

## Stock Pickers' Pickle

Let's begin by looking at the overall environment in which we as "stock pickers" have been operating over the last year and a half, dating back to January 1, 2004. We don't much care for the slang expression, but it serves the purpose and differentiates us from market timers, momentum players, and others of that ilk. In terms of the broad averages, we have regularly used the S&P 500 index as the benchmark. It is the measurement standard, not because it's indicative of the makeup of our portfolios, but simply because it's the most widely recognized stock market index.

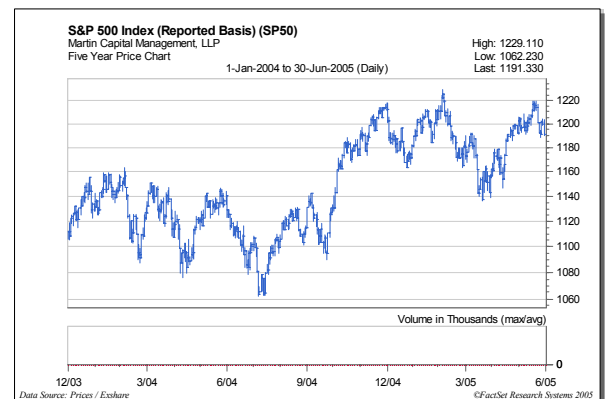
	<u>2nd quarter</u>	<u>Year-to-date</u>
S&P 500	1.4%	-0.8%
NASDAQ	3.1%	-5.1%
Dow Jones	-1.6%	-3.7%
MCM equities*	-1.1%	-2.5%

\*net of fees

Parenthetically, the Dow Jones Industrial Average was the generally accepted benchmark for decades, long after its utility had waned for no reason other than it was the flagship index of the Dow Jones Company, coincidentally publisher of *The Wall Street Journal* and *Barron's*. More than 250 years ago Benjamin Franklin was fully aware of the power of he who buys his ink by the barrel. Even the bastion of free markets (*The Journal*) wasn't above employing the crude and crass version of the golden rule: "He who has the gold, rules." Alas,

the venerable rag was disrobed, ironically, by those same markets for which supply and demand, not gold, constituted the final arbiter.

So much for the aside. If one were to draw a best-fit horizontal trendline through the S&P 500 index chart for the last 18 months, the line would fall around the 1150 level, with the "practical" high and low about 50 points, or less than 5%, from the midpoint. By "practical" we don't mean the absolute high or low, but a level at which enough activity took place so that more than a handful of traders could take advantage of the price. Suffice it to say, the volatility of the index — since the post-Iraq invasion rally peaked in late 2003 — has been lethargic. In fact, the comparatively flat-line performance of the index for the aforementioned time span has been one of the more soporific in many years.



As always there are many examples of greater volatility within the S&P 500 that stand in stark contrast to the entire index, which represents approximately 80% of the approximately \$14.9 trillion total market cap of all domestically based, publicly traded companies, according to the Wilshire 5000 (actually 6300 companies) Index, the most comprehensive of which we are aware. Such greater volatility among individual companies or industries is a mathematical certainty and, as noted in the first sentence of the next paragraph, can be a source of either quiet satisfaction or gnashing of teeth at MCM. With the benefit of hindsight, 41% of the stocks that make up the S&P 500 advanced or declined by more than 25% during that same span. Of that 41%, we had advance warning on nary a one! Nor do we expect to improve on our record as short-term price forecasters in the future. On the other hand, when we find situations of extreme under- or over-valuation, we are rarely surprised when regression to the mean often occurs at some point in the future.

In fact, when a company we know and admire comes down with a bad case of the “flew,” when momentum or hot-money players depart *en masse* — often giving “rise” ☺ to conspicuous under-valuation, irrespective of the state of the market as a whole — the bat (referring to the much-maligned Ted Williams metaphor from various and sundry MCM annual reports) is certain to leave our shoulder. Unfortunately, in markets, such as the one in which we find ourselves, we’ve seen far too many “high and tight” pitches. The scarcity of opportunities sailing toward our sweet spot can be explained in part by harking back to the Wilshire 5000 referenced earlier in this paragraph, examining its five-year history, and returning once again to the message implicit in the 2004 annual report. *Using year-end dates only*, after peaking at over \$15.8 trillion at the end of calendar year 1999, the index fell to \$10.2 trillion at the end of 2002, between the depressing autumn of the year and just before the second, more angst-ridden Iraq invasion in the spring of 2003. As is almost always the case, out of the bad-news blues it rallied a striking 30% or, in dollar terms, \$3 trillion to \$13.2 trillion in calendar year 2003. The pace slowed in 2004 to a gain of \$1.7 trillion, finishing at \$14.9 trillion, precisely where it stands today, six months later. The stock market is alive and ... well, we’ll withhold our opinion on the word following the ellipsis until we talk about earnings prospects and price-earnings ratios below.

