MARTIN
CAPITAL MANAGEMENT, LLP
Registered Investment Advisor

QUARTERLY
CAPITAL MARKETS REVIEW

JULY 2009

Envisioning the Puzzle by Looking at a Handful of Pieces

What sets Berkshire Hathaway's co-chairman Charlie Munger apart from other investing greats is the breadth of his knowledge—his ability to intertwine the lessons of a variety of disciplines, what he refers to as a "latticework of mental models," with this the art/science of investing. A master of the metaphor, Munger responded to a question during the Berkshire Hathaway annual meeting in May by telling a story of master composer Wolfgang Amadeus Mozart. The story went something like this:

A young man, around 25 years old, goes to Mozart and asks him for advice on writing symphonies. Mozart suggests to him that he is too young to write symphonies. The young man is confused and reminds Mozart that Mozart himself had been writing symphonies since he was 10 years old. Mozart responds, "Yes, but I wasn't asking anyone for advice." The exercise that follows has helped the undersigned expand his "latticework of mental models." Perhaps we'll learn enough that we won't have to ask Charlie for his advice. ☺

Thus the enclosed graphic is *not* a picture worth a thousand words. A quick glance won't get the reader much closer to enlightenment. It is a presentation of intricate political, economic and behavioral intrigue, worth a thousand thoughts, that can be compressed into a latticework of mental models for the curious. The task is, admittedly, tough slogging. Doubtless not all readers aspire to be financial Mozarts?! However, given the creativity expressed by the graphic, the handiwork of MCM analysts Clint Leman and Aaron Kindig, CFA, it would appear that these young men may have Mozart-like ambitions.

What you see upon closer inspection is an 18-month high-low-close (blue) chart of the S&P 500 from the beginning of 2008 through the date of this report. Various well-publicized financial and economic events and the political and regulatory responses are summarized in the boxes, with lines drawn to the S&P chart to indicate market levels—and when events and responses occurred.

The lower section of the graphic is a tad more technical but adds emotional color to the otherwise matter-of-fact top section. The gray vertical bars indicate the daily percentage price changes in the S&P index from the prior day's close. To put the data on the chart in historical context, there was not a single day in 2004–05 when the S&P fluctuated more than 2%. If you count them up, there have been 117 such days since January 2008. Unthinkable since the '30s, fluctuations of over 5% occurred 21 times, of which nine were up, 12 down. During the most dramatic selling climax of this bear market, beginning on

November 19, the market first fell over 6% in each of two consecutive days only to rebound by that same amount in the two days that followed. The emotional selloff is clearly visible on the chart. The solid lines, the 12- and 26-day moving averages, smooth out and highlight short-term trends of different durations.[1] Without viewing events and reactions against the backdrop of the emotional impetus that flavors them with human impulses, politics, economics and markets are observed bereft of the powerful but less visible behavioral forces that forever reflect the immutable and animated passions of humanity.[2]

Since human emotion—predominantly fear magnified by uncertainty—has played an outsized role in crisis-atmosphere decisions made in the economic, capital markets, and political realms since this reversal of fortunes began, let's begin with the bottom section. Call it the "anxiety indicator," if you will. The amplitude of the daily price changes is a rough proxy for the extent of fear and uncertainty at the moment. Apart from the slightly irregular heartbeat during the Bear Stearns bailout, daily volatility didn't forcefully erupt until early September. Panic has a short half-life, and it subsided toward the end of 2008. By mid-January it resurged, once again reaching fever pitch as the market slid to its low point, thus far, in early March. By mid-April daily price fluctuations had moderated as the low-volume market rally relieved the emotional pressure by, in its own perplexing way, restoring some semblance of hope. (It is in the stock market, and certainly not the supermarket, where rising prices are greeted with elation.) Deflation and depression have presently taken leaves of absence from pundits' vocabularies. In point of fact, economic forecasters surveyed by the *Wall Street Journal* on June 11 boldly and brashly concluded that economic recovery would begin in August.[3]

