

Broken Record

Like the monotonous humming of a treadmill, the stock market has spent the year making noise, but going nowhere. Modest gains one month are offset by modest losses the next. So it was in the third quarter as illustrated in the table below.

	<u>3rd quarter</u>	<u>Year-to-date</u>
S&P 500	-1.9%	1.5%
NASDAQ	-7.2%	-5.0%
Dow Jones	-2.9%	-2.1%
MCM equities	-3.0%	-0.5%

Perhaps more surprising than the bland performance of the market this year has been the fact that MCM portfolios have rather tightly mimicked the indices. In most years we expect our concentrated strategy to deliver meaningfully different returns, sometimes better and sometimes worse. Over time, we believe this is the only strategy that gives us a chance to earn superior returns.

Since the stock market has, in general, remained unchanged for the last nine months, and the long-term prospects for earnings growth are likely to be more in line with the long-term trend, we don't see the impetus for outsized gains from the equity markets in general. Stocks are, for the most part, generously priced, and interest rates seem likely to increase over the next few years if the economic recovery stays on course. Whether this is the calm before another storm — or simply a time when the market pauses waiting for earnings to catch up — nobody knows.

Availability Bias

We all have biases of many sorts, and few are stronger than the “availability bias.” The basic idea is that we tend to overweight those factors and influences that register most strongly in our minds, either because they are more recent or because they are larger in scope (more traumatic). The most practical application of this idea from the investment world is the overemphasis on the problems or opportunities of the day. During the late 1990s the track record of growth funds came to dominate the thinking of the investment public. Investors' experience at the time had been nothing short of remarkable (recent and large in scope!), and it led investors to overemphasize a single factor (recent returns) in the decision-making process. The unbalanced perspective led to a ruinous outcome for many investors.

After nearly four years of investment results that range from unspectacular to catastrophic, at least for most investors, we are certainly seeing a lot more focus on the current problems of the day. Investors wonder about the unknowable when, where, and how of another terrorist attack on our soil but seem to have forgotten the post-World War II hair-trigger standoff between the two nuclear superpowers when apprehension about mutually assured destruction (MAD) dominated the synapses. People fear the potential implications of twin deficits (foreign trade and

federal budget) but forget about the twin plagues of slow growth and inflation — known as stagflation of the 1970s and 1980s. Jobless growth is often bandied about as a huge problem, but a 5.8% unemployment rate is not that far from what most economists consider full employment. The media (and certain politicians) like to talk about America's fallen prestige in the world, but that pales in comparison to the collapse of the Soviet Union, the leading Communist model.

Our point is not to dismiss the problems of the day. Any one of them could have grave consequences — even of the economic sort. However, the American people have proven to be flexible and able to adjust to the many destabilizing shocks that come our way. In the midst of an endless stream of endogenous threats over the years, our job as stewards of your wealth is to avoid being distracted by the unknowable (and sometimes the economically irrelevant) and to stay focused on finding those businesses that are uniquely prepared to make it through the difficult times without a significant and permanent erosion of intrinsic value. If MCM performs that duty well and our clients are patient, we should all have very acceptable returns over the long term, irrespective of the swirling maelstrom of unsettling threats: real, possible, or imagined.

New Holding

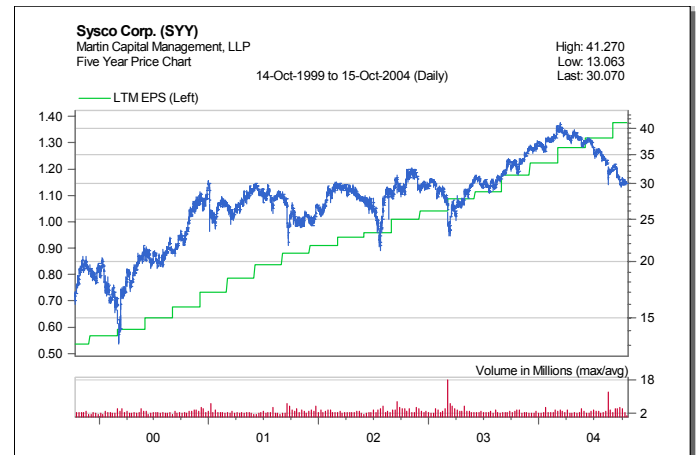
This marks the third straight Quarterly Capital Markets report in which we've introduced a new idea. Please don't confuse that with progress! In our world, more is not always better. Adding to an existing holding is every bit as satisfying as adding a new position. Our excitement level is directly related to a combination of our confidence in the future growth of a business and how cheaply we can buy it. In the case of Sysco Corporation, as it was with Walgreen not long ago, our views are mixed. In both cases we understand very well the significant advantages and growth opportunities these companies enjoy. However, we paid a full price for the initial positions in both of these companies, though the stocks were down significantly from their highs. We are certainly prepared to buy more at lower prices.

