

APRIL 2008

## The Chronicles of Narcoma

*For the great majority of mankind are satisfied with appearances, as though they were realities, and are often more influenced by things that seem than things that are.*

-Niccoló Machiavelli (1469-1527)

“Most writings emanating from MCM are designed to exhibit continuity from one to the next so that these easily overlooked sea changes don't go undetected until it's too late to react.” The above sentence was second among seven bullet points, thumbnail sketches if you will, for the harried, that introduced the 2007 third-quarter capital markets review, published at what may prove to be the peak of the market in October 2007 under the title *What's Up, Doc?* The concluding bullet point: “Given everything that we have read, studied and in part, assimilated, we have concluded that more financial and perhaps economic headwinds—separated by tempting respites—lie in waiting for the unsuspecting. While this is hardly a forecast, such an environment will not likely treat overall common-stock prices kindly.”

The product of much exertion, thought and reflection, the 2007 annual report, continued the forward-looking warning theme three months later with such section headings as “An Early Epitaph for the First Decade of the New Millennium,” “Credit-Default Swap Alchemy: Transmuting Junk into Gold,” and

“Counterparty Risk.” It concluded with a rhetorical question followed by a statement: “Who May Be Holding the Bag?” and “Coming Full Circle.”

This quarterly chapter, written in late March 2008, could be justly named the fictitious title of *The Chronicles of Narcoma* (a state of suspended sensibility), with all due apologies to C.S. Lewis who wrote the Narnia series.

At the moment Wall Street is center stage in the “theater of the absurd.” But elsewhere life goes on. Even in applauding the brilliantly conceived and refreshing popular success of “American Idol,” I'm prone to a flashback, while still staying on pitch, to the 1960s rock idol Del Shannon. He recorded “Runaway” in 1961. A few years later, desperately competing with the Beatles invasion, he countered in 1965 with “I Go to Pieces”—and that in fact is what he did. Almost prophetically, the two song titles captured investor sentiment perfectly in roughly the first half of the decade of the '60s. The state of suspended sensibility out of which the financial world and perhaps (a few

measures later) the economy are being rudely awakened harmonizes with the lyrics and the melody of “Runaway” as the era (more accurately, error) of financial innovation, only recently in full self-destructive voice, is now scratching out a raspy version of “I Go to Pieces.” Allegory occasionally ameliorates the dreariness of the “dismal” adjective when referring to economics as a science. Since the undersigned believes that economics in reality is some dynamic admixture of science and art, a musical segue seems *apropos!*

What immediately follows are brief sketches of what can be found in the body of the report.

■ **What's on the Other Side of the Fog of**

**Confusion?** In the long run I'll sing along with Warren Buffett and his ukulele, *I'm Proud to Be an American*, and put my faith in the wisdom and steadfastness of one of our most iconic early industrialists, John D. Rockefeller, who embodied the American dream. Undeterred by (or perhaps not fully aware of the potential consequences of) the Wall Street crash of 1929, he shortly thereafter offered these words of encouragement (albeit from a man who would not find himself among the 25% of American workers unemployed three years later, standing in a bread line and/or taking up residence in a Hooversville): “These are days when many are discouraged. In the 93 years of my life, depressions have come and gone. Prosperity has always returned and will again.” Rockefeller was, in due course, right as rain, as I'm sure Buffett will be. The trick for mere mortals is to get through the maze from here to the “long run” without excessive and often unnecessary suffering. Staying focused is essential. The following are thoughts to ponder to keep idle minds from becoming the devil's workshop.

- **From Risk to Repentance.** The sea change from indifference to risk on the extreme to risk aversion on the other is clearly under way in certain sectors of the economy. But it will likely migrate up and down the economic food chain before we eradicate the self-destructive propensities and uncover the fertile psychological soil in which we can confidently predict that the seeds of rationality will take root.
- **Is Cash King?** Holding 70% cash with our equities hedged against catastrophic risk we are, only in the short run, in the catbird seat. The battle is only half won—and the second half is much harder than the first.
- **A Historical Reality Check.** Bear markets rarely perform their cathartic cleansing in only six months, and common stocks are selling nowhere near prices that should be considered bargains. Making capitalizing on impending opportunities that much more problematic—avoiding the bear markets' contra trend rallies, what we refer to as swinging at “sucker pitches”—we must suppress the well-ingrained impulse to buy on dips.
- **Volatility: a Prelude to Opportunity.** Market prices don't react rationally in response to exaggerated uncertainty and are further distorted by emotionally charged central bank intervention in the free-markets pricing mechanism. Volatility is often a symptom and not a cause of underlying financial and economic malaise. Mispricings of this extreme variety, for those who know value, provide equally enormous opportunities.
- **How Will We Know 'When'?** That, dear readers, is the \$64,000 question! Of the two emotions, fear

and greed, the former is much easier to detect than the latter. Recall the lyrics from “The Gambler” in the 2007 annual report ...



