

## Fueling Opportunity

It has certainly been an eventful quarter around the globe. Political and economic turmoil is endemic in our world economy, perhaps ameliorated in some instances by increased interdependence. Most readers are familiar with the goings-on in Germany, Japan and China, to name three of the more conspicuous examples. Dynamic tension is the only constant; to expect a state of serene equilibrium is to defy both history and the nature of humanity. Some problems were manmade, while others reflected the whims of nature. In North America, however, it was devastating Hurricane Katrina and her nasty sister, Rita, who stole the spotlight, the responses to which laid bare some of the best and worst characteristics of our citizenry and the governments it puts in power to look out for the common good.

From a purely economic standpoint, Katrina has clearly affected the economic landscape over the near term. Shortages (or at least fears of shortages) are beginning to develop across a wider spectrum to include trucking capacity and building materials, in addition to crude oil and its byproducts. The risk of increased inflation contributed to the Federal Reserve Board's recent decision to raise interest rates. Spiking prices for gasoline and the threat of a giant leap in the cost of petroleum-based heating fuels is said to be having a negative impact on consumer sentiment, particularly for lower-income Americans.

Every Quarterly Capital Markets Report could begin with its own litany of woes. It's "the nature of the beast" in the world where we ply our trade. Like the terrorist attacks in 2001 against our

citizens and the landmarks that were symbols of U.S. hegemony in democratic capitalism, the back-to-back hurricanes exposed an American vulnerability of a different sort. The consequences of the acts of nature, unlike the terrorist attacks, could have been mitigated had better planning taken place. Both traumatic episodes occurred on our soil; after the rash of natural disasters in 2005, many Americans feel a heightened sense of vulnerability.

Even in the presence of so many uncertainties, the owners and the managers of this country's capital assets must keep their eyes trained on the task at hand. Enduring enterprises simply can't pick and choose the environment in which it must operate. Most businesses are able to prosper when times are good, but they must be able to endure through the rocky interludes. The business that attempts to close up shop until things get better will have no business when the tide turns. The same is true for investors. In fact, amid well-publicized problems often lie the seeds of opportunity. We believe that difficulties associated with higher fuel costs have contributed to improved opportunities in a few select areas, albeit at a small cost in the short run. Chart 1 below reveals the reality of a somewhat difficult quarter for MCM.

	3rd quarter	Year-to-date
S&P 500	3.6%	2.8%
NASDAQ	4.8%	-0.6%
Dow Jones	3.4%	-0.3%
MCM equities*	0.0%	-2.5%

*\*net of fees*

The good news (and far more important in attaining superior long-term results) is that the hand-wringing about higher gas prices and its impact on consumption allowed us to buy shares in three of America's best discount retailers (discussion to follow) and add selectively to a few other existing holdings.

So that we are not misunderstood, let us say that what is true for a few specific stocks is not true for the market in general. We remain wary of a market that sells for 20x earnings per share (EPS), with growth prospects of 5-7%. The math simply doesn't work very well. We also are unnerved by the resurgence of interest in initial public offerings (IPOs) and Internet stocks. Telltale signs of the near ubiquitous aversion to risk that is usually the signal that you can "back up the truck" (and load it almost indiscriminately with bargain stocks aplenty) are nowhere present. Couple that with the growing probability of an upward move in longer-term interest rates, and it's possible that the general environment could at some point get downright ugly. Our portfolios are hedged and/or are carrying large percentages of liquidity so that what might be "oops" (to put it kindly) for some could spell opportunity for us. Toting an umbrella one appears as a dolt when the sun is shining. If an out-of-nowhere thunderstorm blows in, perceptions change as quickly as the weather, and the prior inconvenience suddenly appears trivial compared with the benefits.