Many of the decisions made in a crisis atmosphere have one unpleasant characteristic in common: They are, to one degree or another, undesirable. Human nature suggests that high-risk gambles among undesirable options are preferable to sure losses (assumed to be economic collapse followed by social unrest). As is evident from the left-to-right chronology of the chart, commitments escalated over time and the sunk costs likely dominated many of the decisions. Moreover, in the urgency of the moment, problems seem to be tackled one at a time, often isolating the current problem from other choices that may be pending, as well as from future opportunities to make similar decisions. Rational decision making requires a broad view of the universe of current and pending decisions. Second- and third- order effects do not appear to be vigorously injected into the decision-making process. Common heuristics like organizational optimism and the illusion of control are clearly evident. In sum, the internal governing process within the Obama administration is sufficiently flawed to leave the impartial observer more than skeptical as to its chances of accomplishing its objectives.

---

[1] A stock technician's tool known as the Moving Average Convergence/Divergence indicator. Google "MACD" for a detailed explanation. For the statistically inclined, you'll notice two particular declines: September 15 through October 15 and February 1 through March 9. You may be able to make inferences from observing the juxtaposition of the two moving-average lines even without consulting Google.

[2] Machiavelli: "Whoever wishes to foresee the future must consult the past; for human events ever resemble those of preceding times. This arises from the fact that they are produced by men who ever have been, and ever shall be, *animated by the same passions* [emphasis added], and thus they necessarily have the same results" (MCM 2006 annual report, page 17).

[3] Google "Martin Capital Management," click on the top toolbar on the homepage, MCM Public Library, click on PMPs, and open the document titled "The *Silliness* of Sanctimonious Economic Forecasts."

With the inherent fragility of the decision-making process and the on-and-off-again states of emotional agitation in mind, it's now time to sequentially analyze the precipitating events and typically reactionary responses that followed. Summaries are found in the boxes. Wherever possible when money was involved we have included the dollar amount of the loan, investment, guarantee, or whatever other form of intervention provided largely by Congress, the Fed, or the U.S. Treasury. Depending on the eventual investment returns and loan or guarantee recoveries, actual taxpayer losses will be much less—under optimal conditions materially so.

As we refine our latticework, let's highlight two specific congressional actions: The $152 billion *Economic Stimulus Act of 2008*, enacted February 13, 2008, providing for several kinds of economic stimuli "intended to boost the United States economy in 2008 and to avert a recession, or ameliorate economic conditions." Responding to the need for quick action, it was passed by the House on January 29, 2008, and the Senate on February 7. It all took less than two weeks from start to finish. The popular giveaway law provided that about two-thirds of the funds go toward tax rebates to low- and middle-income U.S. taxpayers, with a substantial portion of the remainder in tax incentives to stimulate business investment, in addition to an increase in the limits imposed on mortgages eligible for purchase by government-sponsored enterprises (e.g., Fannie Mae and Freddie Mac). What self-respecting panderer (er, politician) could say no to serving up a free lunch for voters during an election year?

Fast-forward exactly one year to February 17, 2009. That was the day President Barack Obama affixed his signature to "The [$787 billion] *American Recovery and Reinvestment Act of 2009*." In the crisis atmosphere the Act of Congress zipped through in only four days although, unlike the 2008 law, support was far from bipartisan. No Republican Congressman and only three Republican senators voted for the bill. The end product was based largely on proposals made by President Obama and was intended to provide a stimulus to the U.S. economy in the wake of the economic downturn. The act includes federal tax relief, expansion of unemployment benefits, and other social welfare provisions, as well as domestic spending in education, healthcare, and infrastructure, including the energy sector.

Despite the unanimity and enthusiasm for the 2008 tax rebate program, legislators had overestimated the public response to their plan "to stimulate the economy and avert a recession." The Pavlovian assumption (that the refund checks would be spent) upon which the law was based proved largely false. In the summer of 2008, consumers, in the grips of the "thrift paradox," generally pocketed their refund checks instead of putting them into circulation. For the first time in decades, the sight of a mall did not cause the consumer to salivate.