You may recall the extended discussion on S&P “core” earnings from the 2004 annual report (see pages 22-25). Before we dive into the detail, a few basic definitions may make the exercise less arduous. *Reported earnings* are the GAAP (Generally Accepted Accounting Principles) earnings reported by U.S. companies. Under GAAP, companies have a fair amount of discretion in the assumptions used to calculate reported earnings. In an effort to put earnings comparisons between companies on an apples-to-apples basis, the concept of *core earnings* was developed by Standard & Poor’s. *Core earnings* reflect various adjustments (some of the more important of which will be discussed below) to *reported earnings* that ideally result in a more standardized barometer of a company’s “core” profitability. Finally, the definition of what constitutes the most suitable measurement period for the calculation of earnings for purposes of valuing a business has changed dramatically over the years. Benjamin Graham, way back when caution ruled the day, advocated using an average of the preceding five years. More recently the industry leapfrogged to using just one lone year, known as the *trailing* four quarters. Analysts would add the latest reported results to the preceding three quarters to arrive at that number. Currently, *forward* or estimated earnings for the year ahead is the accepted standard. May Ben rest in peace. The danger in using forward earnings (or even a single year of trailing earnings) is that the process results in a single number that can be influenced by temporary factors. Not putting earnings in the context of a trendline allows for biases, misinformation, outright manipulation, and other factors that increase uncertainty. The counter argument, and a weak one at that, is that a growing company is penalized on valuation databases if trailing earnings are used. Pick your poison.

We recently communicated again with the folks at Standard & Poor’s. S&P’s estimate of *core* earnings for 2005 is \$61.84, compared with \$52.04 estimated for 2004, when the annual report went to press in February of this year. Later, when all the data were compiled, the core earnings number for 2004 was revised upward to \$55.16. These numbers compare to estimated *reported* earnings (before S&P *core* earnings adjustments) of \$65.50 estimated for 2005 and \$58.55 for 2004, respectively. *Trailing* 12 months *core* earnings through June are estimated by us to be about \$58.50, putting the current P/E ratio at 20.5 with the S&P 500 at 1200, compared with 23x we estimated in the annual report based on the core

earnings for 2004 (the number would've been 21.8x using the final core earnings number for 2004). The decline in the P/E ratio over the last six months is entirely dependent on the approximate 6% increase in core earnings. The P/E ratio on trailing reported earnings is approximately 19.4.

Perhaps another explanation of a few of the adjustments to get from reported earnings to core earnings is appropriate. The three main adjustments are for options, pension, and goodwill. The options adjustment for 2005 subtracts an estimated \$3 from the reported figures compared with \$3.30 for 2004. This adjustment would have been lower (offset by similar reduction in reported earnings) had FASB 123 (the on-again, off-again rule on when and how stock options are to be expensed) taken effect at the end of June as proposed. As it stands now, option expensing will begin on January 1, 2006. The pension interest adjustment (the difference between the interest cost on pension assets and actual returns on pension assets) subtracts \$2 from the estimated 2005 reported numbers. This adjustment will logically rise if the market doesn't. The goodwill impairment estimated adjustment for 2005 *adds* \$2.85 to the reported number. Beginning in 2002 the long-standing practice of amortizing goodwill over a predetermined time was scrapped, a change we endorsed. Goodwill is now a discretionary item: To the extent any of it is permanently impaired, the amount of the impairment is written off and therefore reduces *reported* earnings. S&P considers such write-offs as nonrecurring items and excludes them from the calculation of core earnings. Accordingly, the write-offs are added back to reported earnings to arrive at core earnings. As long as impairment charges are modest, there's little to get excited about. However, economic distress and/or a major market decline could result in massive impairment write-offs. The difference between reported and core earnings would wildly diverge as a result, only adding to the confusion about earnings.

