MARTIN
CAPITAL MANAGEMENT, LLC
Registered Investment Advisor

2010
ANNUAL REPORT

February 1, 2011

Dear Client:

For the first time, the annual report this year is being delivered to most of you in electronic form only. It's an effort on our part to more fully embrace the convenience and cost advantage of technology, but also an acknowledgment that we must use all the tools at our disposal to keep you better informed. This year, the annual report is more concise and focused. It will also be available on our website *www.mcmadvisors.com* on May 1 in the newly revamped Library section accessible from our home page with a single click of the mouse.

2010: A Nonconforming View

Walk through any shopping mall in America and you will see the ubiquitous "You Are Here" marker on the kiosk map. To start this year's annual report, we thought it might be helpful to provide the same type of orientation. The graphic above illustrates just how bipolar the markets have been over the last decade, with wild swings between euphoria and fear. The blank years to the right of the "You Are Here" marker are also instructive. They show the unknowable future we face each day in making investment decisions for you, our clients.

Despite the erratic ups and downs, Martin Capital Management has grown investors' capital well in excess of the larger market since the beginning of the new millennium in two primary ways: First, by staying out of trouble and second, by taking advantage of sound opportunities when they appeared. Driven by the dual goals of capital preservation and performance, MCM on average has compounded clients' capital, net of fees, at an average annual rate of 6% since January, 2000. By comparison, the total return from the S&P 500 was .41%. Advertising returns without disclosing the risks assumed, however, tells only half the story (see Chart 1). In terms of dollars and cents (Chart 2), we doubled your money during this period while holding large amounts of cash. Generally high valuations and escalating financial uncertainty left us no choice; the happy result is that your returns came with considerably lower than average risk.

The great advantage of cheap markets is that both preservation and performance can be pursued simultaneously. In expensive years, like 2010, it isn't possible to have it both ways: Preservation must take precedence, regardless of the cost. Our 1.5% total-account return in 2010 reflects the opportunity cost of putting preservation of capital first.

	Annualized Growth Rate			
Year	**MCM Equities ***	**MCM Total Account**	**S&P 500**	**Relative Performance**
		(1)	*(2)*	*(1)-(2)*
2000	29.3%	21.3%	-9.1%	30.4%
2001	22.7%	17.1%	-11.9%	29.0%
2002	-13.6%	-11.8%	-22.1%	10.3%
2003	33.9%	25.5%	28.7%	-3.2%
2004	4.7%	3.6%	10.9%	-7.3%
2005	-0.2%	-0.8%	4.9%	-5.7%
2006	5.0%	0.7%	15.8%	-15.1%
2007	1.5%	3.1%	5.5%	-2.4%
2008	-21.5%	-7.8%	-37.0%	29.2%
2009	51.4%	21.6%	26.5%	-4.9%
2010	17.9%	1.5%	15.1%	-13.6%

* Net of fees

Period Ending December 31, 2010	**MCM Equities ***	**MCM Total Account ***	**S&P 500 ***	**Relative Performance**
		(1)	*(2)*	*(1)-(2)*
Ten Years	8.3%	4.6%	1.4%	3.2%
Five Years	8.3%	3.4%	2.3%	1.1%
Three Years	11.9%	4.4%	-2.9%	7.2%
One Year	17.9%	1.5%	15.1%	-13.6%

* Compounded annually, MCM data is net of fees

** Disclosure: The MCM Equities Composite shows the performance of the equity investments in all discretionary fee-paying accounts managed by MCM. Historical returns include accounts that may no longer be under our management. The MCM Total Account Composite shows the performance of all assets held in fully discretionary fee-paying accounts who have given us authority to invest 100% of the account in equities and are managed per our model portfolio. Because we began presenting the Total Account Composite in 2008, it contains only accounts that were actively managed on December 31, 2008, plus accounts that have since been added. MCM believes that because the fully discretionary accounts are, and historically have been, so similarly managed in terms of types and proportions of securities, survivor bias—if any—is not material. Both MCM composites are net of all management fees and include the reinvestment of all income but do not reflect the effect of taxes. The composites are compared with the S&P 500, an unmanaged market capitalization-weighted index of 500 common stocks chosen for market size, liquidity, and industry group representation to represent U.S. equity performance. S&P 500 returns do not include consideration for fees or taxes.*

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

Chart 1

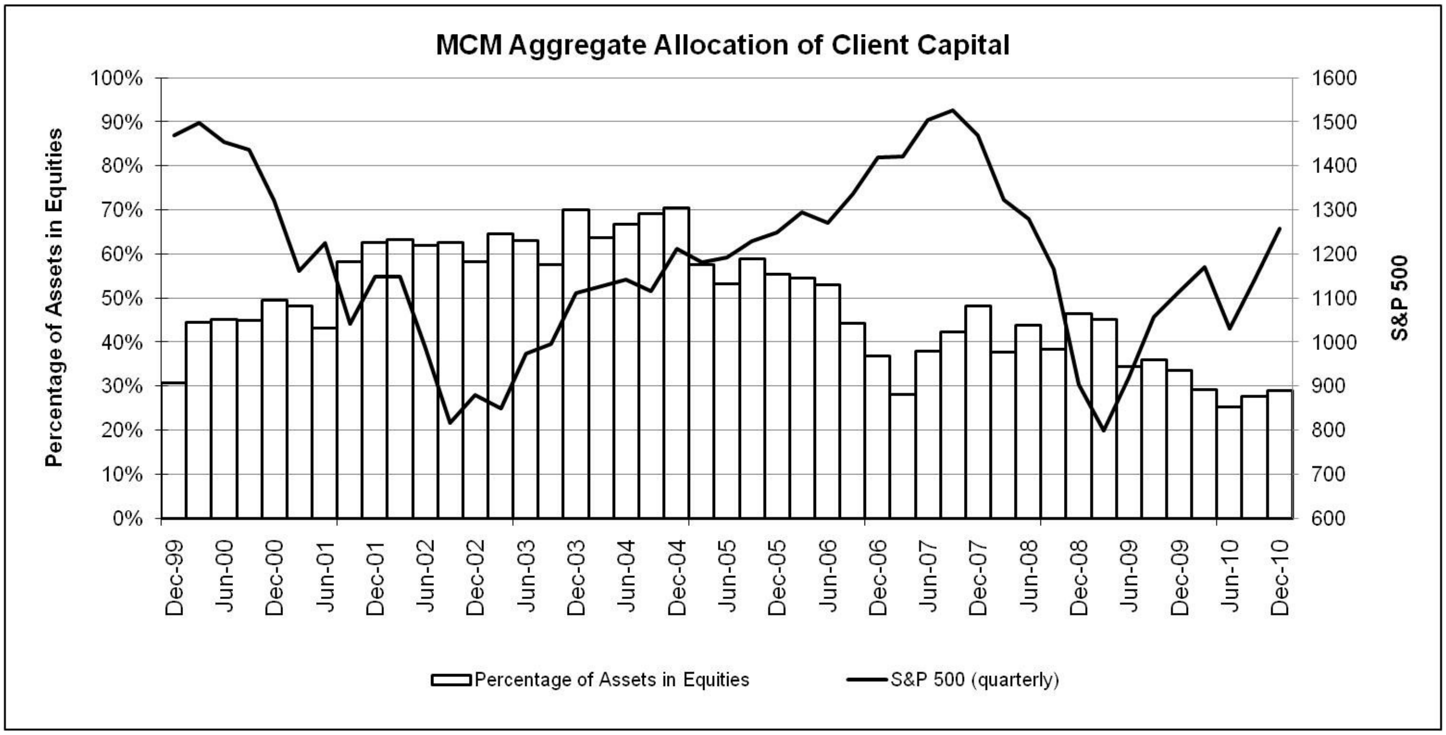
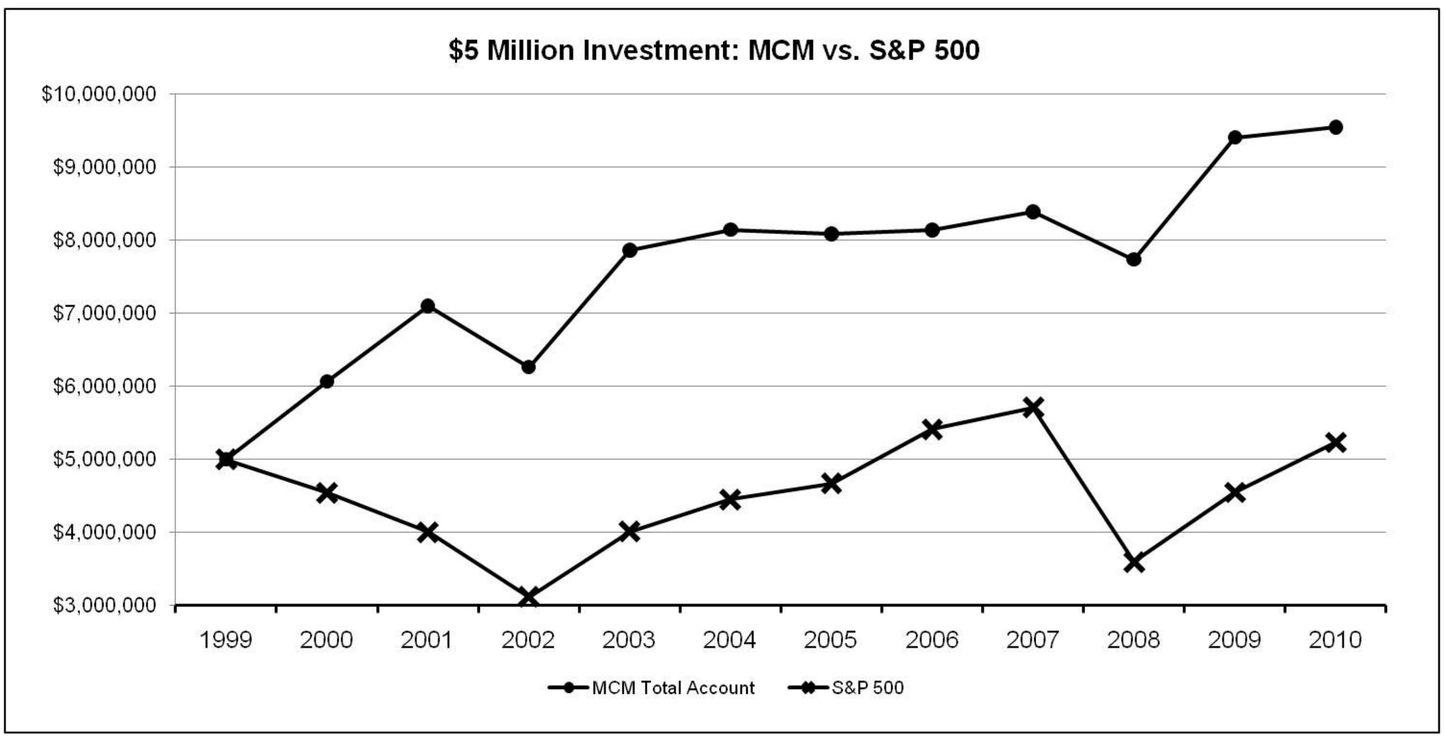