A year later the new president, in office less than 30 days, quintupled the dollar amount of the new fiscal stimulus program, hoping to resuscitate a moribund economy that was on its way to disgorging more than 6 million jobs by May 2009. It was an ominous sign when high-profile Republican Senator Judd Gregg withdrew his nomination as Secretary of Commerce a week before the bill was signed—on the grounds that he couldn't in good conscience preside over what he expected would be huge budget deficits. Gregg appears prescient as the 2009 projected budget deficit has escalated from $1 trillion to $1.8 trillion in a few short months—to a jaw-dropping 13% of GDP. Moreover, the nonpartisan watchdog, the Congressional Budget Office, in what seems to be overly optimistic estimates for economic growth, projects deficits in excess of a trillion dollars in each of the next 10 years, which, if they occur, would cause the national debt to double to 82% of estimated GDP. Such high ratios of indebtedness would likely imperil the creditworthiness of U.S. sovereign debt.

In the spirit of fairness, it should be noted that Mr. Obama inherited almost 90% of the "deficit disorder." The effects of the recession, the costs of the financial system bailout, and the structural legacy of three large tax cuts and two wars bequeathed by George W. Bush is the fiscal lead ball to which Obama's leg is chained. But the liberal, interventionist approach to how the money is being distributed "with strings (chains?) attached" will be Mr. Obama's legacy alone. While we have a vague idea of the deficit costs, economists are all over the map in assessing the potential economic impact of the stimulus package. They line up, as expected, along either side of the political and ideological divide. Keynesians, like Lawrence Summers (Obama's inside economic powerbroker), Paul Krugman, and Joseph Stiglitz, support massive fiscal stimulus. On the flip side, the Washington-based libertarian think tank, the Cato Institute, funded a major advertising campaign with the names of approximately 200 economists who oppose President Obama's plan. The ad stated:

> ... we the undersigned do not believe that more government spending is a way to improve economic performance. More government spending by Hoover and Roosevelt did not pull the United States economy out of the Great Depression in the 1930s... To improve the economy, policymakers should focus on reforms that remove impediments to work, savings, investment, and production. Lower tax rates and a reduction in the burden of government are the best ways of using fiscal policy to boost growth.

Those are the ideological extremes. In mid-March the conservative *Wall Street Journal* published a survey of 49 economists who gave Obama and Geithner failing marks for their handling of the economic crisis and the stimulus plan. Moreover, they were roughly split between those who felt $500 billion more would be needed and the remainder who were "skeptical of the need for stimulus at all."

Early but inconclusive evidence is trickling in on the effectiveness of the Obama stimulus plan. Reduced taxes and increase social benefit payments unleashed by the stimulus package boosted disposable personal income—income after taxes—by an impressive 1.6% in May compared with 1.3% in April. Personal consumption expenditures were flat in April and rose 0.3% in May. The wide disparity between disposable income and personal consumption expenditures is largely explained by the seismic shift in consumers' attitudes about spending and saving in light of the economic malaise. Personal savings as a percentage of disposable personal income was 6.9% in May, 5.6% in April and 4.3% in March. Consumers saved (or deferred consumption) at an annual rate of over $750 billion in May. People started saving more money about a year ago, building emergency cash reserves in case they're laid off. The recession began in December 2007. So far, 6 million jobs have vanished. The "thrift paradox"—what's good for households is not necessarily good for the economy at large—is currently frustrating stimulus efforts. As with the 2008 stimulus program, the 2009 iteration has yet to evoke the hoped-for innate, and often reflexive, knee-jerk response. Consumers appear hobbled by uncomfortable levels of debt, limited access to credit, attrition in the value of their deferred compensation plans and erosion in the value of their homes.

From the ivory towers and the skyscrapers where economists pore over mountains of data we turn to Main Street and Warren Buffett who sees the economy through the financial statements and managers' anecdotes from the 70-plus companies Berkshire Hathaway owns across a broad swath of American industry. In a CNBC interview on June 24, Buffett restated what he wrote in the most recent Berkshire annual report: "The economy will be in a shambles this year and perhaps well beyond." It took a long time to get this far off track and will take a long time to get back on. While a vast array of programs have been implemented, Buffett explained the process as only he can: "You cannot produce a baby in one month by getting nine women pregnant." As for seeing "green shoots," Buffett joked that after cataract surgery a month ago he had hoped to be able to see them. Better vision, he admitted, still didn't allow him to see something that wasn't there.