## The S&P 500: Energized Performance

We also think it important to look beneath the tip of the iceberg to see what's hot and what's not as the market, represented by the Standard & Poors 500, continues its treadmill performance dating back to the beginning of 2004, as was discussed in detail in the last (second quarter, 2005) Quarterly Capital Markets Report. For the year-to-date the S&P 500 advanced an inconsequential 17

S&P 500 Index	Weight	YTD Performance	Weighted Performance
Consumer discretionary	10.8%	-8.1%	-0.9%
Consumer staples	9.8%	1.5%	0.1%
Energy	9.9%	40.0%	4.0%
Financials	20.3%	-3.5%	-0.7%
Health care	13.4%	3.8%	0.5%
Industrials	11.3%	-3.9%	-0.4%
Information technology	15.1%	-0.5%	-0.1%
Materials	2.9%	-7.6%	-0.2%
Telecommunication services	3.0%	-8.0%	-0.2%
Utilities	3.6%	20.4%	0.7%
Total	100.0%		

index points. Absent the historically outsized performance of energy, the modestly positive performance of the index for the year-to-date would be clearly in the red.

Although one of our analysts, Aaron Kindig, had strong and well-supported convictions about why oil prices should trend higher (at a time when the price of oil was much lower), predicting commodity prices is filled with uncertainty. There are simply too many moving parts. More importantly, over an extended period of time, the growth in intrinsic value of a business is dependent on the reinvestment opportunities available to that business. Thus, even if oil stays at \$60 a barrel, the costs (throughout the value chain from exploration, production, and refining to the ultimate delivery of petroleum products) to the consumer will rise in proportion to the increase in price of the underlying commodity, muting the opportunity for producers to sustain superior returns. Oil is still a commodity, and we haven't learned if there is a company that has any special advantages in exploration and development that would make it a perpetual low-cost producer. We much prefer businesses that enjoy sustainable competitive advantages that can reinvest earnings in a manner that leverages those advantages and earns superior economic returns.

We believe that our equity portfolio has attractive economic characteristics. The largely "essentially consumables" retailers that we own offer the best value for the dollar in their categories. Thanks in part to Wal-Mart—or perhaps even decades before when Japan began offering products that defied the presumed direct association between price and value—the American consumer, from Tiffany's to Target, often shops for such goods with a discriminating eye, indifferent to the stigma of being seen in an establishment below his or her "station." For many consumer goods, the shopping experience has become democratized. Accordingly, we believe that the retailers we own will fend for themselves better in down times than their upscale brethren.

Other companies, more susceptible to hard times, are priced accordingly. Like the retailers mentioned above, we are generally comfortable with their price-to-value relationship.

The companies in our portfolio, which sell at roughly 15x EPS, should be able to sustain low double-digit EPS growth over time. In addition, most of the businesses in

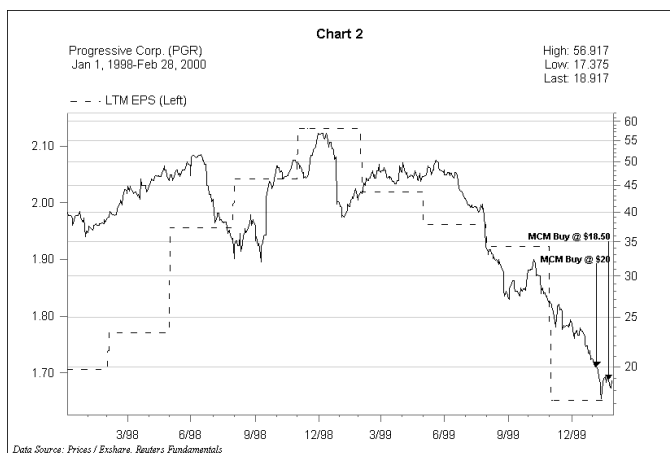
our portfolio enjoy defensive characteristics. The earnings in the portfolio are not dependent on \$60 oil prices (indeed, many of our companies would benefit from lower oil prices) or robust economic activity.

There are approximately 100 industry groups as measured by Dow Jones. Every year there will be winners and losers among the groups. Although there are plenty of managers and firms that go to great lengths trying to predict the winning and losing groups, we're not aware of one that sports a great long-term track record. We're interested in the performance of the Dow Jones industry groups, but we're looking for the worst-performing groups, hoping to find an outstanding business amid the carnage. That's how we found Progressive and Mercury General a few years ago.

