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FOREWORD

Martin Capital Management, a limited liability partnership, is an investment advisor registered with the U.S. Securities and Exchange Commission. After years of preparation, its founder began formally dispensing his brand of investment counsel, which this and earlier missives have recorded, in the months before the memorable autumn of 1987. (All firm publications, as well as SEC filings, are available for review.) Since then, Martin Capital has grown to serve 77 clients, whose combined assets total approximately $335 million. From its beginnings as a one-man, one-assistant operation, with less than $25 million in assets, Martin Capital is now headquarters for nine people, including five investment professionals and four persons in supporting roles. See page 38 for thumbnail biographies.

We at Martin Capital Management hope that in the course of conducting our business we might occasionally encounter other investors with whom we share common values and expectations. If you know of someone for whom the fit appears mutually beneficial, please mention our name. While our $2 million-minimum account size prevents us from helping some people whom we'd very much like to serve, it is necessary to keep our roster of clients small. Our abiding duty is to those who have entrusted their assets to our care, and we will forgo any growth opportunity that may detract from our ability to serve them as they have become accustomed. Careful selection and controlled growth are really about doing a good job and having fun along the way. We never expect to be among the biggest, but our intention to be among the best is not subject to compromise.

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

Frank K. Martin, CFA, Managing Partner
Dennis D. Blyly, CFA, Partner, Director of Research, and Portfolio Manager
Todd B. Martin, CFA, Partner, Director of Marketing, Analyst, and Portfolio Manager
Andrew P. Wilson, CFA, Analyst and Portfolio Manager
Charles R. Kirk, Director of Private Placements
Janet Gilbert, Operations Manager
Lynn Stenberg, Client Service and Analyst Support
Kristin Antalavits, Portfolio Manager's Assistant and Trader
Shawn Harrison, Research Assistant

BUSINESS PRINCIPLES

- Our practice of ethics is quite uncomplicated. We simply conduct ourselves in our relationship with you as if the roles could be reversed at any time. If you would like something more formal, we can send you the Code of Ethics of the Association for Investment Management and Research of which the members of your management team, as Chartered Financial Analysts, are full participants. It is well-thought-out and inclusive.

- We strive to be candid and forthright in our reporting to you. You have placed your trust in us, and we know of no other way to be worthy of that trust. Despite this policy of openness, we will publicly discuss our transactions in marketable securities only when we believe such disclosure will be to your advantage. Good ideas are scarce, and the output of our research efforts is your exclusive property.

- Our portfolio management style is "participatory." We consider it very important for you to be actively involved in the review of our recommended portfolio policy, in mapping out intermediate-term strategies, and in major asset-allocation decisions. Your involvement should not take a great deal of your time, however. The better we get to know you, the more likely we are to appreciate your unique (and sometimes changing) goals, objectives, preferences, biases, and fears, both spoken and unspoken. With your indulgence, we will continue our practice of encouraging frequent face-to-face get-togethers. We also will persevere in communicating our thoughts to you in writing to make it easier for you to get to know us.

- To the extent that security laws and regulations permit, the managing own portfolio and that of our firm are invested in the same securities as yours, varying only to the extent that our goals and objectives differ. In other words, "We eat our own cooking." It probably goes without saying that such a policy demonstrates the sincerity of our position—not necessarily the soundness of it.

- We are a small organization and intend to remain so. A compact organization makes it possible for us to spend our time managing our business rather than each other. Because everyone has much to do, much gets done. Our design appeals to those for whom form is secondary to substance.

INVESTMENT PRINCIPLES

- Our implicit quantitative performance goal is to maximize long-term portfolio returns.
- The universe of marketable securities from which we select most investments is generally limited to: (1) long-term, common-stock holdings; (2) medium-term, fixed-income securities; (3) long-term, fixed-income securities; and (4) short-term cash equivalents. Beyond respecting the investment-policy guidelines established for you, we are not partial to any one of the above categories. We simply search among them for securities that offer the highest after-tax, risk-adjusted returns as determined by "mathematical expectation."
- We strenuously avoid assuming risks that might result in "permanent" capital loss. We will forgo an outstanding investment opportunity if the flip side of that coin is the risk of an irreversible capital loss. We do expect frequent shorter-term quotational losses as rarely, if ever, are we able to buy a common stock or any other security at its absolute lowest price. So long as we feel our business analysis is sound, further weakness in the market price of a company simply gives us an additional opportunity to purchase shares at an even greater discount relative to its intrinsic value.
- Consistent with our attitude toward catastrophic risk, we have little interest in the use of leverage. We do not margin portfolios and usually avoid making investments in businesses that themselves labor under a heavy burden of debt.
- When we purchase common stocks, we approach the transaction as if we are buying into a private business. We insist on a purchase price that represents a "compelling discount" from intrinsic value. Once a purchase is made, we focus the bulk of our attention on tracking the business itself and ignoring short-term price fluctuations. We are quite content to hold onto our investment in a good business so long as (1) the prospective return on equity capital is expected to be satisfactory, (2) the management continues to conduct itself with competence and honesty, and (3) the market does not become excessively enthusiastic about the future outlook for the business.
- We believe that intrinsic value is in essence the central tendency in the price of an asset. It is the investment concept at the core of our analytical methodology. While intrinsic value is an elusive notion, "earnings power" has become the driving force in fixing a range for intrinsic value. Earnings power allows for the existence of an intangible asset known as "economic goodwill" that can be aggregated with tangible assets to arrive at intrinsic business value. Without such a fundamental benchmark, however vague, one is at risk of becoming awash in the occasional tides of euphoria and pessimism that flood the security markets.
- We generally limit the number of companies we own in any individual portfolio to fewer than 20. Contrary to popular opinion, exceptional investment ideas are uncommon indeed. We do not want to dilute the performance of outstanding investments with potentially mediocre ones purchased solely for the sake of additional, and often redundant, diversification. Despite the intuitive appeal of the broad spreading of your risks, extensive computer-backed testing has demonstrated that 90% to 95% of all the benefits to be gained from diversification can be achieved with a well-selected portfolio of fewer than 20 businesses.