For those who desire to know the “why” behind the above reasoning, read on ...

### ■ What's on the Other Side of the Fog of Confusion?

The resilience of the American spirit is the stuff of legend. Unlike the citizens of many countries around the world, mired as they are in seemingly endless despair, as the progeny of our forefathers most of us are hard-wired to be perennial optimists. Our history is resplendent with stories of adversity overcome and change embraced. A mere 48 years ago, on the eve of the assault on racial discrimination, John Kennedy overcame Catholicism as a stigma to win the hearts of America and, with them, the highest office in the land. Today a white woman, a black man, and a hero from an ill-conceived war vie for the same opportunity to lead us into an always uncertain future. Even in the face of daunting challenges and the enveloping uncertainty, Americans by the millions tune out the news of financial crisis and tune in to “American Idol,” a symbol of the expansiveness of the American dream, embodied in our young people, who are our future.

Yet we cannot deny the difficulty of the task at hand. Let's now look at several rules of thumb that might help readers begin to cut through the mists of obfuscation (or fogfuscation) if they, first and foremost, wish not to lose. To begin, dramatic increases in market-price volatility are often early-warning signals of eco-

nommic turbulence ahead. Of course, volatility is most pronounced in those economic sectors most dependent on financial leverage. Second, and clearly interdependent (after the initial collapse in stock prices of companies in these industries), the stocks often rally convincingly—frequently pushing toward previous highs—because, in the first phase of a price decline, the fundamentals remained favorable. In the case of cyclical industries, investors fall prey to the low valuations of these companies based on current earnings. Cyclical companies invariably command relatively low valuations near the peak of the cycle, whereas they have huge price-earnings ratios because of depressed earnings or losses near the bottom of the cycle. For example, shares of homebuilders and subprime lenders had very low price-earnings ratios near their peaks in 2005–06. Despite being bid up by bargain hunters, many of these stocks are likely to be dead money for years, particularly if price volatility, as indicated above, is an early-warning indicator of economic troubles. I am equally concerned that the financial sector—aside from a “dead cat” bounce—will underperform for years. According to the esteemed Bank Credit Analyst, the American financial services industry's share of total corporate profits rose from 10% in the early 1980s to 40% at its peak last year. Its share of stock market value grew from 6% to 19%. These proportions look all the more striking—even unsustainable—when you note that financial services account for only 15% of corporate America's gross value added and a mere 5% of private-sector jobs.

How do we make our way to a more stable tomorrow? Which path do we take? Robert Frost described the dilemma relevantly—and poignantly—in “The Road Not Taken”:

*Two roads diverged in a yellow wood,  
And sorry I could not travel both  
And be one traveler, long I stood  
And looked down one as far as I could  
To where it bent in the undergrowth ...*

*I shall be telling this with a sigh  
Somewhere ages and ages hence:  
Two roads diverged in a wood, and I—  
I took the one less traveled by,  
And that has made all the difference.*

We have chosen the road less traveled. Whether “ages hence” it will have “made all the difference” is not for us to know until then ...

### ■ From Risk to Repentance

The transformation from risk-taker to risk-avertter is generally not a voluntary decision. Like the mule through whose thick skull your commands are unlikely to penetrate until first thumping him politely on the posterior with a 2-by-4, risk-takers are disinclined to repent without painful cause. Once again, this characteristic is indigenous to the nature of humanity. From the consumers who defied the laws of economics and spent more than they earned, to the homeowners who risked being homeless to live in more home than their means justified, to the hedge funds, commercial, mortgage and investment banks who, for the most part, were playing fast and loose with someone else's money, risk-taking became rampant. While there's plenty of blame to go around, the asymmetry of information puts the “experts” in the position of exploiting the ignorant. Accordingly, repentance (seemingly without remorse, if that's possible) is evident among those seeming experts, the money-changers, known as financial intermediaries in today's ver-

nacular. Perhaps my taking literary license with a homonym, *x-spurt*—an unknown drip under pressure—we more fittingly describe those who masquerade as pundits?

As for the novice, whether the fault can be traced to naïveté or negligence, the consumer whose piggy-backed mortgage and home-equity loans exceed the depreciating market value of his home, whose maxed-out credit cards extort 30% in interest costs, he must be wondering in his bewilderment, “What was I thinking, or was I thinking?”