### Cheer the Bad News

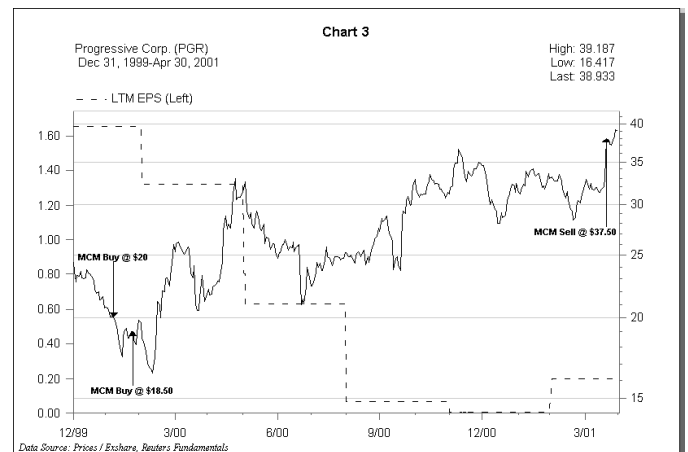
There are few truisms in investing, but one of the more reliable maxims is that the best investments are nearly always associated with a sense of foreboding and bad feelings. Low prices simply can't be had when everything is coming up roses. An example is in order.

In late 1999 and early 2000 MCM made a major investment in the automobile insurance industry in buying Progressive and Mercury General (which many of you still own). As Chart 2 shows, it was an absolutely miserable time to be in the auto insurance industry, which hadn't grown for two years while margins were lousy and getting worse. EPS had been cut in half for Progressive and were down 50% for Mercury. To our knowledge, not a single analyst on Wall Street thought these companies were worthy investments, even though both had wonderful long-term records and compelling competitive advantages.

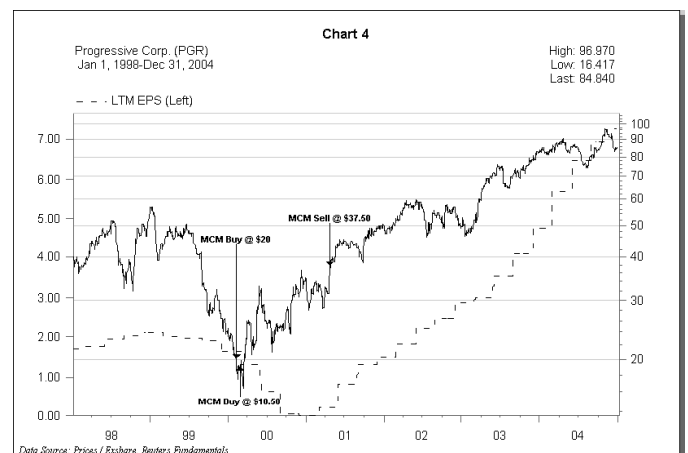


It's important to keep in mind that there were no immediate prospects for recovery. Progressive had begun increasing insurance prices—but at a significant cost in terms of growth. The only thing we knew for sure was that both companies were low-cost producers and that the industry was characterized by distinct underwriting cycles. We took a “this too shall pass” attitude and decided to disregard the temporarily depressed state of affairs.

Now let's look at Chart 3. Indeed, industry conditions did change. Also note that the stock started improving (but not before we were 20% below our initial purchase price) well before any material improvements in the performance of the business.



As a matter of full disclosure, please review Chart 4, which leaves us more than a little red-faced with respect to our sale of Progressive in 2001! Even so, we earned a 100% return in a little over one year. Imagine if we would have waited until the company was setting earnings records.