INTRODUCTION

The writing of the annual report is a special privilege for the undersigned. In addition to the opportunity it provides to communicate with a wonderful group of people, it also periodically induces me to step back from the fray and reflect on the nature of the causes of which the capital markets constitute merely the effect. While its message recommends uncommon vigilance in these heady times, and its tone resonates an earnestness hardly befitting the occasion, it is written to friends, and that makes all the difference. The introduction reiterates the firm's ideological orientation and defines the unique congregation—some would say choir—to which it is preached. Throughout, an atypical attitude toward risk and opportunity is advocated that may make the journey of wealth management less uncertain if not more productive. Much of what follows, as always, pays due homage to Mark Twain's dictum: History doesn't repeat itself, but it rhymes. More on that later.

The report is written for a specific audience—a very small subset of the investor population at large—by at least a provisional member of that group. Having accumulated more assets than I need (owing largely to a parsimonious lifestyle!) or even more than I can wisely use, I confess to weighing in on the side of the capitalist rather than the consumer in such matters as money and wealth, being persuaded more by the words of Ayn Rand than the comportment of Donald Trump. Please don't think of that declaration as braggadocio, but more as an honest admission of the frequent element of capriciousness, if not Rand-omness, in the distribution of the fruits of capitalism. Think then of views expressed below, if you will, as being humbly submitted rather than asserted, open to correction by smarter men or women, better-schooled and more experienced in economics, business, and human behavior. If there are blunders, as surely there will be (and have been), it is to be hoped that they will not be egregiously costly in terms of lost real opportunity or capital. If the past is prologue, such errors will more likely not be in ignoring a molehill, but rather in making a mountain out of it.

Call it philosophical resonance. At some point in our professional lives we come to the realization that we can't be all things to all people, that we must choose sides. As a university student in the early '60s, I had the early-career good fortune of being exposed to the writings of Benjamin Graham well before I was introduced to mainstream thinking. That learning experience proved to be an epiphany. The logic and integrity of Graham's thinking enthralled me. Just as naturally as dessert follows the main course, I later came to embrace the teachings of Warren Buffett, Graham's protégé. Buffett is simply Graham raised to the second power. Such singular focus likewise means there is little room in my intellectual library for the volumes of Modern Portfolio Theory dogma that governs the thinking of many in our profession. It's not so much a matter of right and wrong that separates the two as it is a difference in time perspective. Buffett thinks in terms of buying businesses, while MPT is about buying stocks. The difference is huge.

To be sure, both men are or were (Graham died in 1976) far from superhuman. Their biographies do justice to their strengths and fairness to their weaknesses. As businessmen and investors they have certain traits in common that have encouraged and inspired my 30-some years as an unrepentant student. Although they live—I'll use the present tense in this reference—in a world where precious few folks are the equal of their money, these two tower above theirs. Wealth has never lowered them to extravagance, self-indulgence, the exercise of raw power, or pretense. Rather, it has driven them to thoughtfully shoulder the responsibility and duty that is expected of great individuals. Plainly if not crudely put, Buffett is the antithesis of what so often masquerades as capitalism today. Buffett and Graham have never sought wealth for its own sake; it merely emanated from higher-order endeavors. It is the side effect, the by-product, of a fascination with the pursuit of business and investment, a game they play with excellence and distinction—and to which they bring dignity and respect. They have, in sum, worn their wealth well. On the cerebral side, both men epitomize the triumph of reason and rationality over other more basic and universal of human instincts. They are blessed with enormous intellects, enabling them to reduce complex issues to their rudimentary elements with apparent ease. A behaviorist would say they understand guile, pretense, and greed, yet remain largely unaffected by them. Their understanding of human nature in the marketplace is legendary. Indeed, they are worthy mentors.

And so I continue to refer to Warren Buffett unapologetically. I have never wanted to "*be* like Mike" or Ben or Warren (to borrow a popular phrase often applied to *Sports Illustrated's* Basketball Player of the Century), but I would be infinitely flattered if someone accused me of *thinking* like them. Besides, to avoid misunderstandings we feel obliged to make occasional reference to our ideological underpinnings and continuing orientation.

Here is a test that will help you decide whether you should read any further. Let's say someone were to hand you a revolver with six chambers and one bullet and invite you to play a game of Russian roulette. His offer? "Pull the trigger once for a prize of $1 million," to which I would expect that you would respond with an emphatic "No." "What, then, is your price?" Your answer: "There is no price." If, by chance, you have a price, what follows may be of little interest to you. For the reader with whom we are likely to be kindred spirits, the risk of losing something that's very important in hopes of gaining something of minimal incremental value must appear absurd. In the financial sense the money gained has no utility whatsoever compared with the money and reputation that may be lost.

New and older readers alike have a number of shared perspectives and preferences; the thrust of the report takes that commonality into account. Those who might find the contents to be of use include individual savers and investors, men and women who enjoy the flexibility of living outside the constraints of a paycheck-to-paycheck existence. They own reserve assets and, with that advantage, the implied responsibility to preserve and protect wealth thus accumulated or value thereby stored—in order to meet any number of needs in the future (as well as the present for those who are retired). They are people who are well-to-do and have every intention of remaining that way.

