

MARTIN
CAPITAL MANAGEMENT, LLP
Registered Investment Advisor

2007
ANNUAL REPORT

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FOREWORD

Martin Capital Management, a limited liability partnership, is an investment advisor registered with the U.S. Securities and Exchange Commission. After years of preparation, its founder began formally dispensing his brand of investment counsel, which this and earlier missives have recorded, in the months before the memorable autumn of 1987. (All firm publications, as well as the SEC filings, including form ADV Part II, are available upon request.) Since then, Martin Capital has grown to serve 96 clients whose combined assets total approximately \$554 million. From its beginnings as a one-man, one-assistant operation, with less than \$25 million in assets, Martin Capital is now headquarters for 12 people, including five investment professionals and seven persons in supporting roles. See end of report for thumbnail biographies.

We at Martin Capital Management hope that in the course of conducting our business we might occasionally encounter other investors with whom we share common values and expectations. If you know of someone for whom the fit appears mutually beneficial, please mention our name. While our \$5 million minimum family account size prevents us from helping some people whom we would very much like to serve, we feel we must keep our roster of clients small in order to maximize the time we spend on research.

Our abiding duty is to those who have entrusted their assets to our care, and we will forgo any growth opportunity that may detract from our ability to serve them as they have become accustomed. Careful selection and controlled growth are really about doing a good job and having fun along the way. We never expect to be among the biggest, but our intention to be among the best is not subject to compromise.

Informational and educational materials that seek to highlight the primary tenets of Martin Capital Management's investment philosophy and overall business model are available apart from this annual report. We hope these concise writings will help you gain a deeper understanding of how we conduct the business of managing wealth. Please feel free to call or write us if you would like to receive more information. You also may visit us at www.mcmadvisors.com.

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INTRODUCTION

Who woulda thunk it ... a mere **23** pages of monologue from the Senior Partner, less than one quarter the length of last year's missive. Don't be too quick, though, to smugly claim victory in the long-fought Battle of the Bulge or in demolishing the Tower of Babel (or is that Babble?). To apply a more positive spin, the slimmed-down version aspires to invoke a variation of the Economics 101 principle, the "price elasticity of demand." Where substitutes for the annual report are readily available (one reader and former friend suggested Saturday morning's televised cartoons might be comparable), the "price" of the annual "book," expressed as the number of words also will correlate, at least according to the textbooks, with the demand for it. Theoretically, if demand for the report leans somewhat toward elastic (a likely assumption to be sure), shrinking the report's length will increase disproportionately the number of eyeballs that actually gaze upon it. Stated differently, if the number of words is less than one-third of last year's report, and eyeballs increase fourfold, the change is "profitable." Be advised: This is the most intellectually challenging paragraph in the report: If you made it this far, the rest is easy sledding by comparison and, to be sure, all downhill!

From the writer's point of view, it's much more challenging to write a semi-succinct 23 pages than 108 pages of what one shameless (and admittedly earthy) reader referred to as "verbal diarrhea"! In addition to reducing production and paper costs, the agonizing labor of editing is truncated as well. Life, including writing and investing, can be framed as a series of trade-offs. One, alas, cannot have it all.

On a more serious note, if that is possible, my preparation for this annual exercise has had the most amazing unintended consequences. Abraham Lincoln summed up what was required: "Give me six hours to chop down a tree, and I will spend the first four sharpening the ax." In the solitude of the early-morning hours I have, indeed, sharpened the ax. At that time of day nothing intrudes on my time for reading, thinking, and (applying "healthy" skepticism) constantly inquiring and asking the burr-under-the-saddle question "Why?" During the daylight hours, when the normal world stirs, whether by the miracle of the Internet, the telephone, or face-to-face dialogue, the search for answers to earlier musings becomes all-consuming. The quest for what "Why?" reveals, often the source of wisdom, has, over the years, resulted in encounters with some of the most interesting and fascinating people, past and present, in the disciplines of business, finance, and macroeconomics. The names are too numerous to recite here; you will see a few of them sprinkled throughout the report. This, then, is not truly my report; it is a composite of some of the best thinkers extant. I'm merely the messenger.

It isn't only coincidence that an inordinate number of references are made to John Maynard Keynes and Benjamin Graham. Not surprisingly, these intellectual giants wrote their greatest works in the years immediately following the Great Depression: Keynes, *The General Theory of Employment, Interest, and Money* (1936) and Graham, *Security Analysis* (1934). Analogously, one wouldn't ask a lifelong Floridian how to survive Alaska's winters. Rather, we would seek out Jack London of "To Build a Fire" fame—and, on the financial front, Keynes (from afar) and Graham, who weathered the most cataclysmic economic storm in this country's history.

Essays written but not included in the report will be posted from time to time on our website under the title "Portfolio Managers' Perspectives."

MCM PERFORMANCE

Period Ending December 31, 2007	MCM Equities *	S&P 500 *
Ten Years	8.4%	5.9%
Five Years	8.3%	12.8%
Three Years	2.1%	8.6%
One Year	1.5%	5.5%

* Compounded annually, MCM data net of fees

Year	MCM Equities *	S&P 500
1994	-7.5%	1.3%
1995	19.1%	37.6%
1996	31.8%	23.0%
1997	45.1%	33.4%
1998	-7.4%	28.6%
1999	18.8%	21.0%
2000	29.3%	-9.1%
2001	22.7%	-11.9%
2002	-13.6%	-22.1%
2003	33.9%	28.7%
2004	4.7%	10.9%
2005	-0.2%	4.9%
2006	5.0%	15.8%
2007	1.5%	5.5%

* Net of fees

Long believing that Shakespeare was right in opining that the past is prologue, the reader is encouraged to review last year's discussion on investment performance in the 2006 Annual Report, pages 21–31.¹

¹ On one level, it seems redundant and disingenuous to quote oneself from earlier times. On another level, though, framing what is written today in the context of what was written in prior years, which few people seem inclined to do, strikes the writer as rather logical. Certainly that's the way I approach the writing of the annual report. Each year's effort is not undertaken without carefully reviewing what was written before—in part to see how closely a vague vision and the future as it has unfolded paralleled one another that I might learn and grow in wisdom, particularly where the parallels diverged, and in part to maintain an integrity and continuity of thought and action that transcends the arbitrary boundaries imposed by the calendar. There is nothing like the permanence of the written word, which lives forever as either an indictment of our stupidity or a reflection, most often to some very limited extent, of our capacity for reason and the degree of literacy we reveal in communicating it. Finally, I write with trepidation-induced diligence, knowing that someday my grandchildren may well read what was written years before.

The computer-literate and the curious are invited to Google “Martin Capital Management.” On our homepage, click the “MCM library” button on the top of the page toolbar to find the PDF files of annual reports going back to 1999. Draw your own conclusions ...

An Early Epitaph for the First Decade of the New Millennium

Being fiercely independent and congenitally skeptical, and thus often appearing annoyingly unconventional, please indulge me for a moment as I step back to reflect on the first eight years of the new millennium. After all, sometimes we get so caught up looking at the pieces—worrying about an impending recession or what the Fed might do at its next meeting—that when the last piece is placed we are “puzzled” by what’s before our eyes.

Despite the big interim rally in the S&P 500 (the Nasdaq was not so lucky), the roller-coaster decade that began with the much-ballyhooed non-event, Y2K, has thus far not been kind to U.S. stocks. *It’s hard to believe, but U.S. Treasury notes have trounced them, and even mundane cash equivalents have done better.*

With 2008’s poor start, things are looking even worse. As of Jan. 22, the S&P index’s *annual average total return, capital growth plus dividends, was less than ¼ of 1% from end of 1999.* To put it in dollar terms, \$1.00 invested in the S&P 500 eight years ago is worth \$1.02 today. When the final chapter of this decade is written, the epitaph for many asset classes may read: “So much risk, so little return.” For all the action, anxiety, and wealth-gobbling frictional costs, such as fees and commissions (which would have thrown actual results well into negative territory), most investors would have been far better off in every sense of the phrase parking all their money in U.S. Treasury securities and municipal bonds eight years ago. When it’s all said and done and they look down at the ground, they’ll discover they’ve been on a ... (not so) merry-go-round. Of course, only a few can step off the carousel because, by the nature of the asset ownership construct, stocks cannot simply be put on the shelf in nobody’s name pending a better opportunity. For better or worse, depending upon who’s name is on the certificate, they must be somebody’s property all of the time. The investment management industry was paid hundreds of billions of dollars taking tickets from those who chose to ride in circles. At least somebody got rich.

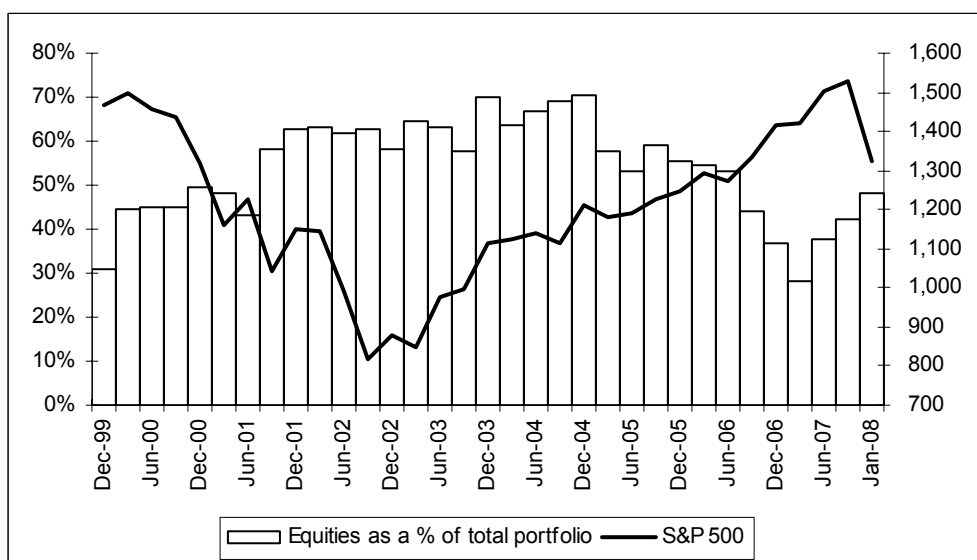
For students of stock market history, the shocking sub-1% total return since the beginning of this decade, before inflation’s purchasing power loss is factored in, is really not so startling. The 1982–2000 bull market was the biggest in history and the excesses it fomented will take a long time to purge. Given what follows in the pages ahead, it’s myopic, in this writer’s judgment, to think that the cleansing is complete. For the record book, without a significant recovery in stocks relatively soon, the decade could finish as the *worst* in annualized total equity returns in the last 100 years, irrespective of whether measured in nominal or inflation/deflation-adjusted terms. The S&P 500 returned a -0.1% in the Depression-era 1930s. When including gains or losses in purchasing power, the ’30s actually registered a return of a positive 1.9% because deflation averaged 2.0%. The 1970s still hold the record as the only negative total return decade in purchasing power terms: -1.5%. Records, however, are made to be broken.

MCM did navigate through what it believed were iceberg-riddled waters the last eight years with a far greater percentage of our assets safe harbored in U.S. Treasuries than virtually all of our peers, not knowing, of course, that being passively content would prove more productive than being actively intense! As for *our* active management, the following is a short chronology.