Chart 2



We've weathered the last three turbulent years by carefully managing portfolios to minimize risk in a sluggish economy shackled with levels of debt not seen since the 1930s, yet with overvalued equity markets more the rule than the exception. We avoided most of the carnage of the devastating collapse in 2008 and early 2009 by disciplined adherence to our fundamental principle of capital preservation. As a result, we had a competitive advantage that was in short supply when the crisis hit: the willpower and liquidity to purchase, in a constructively conservative manner, shares of companies being sold at attractive prices by anxious investors fearful of still greater losses. Our equities rose more than 50% during 2009, doubling the return from the much more diverse S&P 500. As a result, compared with most of our peers who went deep underwater in the 2008 crash and have had to assume greater risks in the struggle to resurface, our client portfolios were already reaching new all-time highs by the time the third quarter of 2009 had come to a close.

A telling statistic about how we approach investing: Since October 2007 when the bear market began and the Great Recession soon followed, MCM client portfolios are up 14.5% on average, while the S&P 500, including dividends, is still down 11.4% over the same time period. In 2010 our 30% commitment to equity holdings appreciated 17.9%, better than the S&P 500 average, but total MCM portfolio returns were restrained by our decision to hold a significant portion of your capital in cash. In "managed" markets, when interest rates are lower and stock and bond markets are higher and riskier than they would otherwise be, protecting capital is painful because conservative investments sometimes produce little or no income. Our apprehensions about synthetic, managed markets persist, and thus in 2010 we took further protective steps in hedging client portfolios. In April we instituted a program of purchasing modest amounts of one-year, out-of-the-money index puts to insure portfolios against loss of capital. Since your interest and approval were solicited beforehand, an update at the midpoint to expiration of the put contracts might make it clearer how we focus on sound process, not on specific outcomes that are simply unknowable. The update is posted to the client section of our website. Though we prefer investing in solid companies for the long haul, on rare occasions, protecting portfolios from, and in fact capitalizing on, the possibility of a sudden market reversal can be a rational risk-avoidance and wealth-enhancing strategy. The war to protect your capital is joined but is not yet finished. Victory hinges not on a single battle but on the combined results of many battles over a long period of time.

We can guarantee you two outcomes from our unconventional conservatism. First, if markets continue to defy the gravitational pull of underlying value, we will fall behind; and second, if they come crashing back to earth, you'll be spared the agony of defeat—and we'll be positioned to put your capital to work at prices that increase the likelihood of high future returns. As you'll read below, the greatest opportunity at the lowest risk comes from having lots of cash on hand precisely when others are consumed by fear. The unavoidable uncertainty as to *when* such opportunities will present themselves does not invalidate the idea; it simply affects the time and the amount of the ultimate payoff. America's most revered 18th-century investor, Ben Franklin, observed, "He that can have Patience, can have what he will." Thanks to your patience and trust in us, we can embody the same virtues as stewards of your capital.

We are not aware of any client who tossed and turned at night thinking about the state of his or her MCM portfolio during the greatest financial crisis since the 1930s—yet that is a strangely mixed blessing. As we all know, favorable outcomes are not the most instructive and enduring of long-term object lessons. It's nearly impossible to gain a deep-seated, risk-averse perspective without having first been burned by risk … a baptism by fire. Vicarious learning is helpful, but it is forever one step removed from reality. In the trenches every day, we were virtually shoulder to shoulder with those whose lives and fortunes were devastated during the crisis. We are humbled by the responsibilities vested in us by our clients and believe that your wealth will not endure unless we are ever vigilant in its preservation.

Reckoning Postponed

One would've thought the near-death experience of many investors and institutions in 2008 and early 2009 would have humbled an entire generation. But shortly after the government focused its seemingly limitless resources on postponing the day of reckoning, the mood of the markets flip-flopped in the spring of 2009 from fear of loss to fear of falling behind. Government intervention essentially pre-empted the natural market-clearing process during which equities have typically plunged to back-up-the-truck valuations. Stocks were only fleetingly on the bargain counter, and we took advantage of the moment to selectively purchase mispriced companies. It's our belief, however, that stocks didn't stay cheap enough long enough to induce a permanent change in speculative behavior—the type of event that has normally been associated with the end stages of historically significant bear markets—and begin to build the solid foundation for what will eventually become the next secular bull market.

We remain steadfast in our belief that the ongoing massive experiment in government intervention can postpone but, wishful thinking aside, cannot prevent the return of a tighter correlation between stock prices and intrinsic value. Piling more debt on top of an economy already choking on it is no cure. Flooding the economy with money creates huge distortions. A policy of monetary alchemy that converts income from workers and savers into capital gains for a comparatively select few seems ill-suited to promote economic recovery. Frugal senior citizens and others who have saved and have played by the rules are earning nothing on their savings, while big debtors and too-big-to-fail oligopoly banks benefit from their subsidy. The act of saving itself has been discouraged by interest rates set near zero, but those same low rates have not spurred an increase in housing and investment spending. Speculation has filled the void, returning with a vengeance. Since the greatest moral hazard of intervention is the widespread belief that Uncle Sam will cushion the fall when bubbles pop, a new bubble in stocks and low-quality debt has already reached dangerous proportions.