I'll side with Buffett because of his Main Street perspective and because he has no ax to grind. Besides, as footnote No. 3 above makes abundantly clear, if economic forecasters were paid on the basis of how well their prognostications squared with the subsequent economic reality, the ranks of the unemployed would swell by precisely the number of people who call themselves economists. ☺

Is the Bubble Machine Still Gummed Up?

If it is credit that greases the skids of commerce, we should not hold out much hope for a quick recovery in the economy. As you read across the chart from left to right evidence abounds of the difficulty in tampering with a market-based system. Virtually all of the initiatives to induce banks to lend and businesses and consumers to borrow are reactive, not proactive. What we have witnessed since Bear Stearns is "central planning"—absent the planning. Last September I observed—with the benefit of six months of hindsight and as one whose vantage point is far enough removed to be a well above the forest and the trees (and whose bent is philosophical)— that Bear Stearns was merely a speed bump on the slippery slope of interventionism. At the time I wondered, What will be the verdict years hence on Hank Paulson's decision to nationalize Freddie and Fannie? To be sure, it is not inevitable that interventionism inexorably leads to socialism. Nonetheless, in the words of F.A. Hayek (1899–1992), Nobel laureate economist and political philosopher (as the words might apply to September 7, 2008's actions), "The danger is the greater because we may choose the wrong way, not by deliberation and concerted decision, but because we seem to be blundering into it." Given the reactions since last September, blundering still appears to be the operative word. I respectfully disagree with my mentor in absentia, Warren Buffett.

Although two of the triumvirate are newcomers (Obama officially replaced G.W. Bush on January 20 and soon thereafter appointed Timothy Geithner as Treasury Secretary to take the baton from Paulson), Fed Chairman Ben Bernanke has been on watch since 2006. Beyond being well above average in intelligence, the threesome's collective résumés are devoid of any leadership experience in the private sector—and, it would appear, none has embraced the ideology articulated in Ayn Rand's capitalist's manifesto, *Atlas Shrugged.* Nor do they appear to be schooled in the foundational free-market thinking of Adam Smith. To paraphrase perhaps the greatest economic philosopher of modern times regarding the conveyance of near dictatorial powers on this threesome, anyone who attempts to direct the employment of capital (Fannie and Freddie were just the first of a growing litany of economic failures "rescued" by the government) will not only bring much unwanted attention upon himself but also will unwittingly or otherwise assume authority that should be trusted to no political entity, however mighty, and which "would nowhere be so dangerous as in the hands of a man who had the folly and presumption enough to fancy himself fit to exercise it" (Adam Smith, …*Wealth of Nations*). Confidence in the success of financial and economic triage performed by a trio of relative amateurs whose credentials, in sum and substance, amount to little more than the triumph of hope over experience is likely to be fragile, even ephemeral.

Returning to Hayek (who would appear to have scripted the evolving scenario): "Once this stage is reached, the only alternative to a return to competition is the control of the monopolies by the state, a control which, if it is to be made effective, must become progressively more complete and more detailed." Lest we forget, efficient planning works best when an individual or board can easily survey all the relevant facts. When the complexity rises to the point where it's impossible to gain a synoptic perspective—most certainly in the case of the increasingly multidimensional morass that might best describe the succession of cobbled-together financial bailout programs—then decentralized decision making becomes the only rational option (the antithesis of the course Obama & Co. have chosen). If history is any guide, Obama's attempt at "market socialism" or central planning and control is likely to fall far short of expectations and put America farther behind China and India who are avariciously embracing the model of capitalism that we are systematically dismantling.

These appear to be the harsh realities, and the reader is encouraged to reread the Stockdale paradox (accepting one's brutal present reality while never losing faith that one will eventually prevail in the future) in the 2008 MCM annual report. Every sane person in command of his or her faculties has some vested interest in the quickest possible return to stability. (This group does not include most hedge funds and owners of credit default swaps. ☺) As Admiral Stockdale made clear, no matter how harsh the reality, the eventual survivors are the ones who hold resolutely to the expectation that someday, some way, they will prevail. Those who hang their hat on anything more specific, like a timeline, for example, will eventually succumb to despair as those dates come and go. On the investment front, the Stockdale mindset will see us through whatever lies ahead.