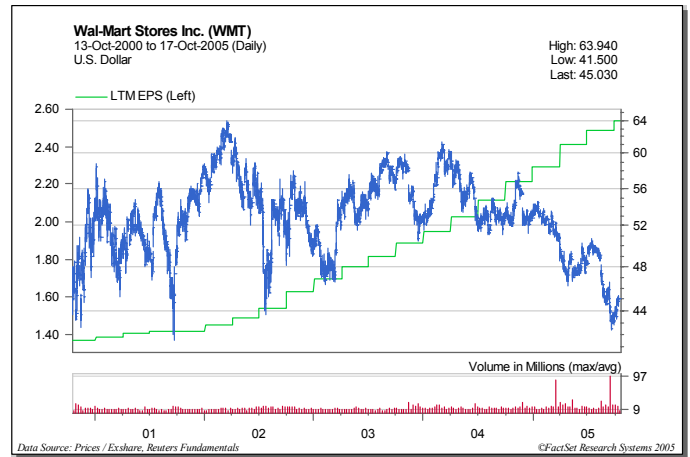
## New Holdings—Retailing

It hasn't escaped our attention that we wrote four research reports last quarter, none of which is included in our group of new holdings. Of course, we continue to monitor those businesses, but the opportunities came in a different area. Discount retailing has been out of favor on Wall Street for some time. The rather steady nature of discount retailing has been snubbed in favor of higher fashion and higher-priced goods. More recently, as mentioned above, discount retailing has been associated with lower-income consumers, which are having a tougher go of it, suffering from relatively high unemployment rates and higher fuel prices. All of this has some truth to it. Nonetheless, EPS continue to grow at Dollar General, Wal-Mart, and TJX, the latter two being our most recent purchases. All of these retailers have their own unique competitive advantages that give them the ability to deliver consumer goods at lower prices and/or greater convenience, neither of which will ever go out of style. Indeed, we rather like the defensive characteristics of our retailers and believe that they're among the better-positioned businesses, irrespective of the general business environment. For these reasons we think that a concentrated position in discount retailing is a good way to manage long-term risk without sacrificing long-term returns.

### Wal-Mart (WMT)

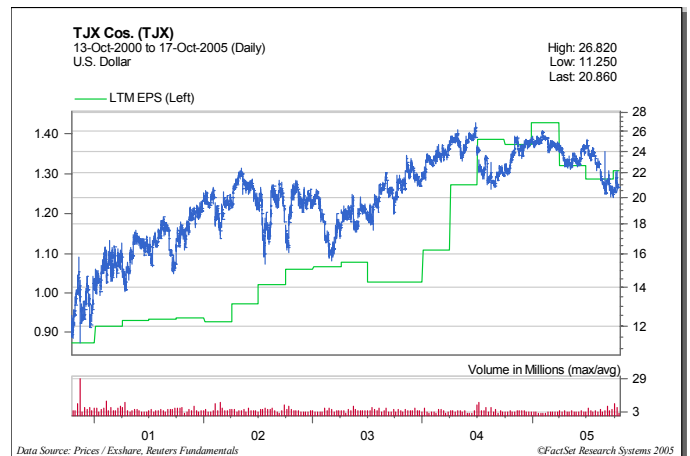
WMT clearly has a sustainable competitive advantage as a low-cost distributor of consumer goods. There is no other company on the globe that can compete with WMT's positioning as an EDLP (everyday low price) retailer. We believe that's an advantage Wal-Mart will enjoy for a long time. The bigger and more relevant question must be with regard to future growth. How can the company continue to grow at the pace it has in the past? Of course, it won't.

If the company can grow at the rate of GDP (and we think it will do even better than that for a while) in the United States and grow at a 20% rate internationally, core growth will be 9-10% per year. However, WMT earns more than 20% on its equity, which means the company will generate significantly more capital than it needs for growth purposes. We think share repurchases can add another 2-3% to the EPS growth rate, making low double-digit growth not much of a stretch. A company that can grow at that rate with such conspicuous competitive advantages should sell for more than 15x EPS.



### The TJX Companies (TJX)

TJX, whose flagship stores are T.J. Maxx and Marshall's, has one of the most unique and profitable (return on equity has averaged over 45 the last five years) business models among all retailers. TJX is the behemoth in off-price apparel retailing. Its uniqueness is derived from two different sources. First, it has a group of more than 400 experienced buyers, each with long-established relationships among thousands of apparel makers. These buyers are always in the market for special deals, many of them stemming from the basic fundamentals of the apparel value chain, which has a six- to 12-month lead time. Fashion-related mistakes are made, and the increasing power of first-run retailers puts even more pressure on manufacturers to find alternative channels of distribution. TJX can acquire merchandise at a fraction of the total cost of department stores.