Zooming in, the equity markets in the year just past can be divided into two distinct parts: pre- and post-August 27. After reaching a rally peak in early April, the markets floundered as earlier hopes for recovery were fading. Down 7% on the year, they had returned to levels last seen in September 2009. Immediately after the 27th, however, the markets did an about-face, skyrocketing 20% right through year end. What marks August 27 as pivotal? That was the day Ben Bernanke gave his annual "state of the economy" speech at Jackson Hole, Wyoming. Voicing his apprehensions that the economy was not proving as responsive as he had been hoped—and clearly sensitive to the market's lethargy and its effect on overall confidence—he let it be known that *he would do everything in his power to prevent the bubble from bursting*. QE2 (the Fed's 2nd round of quantitative easing) was born that day. That's all speculators needed to hear in order to throw caution to the winds.

A pendulum eventually swings in the opposite direction when gravity overcomes inertia. Even Ralph Waldo Emerson would disparage the loss of equilibrium caused by the mispricing of assets and resources. His Law of Compensation states: "Things refuse to be mismanaged for long. Though no checks to a new evil appear, the checks exist, and will appear." In short, *we believe investors remain in the grips of the most pervasive and wealth-threatening mindset in modern economic history.*

Today, as you look at your portfolios, you'll see the extent to which we remain at odds with the crowd. Apart from the Fed deeming it necessary to add another prop to investor confidence in August, the past year felt like 2006. The mid-teens S&P 500 returns were good—as long as they weren't adjusted for the risks assumed. The present year is even more worrisome as the nation, and indeed the world, struggles with the "balance sheet recession" described in the following section of this report. If we truly aspire to maintain a record of long-term success as investors, we know we must always steer clear of tempting situations where emotions could override our rational judgment or where blindly following the herd feels good—until it suddenly feels very bad.

Investing, like the art of hitting in baseball, requires a good deal of patience—but not endless patience. Make no mistake, we much prefer swinging away at hanging curveballs out over the plate. But because prices rose further and further above what we thought to be fair value, we saw almost no pitches in the strike zone in 2010—let alone belt-high in our wheelhouse. Attractive ideas being scarce, we kept the bat on our shoulder and safely harbored much of your money in unglamorous cash and U.S. Treasury bills as we've done with some measure of success under similar market conditions in the past. The reward of patience is knowing that when the pitcher finally slips and serves up a batting-practice gopher ball, we'll be ready.

Our willingness to wait for the fat pitches derives from our temperament, but it is driven home by our one-of-a-kind variable fee schedule, which rewards us for focusing solely on doing what is best for our clients. Don't think us overly charitable, however. We've simply arranged our priorities in their proper order. If we do well by you, we do well by us. Our .65 of 1% (65 basis points) maintenance fee, assessed whenever client portfolios fall below their all-time high-water mark or when we are above the mark but the annualized returns don't exceed 6.5%, is just high enough for us to keep the lights on and just low enough that we don't feel compelled to speculate with client assets in order to justify our fees. On the flip side of the coin, when individual portfolios are above the previous high-water mark and we are earning annualized rates of return in excess of 6.5% (as was the case in the third and fourth quarters of 2009 and the second quarter of 2010), we waive the maintenance fee and share in 10% of the gains instead. That is where we intend to be—as much of the time as is prudently possible.

Most managers are understandably loath to talk about fees. We are just the opposite. After all, fees are the litmus test: They reveal an investment manager's motives and incentives. Most of our clients have consistently said they like our win-win system of rewards. Imagine if the entire investment management profession had been paid on performance rather than assets under management since the beginning of the new millennium. The vast majority did not outperform the S&P 500, which was in negative territory. At some point a cynic might ask, "*What* investment management profession?"

As long-term stewards of your capital, we begin the investment process with the end in mind. Our goal is to keep your capital compounding and growing over the long haul by limiting risk when prices are high and by finding sound investments that promise high future returns when prices are low. Since the "lost decade" began, we have done exactly that. As we embark on a new decade, we will continue to follow our conscience and our best investment judgment, with the end in mind of reporting similar good news in the 2020 annual report.

What's a Balance Sheet Recession—and Why Should We Care?

The United States has experienced 12 economic recessions since World War II, but none of them until now significantly reduced the value of assets on private sector balance sheets (real estate values and retirement savings, for example). In previous economic declines, the majority of people, at the most fundamental level, remained forward-looking. During recessions the Fed typically drove interest rates down, and households and businesses of all types responded by borrowing and spending, which got the economy going again. The Great Recession, by comparison, has been strikingly different.

After deflating for 4½ years, home values continue to fall. Interestingly, mortgage debt has stayed very nearly the same. That, of course, means homeowners' equity is dropping. (Refer to the chart on page 12 for more detail.) In addition, inflated expectations about stock market returns have thrown off the calculus of once rosy retirement, college funding, and other reserves. Coupled with the recession's impact on consumer income and confidence, the imbalance of debt-heavy and asset-light balance sheets appears to be grudgingly curbing America's borrow-and-spend appetite.

Why should smart investors care? As the attitude of household austerity spreads, the recovery is at risk of being crippled by the so-called "thrift paradox." In other words, in an economy where consumer spending accounts for 70% of GDP, newfound household fiscal prudence is good for the family's balance sheet but bad for GDP, the metric on which most policymakers focus as the measure of overall economic well-being. If fiscal and monetary stimulus policies are primarily directed at getting consumers and businesses to borrow and spend us out of the recession, it may be the wrong medicine for the wrong patient, particularly if today's patient believes his economic well-being can only be achieved by shedding the oppressive burden of debt, *not* by buying more things with yet more borrowed money.

Neither are businesses immune to balance sheet pressures, despite dangerously misleading references to record amounts of cash on hand. The very existence of such cash reserves reveals the extent of their concern, not optimism. In fact, despite the run-up in business cash holdings, indebtedness has actually increased $2.2 trillion since 2006, while equity has shrunk $5 trillion. Most businesses haven't *earned* the cash on hand, they've *borrowed* it.

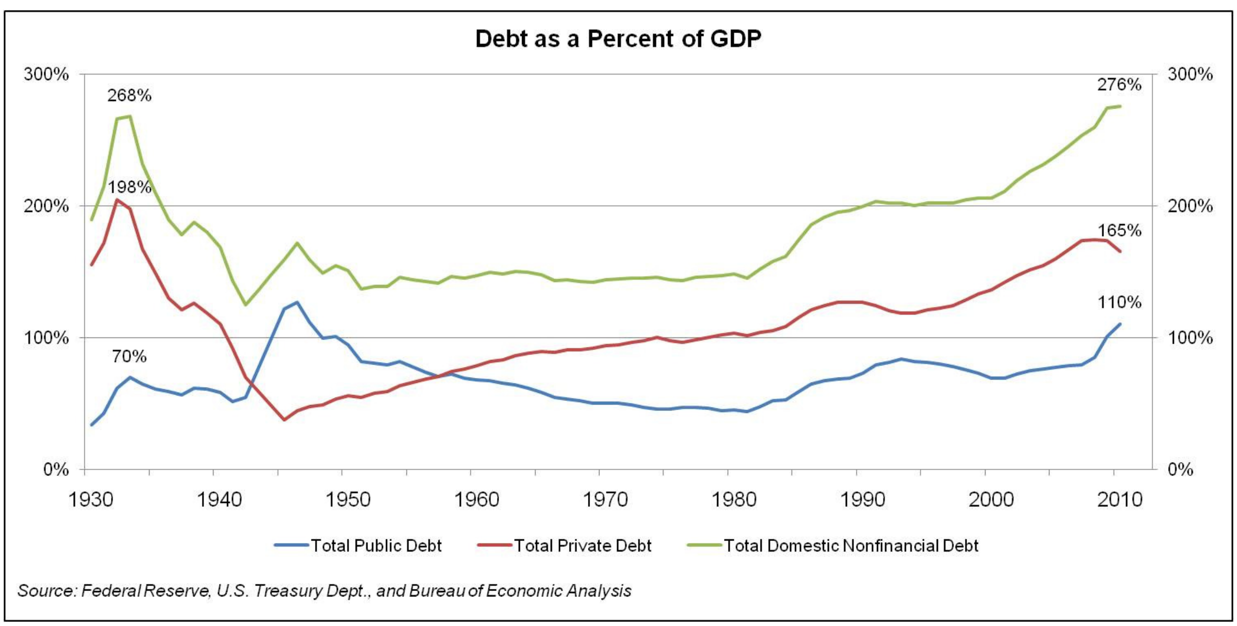
Taken together, household and business equity has fallen an unthinkable $14.2 trillion in the same time span—an amount nearly equal to one year's GDP. Nearly 80% of the decline was related to plunging real estate values, with the bulk of the rest attributable to falling stock prices.