Repentance may lead to changing one's ways. What's good for the individual or the financial institution may beggar his neighbor—in the short run. Metaphorically, what is good for the goose may not be good for the gander. Contrite lenders have become acutely risk-averse, hell-bent on being among the survivors as the crippled financial ship continues to take on water. Not without precedent, after the “bank holiday” of 1933, bankers, anchors set deep in their disastrous past, were loath to make a loan. Potential borrowers, themselves chastised for the earlier recklessness, were reluctant to venture forth, let alone take on fixed dollar amount debt that might be paid back with deflated dollars. Today, whether the Fed, no doubt to be aided by more fiscal stimulus, can induce what is likely to be an increasingly reluctant horse to actually drink is problematic. If not, things will get worse before they get better. If the Fed succeeds, things will get better before they get worse. Neither alternative, in my judgment, is fully priced into stock valuations.

## ■ Is Cash King?

*He said, "Son, I've made a life out of  
readin' people's faces,  
And knowin' what their cards were by the  
way they held their eyes  
So if you don't mind my sayin', I can see  
you're out of aces.  
... Said if you're gonna play the game, boy,  
ya gotta learn to play it right.  
You gotta know when to hold 'em, know  
when to fold 'em,  
Know when to walk away and  
know when to run."*

The melody of "The Gambler" ringing in our ears, with 70% of our portfolios in cash and our equities hedged against catastrophic risk we had grown more and more leery of the odds and what we read in the eyes of "Mr. Market" as a game played on.

As we are quite aware, you can't win a hand if you're not sitting at the table. As we observe Mr. Market and see the fear of loss beginning to displace avarice in his eyes, we know that the odds for low-risk success are getting better. The great John Templeton admonished: "Buy at the point of maximum pessimism."

Templeton did not expect us to take him literally. Like officially designated recessions, such moments are never known until long after they come and go. We expect to be back at the table well before. Accordingly, we cannot avoid risk. We simply prefer small, manageable risks that don't play tricks on our minds. We call it a "margin of safety." In the meantime, the battle is only half won—and the second half is much harder than the first. Money in cash is not without risk. This is certainly true for bank deposits, CDs, all structured products—and even money-market funds where the

return of capital is uncertain. In the case of Treasury securities, money is also at risk for different reasons. Safe-harbored in Treasuries, capital and its return won't be a problem for now, but with yields of less than 2% on two-year notes, 3.7% in 10 years, and 4.5% for a 30-year commitment, Treasury securities carry the risk that inflation (which in real terms currently exceeds market yields) will, given enough time and adverse circumstances, chip away at if not effectively destroy the purchasing power of the principal.

Throughout most of the 1970s interest rates were well below the rate of nominal GDP growth and negative in real (inflation-adjusted) terms. So ... what happened? Inflation accelerated, bond yields soared from 6% in 1970 to above 15% in 1981, and the U.S. dollar tanked. Those who early on bought low-coupon, long-term bonds lost doubly: Bond prices collapsed while the purchasing power of what remained was eaten away by inflation. Fortunes were quietly dissipated in this insidious manner. For those who remained wary and didn't move out on the then-inverted yield curve until 1981–83, ground lost to inflation was regained and much more when the cycle turned and positive real interest rates (during an extended period of disinflation) became the new norm. A steely temperament was required to avoid committing early. Fortunately, the moment of opportunity did not pass quickly or quietly. (Parenthetically, perhaps such a temperament may be called for in the equity markets almost 30 years later?)

A debt-disgorgement deflation is anathema to all but a few. The Fed chairman, who researched the consequences of the deflationary curse of the '30s, is so leery as to have threatened to "drop dollars from helicopters" to forestall the realization of his worst night-

mare. Nonetheless, such an outcome is still a remote possibility. Though nobody wants it, under certain scenarios nobody can stop it. The current freefall in consumer confidence must be causing policymakers apoplexy. Once again, what's good in the long run may be costly in the short run. What if repentant consumers begin deferring consumption, spending less than they earn (formerly known to history buffs as the archaic term “savings”), in an effort to reliquify their balance sheets, imitating the bankers?

When push comes to shove, and debt grows to the point of stretching a country's capacity to service it (a point we have probably not yet reached unless the cash-generating power of the economy goes into an extended slump), repudiation through debasing the currency becomes the road of least resistance and therefore the one that most policymakers opt to travel. Exclusively within the purview of the central bank, despite its enormous economic and social costs, printing claims which have no specific backing, like the thrashing of long-term bond investors in the 1970s, is both expedient and largely undetectable until after the damage is done (and the political guard has long since changed, leaving some hapless chap “Hoover[ing]” the bag).

In the meantime, negative real interest rates are the impetus behind investors, including individuals and institutions of all stripes, among them state and private pension funds, scrambling for “shelter” in risky investments, which, as history reveals, may be the greater evil. Necessity never drove a hard bargain. When all is said and done, the diminution of America's aggregate net worth could exceed many trillions of dollars.