That which began with the 2004 annual report we will endeavor to disclose going forward. Without some attempt to accurately depict earnings we, as well as you, will find ourselves traveling through investment time in the dark without something like a reasonable benchmark with which to find our way. While our focus continues to be on individual companies, as is evident from the rest of this report, we will not neglect the forest entirely for the trees. What follows is one example to emphasize the importance of glancing occasionally at the bigger picture. Beyond the hot public utilities sector, another low-multiple group, the

financial industry, accounts for some 40% of all S&P 500 profits. In the 2004 annual report we referred to the "financial economy," to which the outsized share of S&P corporate profits that come from the financial services sector attests. This gives us "forest" concerns from two points of view:

- First, we believe that the share of S&P profits originating from financial service companies will regress to a much lower mean in due course.
- Second, financial industry profit margins — by the nature of the way they are calculated — are much greater than those from manufacturing, service, and other industries. This difference in methodology has the effect of skewing profit margins upward in a way that erroneously suggests a significant and presumably enduring improvement in corporate profit margins.

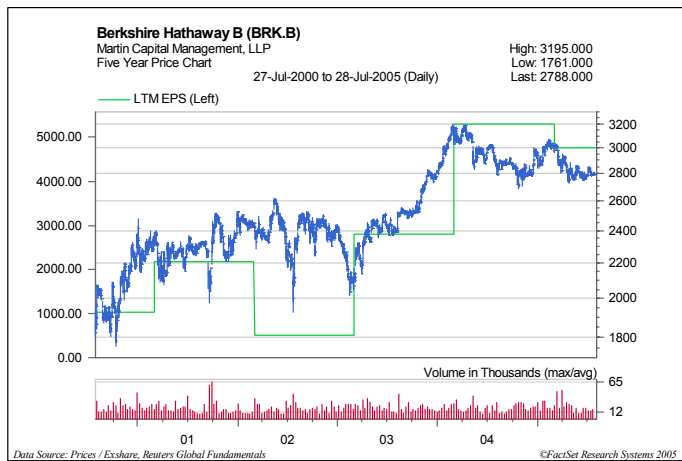
As noted above, S&P's estimate for 2005 *reported earnings* through June 30 is approximately \$62. With the S&P 500 at the 1200 level, this puts the estimated P/E ratio around 19.4. This ratio is not likely to cause nosebleeds unless interest rates rise or earnings fall. Still, a multiple of almost 20 is still a far cry from the average trailing P/E of 15.6, to say nothing of often lingering lows of 8 or less in bear markets during the last secular decline from 1966 through 1981. With the high-growth, new-era economy now nothing more than an embarrassing illusion from the second half of the '90s, perhaps a more historically rational attitude toward earnings growth will set in.

In summary, we find ourselves facing headwinds. That doesn't mean we won't make headway, but it does mean we are far less confident than when the wind is at our back. We look forward to a better investment environment in which rational decisions can be defended with aplomb, rather than with a low level of confidence. We simply don't know when this new environment will come to the fore.

## Equity Holdings

### *Berkshire Hathaway (BRK.B)*

Berkshire has certainly been making the business news headlines, but not always in the favorable way to which investors have become accustomed. The ongoing investigation by the New York Attorney General's Office and the Securities & Exchange Commission into certain insurance practices has spread to Berkshire and has led to guilty pleas and the resignations of a few General Re (a subsidiary of Berkshire) executives for their role in facilitating the improper handling of an insurance contract with AIG (formerly Hank Greenberg's company). While we have no way of knowing the details of the



investigations, it would appear that on more than one occasion Berkshire has been on the other side of insurance transactions that were accounted for improperly by the buyer (Berkshire the seller). In the most publicized cases (AIG and Unum), it appears that Berkshire accounted for the transactions properly. Nonetheless, with an insurance business as large and global as Berkshire's, along with the extensive regulatory review of insurance practices and standards that are under way, we can only assume that Berkshire will be further implicated in some way. CEO Warren Buffett's history would suggest that Berkshire will be fully cooperative and try to get the whole mess behind it as soon as possible. In the meantime, we can expect the stock to trade sympathetically with the headlines. It is highly unlikely, however, that any fines or insurance reforms that result from the regulatory and legal investigations will have a material economic impact on Berkshire.

The other headline-making news relates to Berkshire's proposed acquisition of PacifiCorp for nearly \$10 billion. Furthermore, Buffett has made it known that he would like to make much larger investments in the utility industry. Indeed, he has been lobbying federal agencies to relax the ownership rules for utilities that were made back in the 1930s. This begs the question, "What does Buffett see in the utility industry?" We believe the answer is threefold:

- First, it is a very large industry that needs an abundance of capital, making it a good fit for Berkshire, a company that generates a ton of excess capital.
- Second, the industry supplies a product that will always be needed, making it much more predictable than many other industries. Any significant changes will likely involve less regulation, which will likely benefit the better-managed companies in the industry.
- Third, this is an industry that does not, generally, attract great management talent. Buffett believes that his team at Mid-American brings a lot to the table that can improve the results of acquired companies.