The picture is incomplete, however, if we don't also include the government and quasi-government sectors of the economy. Many of the world's largest financial services companies became wards of the state during the crisis. Deemed too big to fail and too essential for commerce, they were first bailed out and have been subsidized ever since. Has that problem been contained? Or has it actually spread and become potentially more destabilizing? The top five bank holding companies now control a *record 52%* of all bank assets. That's an eye-popping percentage and one that should be cause for great concern about the future. At least two of the five, Bank of America and Citigroup, are far from being out of the woods. Complicating matters, it's very difficult to get a clear picture of what exactly is going on at these gargantuan institutions. By the very nature of the way it does business, the financial services industry is rife with possibilities for misrepresentation. Banks have powerful incentives to deceive, to report their assets in the most favorable light; and all too often the regulators have been knowingly complicit in the vain hope that economic recovery will eventually make marginal loans viable.

Lack of transparency also impedes the analysis of the fiscal health of state and municipal governments. Collectively, state governments have come up some $430 billion short in revenue since the recession began, but they've managed to balance their budgets, in part by robbing Peter to pay Paul—underfunding, for example, state and local pension and post-retirement benefit programs. By some estimates, those programs are now as much as $3 trillion in the red—a number that means little by itself but becomes more alarming when viewed in terms of the budgetary impact. State and local governments have been putting 3.8% of their budgets into pensions, but they've been assuming a return of 8% on their investments. That's highly unrealistic. The return will probably be closer to 5%. If so, states would have to set aside well more than twice as much as they currently do. If they don't (or can't), the obvious remedy would be to reduce benefits. Cuts may play well in the Statehouse, but they surely won't be popular with the 30 million public sector workers who currently receive pensions—or *expect to* in the future.

Finally, even though the federal government has the power of the money press, that authority is not without limit. In mid-January, Moody's and Standard & Poor's, the two most widely known credit-rating firms, publicly reminded investors that though much focus is on sovereign-debt worries in Europe, the U.S. has serious debt and deficit problems of its own. The nation's Aaa-rating could eventually be in jeopardy if burgeoning deficits are not brought under control and/or if the U.S. loses the "exorbitant privilege linked to the U.S. dollar" to fund its deficits.

Stack it all up, and the picture of what may lie ahead should raise a few hairs on one's neck. While there's no precise number or threshold of debt that automatically throws the country into economic reversal, the chart below makes it clear that we haven't seen public and private balance sheets this far out of whack since the depths of the Great Depression.



The noted percentages are for 1933 and 2010, respectively. While the public and private components of total indebtedness have changed a bit (government spending now being a greater portion of the total than in 1933), the overall debt-to-GDP ratio is quite similar—in fact, slightly higher today than in '33. Remember, though, GDP had plummeted by 1933 as the Great Depression entered its darkest days. The actual debt-to-GDP ratio present at the onset of the downturn—around 1930—was slightly under 200%. That makes today's estimate of 276% even more ominous. One might ask if high levels of debt relative to the earnings power of the economy are inherently bad. An answer might be: not if interest rates (and economic growth) remain perpetually low, as in Japan. Perhaps a more pertinent question would be: If deleveraging occurs, voluntarily or involuntarily, can it be made painless? Because of the massive intervention that began in 2008, we have yet to find out.

All Quiet on the Western Front

A balance sheet recession is a two-front war: one front on the so-called real goods-and-services side of the economy measured by GDP and the other on the financial side that typically greases the skids of commerce. It's proving difficult indeed to win the real-economy battle when we're losing the war in the financial trenches.

Even the latest fiscal stimulus legislation, the $858 billion "Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010" that became law in mid-December may fall well short of its desired spending effect. The lame-duck session compromise extended the Bush-era tax cuts for two years, the $120 billion reduction in employee payroll taxes for a year, and federal unemployment benefits for 26 weeks. Given the short effective life of the tax relief and the uncertainty over what new and surely more progressive tax "reform" will be debated throughout the impending election year of 2012, the private sector may apply the perceived windfall toward debt reduction rather than spend it. This wouldn't be the first time in recent memory. Only 12% of the comparatively modest early-2008 $152 billion Bush Economic Stimulus Act was actually spent. Nearly all the rest went to pay down debt.

The (February) 2008 Economic Stimulus Act may have been a harbinger of the ineffectiveness of fiscal and monetary policies to come. The act, which was heralded as the means to avert a recession, revealed the extent to which policymakers continually underestimate the nature and cause of the economy's and the financial system's problems, and therefore overestimate the effectiveness of federal responses to them. The massive government interventions since 2008 seem to confirm Albert Einstein's definition of insanity: "Doing the same things again and again expecting different results."

A year after the Bush Economic Stimulus Act, incoming President Obama's $787 billion American Recovery and Reinvestment Act of (February) 2009, which promised to create or save 3.5 million jobs by the end of 2010 and 6.8 million by the end of this year, seems to be more of the same. Critics have argued that the multiplier effect—how much GDP increases for each dollar's worth of federal spending—was grossly overestimated. If the just-enacted tax relief package results in a noticeable preference for savings and debt repayments rather than the hoped-for spending, the multiplier will be even less. That helps explain why balance sheet recessions are so intractable. It's also one reason why—a year and a half after the recession was officially declared over—the U.S. unemployment rate remains stuck near an unsettling 10%.

The country may thus face another and perhaps more crippling crisis in the next year or two because of the misunderstanding about the current one. If various fiscal stimulus measures prove to be less than needed, the economy could indeed slip into a second contraction—and the sheer weight of those ponderous stimulus efforts would likely increase the magnitude of a second economic earthquake.

During the 2008 financial crisis, people tended to blame themselves for borrowing, speculating, and disregarding risks in real estate, among other assets. "I should've known better" was the common refrain. A second contraction, however, would affect an even larger segment of the population, not just the speculators, as people come to realize that the efforts to fight the downturn—the sum of all governmental monetary and fiscal policy interventions combined—failed. If the government is perceived as not having the muscle to turn the economy around, a general malaise will be hard to prevent.

In 2007 few people understood the umbilical connection between the housing market and the rest of the economy and the financial system. Today we believe few people grasp the significance of the link between overleveraged balance sheets and the goods-and-services economy. We, on the other hand, do have a vague notion, perhaps akin to how we felt in 2005–07, and that's why we remain so unwaveringly watchful.

Could Economists Be Fighting on the Wrong Front?

The year 2010 will likely be remembered as the third consecutive year in which increasingly desperate governments, particularly in the U.S. and the E.U., scrambled to prevent the inevitable consequences of global deleveraging, which has barely begun across the industrialized world. Localized crises, such as Greece in the spring of 2010 and Ireland in the fall, were likely only the first dominoes and have pushed the E.U. central bank and the IMF back on their heels. In the U.S. the mood among economists is more upbeat. In September the independent National Bureau of Economic Research announced that the recession had ended in June—of 2009—18 months after it officially started. Thus in early December, before the tax stimulus compromise was passed, 55 economists polled by the *Wall Street Journal* had raised their GDP growth estimates for 2011 to 3%, saying the probability of a double-dip recession is only 15%. Notwithstanding their optimism, and apparently wishing to be safe rather than sorry, the Fed in November launched its latest $600 billion monetary stimulus program known as QE2, and in December Congress extended the 2001 and 2003 Bush tax cuts as part of a larger tax and economic package. The Bush cuts were originally enacted during the recession and bear market in stocks after the technology bubble burst and were due to expire at the end of 2010.