Cash is the default asset class for us at Martin Capital.

Accordingly, large amounts of it reveal limited opportunities to more judiciously employ capital. It wouldn't surprise me at all if in the next year or two there will be little or no cash in the cookie jar. Good things often happen to those who wait patiently for opportunities to present themselves on a silver platter.

### ■ A Historical Reality Check

Irrational exuberance, like speculative contagion, reflects a generalized propensity to surrender intellectual autonomy, when individuals or institutions submit—often unwittingly—to the beguiling and comforting (who wants to be odd man out?) conformity of the crowd. Like “Gold Rushers,” the irrationally exuberant downplay or even disregard risk in the frenetic, reckless, and compulsive search for illusory riches. This is not news. Almost 500 years ago Shakespeare, in the comedy *The Merchant of Venice*, immortalized this elementary proclivity:

| *All that glitters is not gold;  
Often have you heard that told:  
Many a man his life hath sold  
Had you been as wise as bold ...* |

The aberrant behaviors thus manifested (with the benefit of hindsight) must be considered contemporaneously suspicious by imperturbable skeptics who had the discipline and self-control to remain steadfastly independent. The litmus test: If two years ago, based on information available then, one did not conclude that the run-up in house prices underwritten by fast and easy credit would “not end well,” this lack of discernment (as the evidence was compelling) may not bode well for one's capacity to think independently and rationally about what lies ahead. That's not a problem—if one knows it's a problem!

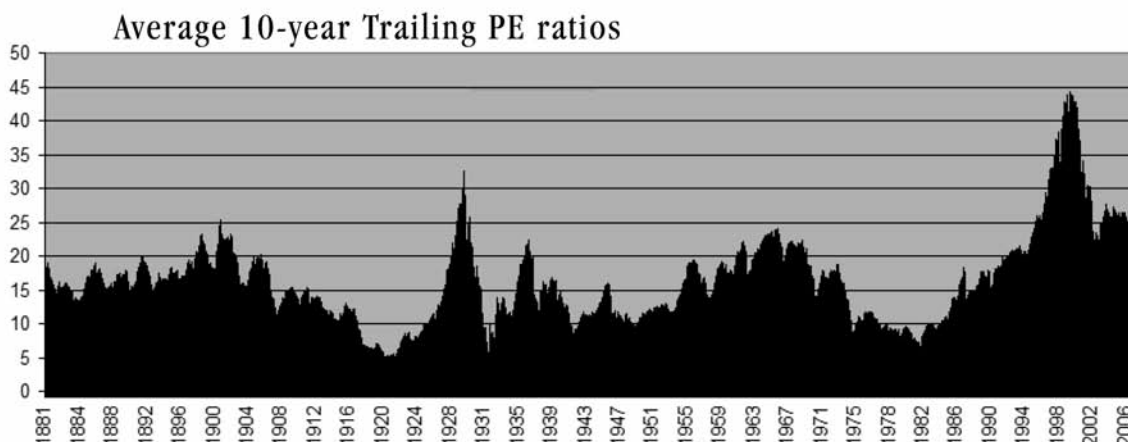
Let's look for guidance in the lessons to be found in similar episodes from the past. Even though the primary trend in stock prices has been downward since October, the S&P 500 has already thrown three teaser contra-trend "sucker pitches" of greater than 5%: December 7%, January 6.9%, and March 6.7%. "Sucker pitches" are indigenous to bear markets. If it were easy to differentiate the tides from the waves, everyone would be rich. There were over 15 such rallies in each of the last two market slumps (1973–74, 2000–02), during which much wealth was both permanently dissipated, with the remainder redistributed from weak hands to the strong. From the October highs through March lows, the S&P 500 gave up 300 points or 19.2%. Through March 28, at the time of this writing, it was down 15.1%. In the 10 bear markets since the end of World War II, the S&P 500 declined 32% on average from peak to trough. The last two bear markets declined 50% and lasted 18 and 27 months, respectively. If the pendulum has indeed begun to swing, it may be closer to the beginning than the end ...

Likewise, corporate earnings and nominally low corporate price-earnings ratios, thought now to be a bastion of support for stock prices in the eyes of many commentators, may be more glitter than gold to the rational skeptic. No stranger to these pages, Robert Shiller, whose arrogance (in my personal experience) attenuates the greatness of some men, nonetheless established himself as a man with whom to reckon in his two sequential books, both under the primary name *Irrational Exuberance*. The first edition, published in 2000, prophesied, with remarkable accuracy as to cause and effect, the bear market in stocks that was soon to follow. The second, equally prescient, recognized that speculation had migrated from common stocks to real estate. You may recognize the name in

the most frequently referred to measure of housing prices, the S&P/Case-Shiller Price Index.