Recent results at Berkshire have been very good. Operating income, led by unsustainably high margins in the insurance businesses, grew 25% during the first quarter. Good operating performance was offset by significant deterioration in the volatile gains and losses category (which we believe should be excluded in the analysis of short-term results).

### *Dollar General (DG)*

DG's first-quarter results were somewhat disappointing. Sales grew at a respectable rate of 13+%, but EPS were flat. Gross margin declined and SG&A (sales, general, and administrative costs) increased at a faster rate than sales. Gross margin was down primarily due to rising fuel costs and weakness in the more seasonal and discretionary categories that carry higher margins. While sales overall were good, the mix of merchandise sold reduced margins. SG&A rose as a percentage of sales because the company front-end-loaded several different investments that are being made throughout the year. This should reverse itself during the second half of the year, but the second quarter could have similar issues.

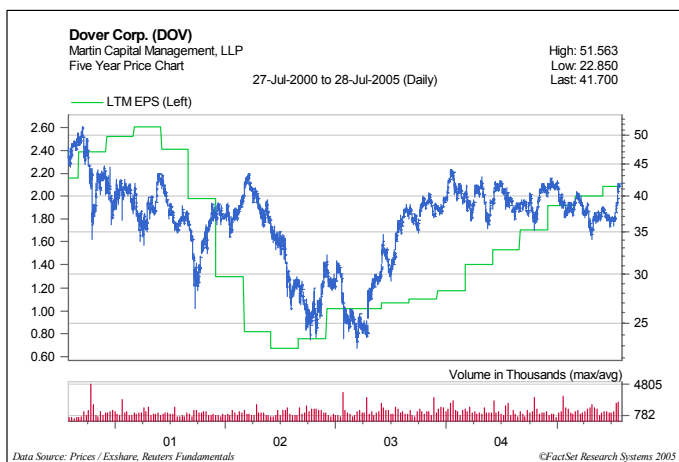
DG's results will likely continue to produce lumpy EPS progress (fourth-quarter 2004 EPS were up 24%). Still, the company's good return on capital will continue to

internally fund square-footage growth of 9-10%, in addition to share repurchases. Combined with DG's 3-5% comp-store sales and gradual margin improvement, we continue to like the long-term prospects of Dollar General.



### **Dover (DOV)**

We sold the rest of our Dover position during July. The company's near-term prospects have improved and Wall Street bid the stock to a level we considered reasonably close to fair value. Given the fact that our longer-term conviction about the company's ability to grow at double-digit rates has diminished, we believe it is prudent to move on. We earned a good return, though certainly not exceptional, during our holding period.



### **Emmis Communications (EMMS)**

The management team at EMMS has apparently had enough of what they (and MCM to a lesser extent) consider to be a grossly under-valued stock. The company

has repurchased 40% of its common stock, making a balance sheet loaded with debt even more highly leveraged. Significantly, though, the share repurchase was made in conjunction with a plan to sell its television stations. While we applaud management for the decision, we believe it was a mistake for Emmis to have gotten into the TV business in the first place. When the stations are sold, debt at Emmis will be quite manageable and give the company, for the first time in a long time, the flexibility and capability to grow intrinsic value per share.