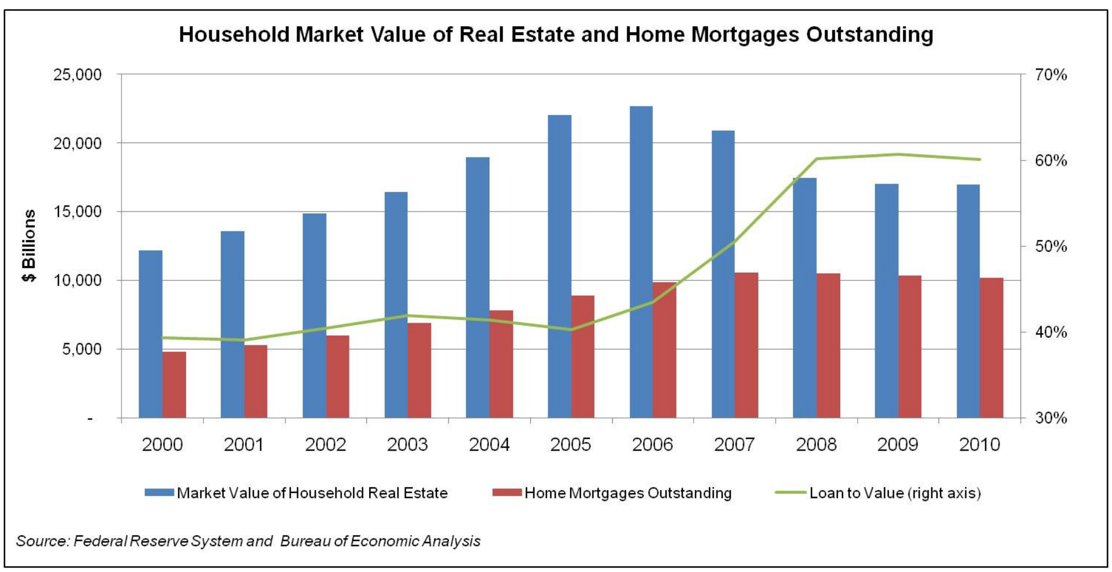
But could economists be focusing on the wrong front? The profession is trained to forecast GDP, the measure of the economy's aggregate income and spending. Debt-laden balance sheets had never been a problem during other recessions in their lifetimes, and therefore few economists took them into account as transmission mechanisms to explain the difficulties encountered thus far in getting people to start buying again. This forecasting weakness may sound familiar. In the years leading up to the financial crisis and ensuing Great Recession, economists made the same error in the opposite direction. They underestimated the *positive* effect on spending as household and financial sector balance sheets surged. More importantly, their backward-looking models did not foresee that real estate prices would begin to plummet in mid-2006, nor the effect that development would have on household balance sheets. They further erred in failing to anticipate the behavioral changes that resulted as households focused more keenly on trying to pay down debt rather than buying more stuff.

If economists have underestimated the importance of private-sector balance sheets, they may be guilty of the same in the public sector. Could the next systemic threat to financial stability be close to home? I refer to the frightful condition of state and municipal finances—America's equivalent of the E.U. crisis. A hodgepodge of 50 different record-keeping systems with a disturbing lack of transparency, coupled with political and investor complacency, could cause the impending state and municipal financial crisis to become the largest threat to the incipient recovery. This is especially true given the backdrop of the household sector's early-stage balance sheet recession. The obfuscation and apparent indifference to the threat flashes me back to the 2008 financial crisis and then to the universality of the famous Hemingway quote: "How did you go bankrupt?" … "Two ways: gradually and then suddenly."

The Nuts and Bolts of the Household Sector's Balance Sheet Recession

The household sector is the 600-pound gorilla in the room, representing 70% of spending in the U.S. Since the recession began three years ago, consumer spending has risen only 6%, with most of it on essentials like services and nondurable goods. Given the hundreds of billions of dollars in government handouts and incentives for consumers to spend, it seems reasonable to ask, "Why, when taken as a whole, haven't they?" Once again, evidence points to the cooling effect of millions of Americans dealing with debts and assets that are out of kilter.

Of the 115 million households in America, 75 million own and occupy their homes, and roughly 50 million have a mortgage. The home itself has been the household sector's most valuable and historically most stable long-term asset. That is, until 2000. Using the respected S&P Case/Shiller home price index, the unprecedented ascent over the next six years saw median housing prices more than double in the 10 major cities that comprise the index. As the housing bubble collapsed over the last 4½ years, prices retreated to mid-2003 levels, still 50% above where they were in 2000 when prices started to rise at an exponential rate.



According to Federal Reserve data depicted in the chart above, the market value of household real estate in America hit its peak at $22.7 trillion in 2006. Home values had fallen to $16.6 trillion by the third quarter of 2010, and that includes the $1.5 trillion spent on homes since the collapse began. In total, that means a drop of 27% in Americans' No. 1 asset.

In a world awash in debt, repairing the balance sheets of banks, households, and nations will take years if not decades. As a consequence, countries' income statements (GDP) will likely follow a different and more uncertain recovery trajectory than most of us have witnessed following recessions of the past. For the crisis economies like the United States and much of Europe, the easy part—spending and printing massive amounts of money—should be nearing completion. The U.S. economy received a temporary boost at year-end from pent-up demand and a Christmas shopping uptick. Fiscal stimulus will soon become fiscal drag, however, and years of state and local governments' yielding to the temptation to put off for tomorrow what could have been done today will finally come home to roost. And all this assumes that stock and corporate bond market bubbles don't collapse and further impede the recovery. In short, the path back to economic health is far lengthier and more treacherous following a balance sheet recession than in the wake of a more typical inventory recession. My view is that we are witnessing a once-in-a-lifetime event.

The Allure of Global Investing

Because of the conditions described above, many U.S. investors are being drawn to markets in other parts of the world. Let me first state the obvious: Many lesser developed countries will grow faster than the U.S. for the foreseeable future. We're hardly alone or original in making that assertion. But why does there seem to be near universal acceptance of its truth? The reasoning runs parallel to the growth record of small-cap versus large-cap companies in the United States. One might simply say the little guys have more room to grow than the big guys, so they can naturally get bigger quicker. Sounds like an investment opportunity ripe for the picking, doesn't it? Not necessarily. Does anyone remember the *dot.com* stocks that were white-hot in the late 1990s? Many investors made the mistake back then of chasing a shooting star primarily because its visible trajectory was upward. It's important to remember that investing is about assessing two interdependent and synchronous variables: The *value* of what you're buying and the *price* the market is asking you to pay. Investors caught up in popular delusions routinely ignore the critical second input—and pay the price when the shooting star turns into a meteorite and lands with a resounding thud back on earth.

When considering international investments, we always begin by asking ourselves this question: Can we feel confident that we fully understand the full range of risks involved? Most investors simply accept the raw growth numbers at face value. They don't give them a haircut, snipping away the myriad risks indigenous to investing outside the U.S. These include, but are not limited to, political unrest and/or instability, accurate valuation, legal and regulatory issues and entanglements, differences in accounting practices, cultural norms, and other uncertainties.

Second, we don't believe we can farm out risk management to a third party. If we purchase a global fund we cannot, one step removed, be fully confident of the extent to which the manager shares our risk-averse philosophy. On top of that, we generally don't double-dip on fees, however small. To be sure, the practice is widespread. Other firms rarely pick their own foreign stocks because they lack the resources and expertise to do so. Instead, they often act as middlemen offering international equity funds. Not only do these firms seldom have competent comprehension of the risks involved in foreign markets, they also are not adequately informed about the risk propensities of the mutual funds in which they invest client monies. They are, in fact, *two* steps removed from understanding the risks. Bernie Madoff thrived in that environment. As you undoubtedly know by now, that's not our style.

As risk-averse investors, we much prefer accessing global markets through the international growth of American companies. Among the S&P 500 companies, all of which are based in the United States, you may be surprised to learn that foreign receipts now account for 47% of total sales. As the global marketplace expands and emerging economies blossom, this percentage will likely increase—creating opportunities to invest in stable, well-understood, well-researched U.S. companies.

Even so, the process is more complex than simply picking a blue-chip company with a growing list of foreign customers. Take Coca-Cola, for example. Coke's international earnings more than doubled from 1999 to 2009—from $3.2 billion to $7.7 billion—and also grew as a percentage (now a remarkable 80%) of the company's total earnings. That might make Coke a solid company, but is it a good investment? In 1999 it traded at $60 a share and now—11 years later—is around $63. Looks like our Coke has gone flat. What happened? The $60 price in 1999 was part of a public mania—a ridiculous P/E of 50 times earnings. Today, at $63, Coke is a mere 20 times earnings—probably still on the high side of its intrinsic value. So Coca-Cola is an example of a company that has exposure to international markets and has demonstrated strong earnings growth as those markets expand, but still would have fallen short of our threshold return. *Caveat emptor.*

If we are disciplined and are not followers of the herd, we think we have a reasonable chance of earning competitive returns over a longer time horizon. Even though we must be vigilant, as in the case of Coke, there are many companies we follow, through which we can participate (when prices warrant) in global growth without directly assuming the country-specific risks mentioned earlier. Why would we want to wander far from home in search of greener grass—other than because everyone else is doing it?

