MARTIN CAPITAL MANAGEMENT, LLP

FIRESIDE CHAT

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"Are you not aware we are in a raging bull market?" That was the question from a businessman with whom I had a chance encounter when he learned that the typical Martin Capital Management portfolio is hunkered down in short-term U.S. Treasury bills—some 60% of all assets the firm manages. For each person who speaks his mind, there are many who do not verbalize what may well be similarly skeptical thoughts, their facial expressions doing the talking for them.

At the time of this writing, the average MCM client over whose account we have full discretion has fared well—particularly given the conspicuously unconventional construct of his or her portfolio. Year to date the average MCM portfolio is up 13%, in a dead heat with the S&P 500, even after the drag of cash squirreled away in low-yielding, short-term Treasury securities. How is that possible? Our equities have been pulling double duty, rising 30% so far this year, twice the rate of increase in the S&P. Despite the relief the rally has brought, the S&P is still 37% below its October 2007 peak. By contrast, MCM's full-discretion portfolios are roughly 5% above where they were when the catharsis started almost two years ago. Finishing on the downbeat, the critic might logically query: Why don't you have us fully invested and making even more money?

First the short, then the long, answer: There are times when we would rather be safe than risk being sorry. As for the performance of our equities, your quarterly statements have made it obvious that one does not rack up those kinds of results with portfolios composed entirely of blue-chip stocks. Since March 9 our equities have appreciated 200%. I don't have the gall to tell you how they underperformed in the six months prior. The cash served a very important defensive purpose then, and it just might be as valuable as a *cache* of buying power in the future... ☺

As much as we might like this happy and no doubt transitional circumstance to be a permanent condition, the "have your cake and eat it too" double play is sure to give way to something less rewarding if the market continues onward and upward.

Returning to the opening question, the answer is yes, we are keenly cognizant of the market's upward trajectory of the last four months. Seven days a week we are inundated with financial news and market prices. We also are aware of the near ubiquitous *approval* of its advance (besides the squeezed short seller, we've heard nary a peep of disapproval from anyone). At the same time, we have noticed that the thinning crowd of naysayers is slipping into the shadows. By all appearances, the markets appear to be telling us that the green shoots are for real.

Just perhaps—now going way out on a limb—the financial crisis and economic contraction should not be the primary objects of our attention. Could we be looking in the wrong place?

With statements like that, we surely keep you wondering why we're marching one way while the crowd goes off in another. Over the years we've made a practice of describing not only our actions but also explaining the reasoning behind them. Given our radical departure from normative behavior (so what else is new? the skeptic asks), what follows sheds a little light into the soul of our thinking.

The Anthropology of Crowds

The title of this chat is a not-so-subtle hint about where we are searching for answers.

The anthropological classic, Charles Mackay's *Extraordinary Popular Delusions and the Madness of Crowds*, first published in 1841, teems with seemingly endless truth-is-stranger-than-fiction historical accounts of crowd follies that predictably dumbfound readers. The iconoclastic market speculator turned statesman, Bernard Baruch, "The Lone Wolf on Wall Street," provocatively summarized the 1932 edition's unspoken synopsis in the foreword with a quotation from the German philosopher Johann Friedrich von Schiller (1759–1805) that leaves one yearning for more: "*Anyone taken as an individual is tolerably sensible and reasonable—as a member of a crowd, he at once becomes a blockhead*."

True to his customary haughtiness, Baruch feigned: "I'm not smart. I try to observe. Millions saw the apple fall, but Newton was the only one who asked why." Baruch's observation is keen. Many may have observed this phenomenon in crowds, but few have asked why.

Perhaps as unknown to Baruch as it has been to much of the scientific community ever since, the seminal work on group psychology was published in 1895. *The* book, the "why" behind the anecdotes from *Extraordinary Popular Delusions*…, was the brainchild of the French social psychologist, Gustave LeBon (1841–1931), not LeBron, for all you "cavalier" basketball fans. The inauspicious title: *The Crowd: A Study of the Popular Mind.*

Realistically, the psychology of crowds is destined to languish in obscurity until someone finds a way to commercialize it. Behavioral economics is making inroads but is unlikely to gain widespread acceptance despite its efficacy (in this writer's judgment) because it is seen as too "soft" and not amenable to quantification—not unlike Warren Buffett's "inverse emotionalism," which masquerades as the more understandable "rationalism" for which he's famous. The fact that no one will pay for it does not, however, mean it is without value. The grandeur of sunsets is free, but who would say they are worthless?