Second, the entire distribution and information technology systems are very different from traditional retailing. In many cases there isn't sufficient purchased inventory for every TJX store. In other words, there simply isn't enough of the deal to go around, which requires smaller and more regional distribution centers. Furthermore, merchandise often comes into the distribution centers in some measure of disarray. Tags need to be taken off and new tags applied. The merchandising systems also are unique to account for the fact that different stores will carry different merchandise. It takes experience and scale to be able to merchandise every store effectively.

High returns on capital and adequate reinvestment opportunities, particularly in the newer TJX concepts, should lead to good EPS growth. The company has reduced its share count by 30% the last seven years while continuing to grow square footage at a 7-9% annual rate.

A few of TJX's newer concepts have struggled over the last year or two, leading to the resignation of the CEO. The company's well-respected founder and chairman has retaken the reins as CEO until a replacement is found. We expect more clarity in the months ahead with respect to TJX's plans for the newer divisions. As such, we are likely to add to our position if (1) the stock price drops or (2) we can be more assured of profitable future expansion of the newer concepts.

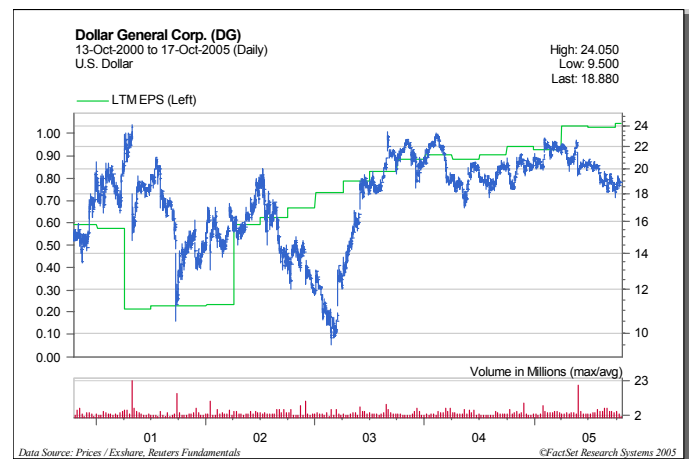
## Equity Holdings

### *Dollar General (DG)*

In our last update we mentioned that EPS progress for DG has been rather irregular. After reporting disappointing profit growth in the first quarter, the company reported an EPS improvement of 21% in the second quarter. There was some gross-margin pressure as transportation costs increased and the mix of merchandise sold continued to shift toward lower-margin consumables. The company knows its customers are under stress because the mix of merchandise changes during the course of the month. Clearly, there are more discretionary items being purchased early in the month, coinciding with governmental program payments. The gross-margin erosion, however, has been more than offset by improved productivity in the stores. The company's EZ-Store initiative, which involves presorting merchandise into

wheeled carts at the distribution centers and wheeling them into the stores, is having the desired effect.

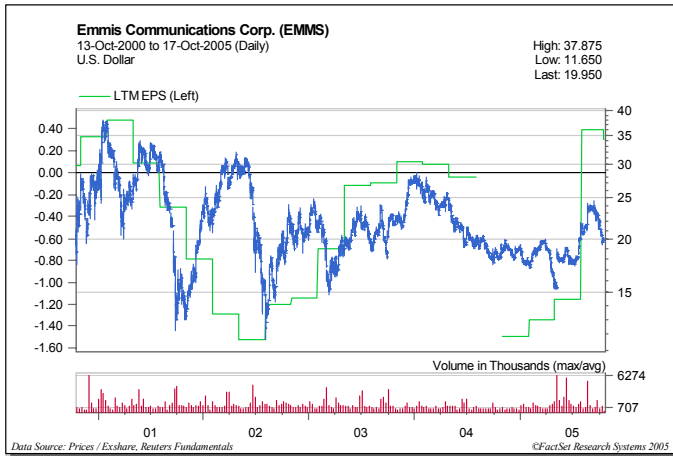
Dollar General is continually trying to improve merchandising and shopability of its stores with several initiatives aimed at these areas. Still, there is no denying that higher fuel and heating costs are having a disproportionate impact on the company's core customer base. We have become increasingly confident in the management team and believe that the company will continue to meet the challenges of the marketplace. It's important to note that, even in a difficult environment, ROE exceeds 20%, and the company continues to grow sales at a double-digit rate, with EPS at a somewhat faster pace.