Having surveyed the investment scene for many years, I'm convinced that the extra burden of stewardship these individuals must carry as a group will not be unbearably heavy if they simply steer clear of the three great destroyers of wealth: greed, fear, and folly. If greed can be contained, fear overcome (if not actually capitalized upon), and folly seen for its inherent absurdity, many of the potholes on the road to wealth preservation and enhancement can surely be avoided. Few are more successful at maneuvering around hazards and obstacles than Warren Buffett. In what I believe is not a display of false modesty, he freely admits that his productivity and durability are not so much because he and partner Charlie Munger have done brilliant things, but because they've done *fewer* dumb things than most. All in all, the Oracle of Omaha's humble formula is well within the reach of most people.

While many of the views expressed herein reveal the influence of the opinions of learned others, they cannot be entirely separated from my own evaluation of the prevailing facts and circumstances; intentional or otherwise, they display my imprimatur, as well as mirror my biases and predispositions. Too, I am greatly indebted to my extraordinarily capable and insightful partners, associates, and staff. We keep each other in check! A few words about each are found elsewhere.

As for the order of things, the report will begin with a discussion of the goings-on in both the equity and debt markets. It will then turn to how the Martin Capital Management ship has navigated them: where we sought deep water and how we avoided possible shoals. Two sections that I wish to highlight are the pervasive scourge of unsupportable expectations that feature heretofore unspoken musings by Warren Buffett on the subject of the outlook for the returns from equities over the next decade or two—and a sequel to last year's discussion on accounting issues. Finally, we invite you to take an up-close and personal look inside our firm's business strategy so that you may better understand the trade-offs—yes, the conscious choices—necessary that we might continue to serve you well.

A TALE OF TWO MARKETS

The defining characteristic of the markets for U.S. common stocks last year was the divergence in stock price performance between those industries favored by investors and those considered passé. The companies leading the information revolution, broadly defined to include communications equipment (computer hardware, software, and services; electronics; and technology services), turned a trend that was well-established in 1998 into a blowout in 1999. The S&P's tech sector jumped 74.7% last year, following 1998's 72% gain. *Technology issues accounted for about 90% of the advance in the overall S&P 500*, which climbed 19.5% in 1999. The venerable Dow Jones Industrial Average, meanwhile, getting a late-year boost from two of its new members, Microsoft and Home Depot, surged ahead 25.2% to a record 11,497. Reflecting the tidal wave in tech issues, the Nasdaq finished 1999 with a record gain of 85.6%. By comparison, the great mass of companies simply languished.

As we are inclined to do, allow us to cast what is happening in the context of both time and space. The 68 companies that comprise the S&P technology index subset accounted for 13.3% of the value of the entire capitalization-weighted S&P 500 composite index at year-end 1997. In 24 months it had tripled to 44.4%. The technology-dominated Nasdaq composite index, also capitalization-weighted, has become the market's force de jure. (The Internet sideshow is examined elsewhere in this report.) The fact that the companies of which the Nasdaq is constituted are the least seasoned in the American economy does not seem to matter one whit to an investing public whose appetite for technology—or perhaps the rising prices that their shares offer—appears insatiable. The market value of the Nasdaq composite, a mere $220 billion as recently as 1990, has ballooned to an incredible $5.7 trillion. In contrast, the market capitalization of the S&P 500 composite index is about $12 trillion (itself approximately 75% of the estimated $16.4 trillion U.S. equity market). Adjusted for the double counting (Nasdaq companies included in the S&P 500 index), the Nasdaq composite looms large indeed next to the sum of the market values of all the other industries that provide the material side of the American dream—industries that build and furnish the homes in which we live; produce, package, and distribute the food we eat and the pharmaceuticals that fill our medicine cabinets; make and retail the clothes we wear; manufacture and sell the cars we drive and the planes we fly (and the fuel that makes them go). You know, the incidental stuff!

To be sure, the information revolution is the most important growth driver in our economy. Skyrocketing share prices are a testament to the premium that investors are willing to pay for growth or, in the case of the Internet, the distant expectation of it—or the extent to which investors have taken leave of their senses. Of the three emotions that periodically sweep through the marketplace like a forest fire fanned by high winds—fear, folly, and greed—which might it be? The price-earnings ratio for the Nasdaq composite exceeds an unimaginable 200. Yes, there are two 0's. The off-the-charts trailing 12-month 27 to 33 times (depending on how you keep score) price-earnings ratio at which the S&P 500 sells pales by comparison. These are the most unusual of times ...

Growth vs. Value

To elaborate a bit more on the subject, it is widely believed that growth investors tend to focus on technology companies and others with rapidly growing profits, while value managers seek undervalued and beaten-down stocks that often have low price-earnings multiples. If we must be categorized as value investors, it's because we only invest in those securities where we can reasonably estimate their value and only at prices that are less than that value. We prefer growth but understand that it is but one component of a company's value. Reflect for a moment, if you will, on the airline industry and its profitless prosperity.