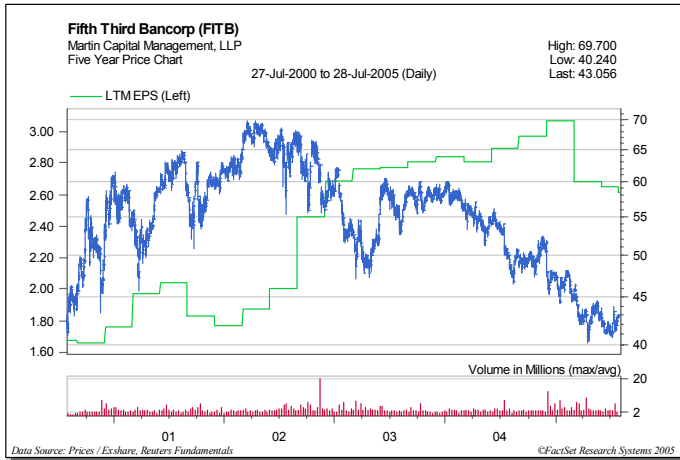


Public valuations for radio stations, with some justification, are still depressed. This has allowed other public radio companies to repurchase significant amounts of their own stock. If the valuation of Emmis doesn't improve after the restructuring, the company will have the financial flexibility to retire 10% or more of its stock per year from continuing operating cash flow. We are monitoring this situation closely and would not hesitate to sell our holdings at higher valuation levels. We're having frequent conversations with management (MCM holdings equal 7% of outstanding shares), not wanting the company to squander shareholder value. It's possible that the entire company could be sold in a leveraged buy-out or some other means. We would likely be content with an ambitious share repurchase program that leaves the balance sheet in good repair.

### **Fifth Third Bank (FITB)**

If we could conjure up the worst possible interest-rate environment for FITB, we could hardly do any "better" than the present-day scenario. A flat interest-rate curve hurts all banks. A low absolute level of interest rates is especially problematic for banks that are more heavily

funded with transaction-oriented deposits. This combination is the most important factor contributing to FITB's lackluster results. Not wanting to sacrifice long-term growth, the company has also added 2,300 sales professionals, a move that has increased expense ratios in the short run.



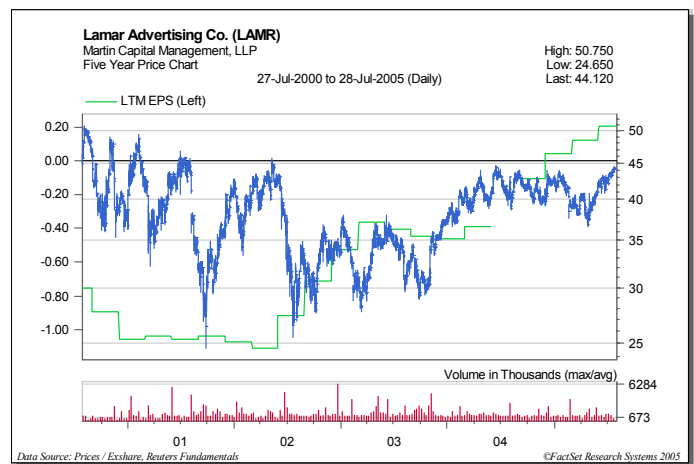
The last few years have certainly been a humbling experience for a bank with a long and proud history of stellar performance. The bank has gone from a premium P/E multiple of 35x to a multiple of 13x, an actual discount to an *average* bank. We believe that FITB's cost structure and a strong culture based on accountability will lead to improved margins and good growth (albeit at a lower rate than when the bank was much smaller) in the future. Yet, even with the current "disappointing" results, the company boasts an ROE of 18%, which is better than 80% of all companies in America. For now we're content to wait for improved results and a more reasonable appraisal by Wall Street, both of which should lead to reasonable returns from our purchase price and quite attractive returns at the current price. The current yield of 3.35%, better than cash alternatives, makes the waiting more tolerable.

### **Lamar Advertising (LAMR)**

We like Lamar's position in the billboard business. It isn't subject to the fragmentation issues that have burdened other traditional media, and technology changes may very well enhance future growth rather than hinder it. Two technological developments could enhance the billboard industry's media positioning in the long term. The first relates to GPS (global positioning systems) that are being tested that would add important demographic information that is currently nonexistent with billboards. Essentially, it is a Nielsen "people meter" for cars that tracks who goes

where (who sees the billboards and how many times). The second new technology is electronic billboards, which add enormous flexibility in terms of selling space. Instead of monthly (or longer) contracts, billboards could be sold like radio and TV. Displays could be changed at will and pricing would be determined by traffic levels. This would open up whole categories of advertising that were previously not possible due to contract lengths and display inflexibility.

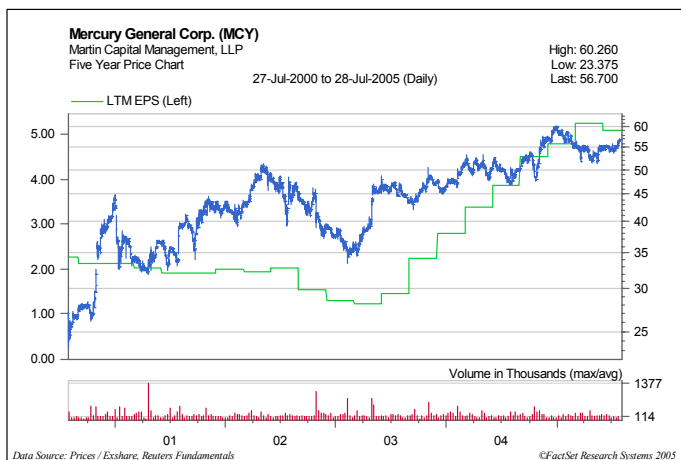
These are trends that will take time to play out. In the meantime, LAMR's business is doing very well. After-tax



cash flow per share increased 24% during the last quarter, and we expect that momentum to continue for a while. We're content to hold our position at current prices and would be buyers on weakness.