Sysco (SY)

Sysco is in one of those industries where the middleman is king. Sysco is the largest distributor of food and allied

products to the foodservice industry (restaurants, schools, hospitals, etc.). It is an industry of hundreds of thousands of customers and thousands of suppliers. As an aggregator of the supply base, Sysco is able to offer tremendous value to its widely dispersed customers. Sysco has a 15% market share, followed by the troubled U.S. Foodservice company with a 10% share. The industry becomes quite fragmented after the top two companies. The third-largest company has only a 2% share.

Sysco enjoys several advantages that we think are sustainable. The company clearly has buying clout with its vendors. There are scale economies in both the national infrastructure (administration/warehousing/logistics) and in the local truck routing schedule. Finally, the company's culture constitutes a significant edge. Local autonomy, accountability, and collaboration are hallmarks of the Sysco culture.

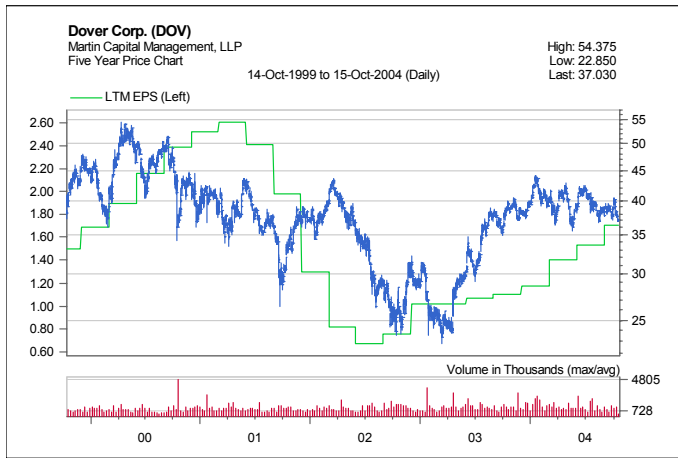


The soft patch during the summer and rising oil prices seem to have taken a toll on restaurant sales. Several publicly traded restaurant chains (especially in the casual-theme category) are reporting disappointing results, which were mirrored in Sysco's latest quarterly results. This top-line softness is occurring at the same time that commodity prices for many food items are increasing, making for a difficult operating environment. We don't know how long this softness will last, but we're confident about the company's ability to weather the storm and continue its stellar long-term record of growth and profitability.

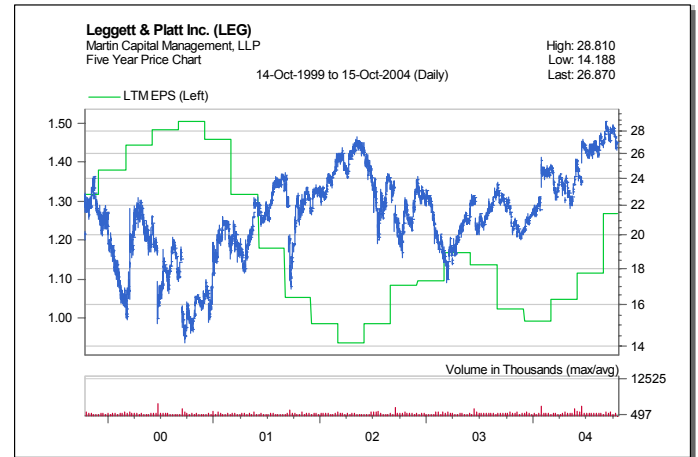
Equity Holdings

Diversified Manufacturing — Dover and Leggett & Platt (DOV and LEG)

The economy continues to trudge along despite the rapid increase in oil prices. It's important to note that the economic recovery, which is officially three years old, is now past middle age by historical standards. We don't want to digress too much on this point, but the number of recessions in recent history are too few in number for us to be confident of any historical precedent. Statistically, there is a considerable sample-size problem when assessing business cycles. Nonetheless, while economic cycles are largely irrelevant to our strategy in a broad sense, they do factor into our thinking as they relate to the progress of both DOV and LEG. The snapback in earnings should be clearly evident three years into a recovery. Indeed, we have seen a significant recovery in earnings from both of these companies, with the current "run rate" of earnings near record levels. However, both companies have 20-30% more capital and, as we indicated in our last report, they have been slow in putting their retained earnings to work.

