a belief that high prices are here to stay, management instituted price increases in the fourth quarter. In addition, LEG's commercial fixtures division has been a miserable performer, in part because of poor execution and in part because of an extended and deep slump in market demand. In terms of execution, this division has received management's full attention and energy, and significant structural improvements are clearly on the horizon. We're not certain when the end markets will recover, but our research would suggest that significant pent-up demand exists.

Like Dover, LEG has recorded record cash flow while it has reduced costs during the recession. For comparison purposes, both LEG and DOV increased their earnings more than threefold during the five years following the last earnings downturn in '91. We don't know with any specificity what the next five years will hold for LEG, but we are optimistic that we will be generally correct about significant earnings growth from 2003 levels.



**Emmis Communications (EMMS)**

Emmis has performed very well in an environment of reduced local advertisement spending. In the radio and television business, revenue follows ratings (how many ears are hearing and eyes are seeing the advertising messages). This is where Emmis excels, and 2003 was no exception. Rating increases have allowed the company to outperform its competitors pretty much across the board. Indeed, Emmis was the only TV station group in the nation to increase revenue during 2003. (Odd years are tough comparison years due to reduced political spending and the absence of Olympics coverage.)



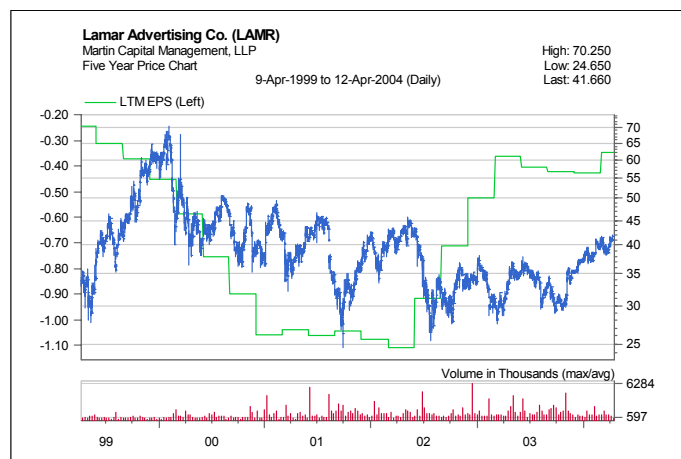
We expect Emmis to enjoy robust earnings growth in 2004 as the local advertising market recovers from two years of lackluster results. Emmis owns great radio stations in some of the best markets and has, in our view, shown an ability to significantly improve the radio and TV stations it

has acquired, albeit at extravagant prices. Thus, we will carefully monitor the company’s use of the cash generated from its businesses.

Increasingly, we have been asked about the impact of satellite radio on the radio broadcasting business. While we continue to monitor developments in the satellite medium, we think it will be some time before we see much meaningful impact on broadcasting ratings. Moreover, network TV ratings have been declining for many years, without much impact on advertising spending. We expect the same, at least for a while, in radio broadcasting, given that satellite radio is ill-suited for local advertising at this stage of development.

**Lamar Advertising (LAMR)**

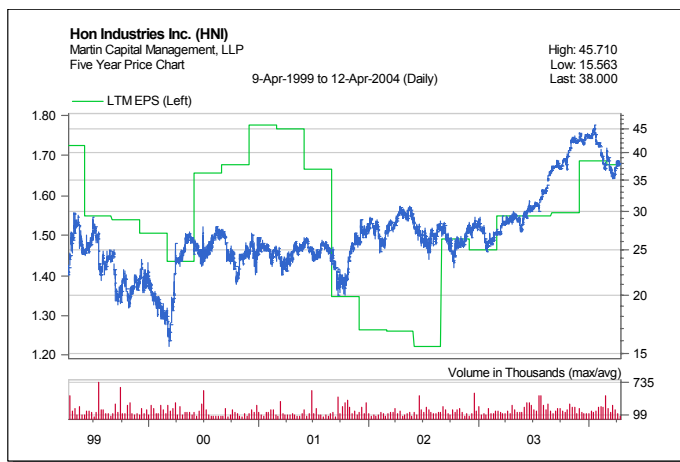
The recovery in local ad spending will clearly provide a boost to Lamar’s earnings. Occupancy rates already are beginning to improve, and pricing will closely follow. At the outset of the decline in advertising demand (in 2000), LAMR management made the critical decision to hold the line on pricing so as not to “train” the market to look for discounts. Clearly, this produced wider swings in occupancy rates during the downturn. The market is recovering nicely, however, and LAMR’s salespeople are on the offensive, pushing occupancy instead of occupancy and price. The billboard business is quite lucrative, with very high margins and operating leverage. Earnings will improve quite rapidly as occupancy rates increase. Moreover, the billboard “medium” is not threatened by new technology (e.g., satellite radio) or fragmenting audiences (television). Among all media, it continues to be the lowest cost way to reach potential consumers.