Stocks Untethered?

As for the capital markets, those who pin their hopes on the recent rally in the world's stock markets as a harbinger of a return to times past do so at considerable peril. Alan Greenspan, whose repentant voice still gets a hearing at the *Financial Times,* wrote one of his more desperate pieces on February 26. Obsequiously bowing to the capital markets as the cause, rather than the effect, of economic outcomes, he tried to make the case that it's the tail that wags the dog. The stock market is not, according to Greenspan, a leading indicator as most economists think, but a major precipitating force behind economic activity. It apparently matters not to the former Fed Chairman that valuation metrics place the market in the mid-range of historical averages, nor that rising stock prices in the late '90s led to bust, not boom. If there is more agony yet to come, whether expressed in Greenspan's "markets as instigators of economic recovery" theory or economic information itself, optimism may give way to crippling despair. Should stocks eventually sell at levels that reflect abject misery and desolation, the Stockdale stoics will be among those still standing.

The prices at which stocks sell relative to earnings tend to be distorted in chaotic economic and/or financial times[4] and, as a result, PE ratios are perceived as an unreliable indicator of under- or over-valuation of stocks and markets. Understandably, only occasional mention has been made in the popular press about current PE ratios as the crisis has evolved. The dangerous unintended consequence is that while the crisis reigns, stocks become untethered from earnings, the ultimate source of their value. Introduction of a moving average of earnings helps reduce the PE unreliability factor and therefore makes it possible to frame the markets' current valuation in the context of the historical record.

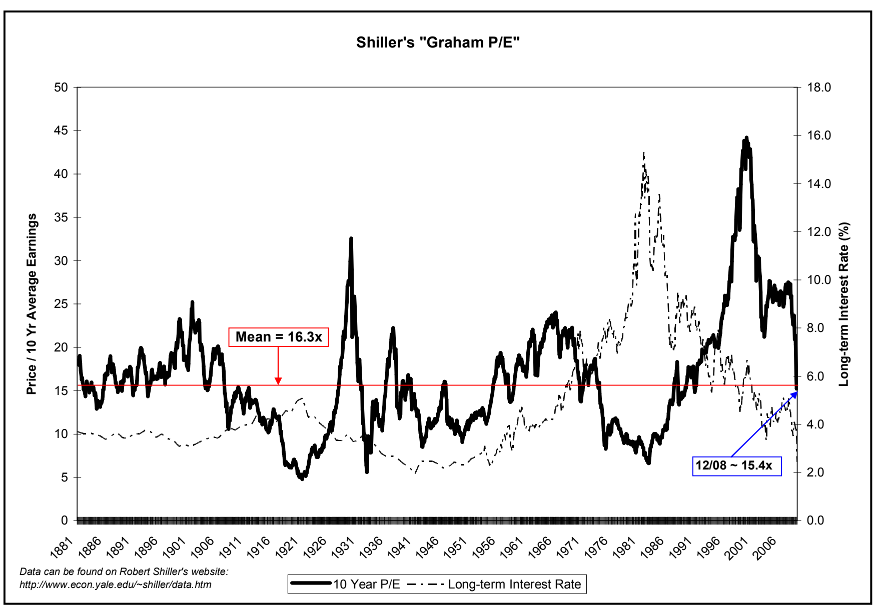
---

[4] Earnings are the residual; i.e., a relatively small change in top-line revenues against which fixed and variable costs must first be deducted can result in a much larger proportion change in what's left over: earnings. In times of sharp economic contraction, earnings become especially volatile.

According to Shiller's "Graham PE" ratio, which is calculated as the 10-year moving average of price deflated S&P index value and earnings, the volatility of annual earnings is mathematically smoothed out. The sobering message from the annals of history, as the chart clearly displays, is that there have been five times in the last 100-plus years when the Shiller PE rose to 25 times or above: at the opening of the 20th century; during the Great Depression; in the mid-1960s; the supernova of them all, the tech/dot.com bubble that saw an off-the-charts PE of 45 at the dawning of the 21st century; and in 2007, the peak of the financial bubble. While the aftermath of the last two episodes of Shiller overvaluation will not likely be known for years, the consequences of the first three are not encouraging. *In each case, after the peak was reached, the markets moved inexorably lower—punctuated, as always, by beguiling contratrend movements—for roughly the next 20 years, with the Shiller PE bottoming out in near proximity to five times 10-year trailing earnings.*