As an example of its relevance to understanding crowds, one need only study the life's work of Edward Bernays (1891–1995), a nephew of Sigmund Freud, who was clearly influenced by LeBon's theories. As an immigrant pioneer in the U.S. in the field of public relations (a phrase he coined because it connoted a kinder image than "propaganda," which was then linked to the Third Reich), Bernays observed: "If we understand the mechanism and motives of the group mind, is it not possible to control and regiment the masses according to our will without their knowing about it?" He called this scientific technique of opinion molding the "engineering of consent"; it has been successfully employed by corporations and politicians to manage public opinion ever since.

In an ironic twist, it was Paul Mazer of Lehman Brothers (circa 1930s), with Bernays at his right hand, who uttered the words that synthesized the profound reorientation in consumerism in the decades that followed. "We must shift America from a 'needs' to a 'desires' culture; people must be trained to desire, to want new things even before the old has been completely consumed. We must shape a new mentality in America; man's desires must overshadow his needs." Lehman's demise, three-quarters of a century later, resulted because it recklessly financed those desires.

After researching the many mass media campaigns designed to appeal to consumers' feelings about home ownership rather than their objective reasoning and judgment, the irrational decisions by many subprime borrowers are seen in a different light. The pejorative question frequently asked, "What were they thinking?" could be honestly answered with the statement: "They weren't thinking; they were only following the crowd." Someday the true story will be written about how politicians and Fannie Mae and Freddie Mac, to say nothing of a host of others who were complicit, conspired to recklessly promote homeownership among those who could least afford it. Fomented desires gradually and insidiously enslaved consumers who increasingly wrote checks their banks couldn't cash.

"What does this have to do with the stock market?" you might be wondering.

Dumbing Down the Capacity for Reason: The Crowd's Transformation of the Individual

The answer to that question (and perhaps others) may be revealed as you continue your process of discovery. Let's begin right where we are—and with what most people believe.

The governing nostrum in today's capital markets is known as the efficient market hypothesis (EMH). Its legitimacy hinges on the assumption that, *on average,* investors are rational. Some investors may overreact and some may underreact to news. So long as the randomness of individual behavior is offsetting and therefore normally distributed (graphically portrayed as a Bell curve), the theory holds that no one can gain an edge and thereby exploit (nonexistent) pricing anomalies. Thus, EMH concludes, any one person can be wrong about the market—indeed, everyone can be—but *the market as a whole is always right.*

Benjamin Graham's "Mr. Market" allegory throws a wrench into the cog of EMH's exquisite mathematical model. Mr. Market's collective manic-depressive proclivity implies that market participant behaviors are not symmetrically random insofar as they don't always cancel each other out, that the point of highest frequency on the Bell curve does not at all times represent optimal rationality. Logical deduction leaves us no alternative but to conclude what EMH advocates would consider apostasy: *that the market as a whole is* ***not*** *always right.* As is apparent from what you will read below, LeBon and Graham were kindred spirits, even though it's unlikely they ever collaborated. Graham was 37 at the time of LeBon's death, and Graham's autobiography, *Benjamin Graham: The Memoirs of the Dean of Wall Street*, gives no indication that he grasped the importance of the peculiarities of the provisional crowd until he wrote about the phenomenon as a victim—in the first edition of *Security Analysis* (1934).

LeBon's concise and systematic principles on crowd psychology are particularly pertinent to today's capital market environment. First, LeBon takes direct aim at a crowd's capacity to think rationally. Merely by joining a psychological crowd an individual surrenders his free will and thus his capacity for independent, rational thought. The collective brain of a crowd cannot simultaneously serve two masters.

> The most striking peculiarity presented by a psychological crowd is the following: Whoever be the individuals that compose it, however like or unlike be their mode of life, their occupations, their character, or their intelligence, the fact that they have been transformed into a crowd puts them in possession of a sort of collective mind which makes them feel, think, and act in a manner quite different from that in which each individual of them would feel, think, and act were he in a state of isolation. There are certain ideas and feelings which do not come into being, or do not transform themselves into acts except in the case of individuals forming a crowd. The psychological crowd is a provisional being formed of heterogeneous elements, which for a moment are combined…

Second, members of a psychological crowd not only "feel, think, and act" differently than if they were in isolation from the crowd but often do so at a primitive level. Subconscious impulses, basic instincts belonging to all humanity, become the common denominator for crowd functioning. Crowds, as you'll read later, can and often do transform intelligent individuals into the "blockhead" of which Baruch wrote in 1932.

