

MARTIN
CAPITAL MANAGEMENT, LLP
Regional Investment Advisor

FIRESIDE CHAT

Chat No. 1

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“Good evening, friends.” With these words Franklin Roosevelt greeted his radio audience during “fireside chats” beginning in March, 1933, only days after he was inaugurated as our 32nd President. He sought to assuage the fears of the nation during the depths of the Depression. Roosevelt’s first chat addressed the Bank Crisis. Seventy-five years later, almost to the day, we find ourselves embroiled in another national, if not global, financial crisis. Perhaps an occasional fireside chat will help tie disparate and often confusing news fragments together into a more cohesive, less uncertain whole.

To begin, it is not your qualms that my words are attempting to assuage. With our average cash ratio at almost 70% and our remaining equities hedged against catastrophic risk for those who allowed us to purchase Index puts where hedging was necessary, my message is quite different than what you might hear from other managers. Humility and boldness, with dispassionate rationality instead of fear-based emotion, should be what you read in my voice as we

attempt to define the scope of the problem and how we, as stewards of your capital, may capitalize on opportunities that it presents.

The MCM Annual Reports of 2005 and 2006 matter-of-factly warned of what might lie ahead. Some of those warnings have become a reality and are making headlines today. The just-released 2007 report adds further evidence, arguing that the end of whatever has begun is not close at hand. Despite the temptations to capitulate to the human need to always be doing something, there are times when simply thinking will often better suffice. It was thinking independently that resulted in us having lots of cash when others were fully invested. Anticipating that the investment community would eventually discover the reality of Keynes’ admonition, “there is liquidity for some, but not for all,” we thought of the necessity of leaving the theater before someone yelled “fire”! However, the most arduous and demanding work lies ahead of us. We must again patiently think—rationally and independently—to identify and acquire the lowest risk, highest expected return

opportunity investments as they appear. Temptation abounds. The financial sector is littered with seeming opportunities that, because of rampant leverage, may be little more than sinkholes. We will be, figuratively, tiptoeing through a mine field.

Make no mistake, I believe things are worse than they appear. The human propensity to put off bad news as long as possible, coupled with complicit accounting, allows us to see only that which is above the surface, the tip of the iceberg. Remember the quote from Dietrich Bonhoeffer in this year's Annual Report, and I quote, "knowledge of an apparently trivial detail quite often makes it possible to see into the depth of things." In the last week New York City's Citicorp revealed its dirty little secret. As much as \$1.1 trillion of the holding company's assets are housed in off-balance-sheet vehicles. No trifling amount, the undisclosed assets are equal to about half the bank's total footings. In a statement in reaction to the Citigroup disclosure, the best that Robert Herz, chairman of the Financial Accounting Standards Board, could lamely utter was: "Whenever you have a stress test like this in the market and people are saying there are reporting problems, we need to understand the nature of those problems and to what extent there's something we have to change ... But we also don't want to have blanket rules that make everyone consolidate everything." Friends, the rules were crafted in the wake of the implosion of the former

Enron Corporation, which used off-balance-sheet vehicles to mask its financial results. They were supposed to limit the use of such vehicles, but banks found ways to tailor structures that sidestepped the new rules.

As I continue through this Fireside Chat, I will attempt to debunk commonly held beliefs that I will argue are untrue. One that has achieved a near universal acceptance is that a repeat of something like the 1930s is impossible because of the many safeguards in place that did not exist 75 years ago. This "conventional wisdom" is as easily embraced as it is dangerously flawed. The defect is not so much in the efficacy of such systems but in how and why humans attempt to circumvent them. The Citigroup disclosure is but one of countless "trivial details" of a widespread and wanton desire to game the very systems that are designed to protect the gamblers from their own avarice. When many are playing the same game, self-reinforcing meltdowns, in this case financial, are increasingly probable. In mid-January a normally reticent Paul Volcker, the Fed chairman who courageously broke the back of inflation in the early 1980s, stepped out of the shadows with this loaded comment: "Too many bubbles have been going on for far too long. The Fed is not really in control of the situation." As late as May 2007, transparent to a fault Ben Bernanke gave a speech in which he opined that "the effect of the troubles in the subprime sector on the

broader housing market will likely be limited.”