After successfully avoiding the manifold temptations in technology and dot.coms in the late ’90s, we seized the opportunity presented on a platter to value investors in the 2000–02 bear market. Our absolute performance was solidly positive, while the S&P 500 lost half of its value from peak to trough and the Nasdaq surrendered 80% and still trades for less than 50% of its high nearly eight years later. The year 2003 was the best year for clients in the firm’s history, the result of a rising market and a larger portion of client capital committed to equities. Throughout those tumultuous years we honored our commitment to protect client capital during periods of high perceived risk and capitalize on opportunities during times of low perceived risk.

From 2004 through October 2007 we had some tough sledding, as reflected in our absolute and relative returns. Finding the kind of companies that met our standards at prices that assured us of an acceptable margin of safety proved problematic. Tempted as we were by the rapidly growing financial services and housing and related industries, we believed both to be riding an unsustainable wave, inherently cyclical and imprudently leveraged, and, to our mutual good fortune, we passed. The ongoing wealth-destroying collapse of both, which we began warning against in the 2005 annual report, has been making the headlines for months. Commodity-based businesses (e.g., agricultural and mining products) and their stocks have been stellar performers the last several years, including, most noticeably, 2007, and have not yet had a comeuppance, as most likely they will. Such businesses, by their very nature, are prone to capacity-related boom and bust cycles. Most don't make it through our filters that require a company to have sustainable competitive advantages and a long history of high returns on invested capital.

Aggregate Allocation of Client Capital
December 31, 2007



As noted in the table above, the scarcity of fat pitches (see baseball metaphors in previous annual reports) resulted in our commitment to equities falling from 70% of assets at the end of 2004 to 30% in March 2007. As we were able to purchase the depressed shares of companies that we wanted to own, equities inched up to 50% of total assets. In a number of instances the prices had farther to go on the downside, and we'll no doubt continue to take advantage of Wall Street's short-term perspective in the period ahead. At the same time, we made some misjudgments of which you're all aware. Despite avoiding most of the investment air pockets, one notable exception assures us that hubris will never replace humility.²

As for 2007 in particular, during a year when the S&P 500 price advanced 3.5% (only to give it all back and much more in the early going in the new year), the undersigned continued to observe

² The final chapter on Emmis Communications is yet to be written. We believe we have an informational edge that gives us some measure of confidence that conventional wisdom may be proved wrong. Under a scenario we don't think too far-fetched, Emmis may be the cheapest stock in our portfolios.

that the majority of institutional investors were preoccupied with finding the best deck chairs on what is looking more and more like the Titanic. Having nothing to do doesn't mean doing nothing. Like Santa's elves referred to later, we've been proactive about strengthening our process of investment management and stockpiling investment ideas as discussed in detail in the section on value investing, beginning on page 17.³

As long-term investors for whom wealth preservation is our No. 1 priority, here's a thumbnail synopsis of the MCM decisions made over the last eight years. An atypically large portion of your assets that were invested in the default class—Treasury securities and municipal bonds, the source of liquidity that we tapped in 2000–02 and expect to access as opportunities once again proliferate—handily beat the total returns from the S&P 500 benchmark. The only thing we dislike more than sitting on cash is losing money. As for the actively managed equities within your portfolio, they produced a total annual compounded return of 9.4% over the eight years compared with next to nothing from the S&P 500. Of course, we're fully aware of the importance of when you start counting. We would strenuously argue, as we have written, that the end of 1999 was the right time, as it signaled the termination of the great bull market of the '80s and '90s. Corroborating that conclusion with our actions (and unable to find companies priced where the odds of success were tilted strongly in our favor), 70% of your money was in cash in 1999 just before 20 years of good times came to a close.

At this point several questions might come to an active reader's mind. Anticipating them, I'll try to provide answers. First, you might be thinking, if your equity returns were nine times greater than those produced by the S&P 500, why didn't you folks have more of my money invested in equities? The short answer is our mantra, which you have read before in these reports: If we err, let it be on the side of losing opportunity rather than permanent capital. Had we been blessed with perfect foresight, we would've been 100% invested in equities—*when and only when* the kind of companies we like were available at prices where the odds clearly favored us and not the house. The preceding table gives you a rough idea as to when those times have occurred over the last eight years. Unfortunately, we can't see the future through the rearview mirror. The impudent answer: Thanks to derivatives, the only thing that stands between me and the Forbes 400 Wealthiest list is a single idea that will double in a reasonably short time. That will never happen because the future is unpredictable. Any attempt to short-circuit the immutable law of uncertainty is both illegal and, more importantly, immoral. Simply put, it's stealing (see the Ten Commandments, No. 8).

While in a bold frame of mind, but hopefully not offensively so, let me answer another question that may be on your mind. "Why don't you manage our equities, and we'll feed you cash when you need it?" There are four answers.

- First, you are paying us to think. Actions follow thoughts ... but not in lockstep. Sometimes thoughts lead to inaction. When thinking is sound, there is economic value associated with it. Would it be a fair transfer of value to pay us only when there is activity, when true value (aka enlightened thinking) precedes all action?
- Second, in markets like these the decision to commit large amounts of capital to a company we may have gotten to know over a period of years can easily be made in a matter of minutes if a big seller appears on the scene. Without the funds, our hands are tied. The logistics of getting all that money wired to your accounts, assuming funds are in liquid form,

³ Effective June 1, 2007, MCM instituted an investment performance-based financial incentives program for our analysts. A significant portion of their compensation is tied to the market performance of the ideas that they, and any other team members with whom they've shared ownership of the idea, have proposed and we have purchased. The result has been increased collaboration, ruthless calibration (you can't hide from the numbers) in learning from both successes and failures, and greatly increased accountability.

before a purchase can be made would be a nightmare—and that assumes we can reach you and have the manpower to do so promptly. Besides, we deserve a modicum of anonymity if we're to meet our commitment to you—and not inadvertently telegraph our carefully considered decisions to others who might expropriate our work for which you have honorably paid.

- Third, our fee structure is calibrated to keep your cost of us watching over your ever-fluctuating default asset—cash—to a minimum.
- Finally, I know a number of wealthy individuals who have a substantial amount of money invested in “enhanced yield,” tax-exempt money market funds. If this includes you, I doubt that you've read the fine print in the prospectus. In addition to paying fees far greater than ours, your money is a whole lot safer with us.

Referring back several paragraphs to the 30% of client assets in the default class in 1999, that ratio had flip-flopped by 2004. Within months of the all-time high in the S&P 500 last summer we were again bereft of lots of ideas with green-light prices, finding ourselves defaulting to a purely coincidental 70% cash ratio once again. We are now flush with anticipation (and cash). If and when the current catharsis has reached the capitulation stage, we can expect to find more slam-dunk opportunities than we have cash and, equally important, we anticipate tailwinds to help levitate the prices of bargain-basement purchases for years to come. And during the trying eight years just passed we (and, we trust, you) lost nary a night's sleep. With history as our guide, it's practically predictable that at the very point when active management will reach the maximum point of disrepute, and investors throw in the towel in favor of something safer like U.S. Treasury securities, our season for active management will have arrived! We are ready.

HOW MANY PIECES ARE NECESSARY ...

... before you can visualize how a puzzle must look when completed? Benjamin Graham spoke volumes with the following statement: “If you see that a man is very fat, it makes little difference that you are able to precisely calculate his exact weight to enhance your conclusion.”

Clear-thinking Dietrich Bonhoeffer, the German Lutheran pastor and theologian, penetrated the mist surrounding the propaganda and Hitler's charismatic oratory to the evil that lurked within the madman's mind. He was able to visualize consequences that most non-Jewish Germans, to say nothing of Neville Chamberlain, Britain's prime minister, failed to see. Bonhoeffer was part of the German Resistance movement against Nazism for which he was ultimately hanged by special order of youngish Heinrich Himmler (44), founder and officer-in-charge of the Nazi concentration camps who held final command responsibility for annihilating “subhumans” whom the Nazis deemed unworthy to live. In the saddest of ironies, Bonhoeffer was executed on April 9, 1945, just days before liberation by Allied forces. Himmler himself committed suicide six weeks later. The following insights into the nature of wisdom from Bonhoeffer are all the more poignant because of the price he paid to acquire them.

To understand reality is not the same as to know about outward events. It is to perceive the essential nature of things. The best-informed man is not necessarily the wisest. Indeed, there is a danger that precisely in the multiplicity of his knowledge he will lose sight of what is essential. But on the other hand, knowledge of an apparently trivial detail quite often makes it possible to see into the depth of things. And so the wise man will seek to acquire the best possible knowledge about events, but always without becoming dependent upon this knowledge. To recognize the significant in the factual is wisdom.

Warren Buffett would appear to have Dietrich Bonhoeffer's rare capacity to parse seemingly random details "to recognize the significant in the factual." In the Berkshire Hathaway 2006 Annual Report published in March, 2007, the Oracle of Omaha ran what was ostensibly a "routine" ad announcing the beginning of a search for a successor for himself and Lou Simpson (who is only six years his junior) as manager of Berkshire's marketable securities portfolios.

Picking the right person(s) will not be an easy task. It's not hard, of course, to find smart people, among them individuals who have impressive investment records. But there is far more to successful long-term investing than brains and performance that has recently been good. Over time, markets will do extraordinary, even bizarre, things. A single, big mistake could wipe out a long string of successes. We therefore need someone genetically programmed to recognize and avoid serious risks, *including those never before encountered*. Certain perils that lurk in investment strategies cannot be spotted by use of the models commonly employed today by financial institutions. Temperament is also important. Independent thinking, emotional stability, and a keen understanding of both human and institutional behavior are vital to long-term investment success. I've seen a lot of very smart people who have lacked these virtues.

Why did Buffett choose to make public a need that he could have satisfied with dispatch in private? No investor is better known or knows better. A few well-placed, quiet inquiries would have generated a short list of eminently qualified candidates and avoided all the hoopla—and that assumes Buffett doesn't already have his list of diamonds in the rough. Is it consistent with his behavior that he will actually screen the reported 1,000 applications received? Just perhaps his motives were more subtle ... ? Could it be that he was obliquely sounding a ringing note of caution to those readers who are "thinkers," as defined at the close of this essay?

All of Buffett's earlier tocsins (e.g., the long-term consequences of persistent trade deficits) came from the mind of a man who *thinks* about long-term consequences, and his utterances were designed to provoke thought, not action. None, as best I can recall, triggered an emotional market response. Buffett, Bernanke, and others in high places are keenly aware of the adage "No love is lost on the bearer of bad tidings." Roger Babson's speech on September 5, 1929, was as prescient as it was ill-considered: "Sooner or later a crash is coming, and it may be terrific." Unfortunately, Babson's warning was the equivalent of screaming "fire" in a crowded theater, and the panic that ensued was clearly an unintended side effect. The events that followed surely contributed anecdotally to Keynes' contention five years later that there is "liquidity for some, but not for all." (If only Babson had whispered ...) As historical accounts have made abundantly clear, Babson was roundly denounced for his doomsday prognostication. The prominent Yale professor, Irving Fisher, equally infamous for stepping in front of the freight train of shifting sentiment, personalized his attack on the messenger of imminent mayhem. Wall Street's (conflicted) power brokers sneered at Babson's "intemperate predictions. The advance will continue as before—despite such 'gratuitous' forecasts." Whether Buffett "whispered" in his chairman's letter—or the undersigned read far more into his message than was intended—will be known only in the fullness of time. Were I to personally attempt to reach Buffett by phone, it's unlikely that I would learn anything more than I already know. Benjamin Franklin observed: "Three may keep a secret, if two of them are dead." I don't like what that implies!

And yet, for posterity's sake and because of the responsibility Buffett may feel as a modern-day economic "seer," it is possible, in this writer's judgment, that he may have whispered. And if his words are ever turned against him in an effort to make him the scapegoat, he can always quote Alan Greenspan: "If I have made myself clear, you must have misunderstood me." Charlie Munger, despite the brilliance of his insights, does not have the public persona to move markets.