### *Emmis Communications (EMMS)*

Almost everything has changed at Emmis except for the underlying fundamentals of its remaining business, which is radio. The industry continues to adjust to fewer commercials ("inventory loads" in industry parlance), which has put a damper on industry growth. Emmis stations continue to perform exceptionally well relative to their local competitors.

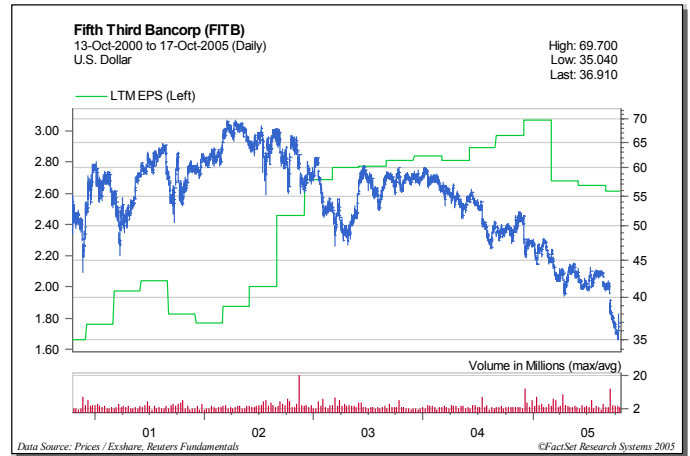
Deals have been announced for the sale of most of the television stations at prices well above general expectations. This helps confirm our conviction that the underlying asset value of EMMS exceeds its market price by some margin. The TV assets will be sold for more than \$1.3 billion, which will be used to reduce debt, which temporarily skyrocketed after the company repurchased almost 40% of its stock earlier in the year.



EMMS will have a newfound financial flexibility after the remaining TV stations are sold. At that point the company should have a wonderfully profitable mix of large market stations but with limited prospects for growth. Private market values for radio properties are still high and uneconomical by our standards. We believe that the management team should take the company private, and it would be financially feasible at a price in the \$25 to \$30 range and perhaps higher. Our worst fear—the possible purchase of the Washington Nationals baseball team (CEO Jeff Smulyan has a passion for baseball)—is largely off the table as any Emmis investment would be limited to \$100 million. We'll closely monitor the company's decision-making process and won't hesitate to sell our position if it appears that shareholder value is being compromised.

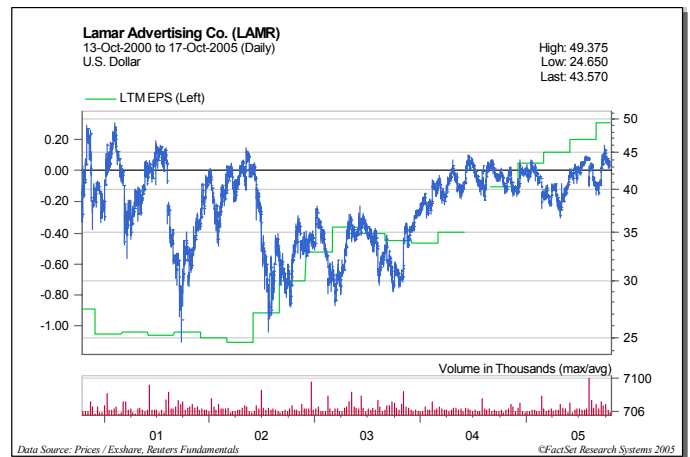
**Fifth-Third Bank (FITB)**

It's taking far longer than we thought for Fifth-Third Bank to return to the levels of profitability that we have been expecting. For that, we have all paid a price. Clearly, a flattening yield curve has contributed to poor performance, but there has been a series of management miscues as well. We're looking for two things to happen. First, we want to see progress on the efficiency ratio, probably the most important measure of low-cost status in the banking industry. We're convinced that one must be a low-cost producer in this industry. Second, we want to see improved capital management at the bank. Both of these need to occur within a reasonable timeframe in order for MCM to stay with FITB as shareholders.