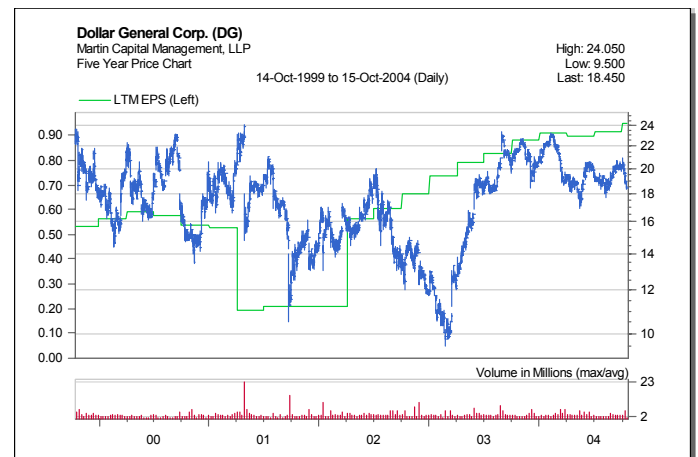


A more competitive acquisition environment has definitely affected the growth rate of both LEG and DOV. We're a little more concerned about DOV than LEG, given DOV's higher valuation level. As such, we're likely to reduce our position in DOV in the coming months.



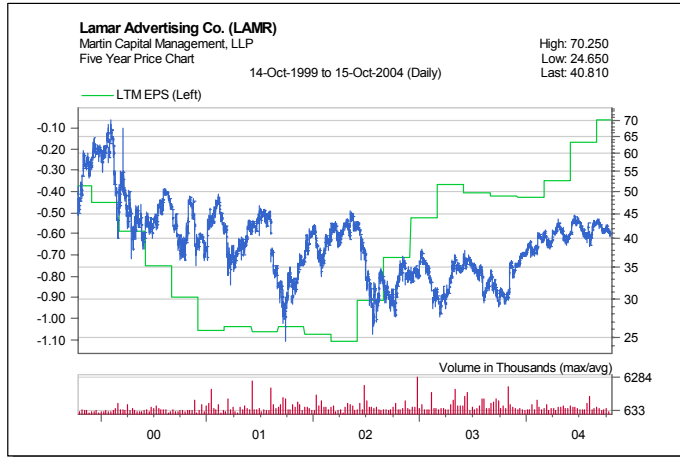
Dollar General (DG)

We are quite pleased with the progress of DG. The company is growing its store count by 9-10% per year and is investing in many other aspects of its business to position it for continued growth and enhanced profitability. These investments have taken the form of coolers in the stores, store manager training programs, logistics and information systems, shrinkage controls, and new merchandising initiatives. The company also is experimenting with a new store concept (Dollar General Market) that is roughly three times the size of its existing model. Preliminary results are well above initial expectations. We expect earnings to accelerate as the above-mentioned investments begin to offer paybacks.



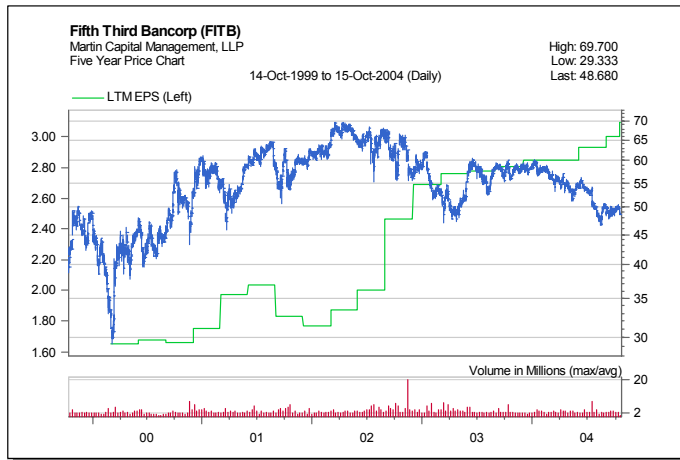
Lamar Advertising (LAMR)

We like the billboard business. It is simple, lucrative, and much less susceptible to technological change and media fragmentation. Billboard occupancy rates are improving, and pricing is beginning to firm up. We should see significant increases in earnings power over the next few years, and we're more than willing to go along for the ride.