Further, we have high regard for management, which has been retiring debt with excess cash flow. We concur with this strategy and will be curious to see how the company responds to the issue of capital allocation, given the reduced acquisition opportunities in the billboard industry.

**Hon Industries (HNI)**

Last year was a mixed bag for Hon. The office furniture industry, Hon’s largest business segment, continued to swoon (an unprecedented third straight year of decline). The good news is that Hon performed exceptionally well in that environment. The company continued to gain market share and has actually improved its profitability in the office furniture segment despite significant industry contraction. Hon’s hearth business was solid, no doubt reflecting the housing construction boom and significant new product development.

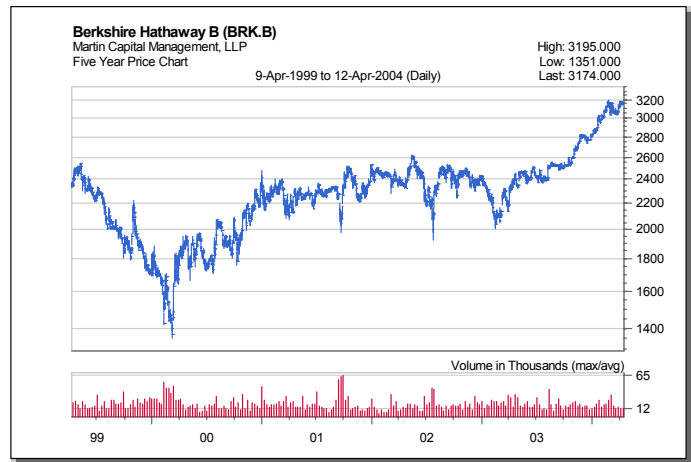


Hon’s pretax return on capital was more than 23% in 2003 in what was not exactly a great year for the company. Over the last three years the company has generated \$470 million in free cash flow (after all capital expenditures) while using roughly \$650 million to \$700 million in total capital. Hon is basically debt free, even after an \$80 million acquisition that closed in January. There will be more acquisitions.

We like this company and its management team, but at prices in the low- to mid-\$40s, we attempted to sell a portion of our holdings earlier in the quarter. Unfortunately, the trading volume was too thin. At current prices we’re content to hold our position.

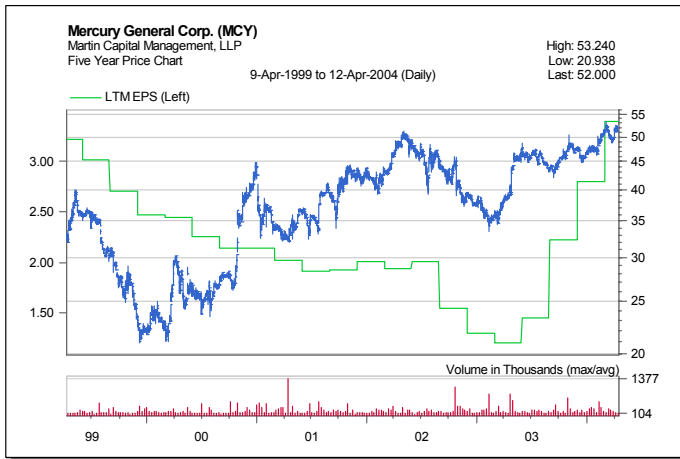
**Berkshire Hathaway (BRK.B)**

Berkshire continues to transform itself from an overcapitalized insurance company with a large investment portfolio to a holding company full of “wonderful businesses” ... that still has a large investment portfolio. Berkshire has become a very large company with \$60 billion in revenue and \$180 billion in assets. Obviously, Warren Buffett doesn’t have a chance, as he constantly reminds investors, of continuing to compound Berkshire’s net worth at a rate north of 20%. Nonetheless, Berkshire generates huge amounts of cash, which, along with \$30 billion in existing liquidity, represents significant untapped potential. If economic or market conditions deteriorate, there will surely be more opportunity for Buffet to put shareholder money to good use. In this context, the worse things get, the better Berkshire Hathaway will ultimately be.