For the bold and brash investor (or speculator) who makes the case for much higher stock prices, we humbly think the burden of proof rests on him as to why things will be different this time. We don't typically make forecasts. However, I'll venture one that I've never heard made before. With history and rational analysis as my guide, I will boldly forecast that the rational investor who ventures intelligently into the markets on those infrequent occasions when they are selling in the "Shiller sweet spot" (less than 10 times 10-year trailing earnings, with the sweet spot getting sweeter should the buyer be fortunate enough to witness the PE approaching five times) need not waste a moment fearing wealth-destroying capital losses. (At no other market level can such assurances be made.) While I'm being bold, I'll go so far as to add that over the next 10–15 years the intelligent investor's returns will be well above average. Remember … "To win, first you must not lose."

Despite the likely headwinds, the rare rational investor who possesses a steely temperament usually seems to have an uncanny knack for



making lemonade out of lemons.[5] Following is the history of the growth in the book value of Berkshire Hathaway during an earlier desultory time.

The Shiller PE was below 10 the entire time during the last half of its 20-year down cycle from 1966 to 1986, gradually working its way lower to its final low of about five in the mid-1980s. The Berkshire record highlighted begins with the 1973–74 bear market and compares Berkshire's results with the unmanaged S&P 500 index. Berkshire's compounded annual rate of return on book value was 27.3%; the S&P 500, 10.0%. During these overall dark times, Buffett turned $1 million into 29.3 million. The S&P 500: 3.8 million.

	Berkshire	S&P	Difference
1973	4.7	(14.8)	19.5
1974	5.5	(26.4)	31.9
1975	21.9	37.2	(15.3)
1976	59.3	23.6	35.7
1977	31.9	(7.4)	39.3
1978	24.0	6.4	17.6
1979	35.7	18.2	17.5
1980	19.3	32.3	(13.0)
1981	31.4	(5.0)	36.4
1982	40.0	21.4	18.6
1983	32.3	22.4	9.9
1984	13.6	6.1	7.5
1985	48.2	31.6	16.6
1986	26.1	18.6	7.5

[5] Careful study of the Berkshire Hathaway chairman's letters from the first in 1977 through 1986 is both essential and invaluable. As a hook, please read the excerpt from the 1978 report that follows.

"We get excited enough to commit a big percentage of insurance company net worth to equities only when we find (1) businesses we can understand, (2) with favorable long-term prospects, (3) operated by honest and competent people, and (4) priced very attractively. We usually can identify a small number of potential investments meeting requirements 1, 2, and 3, but 4 often prevents action. For example, in 1971 our total common stock position at Berkshire's insurance subsidiaries amounted to only $10.7 million at cost, and $11.7 million at market. There were equities of identifiably excellent companies available—but very few at interesting prices. In 1971, pension fund managers invested a record 122% of net funds available in equities; at full prices they couldn't buy enough of them. In 1974, after the bottom had fallen out, they committed a then record low of 21% to stocks.

"The past few years have been a different story for us. At the end of 1975 our insurance subsidiaries held common equities with a market value exactly equal to cost of $39.3 million. At the end of 1978 this position had been increased to equities (including a convertible preferred) with a cost of $129.1 million and a market value of $216.5 million. During the intervening three years we also had realized pre-tax gains from common equities of approximately $24.7 million. Therefore, our overall unrealized and realized pre-tax gains in equities for the three-year period came to approximately $112 million. During this same interval the Dow-Jones Industrial Average declined from 852 to 805. It was a marvelous period for the value-oriented equity buyer.

"We continue to find for our insurance portfolios small portions of really outstanding businesses that are available, through the auction pricing mechanism of security markets, at prices dramatically cheaper than the valuations inferior businesses command on negotiated sales.