Accordingly, his manifold warnings are offered frequently and not in his normal equivocating manner. ☺

Those who perused the extensive essays in the MCM 2005 and 2006 annual reports should not be surprised by the current goings-on in the credit and housing markets. If the annual reports are analogous to a screenplay, the early scenes of the movie are playing in theaters around the world as this report is being written. A year or two ago we didn't need to know all the precise causal details, for which the credit pandemic is now the effect, in order to draw rational conclusions.

Unlike the labors required to plow through the last two annual reports, I'll not drag you through all the reasoning in 2007 that led me to conclude that the odds convincingly augur that it's better to be safe than sorry. Unlike Buffett, I live in the luxury of relative anonymity, and my words have the same effect on markets as they might on the dozing patron in the final act of a Mozart opera. Such a somnolent sort is not stirred in the least from his stupefaction by the crescendo of superb drama, harmony, melody, and counterpoint. Truth be told, it's all I can do to get Marsha to take the garbage out on Monday mornings! Rather, I'll hearken back to the wisdom of Bonhoeffer and present an apparently trivial—only insofar as it's not commonly understood or appreciated—fact that “quite often makes it possible to see into the depth of things.” If the gist of what follows in the pages ahead doesn't hit you like a blindside tackle from Brian Urlacher, you may want to think of yourself as the patsy at a table of card sharks. “The Gambler,” in the song that made Kenny Rogers famous, lays the cards, face up, on the table (excerpts):

*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.
You never count your money when you’re sittin’ at the table.
There’ll be time enough for countin’ when the dealin’s done.”*

Taking a cue from “The Gambler,” Buffett, in his so-called ad, referred to the importance of “temperament, emotional stability, and a keen understanding of both human and institutional behavior so vital to long-term investment success.” Benjamin Graham said if you don't have an intimate knowledge of the chronic behavioral anomalies of “Mr. Market,” the imaginary manic/depressive who personifies the emotional impetus behind the actions of the “crowd,” you're doomed to mediocrity or worse. Bringing all your intuitive capacities into play, you must read the faces around the table and the cards in your hand to draw an inference on the basis of admittedly insufficient data whether it's time to hold 'em or fold 'em. To be sure, we're referring to markets, not individual stocks. There are wonderful exceptions to the rule, but the workings of arbitrage (the preoccupation of speculators in finding, capitalizing upon, and therefore neutralizing pricing anomalies among and between similar securities) in a crowded marketplace renders them as scarce as hen's teeth. Of course, the arbitrageur's perspective is short-term, still leaving plenty of opportunity for the investor who can look forward a few years ... and whose clients will permit him to do so.⁴

⁴ A market index is an average, however configured and weighted. Within the “averages” there are industries and companies whose prices are anything but reflective of the average. The question an independent analyst

As you've seen so often on these pages, in this age of unfathomable advances in technology, financial developments remain archaic and stubbornly cyclical. The latest iterations are little more than a new mask on the face of reincarnated bad judgments and misaligned incentives. John Stumpf (CEO) of smartly run Wells Fargo summed up the plight of his peers: "It's puzzling why bankers have come up with these new ways to lose money when the old ways were working so well." Warren Buffett, singing from the same hymnal, addressed the challenges of remediation: "That a plan by some large banks to create a fund to buy tarnished mortgage securities is unlikely to cure what ails the financial markets ... You can't turn a financial toad [into a prince] by kissing it or by securitizing it or by transferring its ownership to somebody else." Both men were obliquely making references to one element, man's proclivities, and their rippling effect on the whole of things. Mixing Christianity and Islam—first from Ecclesiastes: "There is nothing new under the sun." Second, as Muhammad observed eons ago: "Believe, if thou wilt, that mountains change their place, but believe not that man changes his nature."

Just a Few [Pieces] Will Do

The alchemists in structured mortgage finance, operating in a tailwind economic environment of low interest rates, rising home prices, and well-below-average defaults, mixed a potentially fresh toxic concoction of low average-quality securitized mortgages. Repackaged again as a plethora of exotic structured finance securities, meagerly over-collateralized so that many tranches carried the AAA imprimatur, massive amounts of leverage were added to the bubbling brew. With complexity growing exponentially so that it became nearly impossible to find the beginning if you started at the end, the system edged toward its breaking point, hinging precariously on a single model assumption: that future defaults would be in line with past experience. When the first signs of softening in real estate prices surfaced, lenders quickly learned that the default assumptions—mechanical extrapolation of the abnormally favorable delinquency experience of recent years into the future—proved that mortgage bankers had been fatefully optimistic. Lenders had grossly underestimated and therefore under-priced risk; they were goaded on by animal spirits and asymmetrically inflammatory incentive arrangements ("Nothing is quicker at changing a man's moral outlook than cash in large sums"). The brass ring and corporate competition for market share blinded players of all stripes to the ultimate consequences. So engaged were they in the battle that they lost sight of the war where sea changes were occurring. Semi-rational lenders were easily blown from their moorings as the contagion spread. By collectively taking on far more risk than any one lender realized, the aggregate losses, once they began to snowball, couldn't be easily contained.

The severity of the subprime debacle⁵ may be only the prelude to the main act yet to take center stage, a tragedy of grander scale playing off-Broadway in the equally Byzantine corporate credit markets. The generally unanticipated (though not for my faithful readers) and unprecedented decline in housing prices⁶ may have been the catalyst in bringing the subprime mortgage markets to

must ask is: How does today's stock price compare with what may be the intrinsic worth of the company five years hence, properly discounted to its present value?

⁵ Based on the current price of the ABX subprime credit-default swap (CDS) index, admittedly only an approximation, losses are expected to total \$300 billion, with \$80 billion announced before year end by some of those left standing when the music stopped.

⁶ Home prices in 10 major U.S. metropolitan areas in October were down a record 6.7% from a year earlier, according to the S&P/Case-Shiller Home Price Index. To put the decline in context, the index jumped 74% in the six years through 2006, while U.S. median household income rose just 15%. At press time *The Wall Street Journal* announced that December year-to-year new-home sales were 41% lower than the level in December 2006. The median price of a new home decreased by 10% to \$219,200 in December from

their knees, but it may be a recession that is necessary to expose the “under the radar” reckless abdication of fiduciary duty in the corporate credit markets. Over the past decade, the exponential growth of credit derivatives has created heretofore unequalled amounts of financial leverage in corporate credit. Similar to the growth of subprime mortgage structured finance products, the rapid rise of corporate credit innovations required ideal economic conditions and separated those who evaluated risk from those who bore it.

To be sure, I’m not suggesting that the consequences of the subprime mortgage fandango are behind us. Blundering legislative intervention, interest-rate resets, and foreclosures are likely to cause great suffering for hundreds of thousands if not millions of Americans over the next couple of years. In daily financial press accounts, we’re reminded that lenders can postpone the day of reckoning only so long. Citigroup and Merrill Lynch, serial disclosers, announced on January 15 the infusion of another \$19.1 billion, dripping with irony and soon likely to be followed by political backlash, from Sovereign Investment Vehicles. The remediation process has been obstructed by contrite lenders who, like in the ’30s, live by the adage: “Once burned, twice shy.” When the system is crying out for looser credit, the bankers respond by tightening. They exacerbated the problem and are now stymieing the orderly resolution. Still, this “demon of our own design” is no longer lurking in the shadows.

Credit-Default Swap Alchemy: Transmuting Junk into Gold

Today’s commercial bank is not your grandfather’s bank. Unfortunately liberated from the straitjacket of Glass-Steagall and other post-Depression Era safeguards, the once prosaic corporate credit market advanced in just a decade like General Sherman’s 1864 march to the sea through such a mind-boggling, easy-money-enabled series of incarnations that it metaphorically may resemble the fairy tale “Rumpelstiltskin” from the collection of the Brothers Grimm (any resemblances are purely coincidental). The mythical dwarf possessed the power to spin straw into gold. Alas, as if co-authored by Ayn Rand a century later, the fictitious little fellow proved that “no man may be smaller than his money.”

In this heretofore unimaginable environment the investment banks saw fertile soil (read: fees booked immediately that approximated 8% of the premium). As referenced in footnote 5, in the mid-1990s Wall Street gave birth to the *credit-default swap* (CDS),⁷ the basic contract from which all credit derivatives emanated, in order to meet the need for a more fluid trading vehicle. The CDS is an innovative financial instrument that revolutionized the way credit instruments change hands. A CDS is a financial agreement between two parties where liability is transferred to a counterparty for value. Simply put, it is a marketable, radically non-standard insurance pact that is virtually devoid of

\$244,700 in December 2006. Obviously, price trends in new homes have an impact on price trends in used homes. Although unprecedented in magnitude in recent history, the boom/bust cycle in housing could well follow a typical, though painfully elongated, self-correcting pattern.

⁷ Thus far having no direct experience as buyer, seller, hedger, or speculator in the murky world of credit-default swap (CDS) derivatives, I set about learning as much as I could vicariously so that a vague threat could be reduced through familiarity to something less mysterious. As it happened, one of the most incisive investigative financial journalists extant, my friend Kate Welling (with whose keen intelligence, insatiable curiosity, and literary excellence most of you are by now familiar), led me through the maze. Attribution for what follows in the text above starts with Ms. Welling and ends with a host of other unnamed sources to whom my research led me. Framing all this in the context of a possible systemic conflagration would not have been possible without an understanding of the financial innovation infrastructure provided by yet another friend, Rick Bookstaber, Ph.D., author of the must-read *A Demon of Our Own Design: Markets, Hedge Funds, and the Perils of Financial Innovation*. Sometimes it’s not what you know (particularly if you hail from little ol’ Elkhart, Indiana) but who your friends are—and what *they* know—that makes all the difference ...

the safeguards indigenous to traditional property and casualty insurance with which we're all familiar. The standard contract is for five years, though they're selling in the secondary markets like hotcakes. Bank loans or marketable corporate debt are the underlying assets. The buyer of CDS pays the periodic premium to purchase credit protection on a specified, notional amount of exposure. In the event the corporate debtor faces, in the parlance of the trade, a "credit event"—typically a bankruptcy, failure to pay, or restructuring—the owner of credit protection receives payment for the amount of the loss. In terms of exposure, a buyer of CDS is "short" the credit risk of the debtor. He may have purchased the CDS as a hedge to protect a portfolio asset or, more likely, to speculate that the value of a loan or a bond would become impaired. Conversely, the writer of protection assumes a risk comparable to owning the loan or bond, receiving a premium payment in the presumed value-for-value exchange. Thus, the CDS market is a zero-sum game between the buyers and sellers of default protection.

The introduction of CDS coincided with a favorable economic climate for creditors and debtors. Since the nadir of the last credit cycle in 2002, creditors had a uniformly positive lending experience with defaults running at about 1%, well below the historical average. The CDS market blossomed in the era that may be known as "casino capitalism," and the issuance of credit and credit insurance continued apace, unrestrained by considerations of risk. From a modest infancy a dozen years ago, the notional value of CDS today is so large that it surpasses the amount of actual bonds or loans issued or granted by an order of magnitude. That is to say that a company may have issued \$1 billion in bonds and yet have \$10 billion of CDS contracts outstanding concurrently. If the debt were to default with eventual recovery of 40 cents on the dollar, then the loss to investors holding the bonds would be \$600 million—but the loss to credit-default swap sellers would be \$6 billion. In addition to spreading risk, credit derivatives, in this case, also amplify it dangerously. Leverage comes in many forms.