### **Mercury General (MCY)**

Heavy rains in California (a state that accounts for 70% of MCY's total business) led to higher loss ratios, especially for the small homeowner's book of business, and lower earnings for the first quarter. Loss ratios are notoriously volatile, and the company still had above-average margins in the quarter, albeit below the stellar levels of a year ago. More importantly, growth in policy counts and premiums continued at a rate of over 15%, led by 65% growth outside California.



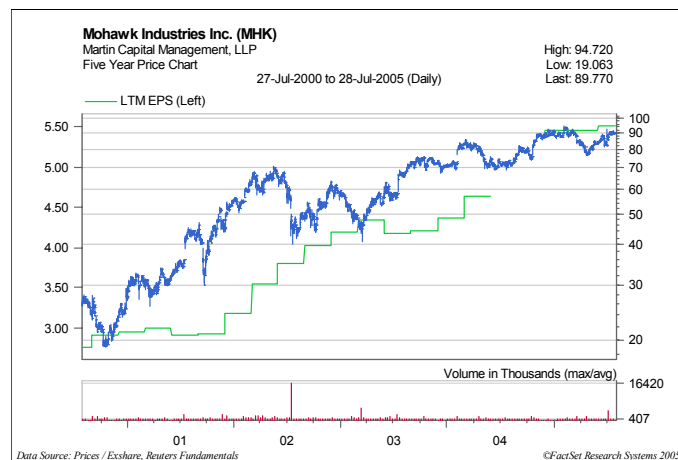
We're quite pleased with the company's progress, but the auto insurance cycle is entering a period that promises to be more competitive and, eventually, less lucrative. How much so is difficult to know. Our position in MCY is not large, and we have made a lot of money in auto insurance by buying Mercury and/or Progressive during the darkest moments of the down cycle. We hope to have a similar opportunity to add to MCY or repurchase Progressive down the road.

### **Mohawk Industries (MHK)**

MHK's earnings power continues to grow, although at a slower rate than recent quarters. EPS was up 8% in the most recent quarter, slowed by slightly softer sales (some of which were weather-related) and compressed margins due to the rise in the price of oil. The company has successfully passed along the increase in raw-material costs, but there can be a lag.

Demand for the company's products (floorcoverings) should continue to be strong. Housing starts are still close to record levels (25% of sales are for new residential construction) and the commercial construction market (another 25% of sales) is rebounding after a multi-year slump. The wild cards in the short run are the price of oil and the timing of price increases.

MHK recently announced the acquisition of Unilin, a Belgium-based manufacturer of laminate hardwood and other building products for \$2.1 billion. It is the company's largest acquisition in terms of size. MHK currently sources all of its laminate hardwood products it sells through its extensive distribution network. Approximately 35% of



Unilin's sales are in the U.S. (the rest sold in Europe). MHK plans to keep the existing distribution channel in place and grow the business through expanded distribution. It will also give the company a platform to grow, eventually, in Europe. Laminate hardwood is the fastest growing floor covering category in the U.S. and MHK should be able to accelerate its growth rate in the same way it has with Da-Tile, which has grown at a 15-20% rate since it was acquired by MHK in 2002.

### **Sysco (SYY)**

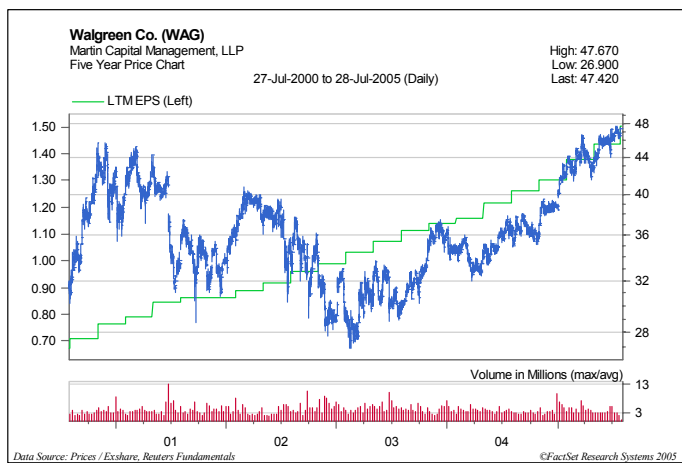
Sysco managed to grow EPS 13% in its latest quarter, despite soft industry conditions and high fuel costs (in a sense, this is a trucking company). Sales growth has diminished as the company has sharpened its focus on its more profitable customers and stopped doing business with those that don't meet profitability thresholds.