Taking a page out of Benjamin Graham's "book," Shiller compares price-earnings ratios using *current* reported earnings with a cyclically adjusted 10-year moving average of earnings when calculating the S&P 500 price-earnings ratio, which is also deflated by the Consumer Price Index. Although not pictured, the data show that the *current* price-earnings ratio is now very close to its long-run mean of just over 15. The most recent cyclically adjusted price-earnings ratio, however, is 26.5, or about two-thirds above its long-run average. Given the volatility in earnings, a single data point can be misleading. In times like the present when respectable forecasters believe we have already entered a business contraction, made all the more vulnerable by what are likely to be unsustainable record high profit margins, using forward earnings borders on misrepresentation or stupidity. A moving average smoothes out these wrinkles in the earnings trendline. Detractors say a moving average understates earnings and overstates price-earnings ratios. Proponents, of whom I'm one, argue that it moderates the impact of extraneous and transitory factors. Examine the chart on the next page for yourself.

Shiller's method also effectively highlights periods of prolonged and ultimately unsustainable stock market euphoria, and equally important, times when stocks in general sold at giveaway prices. Even the most cursory look at the chart reveals those secular peaks and troughs that, if generally recognized as such, greatly enhanced investors' long-term returns. First look more closely at the years 1920, 1932, 1942, 1974, and 1982. In each case the moving average sunk below 10 times earnings and was often not limited to a single year in the doldrums. These were the years during



which a blindfolded chimpanzee throwing darts at a *Wall Street Journal* as a random method for selecting stocks would have earned way-above-average returns over at least the subsequent 10 years. Now look at 1900, 1929, 1937, 1966, 1972, 2000, and 2006. Professional investors invariably sacrificed their reputations on the rocks of overvalued, euphoric markets. Always in search of ironic historical parallels, “monkey see, monkey do” is a traditional cliché that popped up in American culture in the early 1920s. ☺

Since the past is but prologue, here's how I interpret the current environment. The price-earnings ratio of the S&P 500 reached its all-time peak in the late 1990s. The capitalization-weighted index's price-earnings ratio was skewed upward by the dominance of the high multiples paid for the big-cap technology companies like Microsoft, Intel, and Cisco. Even the “Nifty 50” craze culminating in 1972 was no match for the valuation extremes as the information economy, with the new kid on the block, the Internet, emerging as the crowning achievement of the newest era. The Nasdaq Composite Index, which incubated and still represents many of the most exciting Information Age companies (and is well-represented in the S&P 500) sells for approximately 50% of its peak of 5000 in 2000. What the S&P 500 lost in terms of contribution from richly priced technology shares, it made up for

(as has been covered extensively on these pages) with the enormous profits that were generated in the age of financial innovation. Technology advances are secular, while financial innovation is cyclical. It's important to know the difference.

Each speculative high in the 10-year moving average price-earnings ratio was eventually followed by its opposite. While the steps leading to the bargain base-ment are often two steps down and one step up, the confusing opposite is also true. Still, no matter how uneven the trend, history and the odds suggest that lower valuations (and correspondingly lower risks, at least as we define them) and greater opportunities lie ahead. And, you might logically ask at this point, just how far is “ahead”? If I knew with 90% certainty, we'd all be living and breathing embarrassments of riches! Given what I've written over the last several years, and the extreme precautions we've taken in preparation, I would not be surprised by the steepness of the decent. If the adage, “The bigger they are, the harder they fall,” applies, it should not come as a shock to any of our readers. Although that's largely conjecture, it is the following to which I would give a 90% probability. When the “perfect storm” has run its course, it will be followed by a rising barometer and stable, low-risk weather for years. Getting from here to there, however, is the period of great temptation, which will likely

separate those who see only the trees from those who also see the forest. Someday we may look like geniuses while, behind the scenes, we're just a bunch of chimps throwing darts at *The Wall Street Journal*! Even a monkey shines in such times. In others, a market guru can look like a baboon.

To be sure, a stock market is also a market of stocks. While bucking the trend is riskier than riding the trend, strong individual companies will swim upstream like salmon in the Columbia River come spawning season. History makes clear that smaller companies underperform their larger brethren in falling markets and outperform in rising markets. Thus, the worse the market gets, the more likely it is that the most compelling bargains will be found among well-managed and well-capitalized smaller companies. As logical as that statement is, most investors will be doing the opposite.