Wanted: Clearance Sale

Because of the balance sheet recession, macroeconomic fundamentals seem grim to us at present. Meanwhile, securities—both stocks and bonds—strike us as generally overpriced at best, and at worst *dramatically* overpriced. The risks to investors today are invariably high, while the potential rewards tend to be low. The way we see it, investors are simply not being compensated for the risks they are taking.

With capital preservation uppermost in our minds, we thus did very little buying in 2010. Client accounts remain on average 30% invested in equities, with the remainder in cash. As noted earlier, many accounts also have allowed us to implement a put position on the S&P market index as a way to hedge against the downside. Though we're currently playing defense, rest assured that we will put your capital to work when markets sell off and begin to compensate us for taking risk on your behalf. To this end, our research efforts remain robust and intense. Indeed, times like early 2011 are precisely the moments to do research *in anticipation of* a period when securities hit clearance sale prices.

More in a moment on our research process and efforts to gain an edge. First, however, allow me to address both stocks and bonds individually.

Equities

We approach the valuation of equities with dual lenses, not rose-colored glasses. From a top-down perspective, we survey the stock market in the context of the broader economy and analyze the metrics that relate to its overall valuation. From a bottom-up perspective, we study individual companies and constantly ask ourselves the same question we raise about the overall market: Given the asking price, is the potential reward high enough? Are prices low enough to justify taking risks with clients' money? In its simplest form, we are doing what Americans do every day when shopping for groceries, clothes, or other items: What is the price I'm being asked to pay, and what is the value I'm receiving in return? Is it a good deal?

Our answer today is a resounding no. Stock multiples are high on a trailing 10-year basis, and that's on top of earnings derived from what may be peak corporate profit margins. High multiples imply low risk premiums, and tight credit spreads in bond markets also suggest that the investing public in both stocks and bonds is generally complacent about risk. Future returns from both asset classes are likely to be anemic. Things were quite the opposite during the crisis. By the time the market reached its low on March 9, 2009, we had invested almost 60% of our assets (at cost) in such companies as Gannett, Brown & Brown, Mohawk, Lowe's, Lamar, Gentex, McGraw-Hill, Progressive, and GE (ranked by the size of commitment). We also bought deeply depressed financials like Wells Fargo, U.S. Bancorp, M&T Bancorp, Torchmark, and Fifth Third Bank when talk of nationalization of banks had reached fever pitch. Even though we added to our positions in many instances as prices fell, on March 9 our equities were selling *50% below their cost.* Because the Great Recession was gaining momentum, and the impact on future earnings was anything but predictable, it was a little tenuous making the case that stocks were cheap on a valuation basis. What we did know is that fear and uncertainty had created a selling frenzy, with many investors willing to trade their stocks for cash at any price. In light of the circumstances, we think we made some prudent exchanges. That's the temperament value investors must have.

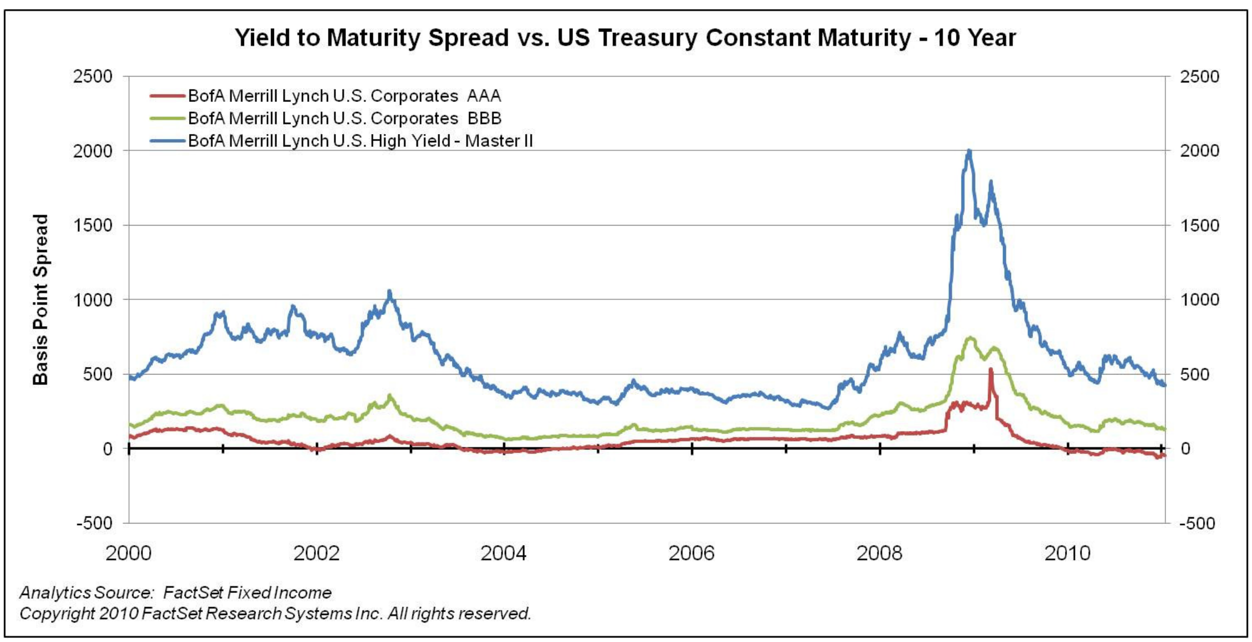
On a more macro basis, one of the most useful ways to judge stock market valuations is to calculate a giant price-to-sales comparison for the entire nation. The process is relatively simple: We take the market capitalization of the entire U.S. stock market and divide it by the gross domestic product of the country. Historically, this has proven to be a very reliable gauge of overall valuation. Generally speaking, anytime over the last century the ratio has drifted toward the 50% mark, it has been a signal that stocks were relatively cheap; anytime it drifts toward 100%, it is a clear signal that the market is fairly seriously overheated and therefore vulnerable. A price/GDP ratio of more than 100% has blipped on the radar screen at such inauspicious times as 1929, immediately before the *dot.com* crash in 2000—and just before the crisis of 2008. In March 2009, this ratio was roughly 60%, confirming our bottom-up feeling that stocks were, if only for a moment, cheap. Now, however—and this is the critical part—*most people don't fully understand that the market has rallied a full 80% from its March 2009 lows, which means that the price/sales ratio for the overall U.S. stock market has moved from near 60% to 100% today.* This is clearly hazardous territory.

Several important factors currently lead us to believe that profit margins and corporate profitability could be ripe for a fall. Corporate profit gains have come largely at the expense of labor, which has been rather quiescent for more than a generation. This could change as job security, wages, health insurance, pensions, and other benefits come under increasing pressure. Even if labor remains compliant, the twin facts that the unemployment rate has been greater than 9% for 20 consecutive months and wages for those who do get jobs have been falling are not encouraging. Again, this hasn't happened since the Great Depression. It's hard to imagine a robust consumer and economy, along with robust corporate profits, given such a backdrop.

Bonds

Bonds have enjoyed a tremendous bull market over the last generation, and there is some evidence—at least in the short term—that the run might not be over. The forces of deflation are powerful, boding well for bonds at least for a while. Yet in the medium to long term, we could equally envision a very messy scenario for bonds. While it's hard to predict precise outcomes, it's fair to say that a spike in interest rates and inflation is possible. Sovereign nations in the developed world have been nothing short of profligate in amassing debt over the last generation; this trend reached its peak in the great bailouts of 2008–09. Both fiscal and monetary policy have thus been explicitly inflationary; in short order, we may be staring down the business end of the barrel of that old adage: "Be careful what you wish for; you just might get it."