"This program of acquisition of small fractions of businesses (common stocks) at bargain prices, for which little enthusiasm exists, contrasts sharply with general corporate acquisition activity, for which much enthusiasm exists. It seems quite clear to us that either corporations are making very significant mistakes in purchasing entire businesses at prices prevailing in negotiated transactions and takeover bids, or that we eventually are going to make considerable sums of money buying small portions of such businesses at the greatly discounted valuations prevailing in the stock market. In 1978 pension managers, a group that logically should maintain the longest of investment perspectives, put only 9% of net available funds into equities, breaking the record low figure set in 1974 and tied in 1977.

"We are not concerned with whether the market quickly revalues upward securities that we believe are selling at bargain prices. In fact, we prefer just the opposite since, in most years, we expect to have funds available to be a net buyer of securities. And consistent attractive purchasing is likely to prove to be of more eventual benefit to us than any selling opportunities provided by a short-term run-up in stock prices to levels at which we are unwilling to continue buying.

"Our policy is to concentrate holdings. We try to avoid buying a little of this or that when we are only lukewarm about the business or its price. When we are convinced as to attractiveness, we believe in buying worthwhile amounts."

As Lloyd Bentsen said of Dan Quayle during the 1988 vice-presidential debate, “Senator, you're no Jack Kennedy,” so we readily admit that we are no Warren Buffett. Refer to the Shiller PE chart on page 7 for rough approximations of levels at which the S&P 500 might sell, which would indicate that gloom and despondency had pervaded the social psyche to such an extent that to suggest that they might fall dramatically farther still defies both history and rationality. In the meantime, investment decisions based on the “fear” of being left behind in the race for (recovering) riches are more emotional than rational. Committing capital in the face of abiding despair, preoccupied only with the relationship between price and value, minimizes the effect of an emotional tug of war and facilitates rational response. When things are so quiet that one can hear the proverbial pin drop, the tortoise will know the race is on. In the long run, it could be a hare-raising spectacle!

The Nuts and Bolts of Portfolio Strategy

Today we find ourselves in a conundrum similar to 2006–07. As more and more advisors and retail investors jump aboard the bullish bandwagon, we’ve effectively been selling to them and now find ourselves with more than 65% of our client assets in short-term Treasuries. Even with the drag of next-to-zero return Treasuries, our clients are up 5% year-to-date and 26% from March 9. The S&P 500 total return year-to-date is 3.2%. If the market remains untethered to earnings and marches higher throughout the year, we will certainly trail the index from this point on.

Most importantly, if the emerging, albeit fragile, euphoria eventually gives way to its antithesis, we could find ourselves in a situation that plays to our strengths. We have both the cash and the temperament to step up to the plate when the bullpen is empty to take serious cuts at the fat pitches that come our way. It won't necessarily be pretty, but it should get the job done.

While some will accuse us of procrastination or, worse, an inability to swing the bat no matter how fat the pitch, the virtue of purposeful patience—if that’s what it proves to be—sometimes earns its just rewards. Imperturbable and with equanimity we wait, impervious to the Sirens’ call of the “madness of crowds” and at least partially comforted by the lessons history has taught us. The seeming passivity of a patient individual often masks a mind that is anything but idle. We can give no ironclad assurance that our reasoning is not badly biased or fatuously flawed. Of course, every strategic decision we make that is contrary to conventional wisdom assumes that risk. Each inflection point puts us to the test once more.

Spring Rally’s Portfolio Impact

Our own portfolios participated nicely in the equity market recovery as the accompanying data illustrate. Indeed, MCM’s quarterly equity performance was one of the best in our 20-plus-year history. From the lows in March, several of our holdings doubled (or more) in price. Absent any improvement in fundamentals, we sold several positions as the rally progressed. Notably, we sold nearly all of our financials (including the three better-quality banks acquired in the first quarter, Wells Fargo, U.S. Bancorp, and M&T Bank), which led the market after being given up for dead (or nationalization—if there’s a difference). On average, the equities sold represented roughly 20% of our portfolios.