Fifth-Third (FITB)

We continued to add to FITB during the quarter. The company had been going through an unusually difficult period caused, at least in part, by the limitations of the "Written Agreement" imposed by the Federal Reserve Bank of Cleveland back in March 2003. Acquisitions are an important component of FITB's growth model, and

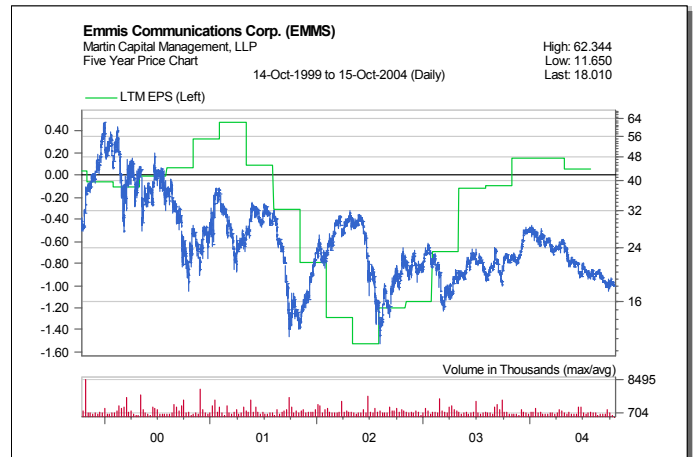


the agreement prevented FITB from engaging in any acquisitions. Extraordinarily low interest rates also have

squeezed FITB's net interest margin. The main drivers of growth, however, remain healthy. Loan growth is well above average for the industry, and FITB has proved over and over again that it's capable of funding asset growth through relatively cheap transaction deposits. At current prices, the share repurchase program will also materially contribute to EPS growth in the future. We like this bank and believe the stock price is nearing bargain levels.

Emmis Communications (EMMS)

The radio business is sluggish, and radio stock prices, including EMMS, are down in the doldrums. We believe investors are overly concerned about satellite radio and other music alternatives. Our view is that the current sluggishness in radio advertising is self-inflicted, resulting from increased commercial loads (commercial time per hour). The radio industry growth is based on supply and demand. Since the number of radio stations tends to be fixed — as advertising demand grows with the economy — advertising rates climb. Increased commercial inventory spots, due to growing commercial loads, have created a temporary lull in that dynamic.

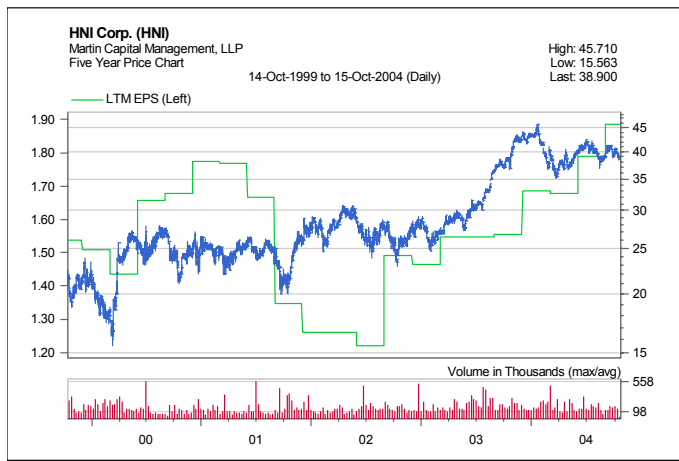


The number of satellite subscribers is not anywhere near high enough to affect the results of radio advertising. Over time, of course, if the broadcast radio industry doesn't respond to the satellite incursion, the broadcast model could be threatened. In the long run, however, broadcasters will have time to explore the use of the digital spectrum — and who knows what additional services could develop. In the meantime, we believe that the radio broadcasting industry is already in the process of correcting some of its mistakes of the recent past.