For now, however, it's smooth sailing. Desperate for yield in a virtually no-interest rate environment, investors have pushed prices of all fixed-income securities upward and yields downward. Despite a horrific financial picture, the bonds of states and municipalities do not yet reflect the likely extent of the damage. Similarly, spreads of corporate bonds over U.S. Treasuries have compressed back to pre-crisis levels, suggesting an eerie complacency about corporate America's current state of affairs. (See chart below.) When such indifference reigns, usually the endgame is not good. Remember, we're in the business of putting capital to work only when the odds are heavily weighted in our favor, and we don't see those odds right now in bonds.



Our Edge

Though we're currently in capital-preservation mode, as surely as night follows day the manic side of Mr. Market will give way to its opposite, and we will return to our favored capital-growth mode. That's the nature of markets. When we assimilate all of our inputs, we believe that the markets are on the high side of the emotional seesaw. Experience has taught us that if we wait patiently, we can climb aboard when it comes back down.

In fact, when we reflect on what gives us our "edge" over others in investing, temperament plays a big part. I have written extensively to you about this in the past: The willingness to stand apart from the crowd, to be out of step with convention, to be temporarily unpopular, is a huge part of being a good investor. Temperament, however, is only one part of the equation: In logicians' terminology, it is a necessary but not sufficient cause of superior performance. To complete the formula, you need thoughtful and thorough research. You need to understand the companies you are buying, you need to know and understand the managements that run these companies, and you need to have an accurate assessment of the relationship between market price and intrinsic value. To do this, you need to have boots on the ground researching individual companies and economic sectors so that when stocks get cheap, you know where to concentrate your buying activity. As the famous Hoosier philosopher John Wooden said, "Failing to prepare is preparing to fail."

Of course, the Wizard of Westwood also understood that great preparation depends on having great people on your team. He had a few over the years. So do we. And I'd like to have you get to know them a little better.

MCM: New Team, Time-Honored Principles

Very little has changed from where I sit as an investment manager: I remain, as I have over the last four decades, cautious with your capital and sobered by the trust you have placed in me. As outlined earlier in this report, the ongoing balance sheet recession poses grave risks to the U.S. economy, as well as the global economy. Continued caution therefore seems warranted, and until the time comes when the risk/reward pendulum swings back in our favor, we will continue to "win by not losing."

However, it is precisely for when that day comes—and it will surely come—that much has changed within the MCM organization since my last annual report to you. I must tell you I could not be more excited and energized about the future. The unsung hero during these changes was Gary Sieber, officially Director of Marketing but in reality so much more than that. He is a major contributor in every aspect of our business, from personnel to client service to growing the firm. A former full-time journalist, Gary could easily step into a research role. In fact, he sits in on all research meetings, the better to understand and convey the MCM story to both current and prospective clients. Humble and unassuming by nature, in addition to his prodigious intellect, Gary brings considerable emotional stability and maturity to the firm.

More pertinent to the core of what we do, our research team—the engine room for any successful investment-management enterprise—has been infused with a breadth of experience and perspective that MCM has never seen. Industry veteran Adam Seessel has come aboard as Director of Research. He brings with him a number of important attributes and skills that will benefit you, our client:

1) **Research acumen.** Adam began his professional life as a nationally awarded investigative reporter with a newspaper in North Carolina. In that role, he became highly skilled at developing accurate, reliable sources and tenaciously gleaning information from mountains of text and database records. He also learned the effectiveness and efficiency of news departments organized by area of expertise or specialty—a "beat" system as it's called in the media, or "circles of competence" as Warren Buffett has described it in investing. These, of course, are the same skills necessary to get an edge as a security analyst—and to put together a team of researchers who can find what we're looking for.
2) **Strong track record.** After moving to the financial world, Adam established a successful track record as an analyst with Sanford C. Bernstein, Baron Funds, and more recently with Davis Selected Advisers, a prominent value-based investment firm with $60 billion under management. For his research contributions, Adam was named the first-ever Managing Director at Davis. In 2003 he left to start Gravity Partners as a long/short hedge fund but came to find that the hedge-fund world did not employ the high standards of research he insisted upon. In 2008 he began the Gravity Long-Biased Fund, which combines *research discipline* with *investment flexibility*. The Long-Biased Fund was down only 6% in 2008, net of fees, far outdistancing the S&P, and beat the broader market again on the upswing in 2009.
3) **Investment philosophy.** The willingness and discipline to preserve capital, which Adam exhibited in 2008, demonstrates strong compatibility with MCM's risk-averse approach. Protecting clients from calamitous downturns and making money during market rebounds are the hallmarks of successful value investors. At the same time, Adam insists that success is not attributable to market timing, but rather to a strong research process that takes advantage of securities when they are on sale. We clearly agree.

Zack Clark also has joined our firm as an analyst and will work alongside MCM veterans Aaron Kindig and Clint Leman—all under Adam's research direction. Zack is an attorney from Toledo, having earned his J.D. from the University of Toledo College of Law in 2005. At the law firm of Niehaus & Associates, Zack became a specialist in corporate law, handling cases involving bankruptcy reorganization, business and commercial real estate, labor issues, and commercial litigation and arbitration. A voracious reader and longtime devotee of Benjamin Graham and Warren Buffett, he focused his practice on mergers and acquisitions, which stoked his interest and sharpened his skills in security analysis.

While much attention is rightly directed at the new additions to our team, Aaron and Clint must be singled out for their commitment and dedication. Change can bring out the best—or worst—in people. Some find it threatening, others find it liberating. Some cower in fear, others step forth and face uncertainty boldly. Aaron and Clint are clearly of the latter stripe. A need arose, and they filled it without hesitation, invariably delivering far more than they were asked. In that respect, they also might be considered new: Already key contributors, they have blossomed as team leaders at precisely the right moment.

Going forward, the structure of the MCM Investment Team is simple and elegant: As Chief Investment Officer, I will have final say on both individual security selection and overall risk exposure. Adam, as head of research, will lead the effort to find investment opportunities—directing our four researchers (with Adam himself included in the mix) and filtering ideas for my review. As for the analysts, they couldn't be more excited to have industry sectors ("beats") to call their own and master over time. Aaron will cover healthcare and energy/commodities. Clint has immersed himself in his two sectors, manufacturing and technology. As for Zack, he has the task of mastering the large and complex financial sector, and he also will assist me in my macro-influenced inquiries.

I have long believed that the ideal research combination is a synthesis of top-down thinking (the treetop view or macroeconomic picture), in which I have developed some competency over the years, and bottom-up, individual company research, for which I now have Adam and his team responsible. Left unchecked, top-down thinking can become rigid and lead practitioners to become "perma-bears"—so convinced things are going to hell in a handbasket that client money is never, ever put to work. On the other extreme, it is equally dangerous to perform research solely on individual stocks and bonds with little thought of the overall macroeconomic environment in which those businesses exist. An investment firm that can wisely and judiciously combine these two ways of thinking, however, can gain a big advantage over the rest of the field.

While these changes are not without risks, I go to work every morning supremely confident. Although this is not a good time for a risk-averse investor to be buying stocks and bonds, that day will come. When it does, we have a team in place that will have identified strong sectors and outstanding individual companies in which to invest. Moreover, our outstanding operations staff led by Karman Eash stands ready to handle the day-to-day practical account management needs of individual clients. Karman's team (Sue Massey, Karen Sherer, Kristen Myers-Smith, Christine Broadbent, and Connie Williams) has been a pillar of consistency and professionalism throughout this period of change.

One further note to clients: As mentioned, Adam's background as an investigative reporter taught him the value of having utterly reliable and knowledgeable human sources of information—people with whom he and his team can talk to gain a better understanding of a particular industry or business. Adam has already noticed the wealth of such sources contained within MCM's client base. These tend to be concentrated in, but are not limited to, the manufacturing and healthcare sectors. So … stay tuned. If you're willing to help, he and/or his analysts may be contacting you later this year.