Company Commentary

Earlier this year we promised to highlight any significant developments in individual holdings that are in the mix between core and non-core holdings. Our non-core holdings remain at roughly 20% of equity portfolio. These include Lamar, Fifth-Third, Brunswick, and Gannett. As occurs occasionally, we have moved one stock (Garmin) from one category to the other. Normally, movement from core to non-core signals, by its very nature, a mistake. Our core holdings are well managed, well capitalized, and have sustainable competitive advantages that allow them to earn above-average returns on capital. Obviously, falling off this list is not a good development. Happily, we've moved Garmin in the other direction upon further analysis of the company's businesses, apart from the PND (personal navigation devices) market. In our view the company's aviation, marine, and outdoor/fitness businesses—in addition to its net cash on the balance sheet—are enough to support the existing market capitalization. It's still a small position, but there may be a better opportunity to add to it if the PND market deteriorates faster than generally expected.

Our research effort is focused primarily in two areas. First, we are keenly interested in how our companies are navigating their way through this economic storm. All of our core holdings keep generating cash, and many (though not all) continue earning good returns on capital, even in this tough environment. We expect our holdings to maintain or increase market share as they use the downturn to capitalize on the ability to do more with less. HNI, for example, has closed manufacturing and distribution facilities without reducing total capacity. Lowe's and Walgreens are gaining substantial share. Brown & Brown is doing what it does best—using its considerable cash flow to acquire and further build out its brokerage network.

Our second area of focus is "drilling more holes." There are a good number of high-quality businesses that we have more or less neglected because of a long history of outrageous multiples. With two of the worst bear markets in a generation occurring within the last decade, valuations have improved enough to warrant a closer look. As such, we are eagerly expanding our shopping list with a particular emphasis on (1) businesses with relatively good pricing power and/or (2) "asset-lite" enterprises. Higher unemployment and much excess capacity are likely to keep inflation at bay for a while, but both of these characteristics would prove advantageous in the event we return to a period of higher inflation in the future.

Performance

	2nd Quarter	YTD
MCM Equities *	36.6%	6.7%
MCM Total Account *	**15.0%**	**5.0%**
S&P 500	15.9%	3.2%
Nasdaq	20.3%	17.0%
Dow Jones	12.0%	-2.0%

** approximate, net of fees*

The MCM Equities Composite shows the performance of equity investments and equity-based options included in the accounts we manage at Fidelity. The equity percentage that each account holds at any given time may vary from 0% to 100% of the portfolio depending on each individual investment policy. Consequently, the returns shown do not necessarily reflect the returns any individual client actually obtained and are certainly not an indication of how your account will perform in the future. The MCM Total Account Composite shows the performance of all assets held in fully-discretionary fee-paying accounts that we manage at Fidelity, who have given us authority to invest 100% of the account in equities, and are managed per our model portfolio. Due to timing related to the QCM and MCM's desire to provide timely information to clients, a complete detailed calculation of returns is not done on a quarterly basis and both composites are therefore approximate. Both composites are net of all management fees and include the reinvestment of all income but do not reflect the effect of taxes.

The S&P 500 Total Return Index is an unmanaged market capitalization-weighted index of 500 common stocks chosen for market size, liquidity, and industry group representation to represent U.S. equity performance. S&P 500 returns do not include consideration for fees or taxes.

The NASDAQ Composite Index is a market capitalization-weighted index of over 3,000 domestic and international based common stocks listed on the NASDAQ Stock Market, and is used to represent broadly the performance of the U.S. and international stock markets. The NASDAQ returns do not include consideration for cash dividends paid by securities.

The Dow Jones Industrial Average is a price-weighted index of established U.S. companies selected at the discretion of the editors of The Wall Street Journal from diverse industries, including financial services, technology, retail, entertainment and consumer goods, and is used to represent broadly the performance of the U.S. stock market. The DJIA returns take into account stock splits and dividends paid by securities comprising the index.

Due to client nuances including equity allocation constraints, start date and cash flow differentials, derivatives constraints, tax issues, etc. an individual's account performance may differ materially from the composite. ***Past performance is no guarantee of future results.***

Website Information

www.mcmadvisors.com

Fireside Chat #5 was added to our website in June, 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.

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.

MARTIN
CAPITAL MANAGEMENT, LLP
Registered Investment Advisor

300 NIBCO Parkway, Suite 301 ■ Elkhart, IN 46516 ■ Phone 574.293.2077 ■ Fax 574.293.2153 ■ www.mcmadvisors.com