**Lamar (LAMR)**

Lamar, the 3<sup>rd</sup> largest company in the billboard business, is beginning to hit its stride. Occupancy rates are up (especially in posters), and rates per billboard increased 5-7% over the same quarter last year. EPS, based on GAAP (generally accepted accounting principles), increased 17%, but the more important figure, growth in after-tax cash flow, was up only 5%, as the company makes the transition to becoming a full taxpayer.

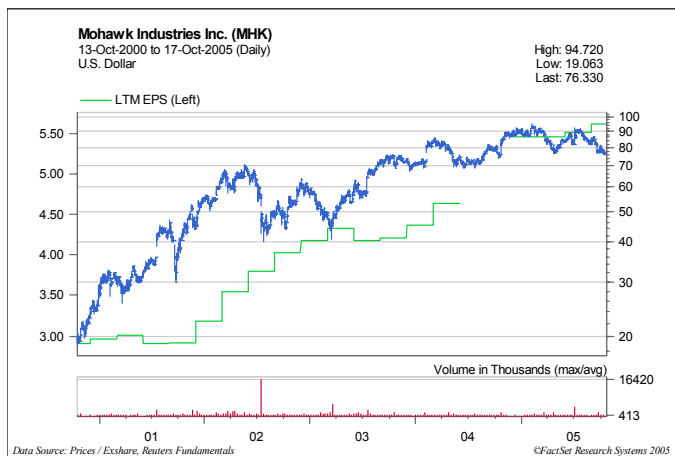


Our original investment thesis is playing out as planned. We made this investment in the throes of a significant advertising recession, during which occupancy levels for the entire industry were severely impacted. Unlike the competition, Lamar made the difficult decision to hold the line on pricing and not let existing and prospective customers negotiate better prices during the tough times. As a result, Lamar's occupancy levels fell well below those of its competitors. With hindsight now 20/20, this

strategy was beautifully executed, and rates are now starting to produce nice returns at the operating-income line. We expect improved expense leverage as occupancy and rates continue to recover.

### **Mohawk (MHK)**

EPS growth has slowed at MHK (+8% last quarter). Fiber (an oil-based derivative) represents roughly 70% of the cost of goods sold for the carpet division. Moreover, rising fuel costs make running its own distribution system (a big competitive edge) more expensive. Fortunately, the consolidation in the floorcovering industry has resulted in a much more rational pricing environment. As such, margins have held up well as MHK has been able to pass along increased costs, albeit with a lag. We expect more of the same in the short run. The fear of rising raw-material prices allowed us to increase our holdings at very reasonable prices.



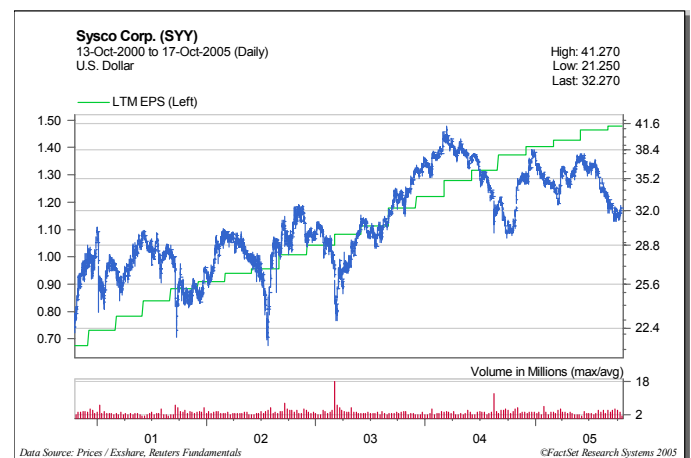
Much more significantly, we have become increasingly confident that MHK's \$2.1 billion acquisition of Unilin will contribute materially to earnings growth for the next few years. The acquisition will be additive, and subsequent deleveraging will further contribute to earnings growth.

We agree with most other commentators that the growth in housing demand is bound to slow. New residential construction accounts for 25% of the industry's sales. Replacement demand and remodeling account for about 50% of sales. We expect, therefore, that EPS progress at MHK to be lumpier than with many of our other holdings. We also believe that there's latent margin potential if we get some relief in the price of oil over the next year or two. The management team at MHK is experienced and

talented, and it knows how to operate the business in all economic environments.