A Detailed Research Example: Muni Bonds

As a firm largely dedicated to high-net-worth clients, over the years we have invested hundreds of millions of dollars in state and municipal bonds. The allure was obvious: These bonds are often double tax-free and offered attractive investment yields in a higher interest rate environment, with virtually no credit risk. As interest rates fell, nearly all of our competitors stepped down in quality (lower investment-grade or insured bonds) in search of higher yields. When it became apparent that nearly everyone was drinking the Kool-Aid, we were even more convinced not to deviate from our long-established practice of purchasing only pre-refunded Aaa/AAA-rated issues that were actually backed by U.S. Treasury bonds. When mortgage-backed securities came along, we realized just how far bond investing had drifted from its once conservative ways. The supply of pre-refunded bonds shrunk as yields dropped, and taxable Treasury issues became our only viable option, not lower quality municipal or mortgage-backed bonds. "Necessity never drove a good bargain," as legions of fixed income investors have discovered. Now, though, our interest in municipal bonds has once again been piqued as prices have fallen.

The following "Pennsylvania/Tennessee story" is offered as an example of both our current, contrarian thinking on the matter and our research efforts on the subject. In light of what was written several pages ago, is it any wonder that municipal bonds are becoming the hot potato nobody wants to hold? The good news is that not all states and cities are facing problems of the same magnitude—and we are working diligently to separate the healthy from the sick. Experience has taught us that when a few of the bad actors in municipal finance finally face how bad things really are, the entire muni market will react negatively. And if history is any guide, the sound credits should sell off almost as much as the marginal ones. Therein lies a huge opportunity for us.

In a perfectly priced universe, the yield on a given fixed-income security should match the underlying risk facing the investor. Market dynamics, crowd psychology, and the general tendency toward short-term thinking, however, often lead to something quite different. We think this is what's happening today in the milieu of state and municipal bonds. Consider two general obligation bonds maturing in 2021—one issued by Pennsylvania, the other by Tennessee. As of the date of this writing, the Pennsylvania bond offered investors a yield of 3.87% compared with 3.75% from the Tennessee bond—very little difference. Considering this, one would expect the economic outlook of both states to be more or less the same, but in reality Pennsylvania is currently in far worse shape.

As evidence, here are the following figures from the 2009 fiscal year:

	Pennsylvania	**Tennessee**
General revenue	$60,725,555	$23,665,207
Total expenditure	$77,564,247	$27,815,474
Budget deficit	28%	18%
Total debt at end of fiscal year	$41,924,042	$4,847,786
Percentage of general revenue	69.0%	20.5%
Unfunded pension liability	$13,724,480	$1,602,802
Unfunded state retiree healthcare	$9,956,800	$1,746,879
Debt + unfunded pension + unfunded retiree healthcare	$65,605,322	$8,197,467
Percentage of general revenue	108.0%	34.6%
Yield for GO bond maturing in 2021	3.87%	3.75%

Clearly, things are much worse in Pennsylvania, an old Rust Belt state with generations of bills coming due, than they are in the faster growing, fringe Sun Belt state of Tennessee. And yet the market is pricing both of their general obligations at almost exactly the same price. Why?

The question becomes even more curious when one considers that Pennsylvania's problems are, from a daily operating standpoint, even more serious than the above chart indicates. Like Illinois, it has resorted to shifting money around to pay its bills. It recently appropriated funds from a state medical malpractice trust to make ends meet; a recent court decision ordered Pennsylvania to return the money. This leads one to wonder: If raiding a physician trust account was the best option available to plug Pennsylvania's budget, what were the "less good" options? The state is hurting on other fronts as well. Its pension fund lost more money in 2008 than any other in the nation—nearly 30%—and is underfunded by more than $20 billion. And yet while some states have taken steps to raise the retirement age, increase employee contributions, and adjust the amount of promised benefits, Pennsylvania has thus far declined to make any such hard choices.

The answer to the above question must be that people who invest in muni bonds today simply aren't paying attention—or aren't discriminating enough. To us, this is simultaneously disturbing and exciting. The disturbing part is that investors as a whole don't understand the difference between a healthy state and an unhealthy state. The exciting part is that just as they don't discriminate between risks when everything appears rosy (as it does today in the equity markets), they likely won't discriminate when the first wave of state and municipal bonds runs into serious trouble. When that occurs, investors can be expected to throw out Illinois' and Pennsylvania's bonds—but they will likely throw out Tennessee's and other healthy states' too.

It's worth noting that muni dealers estimate that as much as half of all municipal bonds are owned by mutual funds and other pooled vehicles that use leverage to augment returns. If these funds are hit with redemptions in a panic, the pools will indiscriminately sell what they own, and this selling will be intensified by the leverage they have been using. If the yields on the good credits more than compensate us for the risks assumed by a compelling margin, including the risk of resurgent inflation in the future, we will feel justified in owning something other than government bond-backed municipals. We have no qualms about taking risks in municipal bonds—as long as we are hugely overcompensated for doing so. That's no different from our attitude about common stocks.

Ending with the Beginning in Mind

In concluding this annual letter, I am imagining what will be written in 2020. Out of necessity, thinking that far ahead requires focus more on processes than outcomes. Good endings are a function of well planned and well executed beginnings. Sound processes generally produce favorable outcomes, as is apparent from the performance of your portfolios since the new millennium began, but over shorter time spans the connection between cause and effect is less predictable.

In your hands you are holding evidence of the process improvements under way at MCM. Apart from the obvious signs—brevity, simplified sentence structure, and continuity of thought—this report reflects a first-time-ever collaborative effort. While the thoughts are mine, I cannot take any more than a smidgen of credit if this is the most understandable MCM annual report you've ever read. The document is merely a manifestation of the many process changes that Adam Seessel and Gary Sieber are engineering at MCM. I've had to add another gear on my wheelchair just to keep up. I'm not quite ready to be succeeded, but when that day comes the response that would indicate things are in good hands would be: "Frank who?"

We all know two things: that *synergy* is one of the most overrated (and overused) words in the English language and that most marriages fall somewhat short of honeymoons expectations. With those caveats in mind, my enthusiasm is kept in check as I envision the future. MCM is now an LLC, which on its face doesn't say much. However, accountability, once horizontal and sometimes a little fuzzy, is now clear and vertical. I have ceded critical authority to a Board of Directors (John Collins, John Dille, Pete Farner, Keith Rockey, and Wally Wells), in whom I have placed my trust. This was an essential step in putting into practice a long-term succession plan.

In terms of day-to-day operations, the new structure makes implementing a team-centric meritocracy a practical reality. As noted earlier in the report, clear lines of responsibility and authority have been drawn. We all know our assignments, and yet we also know that our chain is no stronger than its weakest link. Under the direction of the board and the leadership of Adam and Gary in their broad areas of responsibility, an inspiring cohesiveness has developed. Yes, it appears we do have synergy. And if the marriage is only half as good as the honeymoon, the transition will be a rousing success.

In the midst of change, rest assured that a few guiding tenets critical to MCM's investment management process remain inviolate:

- Our investment management process is predicated on the belief that aspiring to above-average, long-term returns requires that one often take a different path from the majority of practitioners, particularly in unsettled times. Loneliness, frequently exacerbated by derision, is the price one must pay. That path will always be the one less taken.
- We believe it is the nature of the majority of investors to be proportionately emotional, i.e., their sense of well-being tends to rise and fall with share prices, whether individual stocks or entire markets. We believe investment success demands an opposite response—to buy when others are despondent and to sell when they're euphoric.
- Because of the nature of compounding, one episode of big losses can ruin years of successes. Thus, we will forgo opportunities that present heightened risk of permanent loss of capital and, perhaps more importantly, the loss of the willingness to venture.
- In that vein, we will sometimes be wrong in our judgments. Our focus therefore is not on striving for perfection in our discernments, but on minimizing the portfolio consequences when we inevitably err.
- We believe in the inherent superiority of a risk-averse process rather than a return-seeking process. It's the skill and discipline in the planting that determines the abundance of the harvest.
- The portfolio as a whole is the sum of its parts. Each individual fractional interest of business that we purchase must be justified solely on its own merits. If we exercise great diligence in the small things, the big things will take care of themselves.

Voltaire once said, "Doubt is not a pleasant condition, but certainty is absurd." The French philosopher, it may be deduced, must have known something of investing—where only a fool would profess to have all the answers all the time. But he clearly knew nothing of our beloved client relationships. If he did, he would have created an exception to his maxim—for we are ***certain*** we have enlightened, intelligent, and patient investors. Your trust bolsters our spirits, and your long-term orientation is liberating. Our greatest joy comes from serving you. Please accept our gratitude, as well as our best wishes for a happy and prosperous new year.

Frank K. Martin, CFA