A candidate for the title of Godzilla⁸ of potentially catastrophic derivatives, CDS contracts now total a mind-boggling \$45.5 trillion⁹ of outstanding credit risk, swelling an astonishing ninefold the last three years alone. Putting such a large number in perspective, it's almost five times the U.S. national debt and more than three times the U.S. GDP.¹⁰

While a recession would almost certainly knock the CDS market into a cocked hat, this feat of financial legerdemain is so ill-constructed, with only the slimmest margins for error, that it may fall of its own weight even without the help of a stumbling economy. Credit-default swaps taken as a whole are really little more than a thinly disguised unregulated insurance instrument without the conventional insurance underwriter's obligation to maintain statutory loss reserves or minimum regulatory capital, to say nothing about minimum ratios of liquidity on their balance sheets. Not only do the incentives encourage the taking of helter-skelter risks, the underwriters have shown a

⁸ Godzilla is one of the most recognizable symbols of Japanese popular culture. The early Godzilla movies—there have been 28—were a filmographic metaphor for the United States, portraying the tyrannosaurus rex-like dinosaur as a frightening nuclear monster, embodying the fears that many Japanese continued to hold about the nuclear attacks on Hiroshima and Nagasaki, as well as the nightmarish dread of recurrence. Godzilla's character changed over the years, making him more heroic and thus more appealing to children. Today's Godzilla has fallen somewhere in the middle, from protector to harbinger of destruction. The metaphor lives, and it morphs ...

⁹ According to the comptroller of the Currency's Quarterly Derivatives Report ...

¹⁰ The total risk will be mitigated to an unknowable extent because many of the players hedge their bets. However, given the huge losses disclosed thus far by commercial and investment banks, their "hedged books" were not so well hedged after all. Hedging is typically based on historical risk experience. When risks escalate, hedges often prove woefully inadequate.

propensity to grossly under-price it in their haste to put revenues on the books and, lest we forget all-powerful incentives, accrue gargantuan bonuses. Since few firms have “claw back” compensation provisions (once paid, the Wall Street middlemen for CDS sellers and buyers typically have no recourse against the salesmen), a mispriced distant potential claim carries almost no ethical weight *vis-à-vis* this year’s bonus. Grossly misaligned incentives in the subprime lending industry played no small part in pushing the mortgage-backed security (MBS) market, along with all its many stepchildren, over the edge into insanity. Any system that is structured so that a large premium payment is collected up front while a claim of indeterminate amount—actuarial benchmarks are virtually nonexistent—due months, if not years, hence will often encourage “moral drift.” Imagine the consequences if \$45 trillion of insurance policies experience a natural loss of 5%, and there are no reserves set aside to make good on the \$2.25 trillion in policy claims (or, even \$1.35 trillion, assuming recovery rates of 40 cents per dollar on defaulted debt). No matter how you slice it, the late Senator Everett Dirksen’s wry observation (which he purportedly denied), paraphrased and multiplied by a factor of 1,000, is *apropos*: “A trillion here and a trillion there, and pretty soon you’re talking about real money!”¹¹ A paltry \$300 billion in possible subprime mortgage write-offs seems trivial by comparison.

The moneymaking machine has hummed at ever-increasing velocity as long as companies received cheap financing (or refinancing if primary obligations could not be met), borrowers repaid lenders, and expectations remained cheerful. Given their subordination in the capital structure, junk bonds (or, euphemistically, high-yield bonds) are a logical place to look for the first signs of trouble. Statistics of high-yield issuance reveal relaxed lending standards in a marketplace where risk was benign and therefore ignored. In each year since 2004 more than 40% of all new debt scooped up by investors garnered ratings below investment grade. For perspective, the amount of new paper of poor quality issued in each of the last four years far exceeded the amount of such issuances in any year since the late 1980s.¹² The stars were aligned: cheap money, strong economy, and default rates that were so abnormally low as to be analogous to the perfect sucker pitch—and, *voilà*, CDS issuance blossomed like an outfield full of dandelions in springtime. Under such idyllic conditions, the need for default insurance to hedge or to protect seemed slight. At the end of the day it’s all about monetary incentives, pure and simple. Most people are motivated by self-interest, and they’ll behave accordingly. With all the fees to be generated on both sides of the trade—and with risk of default appearing to be *de minimis*—\$45 trillion in the CDS have been written to date, many of which were probably priced to “perfection” rather than to reality.

High-yield bonds are dubbed *junk* for good reason. Here’s a brief synopsis of the “junk-bond cycle.”

Corporate mortality tables indicate that defaults of high-yield bonds within five years of issuance occur 28% of the time for those just below investment grade and 47% of the time for those with the lowest ratings. Past instances of high default rates lagged periods of strong cash junk issuance by 4 to 5 years, coinciding with recessionary

¹¹ The following comment Dirksen did not deny. It is offered at this point to break the barrage of depressing numbers and bring a smile to your lips: “When I face an issue of great import that cleaves both constituents and colleagues, I always take the same approach. I engage in deep deliberation and quiet contemplation. I wait to the last available minute, and then I always vote with the losers. Because, my friend, the winners never remember, and the losers never forget.”

¹² Payment-in-Kind (PIK) instruments, much like the negative amortization mortgage, which flourished in the 1980s, have enjoyed a renaissance in recent years. In the simplest of terms, PIKs appear when the financial fabric is stretched so tightly that borrowers cannot pay in cash, so they pay in promises of future cash. When PIKs surface, the sharks aren’t far below.

periods in the economy. In good times, issuance is high, underwriting standards are low, and investors forget that risky credits may actually default. A few years later, the economic cycle turns and junk bonds reveal their flawed character.

A disproportional amount of low-grade paper hit the market in recent years, but that was not all. Investors also received meager compensation for taking risk. High-yield spreads over Treasury yields have hovered around historical lows for nearly four years, indicating that investors have paid little attention to the real possibility of loss.¹³

Counterparty Risk

At one time Alan Greenspan actually applauded derivatives as a means of dispersing risk. Warren Buffett,¹⁴ who is both practitioner and visionary, famously described derivatives bought speculatively as “financial weapons of mass destruction.” In Berkshire Hathaway’s annual report to shareholders in 2002, he wrote, “Unless derivatives contracts are collateralized or guaranteed, their ultimate value also depends on the creditworthiness of the counterparties to them. In the meantime, though, before a contract is settled, the counterparties record profits and losses—often huge in amount—in their current earnings statements without so much as a penny changing hands. The range of derivatives contracts is limited only by the imagination of man (or sometimes, so it seems, madmen).” As the movie rolls on, Buffett appears more and more prescient. Greenspan is writing books, coaching from the bleachers, and, just as this report was going to press, he took a position as advisor to hedge fund manager John Paulson whom you’ll meet below. According to the aforementioned Comptroller of the Currency’s *Quarterly Derivatives Report*, the concentration of risk is trending upward, with the top 10 institutions providing 89% of the total notional amount bought and sold. The perennial top four are household names: Morgan Stanley, Deutsche Bank, Goldman Sachs, and JP Morgan Chase. Counterparty concentration appears to remain a feature of this market; JP Morgan is at the bottom of the mortgage derivatives list but at the top of the corporate creditor derivatives list. In its defense, the company has an enormous edge in that the insider information it legally possesses as underwriters for the companies that issue the debt in the first place is asymmetrical. When the expert with whom you deal has superior knowledge and inferior scruples, thumb your way back to the lyrics of “The Gambler” for what to do next.

Who May Be Holding the Bag?

Banks are the primary sellers of CDS, totaling 40% of all written CDS. Banks claim to run hedged books, effectively serving as a market-maker in the CDS market. As should be evident from the events in subprime, even the most sophisticated systems are often unable to fully hedge risks of this size, degree of complexity, and changing character. If printed materials are any indication, banks may be asleep at the switch. The “Counterparty Considerations” section in the Credit Derivatives Primer of market-share leader JP Morgan is a single paragraph on the last page of the volume, which proclaims “the likelihood of suffering [counterparty default] is remote.”¹⁵

It’s estimated that hedge funds have sold about \$15 trillion of CDS, which suits their avaricious fee structures to a tee. Like clipping coupons, they collect premiums that are likely run

¹³ Presentation by Dr. Edward I. Altman, “Current Conditions in Global Credit Markets,” October 2007.

¹⁴ Despite Buffett’s reference to derivatives as WMDs, he owns them. Unlike many 30-something hedge fund managers recklessly selling CDS insurance, few people in the world are better equipped, through long experience and the most rational of minds, to transform the risk inherent in derivatives in his favor.

¹⁵ JP Morgan Credit Derivatives and Quantitative Research, “Credit Derivatives: A Primer,” January 2005, page 25.

through the income statement without adequate set-asides for future claims. There will be no fireworks until someday somebody presents a claim against that insurance sold for which there are no reserves. If the industry experiences a 5% loss ratio, that would just about wipe out the investors' equity in hedge funds. That's what we call counterparty risk. One imponderable is the concentration in the hedge fund industry: It's estimated that some 200 firms control 80 to 85% of all hedge fund assets. In terms of systemic risk, it's probably a forlorn hope that the sellers of unreserved insurance are more broadly dispersed.

Coming Full Circle

As the above idiom implies, perchance we have ended up in this essay precisely where we started. With Ben Graham, do we need to know the fat man's exact weight to know he's obese? Can we infer critical features about the whole by simply comprehending an apparently trivial detail that quite often makes it possible to see into the depth of things, as Dietrich Bonhoeffer did? Did Warren Buffett not tie together in one paragraph the random warnings from "black swan"¹⁶ events hiding in the shadows to admonitions about system-imperiling runaway greed and avarice in his chairman's letters in recent years? Rather than detailing the risks that abound—including some that defy description—summing up, in "an apparently trivial detail" (e.g., the CDS market, heretofore likely unknown to most readers), the consequences of denying the existence of those risks drives the point home. The following is an immutable, and what should be perceived as sobering, law of compounding: A single 100% loss can wipe out an entire lifetime of cumulative gains. Compounding is not an equal-opportunity mechanism. Its rewards and penalties are asymmetrical.

What do these men, both past and present, have in common? In the words of Ernest Dimnet (in a tattered old book published after the Depression that graces my shelves), they were thinkers. *The Art of Thinking* was on the best-seller lists in the U.S. in the 1930s, alongside Dale Carnegie's self-help works, but it is mostly forgotten today. When one reads the description of the thinker, one can't help "thinking" that the book's renaissance may be sooner than we "think." Sometimes it takes repetition to drive home a point: The following paragraphs also can be found in the MCM 2004 annual report.

What is it that characterises the thinker? First of all, and obviously, vision ... The thinker is pre-eminently a man who sees where others do not. The novelty of what he says, its character as a sort of revelation, the charm that attaches to it, all come from the fact that he sees. He seems to be head and shoulders above the crowd, or to be walking on the ridge-way while others trudge at the bottom. Independence is the word which describes the moral aspect of this capacity for vision.

Nothing is more striking than the absence of intellectual independence in most human beings: they conform in opinion, as they do in manners, and are perfectly content with repeating formulas. While they do so, the thinker calmly looks around, giving full play to his mental freedom. He may agree with the consensus known as public opinion, but it will not be because it is a universal opinion. Even the sacrosanct thing called plain common-sense is not enough to intimidate him into conformity. What could seem nearer to insanity, in the sixteenth century, than the denial of the fact—for it was a fact—that the sun revolves around the earth? Galileo

¹⁶ *Fooled by Randomness: The Hidden Role of Chance in Life and in the Markets* (2005) and *The Black Swan: The Impact of the Highly Improbable* (2007) were written by Nassim Nicholas Taleb, a pioneer in the field of complex derivatives, now turned scholar and essayist. A black swan, according to Taleb, is a high-impact, hard-to-predict, and rare event beyond the realm of normal expectations. Prospective readers take note: The books are erudite, but his style on occasion can be offputting.

did not mind: his intellectual bravery should be even more surprising to us than his physical courage. ... Einstein's denial of the principle that two parallels can never meet is another stupendous proof of intellectual independence.