**Mercury General (MCY)**

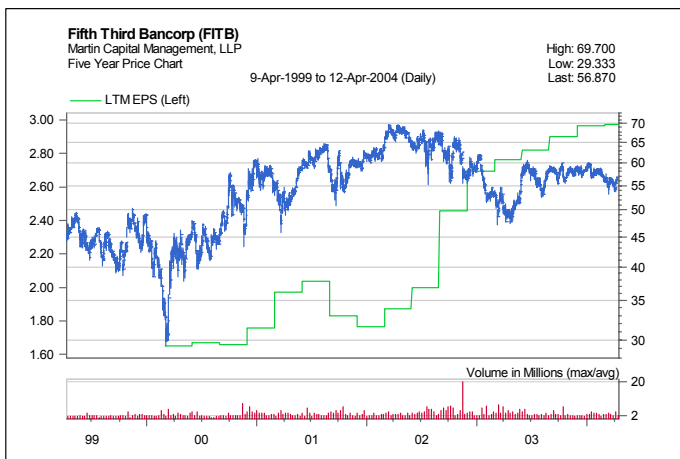
The earnings power of MCY’s automobile insurance franchise has become self-evident. EPS has increased very nicely and now approximates something close to a level we would call “normal.” In addition, we have been pleasantly surprised by the company’s ability to profitably grow in states outside California. George Joseph, the company’s 81-year-old CEO, continues to work every day. He is, however, beginning to slow down. He recently relinquished the title of president to another company veteran, Gabe Tirador, who at 39 is a *much* younger veteran.



## Newer Holdings

### *Fifth Third Bancorp (FITB)*

We're very pleased to add this terrific bank to our portfolio. Over the last 10 years FITB has increased earnings at a rate of 17% per year. During the last five years the stock market has rewarded the company with a multiple of 25-35x earnings, virtually unheard of for a bank. What we believe to be a relatively immaterial regulatory/accounting problem — particularly from a longer-term perspective — took the bloom off the rose and allowed us to build a position at more reasonable prices.



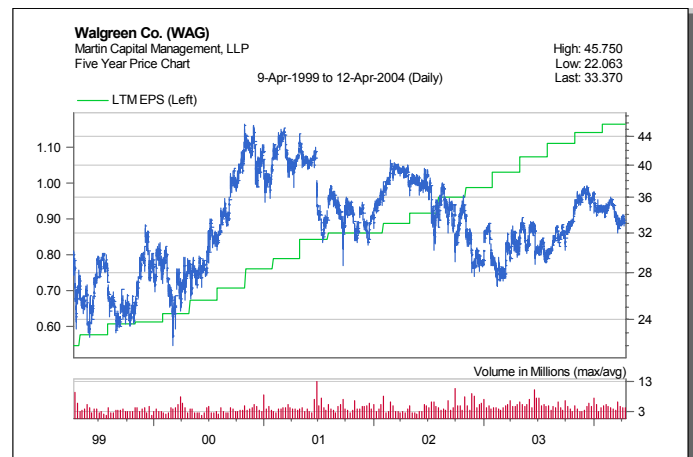
For many years the bank with the odd name has nurtured a performance-oriented culture that differentiates the bank in various ways. Exceptional expense management, an aggressive sales approach, and attractive non-interest

income sources make this one of the most profitable banks in the industry. We think there remains considerable growth potential; the company has a small geographic footprint (Ohio, Kentucky, Indiana, Michigan, and Illinois), with only a 7% share in its existing markets.

FITB has a strong capital base, an outstanding history of credit quality, and we believe the bank has positioned its balance sheet to profit from rising interest rates. Conventional wisdom says stay away from financials in a rising interest rate environment (something we think will eventually happen), but rising earnings will always, eventually, override Wall Street rules of thumb. A research report will be available soon.

### *Walgreen (WAG)*

With the purchase of WAG, we set a new record for Martin Capital, one we don't necessarily plan to break. Never in our history have we paid such a price relative to earnings. This is a testament to our confidence and expectations regarding (1) rapid EPS growth and (2) how long the company can sustain it. Walgreen is simply *the* class act in the distribution of pharmaceuticals. It's also a very good retailer of general merchandise.

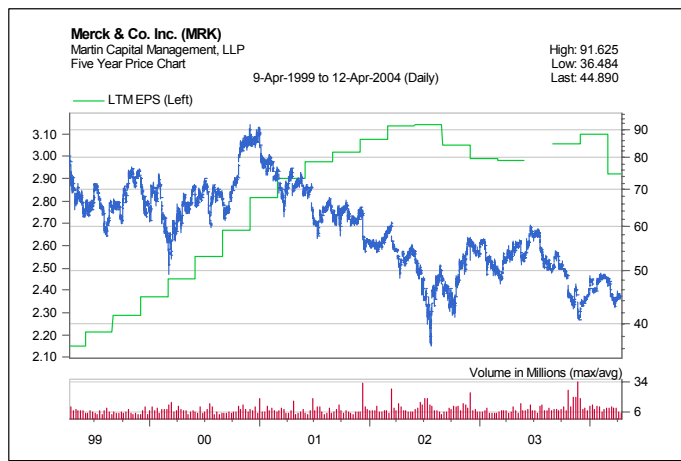


WAG has grown more in the last five years than all other drugstore chains combined. It also is growing faster than the mail order channel. WAG fills more prescriptions than any other company in America in a business where size equals both clout and operational economies of scale. Most of our clients will soon receive a research report that elaborates on the many advantages Walgreen enjoys in

what is not an easy business. If you don't receive a report and would like one, please let us know.