The company is making a large strategic bet on its National Supply Chain Project, a project that effectively re-engineers its entire logistics and distribution strategy. Sysco is currently in the testing phase of its first Redistribution Center (RDC), located in the Northeast, at a current cost of \$280 million. A number of RDCs will be built over the next few years; this rollout will have the twin benefits of lowering the cost of acquiring merchandise (the larger RDC will receive product by the full truckload) and reducing overall inventory levels throughout the system. Management reports that early indicators are on target. SYY's size and profitability allow the company to make an investment of this type — and it will increase SYY's low-cost advantage relative to competitors. This is a well-managed company that is making sound, strategic investments.

**Walgreen (WAG)**

Things continue to roll along at Walgreen; the company reported EPS growth of 20% for its last quarter. As we've explained before, WAG has achieved a very nice balance of reaping and sowing at the same time. The company opens very nice stores in expensive locations that often take up to five years to break even. Thus, at any given time, the company has a large number of stores that are ramping up (reaping) even as the company invests in new stores (sowing). That's one of the primary reasons, along with the fast-growing pharmacy business, that with regularity the company leads the retail industry in comparable store sales gains.



WAG appears to be faring well in its battle with the Pharmacy Benefit Managers (PBMs), which encourage health plans to use the PBMs' own mail-order channel.

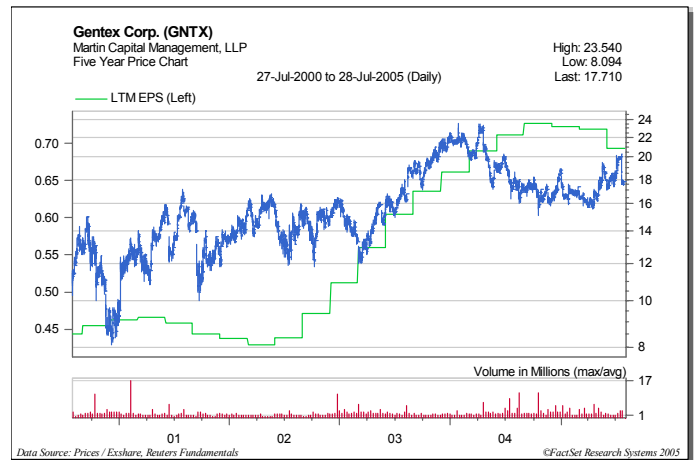
The subtleties of this struggle go beyond scope of this update, but we believe that competition between channels of distribution (mail order vs. pharmacy) is more significant than the competition within the channel (Walgreen vs. CVS).

**New Ideas**

We have completed our research on four new companies during the last quarter: Gentex, Idexx, Techne, and CDW. We will be sending the reports out periodically, at least to those clients who want them, but we thought a brief description of each might be of interest at this juncture.

**Gentex (GNTX)**

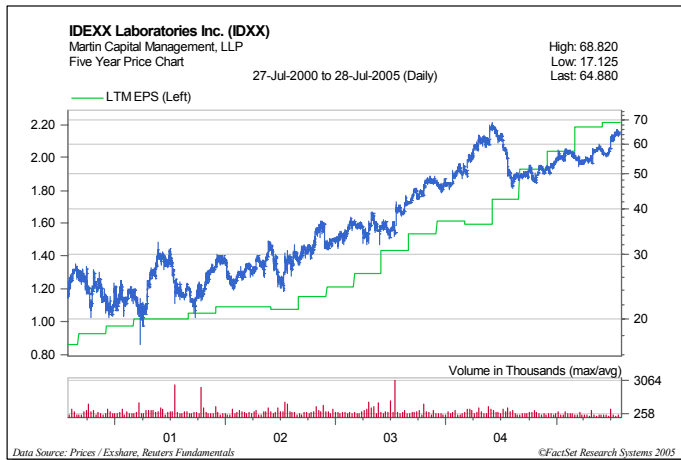
Gentex is one of the few suppliers to the automobile industry that has a long and proven record of growth and profitability. The company basically owns the market for self-dimming mirrors and has made a science of adding "content" to the mirrors as a source of growth. The company enjoys some important competitive advantages, including patent protection, manufacturing know-how, and an innovative culture. Future growth will likely come from additional product features and increased penetration rates (self-dimming mirrors are in only 18% of vehicles).