Third, and as a natural extension of the first two points, the individual who is able to isolate himself from a psychological crowd will likely function at a higher, more rational, cognitive level. As strange as it may seem, there are times when *a minority of one is superior in cognitive capacity than a majority of geniuses.* As intuitively illogical as that proposition may initially appear, please take it on faith pending further disclosure. Finally, if one sees fit to embrace LeBon's hypotheses, it is possible to acquire the emotional backbone to stand on the strength of one's own convictions and not someone else's. This truism (in my opinion) provides the intellectual framework for our atypical portfolio decision-making style. LeBon theories empower us to perform at our highest cognitive levels without intimidation by the roar of the crowd or of conventional wisdom. If the markets end up being led by a madman, we have no desire to belong to the crowd of those who will have been duped.

The 'Mind' of a Crowd

By seeking to understand the primitive thinking and functioning of a psychological crowd, one can more easily comprehend its provisional powers and vulnerabilities. LeBon's theories about crowd behavior, later tested in the most tragic of world-stage laboratories (both Hitler and Mussolini relied heavily on LeBon's insights in developing their propaganda and leadership styles), have been bolstered further by a century of scientific inquiry into how the brain functions. Still, the understanding of the transformational linkage between the individual in isolation and as a member of a psychological crowd remains tenuous.

As we reflect on the dramatic market events since last September, think about Mr. Market's behaviors in the context of LeBon's theories as presented below. The most profound and clearly most controversial characteristic of a psychological crowd (as opposed to a mere agglomeration of individuals, no matter how large in number) is that its collective thinking and actions are governed by parts of the brain that are instinctive and primal and therefore more subconscious than cognitive, which explains why crowds can never accomplish acts demanding a high degree of intelligence. LeBon put it more crudely: "In crowds it is stupidity and not mother-wit that is accumulated." Thus, the crowd, incapable of advanced reason and discrimination, is particularly amenable to suggestion, which spreads rapidly through contagion. A crowd thinks in discontinuous images, unable to distinguish between the subjective and the objective. It accepts the images as real, irrespective of how distant they may be from observed fact. The arousing suggestions in the last year have been both exogenous and endogenous: from the bankruptcy of Lehman Brothers to the failures of Fannie Mae and Freddie Mac to the rescue of AIG, the credulous crowd was surely overwhelmed by mental images of the Great Depression. The phenomenon of falling stock prices themselves begetting further declines, hedge fund luminary George Soros' theory of "reflexivity" became an endogenous self-reinforcing mechanism. Parenthetically, the Soros reflexive "V"-shaped rally has followed every bust in the last 100 years—except 1929. Will that record still stand as we look back in five years?

The dramatic and relatively recent changes in the financial headlines since the 2-by-4 to the senses from September to March have been the perfect breeding ground for incipient euphoric extremism. For a number of months now one has finally been able to view the front page of the *Wall Street Journal* without expectation of nightmarish news. The honeymoon period during which the unprecedented monetary and fiscal stimulus actions have been hurriedly implemented—but before their effects (or ultimate costs) are felt—is a fertile field out of which the crowd's imagination can take unimpeded flights of fancy.

Crowds by definition don't admit doubt or uncertainty and almost always head toward extremes. In the mind of a crowd, nothing is impossible. Individuals forming a crowd, emboldened by numbers, acquire (in their minds) an aura of invincibility. Since in the crowd the individual becomes anonymous, any inclination toward personal responsibility virtually disappears. Whether the investor was an individual or an institution, the post-Lehman panic revealed all of these instinctual behaviors.

LeBon argued that there is a natural need of crowds to obey a leader. Leaders must possess a certain prestige, even charisma, to gain their confidence, and they must persuade through affirmation, repetition, and contagion. Alan "the Maestro" Greenspan was conferred near deity status by the market crowd during his reign as Fed chairman from 1987 to 2006. According to LeBon, prestige is easily lost. When the full force of the financial crisis hit, the "Greenspan put" was exposed as nothing more than an illusion—and Greenspan's aura vaporized. Various leaders have come and have gone (or are going) ever since. Paulson, Bernanke, and Obama are among them. Timothy Geithner never made the cut. None has gained the gravitas of Greenspan in his heyday. Since early March the market has levitated in the absence of any individual leadership, save the levitating leadership of the market itself. That the market is efficient and that it is always right hold sway when prices are rising.

Greenspan's Dubious Delusion

As noted above, the tacit *approval* of the stock market's advance approaches unanimity among onlookers. There is nary a naysayer in the crowd. Always asking "why," I was taken aback as I read the op-ed piece Alan Greenspan wrote for the *Financial Times* on June 25. He not only approved of the market's rise, he conferred on it powers heretofore unimagined. "The rise in global stock prices from early March to mid-June is arguably the primary cause of the surprising positive turn in the economic environment," he began. Later he defended: "I recognize that I accord a much larger economic role to equity prices than is the conventional wisdom. From my [Greenspan's] perspective, they are not merely an important leading indicator of global business activity, but a major contributor to that activity, operating primarily through *balance sheets*. The $12 trillion of *newly created corporate equity value* has added significantly to the capital buffer that supports the debt issued by financial and non-financial companies" [italics added].