We conclude this section with one real-time story that, parenthetically, parallels a similar concurrent experience by the undersigned, albeit on an infinitesimally smaller scale. In this moment of travail, the story begs the question "Whose advice do you heed?" Who are the thinkers? There are two men with the surname, Paulson, one widely known (Henry) and the other (John) obscure—until recently. Goldman Sachs alum (aren't they all?) Secretary of the Treasury (since mid-2006), *Henry* "Hank" Paulson, the political puppet, mouthed the party line of denial until the crescendo of facts exposing the subprime debacle drowned out his hollow words. Concurrently, *John* Paulson, 51, was betting against Henry, conventional wisdom, Wall Street's talking heads ... and the subprime market myopia. While a bit early and despite his first bets being losers, his obsession with the emerging facts, which he consumed voraciously, only strengthened his conviction. "I've never been involved in a trade that had such unlimited upside with a very limited downside," he is quoted as saying. Pure Buffett ... At root, John's story is one of dogged perseverance in the face of relentless pressure to conform. And John is unquestionably an Ernest Dimnet thinker. His reward as a hedge fund manager:¹⁷ \$3 billion to \$4 billion for himself—believed to be the largest one-year payday in Wall Street history. Beginning in 2005, he and his analysts shorted risky CDO slices and bought credit-default swaps that complacent investors seemed to be pricing too low. As his profits mushroomed he began to worry about counterparty risk. Thanks to the wrong bets of some big banks and Wall Street firms—his counterparties—and the first-leaver advantage, his concerns were assuaged for the time being.

John Paulson is a man from humble beginnings and not without compassion. He has kept a low profile, saying he's reluctant to celebrate while housing causes others pain.

As for what's ahead, according to *The Wall Street Journal*, Paulson has taken profits on some, but not most, of his bets. He remains a bear on housing, predicting it will take years for home prices to recover. He's also betting against other parts of the economy, such as credit-card and auto loans. He tells investors "it's still not too late to bet on economic troubles."

While his prose is not as elegant as the one who follows, perhaps Paulson was framing today's problems along the same time continuum and in much the same way as one of the greatest thinkers in the 20th century did some 65 years earlier ... "Now this is not the end. It is not even the beginning of the end. But it is, perhaps, the end of the beginning."¹⁸ Who's to know in advance? One simple little adage has served me well over the years: "The early bird may get the worm, but the second mouse gets the cheese." The differences are as subtle as they are significant.

MCM'S VALUE-ORIENTED INVESTMENT PHILOSOPHY DEFINED

Before describing our investment philosophy in greater detail, it should be noted that mutual funds serve as a convenient and rough proxy for examining the rest of the investment management industry. This is due to the fact that SEC disclosure requirements and the industry trade association (the Investment Company Institute) make copious amounts of data readily available.

To begin, by profiling the average "actively managed" equity mutual fund we can default into defining who we are by first making it clear who we are not. The average mutual fund owns 160

¹⁷ See discussion of hedge funds on page 25. Paulson's unconventional thinking explains why it is so difficult for the lay investor to select the best hedge funds—*ex ante*.

¹⁸ So Winston Churchill observed after the Allied victory in the Second Battle of El Alamein over Rommel's forces in 1942 after a series of earlier defeats in World War II.

companies and turns over its portfolio 100% each year. Since virtually all are measured against a benchmark (e.g., the S&P 500), they do what they have incentive to do: They “try” (80% fail) to beat the index. Diversification to avoid portfolio volatility isn’t the reason they own 160 stocks when a number less than 25% of that would suffice. Rather, benchmarking and minimizing “tracking error” (deviation from the index against which their popularity is determined) are the reasons. Perversely, since their performance is judged against that standard, if the markets are down 40% and they’re down only 35%, they consider it a good year. The focus is on safety for the manager’s career, not safety and enhancement of the investor’s funds. These aren’t bad people, just misaligned incentives. Find out how someone is paid, and you’ll quickly learn how the game is played and whose side the expert is on. The modern mutual fund industry is little more than an amorphous marketing juggernaut. It’s about salesmanship, not stewardship. Funds are paid for managing the most dollars not for managing the dollars well. If you have any doubts, this year’s Christmas book, *The Battle for the Soul of Capitalism*, by icon and friend Jack Bogle, founder of the \$1 trillion Vanguard Group, will likely dispel them.

Passive index funds, which mechanistically replicate an index, are another class of mutual funds with which we have nothing in common. Nonetheless, they may be the best choice for many investors who have neither the time, talent, nor funds necessary to consider other options. Bogle pioneered the concept. While the majority of growth funds demonstrate regularly that an investor can do worse than indexing, it remains true that an intelligent investor can do better. Keynes, as so often happens, said it best: “To suppose that safety-first consists in having a small gamble in a large number of different directions ... as compared with a substantial stake in a company where one[’s] information is adequate, strikes me as a travesty of investment policy.”

By first describing who we are not, we begin to zero in on the relatively small subset of which we are a charter member. MCM’s underlying philosophical orientation emanates from the so-called “value” discipline, i.e., purchasing a fractional interest in a business for less than its intrinsic worth. Value investors are in the distinct minority, *accounting for less than 5% of professionally managed monies*, according to Lou Lowenstein, Columbia law professor emeritus and a self-appointed spokesman for value investors.¹⁹ Warren Buffett is value investing’s best-known adherent and, despite his widely recognized and admired six-sigma success, the small cohort of investors (including yours truly) for whom he is exemplar is likely to remain relatively obscure. Critics dub Buffett a statistical anomaly which, given their presumed familiarity with numbers, is an insult to both statisticians and themselves.

Apart from Buffett, you might logically be thinking, *If value investing is so good, why isn’t it more widely practiced?* Steven Levitt, the young and brilliant co-author of *Freakonomics*, would likely consider “why” a good question from which to begin. The creative genius Pablo Picasso paints an interesting picture with an observation as provocative as his creative expressions on canvas: “Computers are useless. They can only give you answers.” To sneak up on the “why,” let’s begin by scrolling back to the ’30s. Intellectual and legendary economist John Maynard Keynes observed in the post-Depression trauma that human emotions sometimes exert a dominant influence on investment decision making,²⁰ and he therefore called into question the practicable relevance of what later

¹⁹ “Journey into the Whirlwind: Graham-and-Doddsville Revisited” is the January 4, 2006, transcript of a speech Lowenstein gave to the New York Society of Security Analysts in December 2005. Parenthetically, the apple doesn’t fall far from the tree. Son Roger has thus far written the definitive book on Buffett: *Warren Buffett: The Making of an American Capitalist*.

²⁰ Benjamin Graham, in a twist of his more famous quote uttered about the same time, reached the same conclusion: “[In the short run] the market is not a weighing machine but rather a voting machine, the product partly of reason and partly of emotion.”

became sanctified in academia as the efficient market hypothesis (EMH).²¹ Value investing differs markedly from the exquisite mathematics of modern portfolio theory (MPT) and EMH, its indispensable cornerstone, taught in business schools everywhere. Still, the question remains unanswered. Why didn't Keynesian logic take root?

The combination of Keynes' lone voice and Picasso's insights segue nicely into the principal "why" behind the scarcity of value investors: the ubiquitous "institutional imperative." While most universities pride themselves in preaching creativity, in certain disciplines like finance they teach dogma. Finance professors stay their intractable course not unlike Newton's first law of motion—and for reasons that are understandable but by no means necessarily befitting the creativity mandate. Perhaps they rest their case on the misinterpretation of the phrase "survival of the fittest," which has been attributed to Charles Darwin—and which, by extension, takes them one step farther from the truth with the conclusion: "Might makes right" ...? Using anachronistic (at least in an era where crunching numbers takes precedence over gestating ideas) Aristotelian, syllogistic logic as almost a parody, professors schooled in mathematics find it's easier to teach and test for quantitative acumen, measurable with precision, than is attempting to impart knowledge of common sense and the art of intuition, which is not. Because of the self-perpetuating predisposition of formal academic processes—the fail-safe (from their perspective) institutional imperative—the small minority of us who are value investors enjoy a significant competitive advantage ever hinging, to be sure, on our continued relative obscurity. Institutional momentum and the warm blanket of conventional thought (irrespective of its efficacy in the real world) will likely cement the leading position of quantitative analysis for some time to come. Dan Aykroyd, playing Dr. Ray Stanz in the movie "Ghostbusters," said what others only think: "Personally, I liked the university. They gave us money and facilities; we didn't have to produce anything! You've never been out of college! You don't know what it's like out there! I've worked in the private sector. They expect *results*." ☺

As an aside, I personally find it difficult if not impossible to reconcile EMH's view toward the incorporation of the pivotal estimation of future events with the Keynesian view toward the unpredictability of those very events in determining today's "efficient" price. EMH contends prices are "unbiased in the sense that they reflect the collective beliefs of all investors about future prospects." In Chapter 12 of *The General Theory ...* Keynes [to reconcile terms used in the '30s with those bandied about now] referred to the expected future return of an investment as the "prospective yield of an asset." These are one in the same. In the block quotation that follows, the first paragraph introduces the first level of uncertainty: the relative contribution of the present and the future. The second explains what is called the "availability bias" and the predilection or propensity to linearly extrapolate "what is" into the future. Finally, Keynes concludes with the observation that predicting the future is so uncertain as to be futile and thus, effectively, renders as rubbish the thesis that current prices are "unbiased in the sense that they reflect the collective beliefs of all investors about future prospects." If the future is essentially unforecastable, I would contend, of what incremental value is a consensus of the ignorant?²²

²¹ In finance, the efficient market hypothesis (EMH) asserts that financial markets are "informationally efficient" or that prices of marketable, traded assets, e.g., stocks, bonds, or property, already reflect all known information and therefore are unbiased in the sense that they reflect the collective beliefs of all investors about future prospects. The hypothesis goes on to conclude that it's impossible to consistently outperform the market because of the symmetry of information: Everybody knows what everybody else knows, and it's all embedded in the market price. "Information or news," as EMH defines it, is anything that may affect prices that is unknowable in the present and thus appears randomly in the future.

²² One might argue that business is inherently more stable than when Keynes wrote in the '30s and that forecasting, therefore, is more reliable. While I don't think that argument should be dismissed out of hand,

The considerations upon which expectations of prospective yields are based are partly existing facts which we can assume to be known more or less for certain, and partly future events which can only be forecasted with more or less confidence.

It would be foolish, in forming our expectations, to attach great weight to matters which are very uncertain. It is reasonable, therefore, to be guided to a considerable degree by the facts about which we feel somewhat confident, even then they may be less decisively relevant to the issue than other facts about which our knowledge is vague and scanty. For this reason the facts of the existing situation enter, in a sense disproportionately, into the formation of our long-term expectations; our usual practice being to take the existing situation and to project it into the future, modified only to the extent that we have more or less definite reasons for expecting a change.

The outstanding fact is the extreme precariousness of the basis of knowledge on which our estimates of prospective yield have to be made. Our knowledge of the factors which will govern the yield of an investment some years hence is usually very slight and often negligible. If we speak frankly, we have to admit that our basis of knowledge for estimating the yield 10 years hence of a ... [business enterprise] ... amounts to little or sometimes to nothing; or even five years hence.