**Idexx (IDXX)**

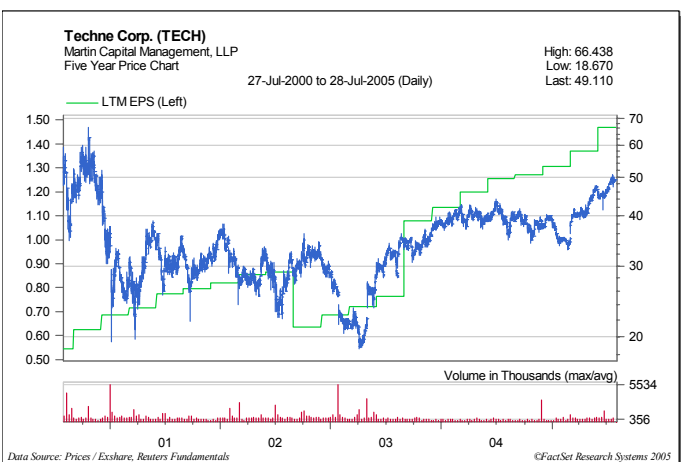
This company dominates the field (over 65% market share) in veterinary diagnostics, a market that has grown nicely along with the willingness of American pet lovers to spend more and more money on their dogs and cats. Once the equipment is sold into a veterinary clinic, the company enjoys an annuity stream of profits from the proprietary

consumables that are used to conduct a variety of diagnostic tests. Think razors/razor blades ... Idexx is a highly profitable business with a management team that has demonstrated a willingness to return excess profits to shareholders in the form of share repurchases and dividends.



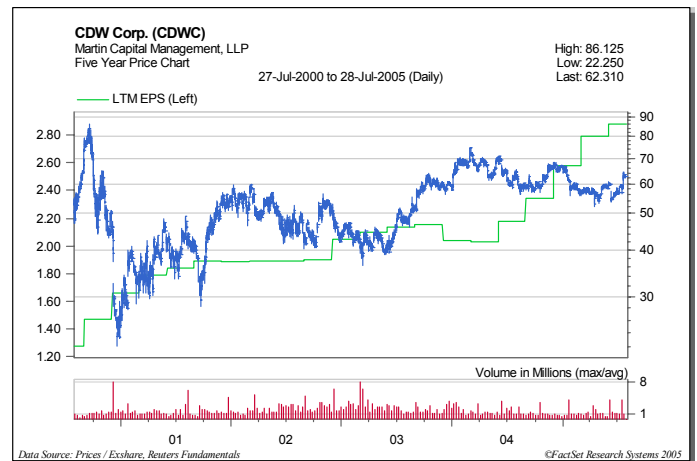
**Techn (TECH)**

Techn supplies the biotechnology research market with essential raw materials. Techn produces more than 9,000 proteins used primarily for basic research. There are several attractive characteristics of this business that should sustain the 50% operating margins the company currently enjoys. We like the fact that the future growth of this company is not dependent on any particular hit drug or diagnostic test. Rather, it's a type of proxy for the future growth of biotechnology research spending.



**CDW (CDWC)**

CDW is by far the largest direct marketer of a broad range of high-technology products to small-to-midsize businesses. Its scale makes it a low-cost producer, and its corporate culture makes it a very effective sales organization. Like Techn, the company's success is independent of any particular high-tech trend. Further, CDW's focus on the small-business market (where there is often no chief technology officer) makes its customers willing to pay a small premium for its excellent service. This premium, coupled with CDW's efficient utilization of resources, translates into returns on invested capital in excess of 30%, excluding cash.



**Website Information**

Address: [www.mcmadvisors.com](http://www.mcmadvisors.com)

User Name: martincap06\*

Password: martincap06\*

\*Updated July 2005

Please remember to contact Martin Capital Management if there are any changes to your address, in your financial or investment objectives, or if you wish to impose, add or modify any reasonable restrictions to our investment management services. A copy of our current written disclosure statement discussing our advisory services and fees remains available for your review upon request.