As for a rough approximation of the growth in the intrinsic value of the S&P 500 index, we estimate it may have increased by a total of 10% to 15% over the 1998-99 period. It was spurred by the

110-basis-points drop in interest rates in 1998 (using the 10-year Treasury note as proxy) in the face of flat operating earnings. The flip side of the coin appeared in 1999 with operating earnings advancing by 16% while weathering a 170-basis-points uptick in interest rates. In sum, over the two years the yield on the 10-year note rose by 60 basis points, and operating earnings for the S&P 500 composite companies advanced at an annual rate of 8.1%. The increase in the market value of the index, heavily weighted by technology issues, was more the result expanding price-earnings ratios than earnings growth. Based on trailing 12-month earnings, from the first day of 1998 to the last day of 1999, the price-earnings ratio of the index advanced from 24 to 33, according to *Barron's*. The S&P value index crept ahead 12% in 1998 and 9% in 1999, more in keeping with the growth in underlying intrinsic value.

The disparity in performance between growth stocks (including both technology and branded consumer-product stalwarts) and value stocks is most pronounced among the smaller and mid-size companies. Looking beyond the S&P 500, the growth stocks in the Russell 2000 index, the small-cap benchmark, were up more than 40%, while value stocks in the index fell 3%. That spread is the widest in 20 years.

The growth/value gap was even more pronounced among mid-cap stocks, with the Russell mid-cap growth stocks gaining about 50% and value stocks unchanged. In the S&P 500 the gap was narrower. The index's growth stocks rose 27.3% last year, and value issues advanced 10.7%.

Hedge fund manager Julian Robertson, writing to the clients of Tiger Management in December, summed up the value manager's dilemma: "... [T]he Internet is a great new technology that will change our lives. But there have been other great developments that created equally important lifestyle changes. In the past, investors overreacted to the promise of these changes. ... We're in a wild runaway technology frenzy; meantime most other stocks are in a state of collapse. I have never seen such a dichotomy. There will be a correction. As to whether or not this correction will take the form of a total market collapse as in 1929, 1973-74 and 1987, I have doubts. Why? The out-of-phase stocks are just too cheap. … [T]his would imply a long-term underperformance of technology (believe it or not, it has happened) while the rest of the market continues to advance. Of course, this would be the ideal situation." As for the last sentence, Julian Robertson hedges more than just his portfolios.

Zeroing in on one of the two most widely recognized investment styles, the table on the following page makes clear the what-price-do-I-pay-for-growth dilemma that a man with money in his pockets faces today. He may be damned if he does and damned if he doesn't. If he forks over an ante that discounts the next hundred years of earnings and something unexpected occurs "'twix the cup and the lip," history may reveal him to be a fool—and a much less prosperous one at that. If "Jack" doesn't, and this bean"stock" grows to the sky, his wealth will grow at the pace of a turtle, while everyone else's imitates the hare. The unwanted consequence of the first choice is that he may find himself absolutely poor and in the second, relatively so. While neither outcome is desirable, the consequences of the first are more severe. We hope you agree.

20 Largest Nasdaq Companies
12/31/99

	Company Name	Market $ bil.	Net Income Last 4 Qtrs	P/E Trailing EPS
MSFT	MICROSOFT CORP	$ 601,029	8,293	72
CSCO	CISCO SYSTEMS INC	$ 355,119	2,016	182
INTC	INTEL CORP	$ 275,006	7,270	43
ORCL	ORACLE CORP	$ 159,540	1,442	115
WCOM	MCI WORLDCOM INC	$ 149,295	3,104	40
DELL	DELL COMPUTER CORP	$ 130,101	1,655	70
ERICY	ERICSSON (L M) TEL -ADR	$ 128,179	1,259	93
SUNW	SUN MICROSYSTEMS INC	$ 120,966	1,189	108
YHOO	YAHOO INC	$ 113,901	35	3,057
QCOM	QUALCOMM INC	$ 113,841	201	520
AMGN	AMGEN INC	$ 61,355	1,053	67
JDSU	JDS UNIPHASE CORP	$ 56,017	(293)	-
SNRA	SONERA GROUP PLC -ADR	$ 49,999	360	110
AMAT	APPLIED MATERIALS INC	$ 47,940	726	66
ICGE	INTERNET CAP GROUP INC	$ 43,012	(4)	-
LVMHY	LVMH MOET HENNESSY -ADR	$ 42,435	-	56
ORNGY	ORANGE PLC -ADR	$ 39,663	(108)	-
NIPNY	NEC CORP -ADR	$ 39,658	(1,653)	-
GBLX	GLOBAL CROSSING LTD	$ 38,395	215	123
CMCSK	COMCAST CORP -CL A SPL	$ 38,007	1,381	28
	TOTALS	**$2,603,459**	**$ 28,140**	**93***

* Yahoo P/E reduced to 200x
Source: FactSet Data Systems

Another hallmark of the times is the harsh retribution dealt companies that fail to "make their numbers." An interesting ritual has developed between and among corporate America's and Wall Street's cognoscenti, and it ties neatly into the discussion elsewhere in the report titled "Ledger d'Maim." Before a company officially announces its quarterly earnings, it is frequently known to "guide" key analysts as they construct their earnings forecasts. So much for independence. Soon a "whisper" estimate mysteriously circulates within the analyst community. Analysts are preconditioned. Understandably, then, when a company's formal release hits the wires there is precious little tolerance for an earnings shortfall. In the new economy the element of surprise increasingly has been "managed" out of profits, leaving a smaller portion of the earnings outcome subject to the vagaries of business, at least in the near term. Failure to "make their numbers," therefore, reveals far more about a company's operating results than a penny or two per share would otherwise suggest. If the earnings disappoint, despite the best efforts of the company's managers to massage out imperfections, something must be seriously awry. The palace revolt is as swift as it is sure.