Seemingly moving in the opposite direction of the increasingly quantitative world of finance, the school of value investing which we practice makes a subtle distinction between facts and factors, when we move from the present to the future. We don't attempt to forecast factual future outcomes, forming instead general notions or conclusions to avoid the overconfidence trap that often is traced, after the act, to unrealistic specificity. *We attempt to draw inferences from causal factors that may increase our confidence in the degree of certainty that a company will persevere through bad times and prosper in good.* These factors include the:

- Quality of the company's assets as expressed in sustainable earnings power derived therefrom (and, as a subset of quality, the unlikelihood of near-term obsolescence due to design, style, or construction, thus making a company vulnerable to a competitor's innovative assault).
- Solidarity of, and efficiency in, the way assets are financed.
- Industry and competitive construct in which the company does business that might better prepare it to fend off rivals and to raise prices relative to costs without undue restriction.
- Demonstrated integrity and business acumen of the company's managers that might give us reasonable cause to believe that they will respond rationally as agents on behalf of shareholders to unforeseen future developments.

Beyond evaluating the qualitative degree of certainty of these indicative factors, requiring both analytical and intuitive skills, purchasing a fractional interest in the business at a price low enough to provide a "margin of safety"²³—analogous to designing a bridge to carry twice the load expected—is

the ever-more-fragile financial economy, because it is the grease on the skids of the "real economy," may cause unanticipated instability in the goods-and-services economy.

²³ So pivotal is the concept of *margin of safety* that Buffett refers to the phrase as the three most important words in investing. Buying into a company only at a substantial discount from what a willing buyer of the whole company would pay is so brilliantly simple ... why is the execution so remarkably difficult? At first blush the motive may appear to be enhancement of the likelihood of gain, but the common thread is different: It's a deep, abiding, almost pathological fear of permanent loss of capital. As cited in *Speculative Contagion* (Martin, 2006) and in his memoirs, Ben Graham suffered mightily, along with his clients, in the Great Crash. The lessons learned would stay with him the rest of his life and were passed on to his students. Margin of safety is not meant to protect against market loss, but rather loss of intrinsic value. Graham's

essential for survival. Keynes goes on to say that it's this component of the investment decision that requires an understanding of the difference between the speculative and economic elements in determining the "prospective yield of an asset."

Value investors focus on individual businesses and analyze and value them on their own merits, not relying on the market's appraisal. Safety comes in the form of intimate knowledge of, and therefore confidence in, individual businesses, not in broad portfolio diversification among businesses. Remember Keynes' earlier quote about the absurdity of indexing for those who are qualified to appraise individual businesses. Because value portfolios comprise comparatively few companies, Andrew Carnegie's admonition can and should be loosely applied: "Concentrate; put all your eggs in one basket, and watch that basket." Most other managers focus on portfolio construction and not on companies. "Tracking error" cannot even be found in the value investor's lexicon.

Not only that, but value investors view the comparative handful of businesses they own as a patriarchal, founding manager would. One manifestation of the "if-you-love-'em-don't-leave-'em" paradigm of MCM and its cohorts is low portfolio turnover rates—roughly one-fifth the rate of the average, actively managed mutual fund. A second-order effect is that the practice of infrequently changing horses makes value investors that much less conspicuous. Far from the frontlines and headlines, they don't move markets but, rather, respond to the opportunities "Mr. Market" offers. They can remain anonymous when in the aggregate they control just 5% of the assets and represent far less than 5% of the volume of trading. The one anomaly is Warren Buffett, Berkshire Hathaway's chief, with more assets than any other U.S. corporation (\$277 billion). He is the lone value investor who casts such a long shadow that, by virtue of both Berkshire's size and his reputation, he simply cannot fly under the radar.

Since the vast majority of investors see markets and stocks as efficiently priced and/or²⁴ because their performance is judged against a market index and not absolutely,²⁵ there is little cause for them

brilliant observation in the 1934 edition of *Security Analysis* has obviously not been forgotten by Warren Buffett—or the undersigned—given the elsewhere-cited virtues Buffett will be looking for in his successor. Said Graham: "The market collapse in October 1929 was no surprise to such analysts as had kept their heads, but the extent of the business collapse which later developed, with its devastating effects on established earning power, again threw their calculations out of gear. Hence the ultimate result was that serious analysis suffered a double discrediting: the first—prior to the crash—due to the persistence of *imaginary* values, and the second—after the crash—due to the disappearance of *real* values" [italics added].

²⁴ With investment management becoming increasingly specialized (according to the Investment Company Institute), the largest fund families offer more investment alternatives than Baskin-Robbins does flavors of ice cream. Investment management firms are often similarly specialized with consultants—the obsequious middlemen, frequently the weakest link in the value chain, to say nothing of adding another layer of costs—allocating assets for their clients among all manner of subset managers. Equity managers are supposed to be fully invested, as the asset-allocation decision is not theirs. Of course, if the consultant is truly an effective opportunist, he or she will be aggressively defensive in rich markets and aggressively offensive in punk markets. I've not seen it work well at game time, but it bats .750 in practice.

²⁵ Lou Lowenstein not only defines the absolute return orientation of value investors well but deftly ties it in with the concept of margin of safety. "What value investors fear is absolute not relative loss; the failure of a stock to move is of no concern if the business is performing well. Everything is difficult to predict ... particularly the future. Value investors have a deep appreciation of this uncertainty, which is amorphous, unmeasurable, and hence quite unlike the quantifiable risks in, say, rolling the dice or the auto insurance business. There are so many variables—oil, interest rates, the euro, you name it. Wall Street uses CAPM (capital asset pricing model) and other formulae in an effort to reduce uncertainty to a quantifiable risk, but as the Nobel economist Friedrich von Hayek said, they are measuring what is measurable, not what matters.

not to be fully invested in their designated asset classes. There's no ideological reason to wait patiently for an opportunity, as none will ever appear since it has already been "baked in the cake." There's the story of the professor who taught MPT (modern portfolio theory), and he and one of his students were walking together across campus. A 20-dollar bill lying in the grass caught the student's eye. Upon bringing it to the professor's attention, the old man didn't avert his gaze but scoffed indignantly at his student: "If there had been a 20-dollar bill, someone would've already picked it up." Operating in the sweet spot of anonymity, the value investor patiently searches for and frequently finds those 20-dollar bills that most investors are taught to overlook. Even if the professor had inadvertently looked down, he would've likely concluded that what he saw was counterfeit!

Lowenstein sees a willingness to hold cash as an indicator of the intellectual strength of a manager. He believes it instills discipline, not in trying to time the market but in refusing to buy unless the price of an asset implies an appropriate margin of safety given the level of uncertainty. Unlike our fully invested, active-manager brethren who, before the current maelstrom, had aggregate cash reserves of a minimal 4.2%, value investors let the availability of risk-adjusted opportunities and not tracking error determine the amount of cash they hold. Buffett calls cash the default asset class, and currently he holds tens of billions of it. Fortunately, he's one step removed from being second-guessed by shareholders. Berkshire Hathaway is not a mutual fund and is not subject to withdrawals. However, it's Buffett's extraordinary record of rational business judgments that ultimately keeps his faithful flock close to the shepherd.

As for us mere mortals, the pressure, both internal and external, to conform is relentless, as the first several chapters in *Speculative Contagion* attest. Keynes spoke to the cold reality of the plight of a long-term, client-oriented thinker in a short-term world. He concluded, sadly, that "It is better to fail conventionally than to succeed unconventionally." As noted in the April 2007 "Quarterly Capital Markets Review," Jean-Marie Eveillard, manager of the First Eagle Fund, knew the cost in pursuit of unconventional success. Enduring the consequences of being four years early in building cash for what became the bloodbath of 2000–02—which included living with criticism day after day and defections from clients demanding instantaneous results—he remained the sanguine fiduciary, saying "I would rather lose half our shareholders ... than lose half our shareholders' money."²⁶ Is there any question about the hierarchy of his loyalties? As a postscript, those investors who reciprocated Eveillard's loyalty were rewarded with a 15.3% compounded annual rate of return from 1996 through 2003.

Among the few advantages of owning public companies are (1) access to huge amounts of information, an impressive portion of which must comply with SEC disclosure standards, and (2) low transaction-cost marketability. For most of the investment community, the former is often overlooked, and the latter has had the unintended side effect of fermenting short-term speculation at the expense of long-term investment. For the value investor, the gold mine of information publicly available is of great import in getting to know companies well, particularly over long expanses of time. If you sequentially study 10 years' worth of annual 10-K reports and proxy statements, as well

What matters, what makes the uncertainty manageable is that margin of safety, which in turn rests on the foundation of a thorough understanding of the business. Here, of course, is where the ranks of would-be value managers quickly thin out."

²⁶ Eveillard was not alone in trying to find value where none existed. The "Goldfarb 10," a group of 10 value investors with remarkable long-term records selected by friend Bob Goldfarb, CEO of Ruane, Cunniff & Goldfarb at the behest of Lowenstein, also found their style out to favor for a character-challenging span of time. Four of them underperformed the S&P 500 four consecutive years, 1996–99, and in some cases by huge amounts.

as quarterly 10-Qs, you'll generally get a feel for the character, worldview, temperament, and independence of judgment of the leaders—and how they anticipate or respond to changes in the competitive rivalry in their industry or to changes in the financial or real economy. Because of the short-term perspective by those who control much of the money that sets prices on Wall Street, enormous mispricings, at least from a long-term investor's perspective, occasionally occur. The combination of high volatility and easy marketability is manna from heaven for us. We strike, and then we hibernate, leaving hyperactive speculators to play what is largely a zero-sum game.

Incentives: Straight Talk About Investment Management Fees

We wouldn't think of closing this discussion without being transparent about the incentive system under which we operate. We've been told by our peers that it is one of the fairest and most unique fee arrangements in our profession. First and foremost, it is structured down to the finest detail to align our interests with yours. When we earn solid absolute returns for you, we are paid well—but not too well. When we can't find enough ideas to put all your money to work, productively and safely, we park your money in short-term U.S. Treasury securities and the highest-grade tax-exempt bonds, when we can find them. For a \$5 million account, if we earn 5% or less as a result, we charge a 50-basis-points “maintenance fee,” similar in percentage to that of many fixed-income managers. Our fee automatically adjusts depending on what and how we are doing for you. The fee has compelling incentives for us to earn high rates of absolute return for you over long periods of time—precisely the formula of compounding returns that Ben Franklin devised almost 250 years ago for the optimal accumulation of wealth. Equally respectful of Franklin, it has a high-water mark that punitively discourages overreaching. We are not eligible to earn a performance fee (between 10% and 6% of portfolio gains, depending on the size of your account) until the portfolio, adjusted for additions and withdrawals, exceeds the standing high-water mark. We pay all commissions for trades executed on behalf of clients to tangibly remind ourselves that trading is a playground for speculators. We have yet to meet our first old, bold, and rich “churner and burner” and see no reason whatsoever to venture into that minefield.

In more traditional investment advisory structures, what kind of actions or behaviors are motivated—or discouraged—by the incentives/penalties provided under fixed fees? Steven Levitt, for whom incentives are the often undisclosed force behind many behaviors in economics and finance, would doubtless spend little time ferreting out this riddle. All the incentives are stacked in favor of gathering assets and *against* bettering the client's lot—or, as you'll see, even protecting it. Keynes' aforementioned insight, “It's better to fail conventionally than to succeed unconventionally,” instinctively pushes most managers toward the anonymity of the middle of the Bell curve. To aspire to outperform carries the disproportionately negative career consequences of underperforming.