### ■ Volatility: a Prelude to Opportunity

Market volatility is not making seeing beyond the trees to the forest any easier, with a record 54% of trading days so far in 2008 advancing or declining at a rate greater than 1%. Those who take their lead from an unusually excitable “Mr. Market” vacillate, sometimes more than once a week, between the bullish and the bearish camps.

While most readers are aware of volatility in the equity markets, they are likely to be less aware of the goings-on in the derivatives market where investors buy and sell protection against bond defaults. The next shoe to drop (if the recession smacks the nonfinancial economy) will likely be the \$45 trillion notional-value credit-default swap (CDS) market, which was examined extensively in the 2007 annual report, under the titles “Credit-Default Swap Alchemy: Transmuting Junk

into Gold” and “Counterparty Risk.”

Telegraphing trouble, even though corporate default rates remain near historic lows, according to Standard & Poor's, junk-bond spreads (the premium in interest rates required above the comparatively risk-free rate of U.S. Treasury securities) have escalated from record low premiums last summer of about 2.4 percentage points to near 8 percentage points.

Using CDS as the measure, the cost of insuring against default by firms like Bear Stearns and Lehman Brothers Holdings Inc. (though dropping since the Fed's actions) is indicative of the volatility among the fringe companies in the financial sector.

Investors can buy protection against a Lehman default on \$10 million of bonds for almost half of last week's price, at \$232,000 annually from \$448,000. The cost of such protection last year was just \$29,000. Behind the scenes (see the story of John Paulson in the annual report), fortunes were made on the long side of CDS.

The extreme volatility in the CDS market presents enormous opportunities for those who remain rational. On March 20, Merrill Lynch announced further possible write-downs for as much as \$3.1 billion due to counterparty nonperformance on mortgage-related credit-default swaps. We're just now starting to see the tip of the \$45 trillion CDS iceberg in corporate credits. The fact that most swaps are written for five years and that nonfinancial corporate credits will not likely reveal serious fissures (unless or until the economic contraction migrates from the financial sector of the economy), the corporate debt CDS remains a potential accident, potentially an order of magnitude greater than the subprime fallout, waiting for precipitating cause. Because of the unique supply/demand imbalance

ance in the market for such complex instruments, opportunities may abound to sell swaps on pristine credits at premiums that discount Armageddon.

■ **How Will We Know 'When'?**

A sneak preview can be found above in “Is Cash King?” for this most vexing of challenges. Anecdotal evidence, reliance on intuition over fact-driven backward-looking models, and other “soft” variables tend to be more reliable in determining the generalized environment that we might characterize as a vague “when.” A simple example will suffice. Turn back to the chart on page 8 and, reading from the left legend, notice the absolute 10-year adjusted price-earnings ratios that preceded long and highly profitable advances in the market (1920, 1932, 1943 and 1982). In all but one, 1932, if you had waited for the market to sink to five-times earnings the train would've left you standing at the station. All we know now is that the absence of widespread repentance and 26.5 times Shiller's adjusted earnings does not provide an adequate margin of safety. When our intuitive antenna

signal that capitulation is pervasive, that risk aversion is the new prism through which investors view the investment world, we will, with certainty, commit large amounts of capital in a time when most investors are frightfully uncertain. Whether the absolute level of Shiller's ratio is five times or 10 times is of secondary importance.

The plot thickens when we examine more closely the reciprocal of the investment aphorism, “a rising tide lifts all ships.” While generally right, it's not universally so. “All” should be replaced by “most” as the modifying adjective for “ships.” We will add companies to portfolios one-by-one, each as its expanding margin of safety reaches the point where it compels us to act. As value investors, we don't buy markets, we purchase fractional interests in companies. Obviously, there is some correlation between fear-ridden markets and the number of companies selling at low risk/high prospective return prices not unlike the “luck” you will have fishing in a stocked pond.

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**Summary**

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While great opportunity lies on the other side of the valley, getting there will be perilous. Along the journey, market participants, one by one and each in his own time according to his skill and temperament, will likely undergo a transformation from risk-embracing to risk-aversion. Cash, for the moment, is king but its castle is built on sand. The best that can be said is that cash is the safest refuge at the moment. This bear market is not long in the tooth in terms of depth or duration. Moreover, the long-cultivated “buy on dips” mindset is no longer appropriate. Sadly, by the time investors discover the need to “sell long rallies,” it will, once again, be time to do the opposite. Corporate earnings, as Ben Graham and now Bob Shiller calculate them, provide little

comfort for investors who believe they're buying low price-earnings ratios. Volatility is likely a forerunner of both lower stock prices and difficult economic times.