Moreover, the new financial innovators, among them investment banks and hedge funds, have displaced the commercial banks as the 600 pound gorilla in the capital markets. It may be a surprise to some listeners that the Fed, as central banker, wields greatly diminished power because of these mostly unregulated avaricious primates. That is the second myth to be debunked. The third is that cheaper money and the just enacted fiscal stimulus package will stem the tide this time. Investment spending on everything from houses to factories and equipment is part cold investment calculus, driven by the concept of the marginal efficiency of capital, and part the very fragile and ethereal state of investor and creditor confidence. The adage “Once burned, twice shy” is playing havoc with the best laid plans of policymakers. Like in the '30s, lenders, once chastised, have lost their appetite for risk. Today their all-consuming preoccupation is with self-preservation. As falling stock prices take their toll, investors will follow the lead of bankers. After confidence has been crushed it cannot be restored by decree. While no one in high places has yet mentioned “pushing on a string” or “leading a horse to water,” I fear that those phrases will become part of the epitaph for this era.

Friends, this ship has lost its rudder as we approach icebergs and the untried captain has fear written all over his face and the unseasoned crew (the lawmakers) is not going to be much help either ... I'm worried that most people are still looking for the best deck chairs, having taken far too literally the *Shipbuilder* magazine assessment that the Titanic was “practically unsinkable.” The ship had a unique double-bottom hull, exceeded the lifeboat standard by twenty, was divided into sixteen compartments with doors that could be closed by a switch on the ship's bridge. The conclusion of the British Inquiry into the sinking was “that the loss of the ship was due to collision with an iceberg, brought about by the excessive speed at which the ship was being navigated.” Sleep easy, we have chosen to sail on the competing Cunard line.

Simply extending the trend line at this juncture is a dangerous way to envision the future. The “primary heuristic”—the natural tendency to imagine the future as a continuation of the past—can be self-destructive at inflection points. The metaphorical pendulum to which I have frequently referred has finally come to the end of its long arc and is beginning to accelerate and gain momentum—in the opposite direction.

I commonly benchmark my own reasoning against other men who I have come to respect and admire after many years of

observation. They are very much in the minority for two primary reasons: their thinking is fiercely independent and unconventional and their investment results are several standard deviations or more above the norm.

Jeremy Grantham is a radically independent investor whose global appeal is so compelling that his coffers are full with an astounding \$150 billion. Grantham contends that when something very big, clearly new, and original is happening there is little alternative but to use your brains to embrace the big picture and to more or less suspend the standard bottoms-up valuation and proforma modeling rules. The current financial crisis is an example. If your mental model of the world has never experienced or envisioned a similar event, it's myopic to expect it to know how to react. Optimal long-term investing seems likely to be a mix of a few important judgmental overrides, interspersed with long periods of cold, disciplined blocking and tackling. The great and unrelenting challenge for those of us who try to think both big and small has always been when to temporarily override our bottoms-up models in deference to something big and overarching in its potential impact. When asked where to put your money in this environment, Grantham deadpans: "I'm afraid cash is the ugly answer that no one ever wants to hear." Jeremy never minces words.

The second is Seth Klarman, who runs the \$14 billion Baupost Capital Group out of Boston. Like all great managers, Seth is as humble as he is brilliant. In challenging investors to be cautious, he concludes and I quote: "If you avoided the frenzy of 1929 and missed the great crash only to jump into the market in early 1930s, the pain you would've felt by 1933 would hardly have been different from the agony of those who had invested at the 1929 peak. We will not be certain until much later whether the so-called bargains of January 2008 were undervalued or merely dangerous temptations for [opportunity-hungry] investors." He further says, "no one can know what the future holds, but a further revulsion against risk in all its forms would not surprise us. Higher borrowing costs, tighter lending standards, and more cautious investor behavior could further slow economic activity, with a resultant fall in security prices. This is a scenario that we do not consider remote, one that we fear and one that we, no matter how well positioned, will need all of our experience, resourcefulness, caution and acumen to survive reasonably intact." When it comes to making a point, Seth and Jeremy do not equivocate. My one-on-one encounters with each revealed such fierce resolve as to make their written words seem almost ambivalent!

Unlike Grantham and Klarman, James Montier, a London-based collaborator and global strategist with Societe Generale, does

not manage money. However, his insights into the behavior of investors and markets have been uncanny. Accordingly, I conclude my reference to others in whom I trust with comments from a recent missive from James.