What incentives does the fixed-fee manager have to go against the grain in trying to protect *your* assets in the face of, say, a bear market? To the extent that your portfolio declines, e.g., 30% in value, the fixed-fee manager's fees from your account will decline proportionately. Very much like the real estate agent whose income is based on turnover, there's no incentive to hold out three extra months to get the seller a 5% better price. If your manager's firm is an adroit marketer, losses in your account will be offset by new assets gathered. The litmus test: Ask your fixed-fee manager if his own portfolio is invested alongside yours. (As a benchmark, those of us who “eat our own cooking” are surely fewer than 5%.)

Given what was written in the 2005 and 2006 annual reports, as well as this report, it should come as no surprise that both of us (you and MCM) are paying the *short-term* price for having almost

50%²⁷ of your/our money in immediately accessible cash equivalents. As this report is being written, the virtue of having lots of dry powder is becoming more and more evident. Make no mistake, we're like Santa's elves in the months leading up to Christmas. We're working feverishly against deadlines that may be near or distant, constantly building and refining our inventory of ideas so that when individual companies hit our "buy" prices, we're ready to pull the trigger. For the patient investor, with equanimity of manner and an understanding of the psychology of Mr. Market, the opportunity to buy great businesses one by one at extraordinary prices (relative to their intrinsic worth) could be well worth the wait. While, like Eveillard, we have felt the sting of slings and arrows and have experienced defections because, like a man blindfolded, we chose not to venture too close to the precipice. For a host of psychological and other reasons, once an investor falls off the cliff, the next stop is almost always the bottom of the abyss. Most impatient investors find it incredibly difficult to break their fall—or cut their losses. During this time of travails, new and often much larger clients have joined our ranks, intrigued by the way we do business and the incentives that motivate our behavior. Several of these accounts are not yet fully funded and are thus not reflected in the asset totals on page 2. To quote Ayn Rand, money, as final arbiter, demands that we sell "not our weakness to men's stupidity, but our talent to their reason." It demands that our clients buy, not the shoddiest service that is offered, but the best that our clients' money can find. Continues Rand: "And when men live by trade ... it is the best product that wins, the best performance, the man of best judgment and highest ability—and the degree of a man's productiveness is the degree of his reward."

Hedge Fund Advisory Fees: Where Is the Customer's Yacht?

Having spent the first 20 years of my career on the "sell" side before moving in 1987 to the "buy" side to found Martin Capital Management, I have an insider's familiarity with how the system works. "Reverse engineering," or thinking backwards about fees, invoking the questions "why and what's in it for you or me?" at every "Y" (or is that "Why?") in the decision tree is likely to lead you close to the truth about motives, loyalties, and the incentives behind them.

Wall Street is rife with examples of behaviors that violate accepted social mores. As just noted, you need only look for the incentives behind the conduct. *Caveat emptor* is not an idle adage. As for the emergence of the private-equity phenomenon, which is cut from the same moral cloth as hedge funds (despite all the protestations about it being a social good), take the time to read the entire history of Blackstone to see if altruism was the driving motive. Diminutive (only in physical stature, to be sure) Stephen Schwarzman, whose stake in the company at the IPO price was a big and tall-sized \$7.73 billion, lives a regal existence that would make Donald Trump blush—and which seems to run counter to his carefully coiffured image as a modern-day Robin Hood. With well-designed incentives, whether the end is noble or self-serving, like Archimedes' lever, one can move the world.

Hedge funds,²⁸ the feature of this short section, constitute one of the more intriguing examples of ignoble incentives. Hedge funds charge fees so rich as to render, in the aggregate, the

²⁷ Clients who have been with us a long time may have a somewhat larger percentage of their assets in equities because of embedded gains in companies that are in that zone where they're too expensive to buy but not so expensive to warrant selling. It is our policy not to herd new clients, for our convenience, into the companies that everyone else owns, irrespective of price. Those who joined us in the last several years have a much larger percentage of their assets in cash. In that respect each client's cash is put to work only as companies within our inventory of ideas fall to prices that provide the margin of safety we require.

²⁸Hedge fund pricing, as one of a family of theoretically possible anomalies in the general theory of demand in microeconomics, is as old as it is clever. In what may be the most creative applications of the basic principles of the Ponzi scheme ever conceived, the *investor* actually perceives value in paying outrageous fees

investment results to the appropriately named “limited” partners uneconomic. The “standard” hedge fund fee, euphemistically “2 plus 20,” translated to its harsh reality means the investor pays an annual fee equal to 2% of his assets for the “privilege” of having his assets managed *and* 20% of the profits, if earned. A 10% overall gain leaves a paltry 5.6% for the investor—before taxes. As for losses, the sharing arrangement, as you might suspect, is ... asymmetrical! Hedge fund managers are masters at exploiting the asymmetry and opaqueness of information. To be sure, some hedge funds will provide spectacular returns like John Paulson (see page 17) just as others, like Amaranth (profiled last year), will perform ignominious belly flops from the 10-meter board. The survivorship bias further distorts the difficulty in predicting prospective winners from losers—in advance.

Ending on a High Note: a Few Simple Rules for Value Investors

Superinvestor Bill Ruane²⁹ concluded years ago that thoughtful value investing meant three things: a small portfolio (20 at most), low turnover, and eating your own cooking. The contrast is all too clear.

He went on to offer a few simple rules about what to look for when searching for investment values:

1. **Buy good businesses.** The single most important indicator is a superior return on capital because it means the company enjoys a unique proprietary position.
2. **Buy businesses with pricing flexibility** [always true but particularly in the inflationary periods].
3. **Buy stocks at modest prices.** While price risk cannot be eliminated, it can be lessened materially by avoiding high multiples.
4. **Buy strong balance sheets.** If this rule is violated, none of the others will matter.

to join the hedge fund club. The 2% ante required just to sit at the table makes the hedge fund the most expensive of fixed-fee investing. The manager prospers regardless. The 20% kicker completes the ignominious picture. Economist Thorstein Veblen, in *The Theory of the Leisure Class. An Economic Study of Institutions* (1899), first pointed out the concepts of conspicuous consumption and status seeking. “Veblen goods” are viewed as high-status and enhance the perception of exclusivity, such as diamonds or luxury cars—or, to the matter at hand, hedge funds—for which people’s preference for buying them increases as a direct function of their price, thereby making them even more preferable. Another related attribute includes the snob effect, a preference for goods because they are different from those commonly preferred. In other words, for consumers who want to use exclusive products, *price is quality*. Finally, the “bandwagon effect,” which needs no explanation, is an example of a positive-feedback loop.

²⁹ Bill Ruane, co-founder of Ruane, Cunniff & Goldfarb, who died in 2005 at age 79, was so well-regarded by former Columbia University classmate Warren Buffett, where they both sat at the feet of Ben Graham in 1950, that in 1969, when Buffett closed down his partnerships to devote full time to Berkshire, one of the three options he proposed to his partners was that they invest their proceeds in the new Sequoia Fund, managed by Bill and Rick Cunniff. Beginning with \$20 million they closed the fund to new investors in 1982. The fund now manages \$14 billion and, according to a 1999 *Forbes* article, the original investors saw their stake increase 110-fold over the subsequent 30 years, which equates to a 17% compounded rate of return. Although not mathematically precise because of more than two years’ overlap in the data (September 30, 1997, through December 31, 1999), the fund’s performance for the last 10 years, through September 30, 2007, was 9.53% compounded annually, a slimmer margin of 300 basis points over the S&P 500. For the last five years Sequoia *underperformed* by 600 basis points, while six of the previously mentioned “Goldfarb 10” underperformed, some by wide margins; agonizing testimony to the difficulty in finding well-priced ideas in the kind of market environment of the last four years. Any similarities with 1996–99 may, or may not, be coincidental.

5. **Buy cash-generating businesses**, those where the earnings are truly available to create future growth or payment to stockholders.

FINAL THOUGHTS

The old Chinese proverb (and curse) seems *apropos*: “May you live in interesting times.” Contemporizing it, in the vernacular of computer hackers, *interesting* is understood to mean “requires thought and genuine effort.” While the source is a bit suspect, it fits nicely into the “thinking” theme of this report.

Sometimes we encounter a monumental challenge that fills us not with dread but, rather, with a call to arms, as almost an epiphany: “It’s as though I’ve prepared myself during my entire career for this moment.” As Laurence Gonzales, author of the best-seller *Deep Survival*, advised me recently, those who prevail when thrust into a crisis for which they have no mental model developed from personal experience must be both bold and humble. May we be blessed with boldness and humility, in nigh-equal measure.

With a superb team of partners and associates, a support group *par excellence*, and a group of client friends without equal, the collective “we” are as prepared as we can be for what lies ahead. Our pledge to protect client capital “come hell or high water” was put through a sterling dress rehearsal in the late 1990s, and the ultimate test of what we are really made of may be revealed in a baptism by fire in the months ahead. Many different words, some complimentary and some not, have been used to describe us. I doubt that anybody, however, has ever called us lemmings!

C.S. Lewis, one of my favorite authors, warned of the risk of sliding down the slippery slopes of middle age without a purpose: “The long, dull, monotonous years of middle-aged prosperity or middle-aged adversity are excellent campaigning weather for the devil.” Oh, for just a few days of tedious sameness! At 65, and with my son, Todd, managing the firm as though he’s intent on becoming my most redeeming legacy, my passions and energies can be refocused on those endeavors which are likely to keep me filled with purpose and passion for years to come: spending much more of my time in the thrilling and ever challenging investment arena, the amphitheater where battles are won or lost and where one is only as good as his last victory. I also look forward to spending time off the field and, in an entirely different venue, enjoying the luxury of moments shared with friends, many of whom are clients, discussing all manner of subjects that are of mutual interest. Finally, for reasons that remain a mystery to me, I have had the distinct honor of keeping the company of some of the greatest thinkers in our industry, in corporate America, and authors who are as diverse as they are fascinating. [Up to my old chicanery, \$5 awaits the reader who brings to my attention the sleight-of-hand in the Introduction. This year’s letter is really the equivalent of 30 pages in the 6” by 9” size used in previous years. Let me know if it was worth 5 bucks to make it this far. If you went right for the prize in this Cracker Jack box, you missed the sugar-coated goodies inside!]

I plan to retire as soon as I can find some endeavor that’s more satisfying and challenging. Don’t be surprised, though, if I’m making that same statement 10 years from now. Thanks to all of you, I haven’t worked a day in my life ...

Frank K. Martin, CFA, Senior Partner

BUSINESS PRINCIPLES

- Our practice of ethics is quite uncomplicated. We simply conduct ourselves in our relationship with you as if the roles could be reversed at any time. If you would like something more formal, we can send you the Code of Ethics of the CFA Institute of which the members of your management team, as Chartered Financial Analysts, are full participants. It is well thought out and inclusive.
- We strive to be candid and forthright in our reporting to you. You have placed your trust in us, and we know of no other way to be worthy of that trust. Despite this policy of openness, we will publicly discuss our transactions in marketable securities only when we believe such disclosure will be to your advantage. Good ideas are scarce, and the output of our research efforts is your exclusive property.
- Our portfolio management style is “participatory.” We consider it very important for you to be actively involved in the review of our recommended portfolio policy, in mapping out intermediate-term strategies, and in major asset-allocation decisions. Your involvement should not take a great deal of your time, however. The better we get to know you, the more likely we are to appreciate your unique (and sometimes changing) goals, objectives, preferences, biases, and fears, both spoken and unspoken. With your indulgence, we will continue our practice of encouraging frequent face-to-face get-togethers. We also will persevere in communicating our thoughts to you in writing to make it easier for you to get to know us.
- To the extent that security laws and regulations permit, each partner’s personal portfolio is invested in the same securities as yours, varying only to the extent that our goals and objectives differ. In other words, “We eat our own cooking.” It probably goes without saying that such a policy demonstrates the sincerity of our position—not necessarily the soundness of it.
- We are a small organization and intend to remain so. A compact organization makes it possible for us to spend our time managing our business rather than each other. Because everyone has much to do, much gets done. Our design appeals to those for whom form is secondary to substance.