A Study in Contrasts: Debt vs. Equity

The two securities that potentially tie up one's capital the longest are common stocks and distant maturity bonds. Ownership can be perpetual, and the return of principal from a bond can be as many as 30 years away. Either, of course, can be sold in the interim under most circumstances. As noted above, technology stocks have paid off handsomely in the recent past, whether one's investment horizon is near or far. Long-dated bonds (we use the 30-year U.S. Treasury bond as proxy) were the mirror opposite.

These "certificates of confiscation," as they are impolitely called, provided a 1999 total return of minus 14.4%, by far and away the worst calendar-year performance ever. Yields on Treasury bonds began the year at 5.09% and finished at 6.48%. The Lehman Government/Corporate Index suffered a negative return for only the second time (1994 was the first) since it was created back in 1973. The miserable showing of bonds in '99 might properly be laid at the door of the booming stock market, with investors accelerating a trend that began five years ago of dumping bonds for stocks. An unprecedented development of the late 1990s was that stocks were driving bonds—rather than interest rates influencing equities as they have in the past. The wealth created by the booming stock market is pushing the economy ever higher. Consider that the Conference Board's index of leading economic indicators rose to a 40-year high in November, thanks in part to the sizzling stock market.

Beyond investors' aversion to bonds, other forces had the effect of nudging interest rates higher as well. The economy continued to boil, the Federal Reserve hiked the discount rate three times, and fears of nascent inflation refused to die.

If there was a consensus forecast for interest rates by the end of 2000, it probably would peg the yield on the 30-year bond at 7%. In spite of, or perhaps because of, economists' underestimation of economic resiliency in 1999, they are calling for more of the same in 2000. Upward pressures on interest rates will continue to build under that scenario.

The wild-card argument for higher yields stems from the uncertainty about how foreign investors will react to any changes in perceptions about the dollar and the attractiveness of the U.S. Treasury market. When the U.S. government borrows money these days, the chances are excellent that foreigners will be the ones writing the checks. Foreign investors—insurance companies, pension funds, central banks, individuals—now own almost $1.3 trillion in U.S. government securities, which is 40% of Washington's $3.2 trillion in accumulated marketable debt, according to the latest federal statistics. Five years ago, by contrast, foreigners held $641 billion in Treasuries, just 20% of the total at the time. Foreigners, effectively, have helped to finance our imports. Princeton economist Alan Blinder, former vice chairman of the Federal Reserve, says there is "an upside and a downside to borrowing money" from abroad: "The upside is you get your hands on the money. The downside is you have to pay it back."

A good case to be made for lower yields is the "flight to safety" proposition. Pronounced stock market weakness could precipitate a scramble for the safe-harbor alternative that high-grade, fixed-income securities offer. Any economic weakness that followed also would reduce the demand for money and, ceteris paribus, its cost.

How We Managed Risk and Where We Found Opportunity

We believe that if you get the risks right, the returns will take care of themselves. As investors who consider patience a virtue and a prudent purchase price an absolute necessity, we looked for a more favorable mix of risk and opportunity elsewhere, given the considerable danger implicit in paying such extraordinary prices for the immensely popular and impressively growing technology companies. And we found such a mix. In our judgment it resides in a number of well-capitalized companies whose primary appeal is not that they have a hot-wire connection to the information revolution but that their competitive advantages within their industries are defensible. Their historical rates, as well as longer-term prospective earnings-growth rates, are likely to be several times that of the economy as a whole.

Your portfolio reflects our ongoing reluctance to pay unprecedented premiums to play in a game in which we have no demonstrated competence and no croupier's advantage. We feel like an old hand at Las Vegas; our gut sense of the way things work tells us that the longer we stay at the tables, the more likely it is that we'll walk away empty-handed. Our rational side dominating, we watch and we wonder. To be sure, our reticence to sit for a few hands of blackjack has been costly in terms of lost opportunity, made all the more obvious by the run of good luck the fellow over whose shoulder we are looking is having. Make no mistake, we believe investing is the only game of chance where anybody who is savvy and independent enough can *become* "the house" and set the odds. We abide in that conviction. Our judgment, however, has yet to be confirmed.

According to Ben Graham and Warren Buffett, the three most important words in the serious investor's lexicon are "margin of safety." In other words, the purchase price of a stock should be sufficiently below the investor's estimate of the company's intrinsic worth—in that if the estimate proves to be low, a cushion in the form of the discounted price still remains. The higher the uncertainty about one's estimate, the greater the margin should be. It's really rather straightforward. How interesting it is that teacher and student nonpareil are, above all, concerned with managing risk. In the end, that's where the game is won or lost. In the meantime, rest assured. We will not do things with your money that we won't do with ours, the pressure to keep up with the (Dow) Joneses notwithstanding. That portion of your portfolio committed to well-capitalized, growing businesses that we think we understand and that we purchased on average about 10 times earnings typically did not exceed 30% of the portfolio's value at year-end. While no two portfolios are the same*, the equities within a representative sampling appreciated by about 18% in 1999, just shy of that recorded by the S&P 500.* The 1999 performance results of your portfolio(s) are included with year-end statements. We look forward to reviewing it with you in detail when we meet in March.

Fixed-income securities in our client portfolios returned less than their coupons. Rising interest rates saw to that. That translates to about a 3.5% total return from Treasuries, and about 2% for municipal bonds. Because of the short durations of our portfolios (average maturities range from one to five years), we were not penalized like long bond buyers by the rising rates. On the contrary, in 1999 we were able to recycle liquidity at the best yields available in several years. Falling bond prices have actually spelled opportunity for us.

Tax minimization was factored into investment decisions made. For tax-paying investors, the lion's share of the gains realized will be favorably taxed at long-term, capital-gains rates, and a varying share of the income earned was from municipal bonds and therefore exempt from state and federal income tax. Interest income from U.S. Treasury securities is also exempt from state income taxes.