Finally, we're encouraged by the company's latest transaction. Emmis swapped its three Phoenix stations for Chicago's WLUP (The Loop) and \$70 million in cash. This gives Emmis an important "duopoly" in the third-largest market, along with cash that will be used to reduce debt. We recently added to our position, given the thumping that radio stocks have received during 2004.

HNI Corporation (HNI)

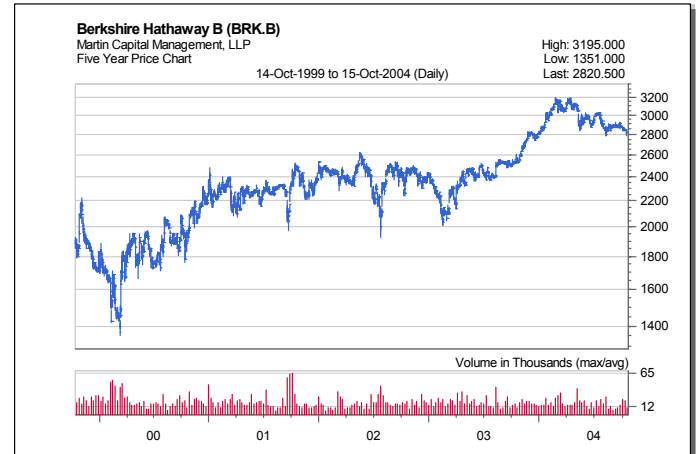
HNI has performed admirably during the worst downturn ever in the office furniture business. It has come out of the downturn with increased market share and record operating margins. The hearth business also is performing very well. We've been encouraged by a more aggressive capital allocation program that was put in place during 2004. The company has made three acquisitions this year and also has intimated a much greater willingness to buy back stock. Like other manufacturers (especially LEG), HNI has had to contend with higher raw-material costs. Even so, the company is operating at near record margins. We're content to hold our position at current prices.



Berkshire Hathaway (BRK.B)

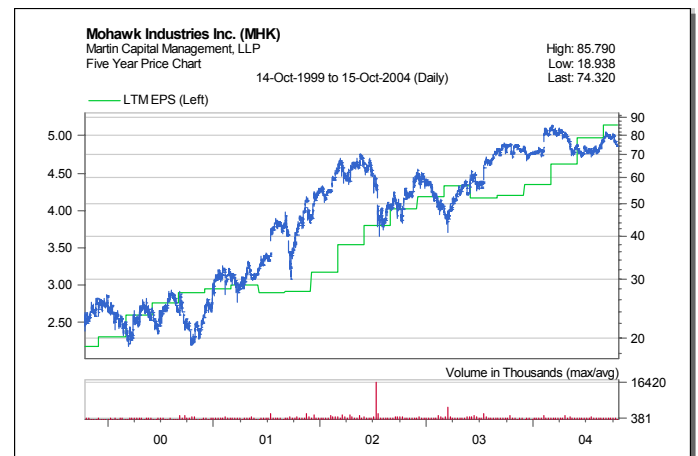
The next major source of growth will probably have to come from BRK's investment portfolio. The growth of float is likely to slow significantly as the commercial insurance market softens. Keep in mind that the earnings from the investment portfolio, which includes \$35 billion in short-term investments, is currently yielding 1-2% and can increase through the acquisition of private or public companies. There is little chance that BRK will grow at anywhere near its historical growth rate. The company has simply become too large. Nonetheless, at current

prices the returns should be quite reasonable and well above fixed-income alternatives. Given the low-risk nature of the company, that suits us just fine, especially in the absence of other alternatives.