Frank Martin, CFA

	<u>1st Quarter</u>	<u>Year-to-Date</u>
S&P 500	-9.4%	-9.4%
Nasdaq	-13.9%	-13.9%
Dow Jones	-7.0%	-7.0%
<b>MCM equities *</b>	<b>-5.5%</b>	<b>-5.5%</b>

\* approximate, net of fees

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## EQUITY HOLDINGS

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Our investment posture served us well in the first quarter (see table). Throughout the first three months we have, on average, reduced our equity positions by 10 full percentage points, even allowing for the increase in our position in Brown & Brown and adding WellPoint to the portfolio. We sold a portion of our three largest holdings (as of year-end 2007): Wal-Mart, TJX, and Berkshire Hathaway. These stocks have all performed well since the bear market started last summer, and the lower margin of safety at these prices does not warrant such a large position. We also sold United Health Group during the quarter. Our primary analyst on the company is no longer employed by MCM, and we could not find an internal advocate to take responsibility for the holding at the price it was selling for at the time. More recently, we added WellPoint, a similar (and we believe better) company at a much-improved valuation (see discussion below).

We have altered our investment process to reflect the potential turmoil running through the credit markets and spilling over into the broader economy. In effect, we are demanding an increased margin of safety. The stock market as a whole should not be considered cheap, although there are areas of distress that are getting more interesting, including financials, consumer discretionary businesses, and certain areas of insurance. We aren't convinced, however, that some of the more cyclical businesses (including financials) reflect the difficulties and earnings pressure still to come. Indeed, we have been early in some of the consumer discretionary names trying to "catch the falling knife." Fortunately, we've held off on the financials (with the exception of McGraw-Hill), which have come to haunt other value managers we greatly respect.

It would be much more clear-cut if the stock market were not a discounting mechanism. We have little interest in the homebuilding industry, which is not a very good business in general, but it will help make the point by way of example. During the last big housing downturn in 1990–91, homebuilding stocks bottomed out about six months before housing starts reached their nadir. These stocks increased threefold to fourfold before their earnings began to improve, and it happened very quickly. We believe that the magnitude and duration of the housing problem dwarfs the problem of the early 1990s, so we would not necessarily expect a repeat. But it does point to the difficulty of knowing not only when the fundamentals will improve but also ascertaining when the stocks will begin to discount future improvements. It's impossible, of course, to know the bottom, but we just haven't seen the anxiety and fear (not to mention the valuations) that would provide us with enough margin of safety to put a significant amount of capital to work.

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## CORE HOLDINGS

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### Berkshire Hathaway

It would hard to find another company better positioned to take advantage of the credit-market turmoil than BRK. Not only does it have \$45 billion in liquidity, it also has a structure that is well-designed (and the only believable AAA credit rating) to take advantage of the dislocations in the insurance and derivatives markets. The problem is that this is well-understood by most investors and reflected, at least in part, in the price of the stock. If a stock price outperforms the business, future expected returns must fall, and that's what happened with BRK. We didn't want such a large position at the price we sold it.

### Discount Retailers (Wal-Mart, TJX)

It would appear that the stock market has finally come around to our way of thinking regarding the retail sector. It's obvious (WMT and TJX were among the very few to report positive comp-store sales over the last few months) that consumers are trading down and looking for bargains. In addition to relatively favorable consumer trends, both companies have done a great job of improving the shopping experience and the merchandising of their stores. We think both companies are well-positioned for the current environment, but if the stocks get too far ahead of the businesses, you'll likely see further sales.

### Consumer Discretionary (Mohawk, Lowe's, Pool Corp.)

For this report we've grouped these companies together because they share a number of similarities. First, while all three of them exhibit some cyclical tendencies tied to consumer spending, at least 50% of their sales come from a more stable maintenance, repair, and replace market. Second, these are all good (but not great) businesses with clear and sustainable competitive advantages. Third, all of these companies continue to report healthy profits, cash flow, and returns on capital, although at less than record levels. Indeed, we would argue that due to astute acquisitions, new products and services, and market-share gains these companies are increasing their intrinsic value despite lower earnings. Finally, all of these stocks were purchased prematurely. We don't have "full" positions in these stocks and may find even more compelling opportunities to add to these positions or other companies that reflect the dour mood on Wall Street toward consumer durable spending.

## McGraw-Hill

Even though MHP is technically not a “financial” company, much of its earnings are determined by the health of the credit markets. In a way it's a coward's way to play an eventual recovery in the credit markets; MHP will not need to be bailed out by the Fed. So far, though, it hasn't been such a great idea. The company's largest business is its much-maligned Standard and Poor's unit where credit ratings account for approximately 65% of operating earnings (credit ratings account for about 50% of the company's total operating earnings). We don't believe that the major credit-ratings franchises (Moody's and S&P) have suffered a mortal blow, but the evaporation of structured finance (asset-backed securitizations) will surely shrink the market for a time. We would certainly consider adding to this position if (1) the stock moves lower or (2) we become more confident about the ultimate impact on the business from the credit-market storm.