As prosaic as this must sound, the 6.5% yield available on five-year Treasury notes and the almost 5% to be earned from Aaa-rated, pre-refunded municipal bonds of similar maturity may provide ample competition for the broader equity market over the next few years. Despite the goings-on in the broad market, we will continue to buy high-return on equity companies (irrespective of size of market capitalization) that enjoy solid growth opportunities, are well-financed, and are selling at prices that offer an attractive trade-off between risk and opportunity. Our performance-based fee structure means that your portfolio's growth and our revenues are "joined at the hip." Moreover, the "high watermark" proviso checks any urge we might have to overlook risk in the face of the temptations of greed or folly. We appreciate your continued forbearance and hope that in time both of us will be proved wise.

Finally, when you think of common sense ("street smarts" in the jargon of Wall Street), the words of Mark Twain again come to mind. What may surprise you is that the great 19th-century skeptic was not in real life the sage that his clever aphorisms would suggest. Twain repeatedly squandered his writing income on questionable investments, including a turn-of-the-century version of biotechnology. He appears to have been swayed by investments linked to well-known businessmen or politicians. In addition to the biotech fiasco, Twain's losing bets ranged from a health-food company to a new printing process to an Austrian carpet-weaving machine. At least he was able to make light of his losses, and his experiences spawned some classic one-liners. For example: "There are two times in a man's life when he should not speculate," lamented Twain. "When he can't afford it, and when he can." Fortunately, some lessons can be learned vicariously.

BACK TO THE FUTURE?

It is not uncommon for investors to imagine the future as an extension of the immediate past. That is, their vision of tomorrow is wherever a straight line that connects the dots of yesterday takes them. It even has Sir Isaac Newton's physical principles behind it—an object in motion tends to remain in motion … And yet financial history, with no regard for our forgetfulness, occasionally reminds us of its cyclic (y)earnings. To be sure, few would disagree with the notion that simple extrapolation of the past is an acceptable beginning point from which to approximate the future—most of the time. But there are moments, inflection points if you will, when and where simply extending the line is a sure prescription for misfortune. It is the line that can be one's undoing. It can lull a person into complacency.

Think of a grandfather clock in slow motion. When gravity gradually and inescapably overcomes momentum, and the pendulum is about to reverse course—when aversion to the mean becomes regression to the mean—linear extrapolation is plainly counterproductive. Periods of linearity are never permanent, any more than are the seasons. In fact, the existence of irregular recurring patterns of events, often well-camouflaged by the abstruse symmetry of their ebb and flow (the timing of which can be annoyingly unpredictable) should at least pique one's curiosity about the possible relevance of the study of bygone days.

As long as I have my foot in the door, an additional but related thesis should require no more than a soft sell: This cyclical tendency of business and the free markets is such that by the time a trend is most pronounced and thus most widely embraced, it is also most pigheadedly inclined to reverse itself. It is one of life's poetic ironies that in the depth of darkest winter the buds of spring begin to form. The swinging-pendulum metaphor may also help to make the point.

We surely need not be reminded that history is a tool, relevant apart from the classroom setting, that actually has practical utility—like a head is more than just a hat rack. Of equal importance, knowledge of where we've been frees us from the constraints of having to simply take things as they are for lack of anything else to hang onto. Paradoxically, it is a lack of familiarity with, or a general disregard for, history's tutorial that may well exacerbate its repetitious nature. If you don't know history, says the sage, you're condemned to repeat it.

Amid the manifold surprises of the first half of the 20th century, full-time historian and part-time world leader Winston Churchill sailed confidently on the ship of destiny, the waters not entirely unfamiliar because, in a metaphorical sense, he had been there or someplace like it before. As *Time* magazine said of its Man of the Half-century, "Shock after shock threw civilization into confusion … [L]ong-familiar bearings were lost in the midst of change. Some of the age's great leaders called for more speed ahead; some tried to reverse the course. Winston Churchill had a different function; and his chief contribution was to warn of the rocks ahead, and to lead the rescue parties." There is no doubt that Churchill the politician was able to envision the future more clearly because of his understanding of what had come before. As many readers may know, he was a first-class historical scholar. In the '20s and '30s he wrote prolifically, including *The World Crisis*, professionally regarded as the best account of World War I. That expanded perspective would make him a doom-saying Cassandra as World War II approached, while later enabling him to see beyond the suffocating despair during the free world's darkest hour. *Time* asserts that Churchill was "not obsessed with the past, but with the application of the past to the present and the future. The business of a serious politician is to foretell; he used history as an instrument of prophecy."

To be sure, history is a teacher in the abstract for those who want to apply to it the future. While, as Mark Twain said, events of the present sometimes "rhyme" with the past, they nonetheless have their own unique rhythm. It is the timing, then, that often proves most nettlesome for those attempting to apply the events of yesterday to make order of today—and to capacitate a clearer vision of tomorrow. Timing errors may humble the prophet, but they needn't necessarily disparage his prophecy. Read on to learn about two modern-day Cassandras whose warnings should not be dismissed simply because they cried "wolf" when none was at the door.