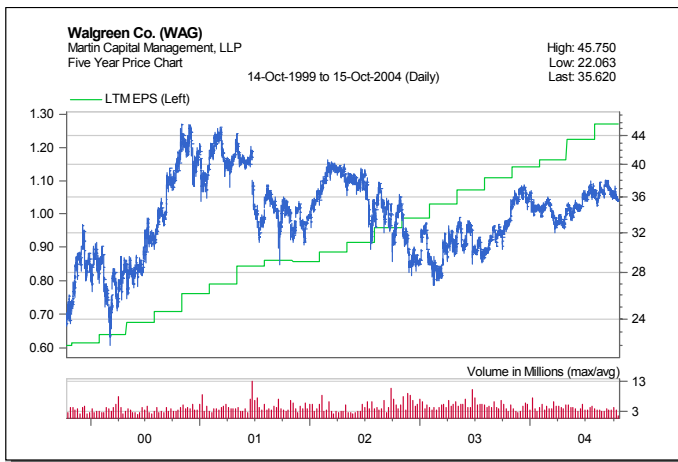
Mohawk (MHK)

MHK made its debut in our last report. The rise in the price of oil has compressed margins a bit, but we've been very satisfied with the company's ability to increase its own prices. Growth has been robust this year, but that is largely due to a lackluster 2003. The new-home construction market (about 20-25% of sales) has shown continued strength, and the commercial and remodel markets are beginning to recover, making for a strong 2004. Next year will be more difficult, especially since Mohawk hasn't made any significant acquisitions this year. The silver lining in high oil prices is that when (presumably) they fall, MHK will have an excellent opportunity to recoup some margin. We will be interested to see how Mohawk's major competitor, Shaw, wholly owned by Berkshire, behaves in such a scenario.



Walgreen (WAG)

This earnings-growth machine continues to motor along. The company reported an increase in EPS of 18% for its latest quarter and 16% for the fiscal year just ended. Earnings have been driven by strong same-store sales gains in both the front end of the store and the pharmacy. Margins are beginning to improve due to an increase of drugs going off patent, as well as continued leveraging of SG&A expenses. These trends should be sustainable, given the relatively young age of the average WAG store and the favorable trends in the pharmaceutical industry.

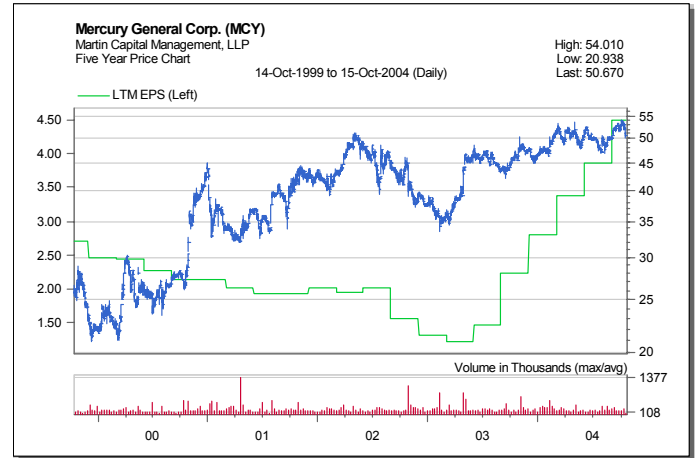


We continue to monitor the growing presence of the mail-order channel and the growth of PBMs (pharmacy benefit manager). While the mail-order channel is growing market share, WAG's market share is actually increasing at a faster rate. WAG has its own mail-order and PBM business. With a 12-13% market share on a national basis and much larger shares in many local markets, WAG has a fair amount of negotiating power. We would purchase more stock at lower prices.

Mercury General (MCY)

Growth is beginning to slow in the auto insurance business, but MCY's margins continue to improve. We also have been pleasantly surprised by the pace of growth outside its core market of California, which should allow the company to easily outperform the industry. We haven't added MCY shares to any of our portfolios in awhile, but should the stock begin to falter as the industry undergoes what we expect to be a rather mild down cycle, we would look for opportunities to buy more. We continue to closely monitor Progressive as well, an

outstanding company we sold a few years ago — inadvisably, we might add.



New Ideas

We have largely completed our work on Jacobs Engineering and Weight Watchers. Jacobs is a fine company, but the economics of the business are not as favorable as many of the other companies with which we're familiar. Still, at the right price we would feel quite comfortable with this holding in our portfolio. Weight Watchers, on the other hand, enjoys wonderful economics, but there's a little more uncertainty with respect to future growth. The stock price seems to reflect a growth rate that is toward the upper bounds of our expectations, so we'll continue to monitor the company while waiting for lower prices.

As always, we're working on a handful of other ideas, in addition to continued analysis of many other companies in the holding tank (those fine companies with stock prices that presently seem just a shade too rich for our blood).

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