## Emmis

What do you do with a sow's ear? We don't believe it's likely that we will turn this into a silk purse, but we'd like not to compound one mistake with another—selling out prematurely simply because we're emotionally fatigued and discouraged. We believe that there's more underlying value, perhaps considerably more, at this company than is reflected in the stock, and that the company has remedies available if the economic slump further pressures cash flow. We're sensitive to those who would like to minimize capital-gains taxes (we've taken further gains this year), but we would remind you that any capital losses may be worth more under a Democratically controlled Congress and administration.

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## STOCK PURCHASES

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### Insurance (Brown & Brown, Progressive, WellPoint)

So what is different about the insurance industry that makes us more comfortable with putting capital to work? First, the demand for insurance is relatively stable and much less cyclical than most industries. Second, Progressive and Brown & Brown in particular are facing their own headwinds unrelated to the economic turmoil that has pressured the stocks. Third, while industry dynamics have created the opportunities, we're more intrigued with the individual businesses and managers of PGR and BRO than we are the industry as a whole. Finally, even though it's classified as one industry, there are three largely independent cycles that are at work, creating more diversity than it may appear. The fundamental factors affecting personal lines, commercial lines, and health insurance are quite different.

## Brown & Brown

BRO is an insurance broker. As a broker, it receives a relatively sticky commission rate on commercial insurance premiums. The industry is currently in a “soft cycle” where premium rates are falling (10–30% in most cases), which makes for difficult revenue comparisons. In addition, in response to populist demands for insurance premium relief, politicians in Florida (an important market for BRO) have replaced a good portion of private insurance with public guarantees of potential insurance losses. They call it Citizens Insurance, but it isn't well-capitalized and will require taxpayer funding the next time the winds blow and the waters rise. The impact of the Florida-specific headwinds is pretty well-reflected in current earnings, and we believe that both headwinds will prove temporary. In the meantime, the company's main source of growth, acquisitions, has picked up in earnest as a result of the depressed industry conditions. The company is run by founder Hyatt Brown, and we couldn't have a better person managing this company.

## Progressive

We're at the point in the personal auto insurance cycle where we can expect lower earnings and low premium growth. It also has led to lower stock prices, and we're very close to adding to PGR, in addition to giving Mercury General (a familiar name for long-time clients) a second look. The stocks could be volatile because the earnings results will likely be disappointing and ambiguous with respect to understanding what is actually going on in the industry. This is the kind of environment in which companies like PGR and MCY excel. We just don't know exactly when, but the turning point in the cycle is coming.

## WellPoint (new holding)

WellPoint, Inc. (WLP) is the second-largest commercial health benefits company in the country, insuring 35 million lives as of the end of 2007. With sales of more than \$60 billion, the company is a giant in a still fragmented \$2 trillion healthcare market. There are some advantages that accrue to large, diversified companies in this industry.

Economies of scale and network effects are mutually reinforcing. A large number of members provide leverage in developing effective provider networks, while having an extensive provider network is a key quality component in the value equation. Diversity, in and of itself, is an advantage because these markets and networks are local in nature and subject to state regulation. Diversity certainly reduces business risk.

Our primary investment rationale behind the investment in WLP is valuation-driven. WLP sells for 8.5 times EPS after the stock price declined from \$90 in early January to the mid-\$40s more recently. The price decline has, in our opinion, offered a significant margin of safety that more than offsets the yet-to-be-quantified political uncertainties and unfavorable mix shift. WLP is not without its blemishes (e.g., massive stock repurchases at much higher prices, full-priced acquisitions, and a large and unwieldy board), but WellPoint can be characterized as an “OK business” that has numerous reinforcing and sustainable competitive advantages. It's also an easy regulatory/political target. The advantages the company enjoys should allow it to achieve a reasonable level of profitability under any of the proposed healthcare plans we've seen outlined during the political debates. At 8.5 times earnings, that should suffice. While we are not making a forecast, one should expect a quicker trigger if we see a rebound in the price due to overreaction to recent news. A more complete analysis of Wellpoint can be found in the investment thesis on the company that we recently produced.

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#### Website Information

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

Fireside Chat #1 was added to our website in March, both in audio and transcript version.

To log in to our site, please enter either your email address (if on file at MCM) or your Fidelity account number into the Username box and MCM into the Password box. You can change your password to whatever you would like once you've accessed the client site.

Should you have any questions, or any suggestions as to how we can make the website more useful to you, please don't hesitate to contact us.

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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.



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