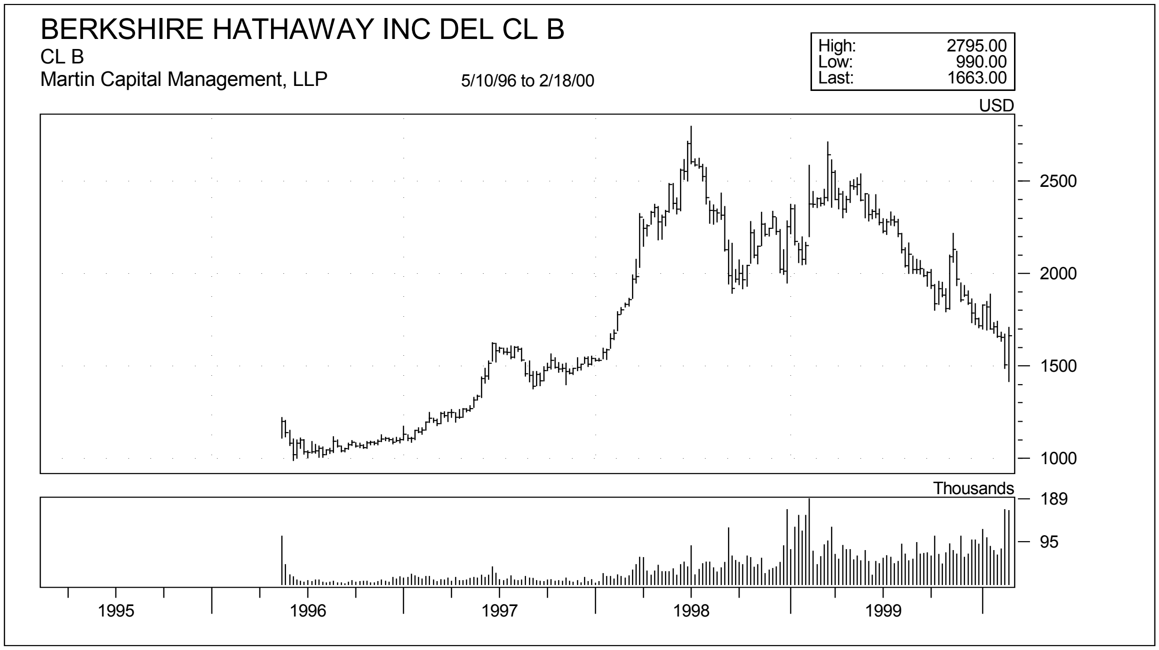
Where's the Wolf?

The date of a most unusual final prospectus was May 9, 1996. The security being initially offered was the new "Class B Common Stock" to be issued by Warren Buffett's Berkshire Hathaway. The relatively small $500 million offering of shares at $1,110 each (the equivalent of 1/30th of the Class A shares and the highest-priced stock on the New York Stock Exchange) was solely to forestall promoters from issuing low-priced shares of a unit trust designed to track the performance of Berkshire's Class A shares.

Stated Buffett recently: "Our issuance of the B shares not only arrested the sale of the trusts, [they] provided a low-cost way for people to invest in Berkshire if they still wished to after hearing the warnings we issued." The timing was thus not of Berkshire's choosing. The following is the impassioned "sales pitch" that Berkshire's chairman provided would-be investors, in full view of even cursory readers, on the cover page of the offering document.

> WARREN BUFFETT, AS BERKSHIRE'S CHAIRMAN, AND CHARLES MUNGER, AS BERKSHIRE'S VICE CHAIRMAN, WANT YOU TO KNOW THE FOLLOWING (AND URGE YOU TO IGNORE ANYONE TELLING YOU THAT THESE STATEMENTS ARE "BOILERPLATE" OR UNIMPORTANT):
>
> Mr. Buffett and Mr. Munger believe that Berkshire's Class A Common Stock is not undervalued at the market price stated above. Neither Mr. Buffett nor Mr. Munger would currently buy Berkshire shares at that price, nor would they recommend that their families or friends do so.
>
> Berkshire's historical rate of growth in per-share book value is NOT indicative of possible future growth. Because of the large size of Berkshire's capital base (approximately $17 billion at December 31, 1995), Berkshire's book value per share cannot increase in the future at a rate even close to its past rate.
>
> In recent years the market price of Berkshire shares has increased at a rate exceeding the growth in per-share intrinsic value. Market overperformance of that kind cannot persist indefinitely. Inevitably, there will also occur periods of underperformance, perhaps substantial in degree.
>
> Berkshire has attempted to assess the current demand for Class B shares and has tailored the size of this offering to fully satisfy that demand. Therefore, buyers hoping to capture quick profits are almost certain to be disappointed. Shares should be purchased only by investors who expect to remain holders for many years.

As the chart below makes abundantly clear, Buffett was anything but prescient. No sooner had he given his "not at this price" warning than the stock began a two-year ascent, during which it more than doubled.



Next we turn to Federal Reserve Chairman Alan Greenspan, the most powerful unelected official in Washington and the most powerful person period when it comes to guiding the U.S. economy. Six months after Buffett pronounced Berkshire stock to be overpriced, the other financial giant of our times, Greenspan, issued his famous "irrational exuberance" statement during a speech to the American Enterprise Institute for Public Policy Research on December 5, 1996. The title of the talk: "The Challenge of Central Banking in a Democratic Society." The chairman of the Federal Reserve Board worried aloud about the economic consequences that might ensue from the collapse of a financial bubble.

> Clearly, sustained low inflation implies less uncertainty about the future, and lower risk premiums imply higher prices of stocks and other earning assets. We can see that in the inverse relationship exhibited by price/earnings ratios and the rate of inflation in the past. But how do we know when *irrational exuberance* [emphasis added] has unduly escalated asset values, which then become subject to unexpected and prolonged contractions as they have in Japan over the past decade? And how do we factor that assessment into monetary policy? We as central bankers need not be concerned if a collapsing financial asset bubble does not threaten to impair the real economy, its production, jobs, and price stability. Indeed, the sharp stock market break of 1987 had few negative consequences for the economy. But we should not underestimate or become complacent about the complexity of the interactions of asset markets and the economy. Thus, evaluating shifts in balance sheets generally, and in asset prices particularly, must be an integral part of the development of monetary policy.