Should a recession be in the offing, Montier does not believe the market has discounted it. He opines that we would need to see the S&P500 decline a further 33% to reach normalized valuation levels. However, if earnings visibility becomes occluded with the onset of an economic contraction of unknown depth or duration, investors may eventually require more than average compensation in the form of lower PE ratios. The evidence suggests that major bear markets don't end until they descend to about 10x earnings. That equates to a 66% decline from current levels!

Now that I have recited the advice from an ensemble of three estimable pros, here's how we are approaching uncertain times. It appears we have reached the end of a lengthy period when all financial, economic, and attitudinal forces were in positive and self reinforcing alignment, including liberal lending standards, cheap credit, economic expansion, robust corporate earnings, focus on return to the exclusion of concerns about risk, resulting in stocks moving to dangerously high price-earnings ratios. Inertia, particularly in the propensity to embrace risk by virtually all players, kept the trend alive.

From near perfect alignment we are now moving in the opposite direction. Lending standards have tightened across the board. While credit is still relatively cheap its cost is irrelevant if you can't qualify for a loan. Fourth-quarter GDP slowed markedly and January data, including a surprising retrenchment in the service economy, was most disconcerting. Financial sector earnings are plummeting after years of lending run amok and non-financial sector earnings are likely to follow. If you're not familiar with the phenomenon known as feedback loops, this might be a good time to familiarize yourself.

The gradual transition from recklessly embracing risk to its opposite, risk aversion, in other endeavors besides credit creation is clearly underway. Such a change in attitudes is as subtle and unstoppable as rivers at flood stage when they breach the levees.

The forces behind this reversal of fortunes are indeed powerful. When the waters eventually recede flotsam will be there for the picking for those who first sought refuge on high ground.

As for the economy, and the financial system on which it depends, any specific forecast would border on the irresponsible. This certainly is not a prognostication but rather, perhaps, a warning predicated on the adage you have read many times from me: "Those

who don't know history are bound to repeat it." Of one thing I am quite sure. There are very few men or women alive today who were old enough to listen to Roosevelt in 1933 and understand the gravity of the situation he faced. Today's decision makers in high places have, using a term referred to by Laurence Gonzales in his book *Deep Survival*, frightfully inadequate "mental models," the frameworks that permit us to efficiently cope with an ever-changing, complex external world. Parenthetically, Lawrence tells me his new book, a more broadly-based sequel, *Everyday Survival: Why Smart People Do Stupid Things*, will be out in September. The response from virtually all quarters to the current crisis is symptomatic, in my judgment, of the inadequacy of the mental models being applied. Quick fixes, not long term solutions, are the order of the day. During the four months between Roosevelt's election and inauguration, the President-elect and Hoover tossed back and forth the hot potato of who would take the fall of the banking crisis while, to refer figuratively to Nero, "Rome burned." Who, I wonder, has the temperament, charisma, and the respect, like a Roosevelt, Churchill or a Reagan, to rally a nation between now and next January?

My long fascination with economic and financial history may have helped me to virtually create a more robust mental model that incorporates possibilities as far ranging

and infrequent as what occurred in the late 1920s and early 1930s.

We expect to be as fully invested as clients will permit before the still-in-it's-infancy reactionary and emotionally-charged preoccupation with aversion to risk subsides, perhaps within 12–18 months. Since any purchases of a stock made within 20% of its bear market lows are, based on my experience, the handiwork of an investment genius, we will almost certainly look bad before you feel good. A steely temperament; focus, to the exclusion of everything else on the objective; vulture-like patience and discipline; imperturbable rationality, and utter disregard for what the crowd is doing will be essential. We have been conservative in that we have taken extreme measures to protect your capital during periods of high unperceived risk. When stock prices become desperately low relative to the intrinsic value of businesses—something we have not seen in a long time—the utopian combination of low risks and high expected returns will appear. You will then see a side of us that I don't believe is oxymoronic: aggressive conservatism.

Under girding everything I've said thus far is our pledge to you: we will pass on any opportunity if, should we be wrong, we will expose your portfolio to the risks of permanent capital loss—whether by your action or ours. If we expose you to losses that are manageable and temporary in our

opinion but, in the high emotions of the moment, are too great for you to tolerate and you capitulate to your fears, we will have failed you. We must never subject you to an environment where panic is your only option; we must never let you board the Titanic.

Until we chat again,

Frank K. Martin, CFA
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