Normally we think of the growth in balance-sheet equity as dependent on two factors involving real money: (1) retaining cash earnings in the business and (2) the sale of equity for cash (which, to be sure, bank holding companies are doing with great haste while the window is still open). By ascribing such importance to something as ephemeral as short-term movements in stock prices—assuming you give some credence to Mr. Market's psychological abnormalities *and* assuming you are not irretrievably subservient to the EMH notion that the market is always right—Greenspan's financial alchemy borders on the delusional.

To further emphasize the point by comparison, the par value of total consumer, corporate, and government debt reached $54 trillion at the end of the first quarter. GDP, the nation's income, was running about $14 trillion. From that we deduct wages and salaries, corporate profits, sundry other items, and, of course, interest and principal payments on the debt. Never in our history has the amount of income been nearly so small relative to the debt it must service.

While Mr. Market's whims can create and destroy trillions of dollars in stock market wealth without a dollar's change in corporate earnings, debt doesn't go away unless it's paid off or written off (or effectively shrunk by debasing the fiat currency in which it is denominated—a story for another day). Greenspan may be missing the main point. The miracle elixir of rising stock prices, whose permanence is anything but assured, pales by comparison to the deflationary burden of far too much unflinchingly persistent debt chasing far too little income. Keynesian "animal spirits" and "spontaneous optimism" may be triggered by rising stock prices, but before they get legs they must get the gorilla of crippling debt off their backs.

Is There a Sentry on Watch?

Although nobody seems to care at the moment, rapidly rising prices make stocks more expensive—and thus riskier. Referring to the Graham/Shiller PE (below, in the written version), as highlighted in the 2008 MCM annual report and subsequent writings, its utility as a valuation tool for long-term investors is in its design: It was constructed to smooth out short-term fluctuations in earnings by using a 10-year moving average and, because it's a longer-term measure, the effect of inflation/deflation on both earnings and the value of the S&P 500 index is largely nullified. While Graham/Shiller states the obvious, it isn't commonly employed as a valuation tool. Given its several indisputable bubble warnings over the last 10 years, one must presume that neither Greenspan nor Bernanke is aware of its existence.

As noted on the chart, the PE fell to a month-end low of 13.3 times in February and is currently at 17.5. With one exception, no bubble market in the last 130 years—defined as one in which the Graham/Shiller PE rose above 20 times earnings—escaped the ignominy of sinking to single-digit PEs in the bust that followed. The exception, at least thus far, is the current bear market (or is this a new bull market?). The game is tight, the time short, and all about us are on their feet screaming for the home team. In the marketplace the rational player must keep his game face, and his seat, stoically aware that "the opera ain't over till the fat lady sings."

Whether there's unfinished business ahead or whether the current episode is the exception to the rule, somebody in high places should be taking note. If the S&P 500 rises another 130 points to 1140, it will have returned to bubble levels. As the debate rages in Washington over which agency should serve as risk czar for the protection of consumers and investors, the next possible bubble is insidiously distending toward the bursting point ("While Nero fiddled, Rome burned").

"If shares fall back to their early spring lows or worse," concludes Greenspan in his op-ed piece, "I would expect the 'green shoots' spotted in recent weeks to wither." For the Maestro to conclude otherwise would be a non sequitur.

The Crowd: a Genius or an Imbecile?

Whether the market as a whole is *always right,* as the EMH theorists claim, or often wrongheaded, as LeBon's theories would suggest, that is the question of the day. In our minority view, too much anecdotal, as well as factual, evidence has accumulated in support of the latter for us to bet heavily on the former.

The following appeared in our 2005 annual report and seems as apropos today as it was then:

> John Kenneth Galbraith had the following to say about those who had the temerity to utter caveats when the "wonderful process of enrichment" was under a full head of steam. "There are, however, few matters on which such a warning is less welcomed," he wrote. "In the short run, it will be said to be an attack, motivated by either deficient understanding or uncontrolled envy, on the wonderful process of enrichment. More durably, it will be thought to demonstrate a lack of faith in the inherent wisdom of the market itself." Duty leaves us no choice. If the future

proves us misguided, we will have cost you opportunity. If we are closer to the truth than even we would like to be, we may have protected your capital and, more importantly, your capacity to venture forth into an always uncertain investment world in the future, perhaps when low hanging fruit is begging to be picked…

Until we chat again,
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