### **Sysco (SYN)**

Higher gasoline prices are having a double-whammy effect on Sysco, the largest distributor of food and allied products to the foodservice industry (restaurants, schools, hospitals, etc.). Eating out is a discretionary consumer purchase, and the \$10 to \$20 per week more an average family is spending on gas takes away from restaurant sales. Like Mohawk, Sysco manages its own distribution system with a huge fleet of trucks, which contributes to additional costs. Therefore, sales and earnings have been rather lackluster. EPS growth for the quarter was about 5%.



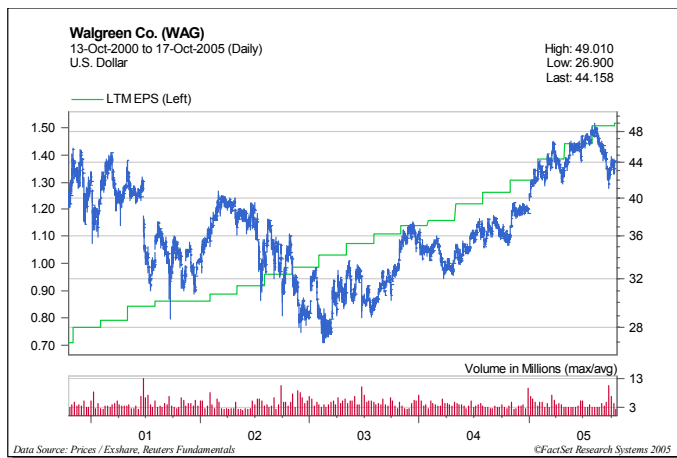
We commend SYN managers' position in providing earnings guidance; they don't do it. The following response is from the Sysco CEO to an analyst asking for any feeling on Wall Street's consensus estimate for 2006: "Answering that question would be giving guidance, Steve. So we don't publish those expectations, and we work hard to take care of our customers and grow our business. We're building and investing for the future. So we're—I think that's all we can say about it." Nicely handled ...

The "building and investing for the future" largely involves investment in sales and marketing, as well as in distribution infrastructure. Both are expensive, and both are targeted at areas that enhance the company's competitive advantage. After scrutinizing its customer base over the last few years, the company is intent on growing market share again through providing better service to its better customers. Even Sysco's best customers meet more than 50% of their foodservice needs through SYN competitors. The company's investment in regional

distribution facilities (the first of its kind in the industry) will further boost the company's low-cost status. These initiatives are relatively early in their development, and we're watching their progress closely.

### **Walgreen (WAG)**

WAG finished its fiscal year (ended August 31) with a 16% increase in EPS (18%, excluding the impact of Katrina). Sales grew nearly 13%, and higher gross margin and a slightly lower tax rate accounted for the rest of the earnings growth. Gross margin is under constant pressure due to the continued mix shift toward lower-margin pharmaceuticals. This was more than offset by a greater mix of generic drugs, which carry much higher margins than branded drugs. However, lower-priced generics reduce the leverage of SG&A expenses. Walgreen truly is a business managed according to contribution margins.



More importantly in the long run, WAG is executing a business plan that is moderating the biggest potential threat to its business, the growth of pharmaceutical benefit managers (PBMs). PBMs are not, in and of themselves, a huge threat to drugstore chains. Rather, it is the self-dealing nature of the PBM mail-order business that poses the greatest threat. We sense that health plans (which hire PBMs) are demanding more transparency and choice from their pharmacy benefit managers. This greatly improves WAG's positioning in the marketplace. We are content to hold our existing position in this fine company.

### **New Ideas**

In addition to Wal-Mart and TJX we have completed research reports on Brown & Brown, an insurance broker, and Waters Corporation, a manufacturer of scientific

instruments. Both are too expensive for our tastes at the present time, but we are encouraged about the quality of companies that we are adding to our focus list.

As we continue to broaden our focus, we'd encourage you to call us if you find businesses with the following characteristics: (1) sustainable competitive advantages demonstrable by good returns on capital, (2) opportunities to reinvest capital in their existing businesses, and (3) able and honest management.

### **Website Information**

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

User Name: martincap07\*

Password: martincap07\*

*\*Updated September 2005*

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