INVESTMENT PRINCIPLES

- Our implicit quantitative performance goal is to maximize long-term portfolio returns.
- The universe of marketable securities from which we select most investments is generally limited to: (1) long-term, common-stock holdings; (2) medium-term, fixed-income securities; (3) long-term, fixed-income securities; and (4) short-term cash equivalents. Beyond respecting the investment-policy guidelines established for you, we are not partial to any one of the above categories. We simply search among them for securities that offer the highest after-tax, risk-adjusted returns as determined by “mathematical expectation.”
- We strenuously avoid assuming risks that might result in “permanent” capital loss. We will forgo an outstanding investment opportunity if the flip side of that coin is the risk of an irreversible capital loss. We do expect frequent shorter-term quotational losses as we rarely, if ever, are able to buy a common stock or any other security at its absolute lowest price. So long as we feel our business analysis is sound, further weakness in the market price of a company simply gives us an additional opportunity to purchase shares at an even greater discount relative to its intrinsic value. We may, from time to time, take positions in exchange-traded options for hedging

existing positions or the market in general. Any one option may, and often will, expire worthless. Unlike any individual business in which we invest, we view the potential loss on any individual option position in the context of the total portfolio.

- Consistent with our attitude toward catastrophic risk, we have little interest in the use of leverage. We do not margin portfolios and usually avoid making investments in businesses that themselves labor under a heavy burden of debt.
- When we purchase common stocks, we approach the transaction as if we are buying into a private business. We insist on a purchase price that represents a “compelling discount” from intrinsic value. Once a purchase is made, we focus the bulk of our attention on tracking the business itself and ignoring short-term price fluctuations. We are quite content to hold onto our investment in a good business so long as (1) the prospective return on equity capital is expected to be satisfactory, (2) the management continues to conduct itself with competence and honesty, and (3) the market does not become excessively enthusiastic about the future outlook for the business.
- We believe that intrinsic value is in essence the central tendency in the price of an asset. It is the investment concept at the core of our analytical methodology. While intrinsic value is an elusive notion, “earnings power” has become the driving force in fixing a range for intrinsic value. Earnings power allows for the existence of an intangible asset known as “economic goodwill” that can be aggregated with tangible assets to arrive at intrinsic business value. Without such a fundamental benchmark, however vague, one is at risk of becoming awash in the occasional tides of euphoria and pessimism that flood the security markets.
- We generally limit the number of companies we own in any individual portfolio to fewer than 20. Contrary to popular opinion, exceptional investment ideas are uncommon indeed. We do not want to dilute the performance of outstanding investments with potentially mediocre ones purchased solely for the sake of additional, and often redundant, diversification. Despite the intuitive appeal of the broad spreading of your risks, extensive computer-backed testing has demonstrated that 90–95% of all the benefits to be gained from diversification can be achieved with a well-selected portfolio of fewer than 20 businesses.

THE MARTIN CAPITAL MANAGEMENT TEAM

Frank K. Martin, CFA, Senior Partner

Frank has 40 years of investment industry experience. He founded McDonald Capital Management, Inc., in 1987, and the firm was reorganized as a partnership in 1991 and renamed Martin Capital Management. He graduated from Northwestern University in 1964 with a major in investment management and earned an MBA, with honors, including membership in *Beta Gamma Sigma*, the honor society of collegiate schools of business, from Indiana University at South Bend in 1978. From 1964 to 1966 Frank served as an officer in the U.S. Navy. He is a Chartered Financial Analyst. Frank has served on the boards of directors of several manufacturing companies, as well as a variety of social service organizations. He is currently a member of the boards of the Elkhart General Hospital Foundation; Fourth Freedom Forum, Goshen; Sauder Stewardship Foundation, Inc., Archbold, Ohio; Western Reserve Partners LLC, Ohio; and the Frank Martin Family Foundation. He is founder and chairman of the board of DreamsWork, a mentoring and scholarship program for inner-city children. Frank published a biography of his father, William F. Martin, in 2000. In December 2005 Frank published the book *Speculative Contagion*. In 2008 Frank plans to continue work on a proposed book, *In Temporary Trust*. Frank assumed the responsibilities of senior partner on January 1, 2007.

Todd B. Martin, CFA, Managing Partner

Todd has 19 years of investment industry experience. He has been with Martin Capital as an associate since 1993 and was admitted to the partnership in 1997. Prior to that time, he was an investment officer with First Chicago Corp. His undergraduate degree is in economics from DePauw University, Greencastle, Indiana. He earned the CFA designation in 1993 and graduated *magna cum laude*, with membership in *Beta Gamma Sigma*, from the MBA program at the University of Notre Dame in 1997, where he remains affiliated as a guest lecturer at the graduate business school. Todd has served on the boards of several social service organizations and is currently a member of the Elkhart General Hospital Board of Trustees and Finance Committee.

Dennis D. Blyly, CFA, Partner

Dennis has 22 years of investment industry experience. He was an associate with Martin Capital Management and its predecessor firm for six years before being admitted to the partnership in 1994. Prior to joining Martin Capital, he was an investment officer for NBD Bancorp. Dennis graduated with honors from Grinnell College in Iowa with a major in economics and is a Chartered Financial Analyst. He earned an MBA, with honors, including membership in *Beta Gamma Sigma*, from Northwestern University's Kellogg School of Management. Dennis has served on the boards of several social service organizations and is currently a member of the boards of Hertzler Systems, Goshen, and Pleasant Street Homes, LLC.

Andrew P. Wilson, CFA, Partner

Drew has more than 12 years of investment industry experience. He was admitted to the partnership on January 1, 2004. Prior to joining Martin Capital in 1995, Drew was an employee benefits consultant with Watson Wyatt Worldwide, Chicago, specializing in qualified retirement plans. He graduated *magna cum laude*, with membership in *Beta Gamma Sigma*, from Loyola University, Chicago, where he majored in finance. Drew earned his CFA in 1998. Drew completed the top-ranked Executive MBA program at Northwestern University's Kellogg School of Management in the spring

of this year. Drew sits on the board of the Center for Hospice and Palliative Care, Inc., as well as the Indiana University at South Bend (IUSB) School of Business Advisory Board.

Aaron J. Kindig, CFA

Aaron joined MCM in 2002 as a financial analyst. He earned a BA in accounting and business administration from Bluffton College (Ohio) in 1995. His honors include the Financial Executives Institute Award and *Pi Delta* Honor Society. He tutored accounting students for three years. After graduation he spent three years in the banking industry, followed by almost five years in investment services. Aaron earned the CFA designation in 2003 and is a member of LaCasa Lending Advisory Committee, Goshen. He also is a DreamsWork mentor.

Karman L. Eash

The most recent addition to the operations team, Karman was recruited by Martin Capital in January 2007 as operations manager. She is a CPA and 1990 graduate of Manchester College, North Manchester, Indiana. Prior to joining Martin Capital she spent 15 months in public accounting with McGladrey & Pullen, four years as controller at Manchester College, and almost seven years at Accuride International where she held assistant controller and division controller positions. Karman also has an additional five years of public accounting experience with Coopers & Lybrand in the South Bend and Elkhart areas.

Kristin A. Antalavits

Martin Capital recruited Kristin in 2000 as a portfolio manager's assistant and securities trader. She majored in accounting at Simpson College, Indianola, Iowa, where she earned her BA in 1990. Before joining the firm, she was employed by Northern Trust Bank, Chicago, as a senior representative in the investment managers liaison group.

Karen M. Sherer

Karen has more than 21 years of experience in the financial services industry. Before joining Martin Capital in 2001, she was employed by Compass Financial Advisors as a registered representative. Karen was also employed for 16 years with Bank One/Chase where she held various positions. She worked in the trust department for 10 years; in 1996 she was promoted to trust administrator, then to trust officer in 1998. Karen earned her BS in organizational management from Goshen College in 1995.

Stephanie A. Malcom

Stephanie joined Martin Capital in 2000 as the business office coordinator. She graduated from Elkhart Memorial High School and has attended various seminars on office management. Stephanie came to the firm from Elkhart-based Energy Management Systems. She began volunteering as a DreamsWork mentor in 2005.

Christine L. Broadbent

Christine joined the firm in 2004 as an executive assistant to three of the four partners. She attended both Indiana University's Bloomington and South Bend campus' studying anthropology and history. Prior to Martin Capital, Christine worked for the University of Notre Dame for 12 years, beginning in the Undergraduate Admissions office, served as Marketing Coordinator for MBA Admissions as well as Assistant Director of Pre-College Programs, a high-talent summer program for rising high school seniors. She spent the last three years with the University's MBA Program as Assistant Director of Student Services.

Kristen R. Smith

Kristen began with Martin Capital in July 2005. She earned her BA with high distinction in general studies, with minors in anthropology and sociology, while also obtaining an International Studies Certificate from Indiana University at South Bend. Prior to Martin Capital, Kristen spent seven years working for ADEC (Association for the Disabled of Elkhart County) as a residential trainer. She also worked as a writing consultant in the Writing Center at IUSB for two years. Kristen started volunteering as a DreamsWork mentor in 2005.

Sue K. Massey

Sue joined the Martin Capital team in October 2005. She earned her associates degree and paralegal studies certificate from Indiana University at South Bend. Sue was employed for 12 years at Bank One/Chase, the last three working as an administrative assistant in the trust department. Sue currently serves as a DreamsWork mentor.

MARTIN CAPITAL MANAGEMENT, LLP

PRIVACY NOTICE

Martin Capital Management, LLP (“MCM”) recognizes and respects the privacy expectations of its clients. MCM considers clients’ data to be private and confidential—and holds itself to the highest standards of trust and fiduciary duty in their safekeeping and use. MCM has not and will not sell personal information to anyone.

MCM collects nonpublic personal information about clients from the following sources:

- *Account Applications and Other Forms*, which may include a client’s name, address, telephone number, Social Security number, and information about a client’s investment goals and risk tolerance.
- *A Client’s Professional Advisors, such as consultants, attorneys, and accountants*, who may provide financial, investment history and tax information about a client.
- *Account History*, including information about the transactions MCM has ordered and balances in various accounts.
- *Correspondence*, written, electronic or telephonic, between a client and MCM or a client’s broker or custodian and MCM.

MCM will not release client account information to any third party unless one of the following conditions is met:

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- MCM believes the recipient to be the client or the client’s authorized representative, including the client’s attorney or accountant.
- The recipient is a broker, custodian, or other service provider with whom MCM must share information in order to manage or service a client’s accounts properly.
- MCM is permitted or required by law to release the information to the recipient.

MCM will only use information about a client and a client’s account(s) to:

- Help MCM better serve the client’s investment and financial needs.
- Suggest services or other materials that may be of interest to the client.
- Fulfill our regulatory obligations.
- Administer MCM’s business.

MCM maintains physical, electronic, and procedural safeguards that comply with federal standards to guard the privacy of clients’ nonpublic personal information.

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