### **Merck (MRK)**

Merck is an exception in our portfolio of companies. For most of our other holdings, we would be willing to add significantly to our positions at the right price. The reason Merck is an exception is simple: It's nearly impossible to know anything about the drugs in its research pipeline. As such, Merck is not likely to be a major Martin Capital holding. It also means that we will have a quick trigger finger, either due to price appreciation or something better coming along.



As a result of a dearth of high-profile drugs in the aforementioned research pipeline, Merck has come under intense pressure from Wall Street. At the same time, some of Merck's best-selling drugs will go off patent in 2006. For example, the company's biggest seller is Zocor, with sales of more than \$5 billion. Within months after generic competition enters the market, sales virtually evaporate. As strange as it may sound, without new drugs, it's possible that earnings could be lower in 2007 than they will be in 2004.

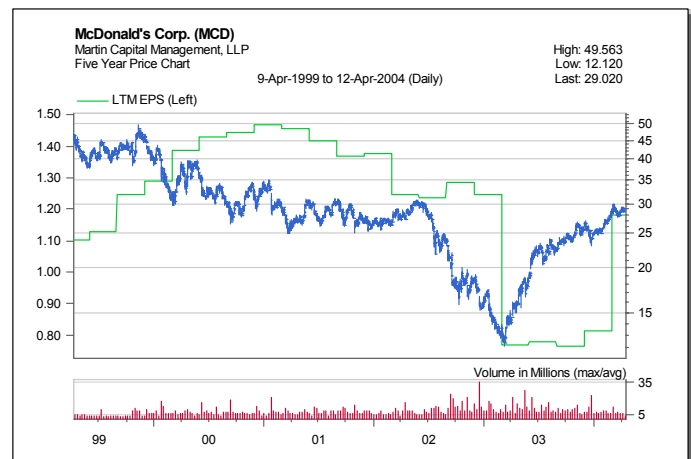
The good news is that the company has a rich heritage of novel drug discovery. We're willing to make a small bet that sometime before 2006 the company will discover something worthwhile. In the meantime, expect all drug stocks to respond to what is destined to be a very political year. Fasten your seat belts!

## **Companies Sold**

We sold two companies that, in a way, illustrate the importance of margin of safety. It would be a stretch to say that our initial assessment of both companies' long-term prospects was on the mark. Nonetheless, these mistakes did not prove to be costly. Indeed, we made a little money during a time when the stock market wasn't exactly roaring. Had we purchased these companies at the rich multiples they have often sold for, the outcome of these investments would have been worse.

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

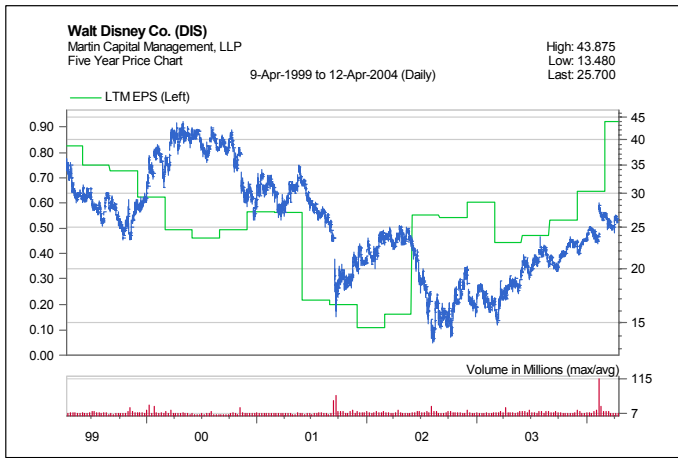
The new management team at McDonald's has done a simply wonderful job. CEO Jim Cantalupo took the company out of a state of denial, and the franchise is once again humming along. It's difficult to know, however, how far the turnaround will carry MCD. What we do know is that our expectations for international growth proved to be too optimistic, and we are left wondering how the company will grow over a long period of time. As a result, we liquidated our holdings as the stock price recovered on the strength of greater optimism under the new management.



### **Walt Disney (DIS)**

Our primary reason for selling Disney is not directly related to the bad press the company has received. It has more to do with an investment decision DIS made two years ago in acquiring the Fox Family cable channel. A company's sustainable growth is a function of two things: (1) return on capital of the existing businesses and (2)

opportunities available to reinvest the earnings at attractive rates of return.



The previously noted \$5 billion investment in Fox Family is large (even for a company Disney's size) and, having had two years to assess the acquisition, we can now say it was a lousy investment. If that was the best DIS could do with reinvested earnings, we decided our long-term growth estimates were probably too optimistic, so we sold our position. For the record, we also voted your shares against Michael Eisner's reappointment to the board.

## Website Information

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\*Updated April 2004