On that date the Dow Jones Industrial Average closed at 5,178.

Having surveyed the financial-section headlines of major metropolitan newspapers for 1999, it is clear to me that Greenspan's apprehensions about the possibility that the financial markets' collective tail may someday wag the economic dog have not faded in the least. Of particular interest is the speech he gave this past October, in which he alluded to the absence of an equity-risk premium that historically has been embedded in stock prices. The word "risk" appears in the text 53 times, as if in Greenspan's tangential way, he was trying to emphasize the point by innuendo so as to avoid the chance of instigating the very event that he clearly fears.

How could these two men, perhaps the most knowledgeable and respected leaders extant in the fields of finance and economics, be so far off on their timing? How could they turn cautious three or more years in advance of a storm that does not yet even loom on the horizon? Unapologetically, Buffett observes matter-of-factly, "Markets behave in ways, sometimes for a long stretch, that are not linked to value. Value, sooner or later, counts." Peter Bernstein in *Against the Gods* identifies the phenomenon mathematically as regression to the mean. Dependence on reversion to the mean for forecasting the future, he cautions, tends to be perilous when the mean itself is in flux. And yet without some regard for the eventual central tendency of stock prices, valuation anomalies like the 200-plus-times earnings at which the Nasdaq composite sells are possible. Price fluctuations, however random they appear, must be tied to something more stable than themselves. Indeed, they are accepted with equanimity these days—without triggering cries of alarm much beyond the measured exhortations of the likes of Buffett and Greenspan.

Even the smartest and best-informed economists and investors can't pinpoint the extremes to which crowd psychology—sometimes manic, sometimes depressive—will oscillate (or if and when it will lose its oomph and eventually display its opposite side). Don't lose patience or get distracted, for the race is long. With all of Buffett's "sins" of omission (the most recent being his reluctance to embrace technology or Internet stocks), his net worth is still, shall we say, respectable. Think of him as a $26 billion "loser." But even he admits that his best days may well be behind him, that 15% is more achievable. For years he has warned that size alone militates against the intrinsic value of Berkshire compounding at a rate of return anywhere near the 23% of the last 35 years. By the way, how impressive is that rate?! A college graduation present of $13,600 to a 22-year-old this spring who can match Buffett's after-tax rates of return will have enough seed money to ensure a $100 million nest egg at normal retirement age. Nonetheless, with Berkshire stock down 23% in 1999, the first annual decline since 1990, the vultures are beginning to circle. *Forbes* columnist and money manager Martin Sosnoff recently took Buffett to task for being out of touch with the new economy in an article titled "Buffett: What Went Wrong?" The feature article in the December 27 issue of *Barron's* posed a similar rhetorical question: "What's Wrong, Warren?" What if it isn't Buffett who's out of touch?!

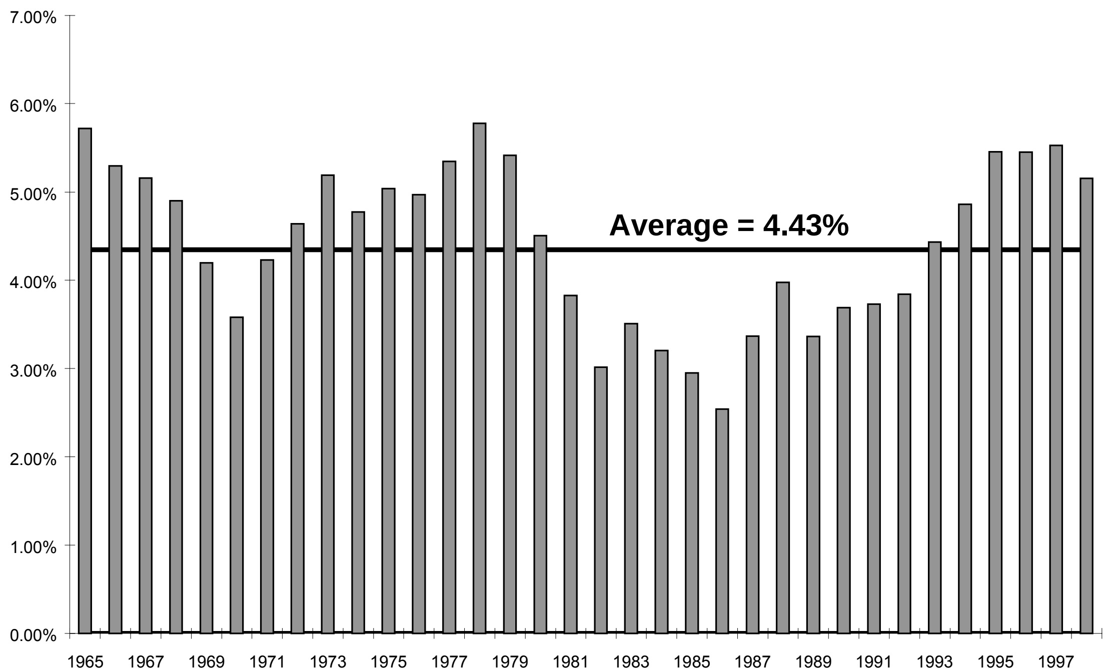
Warren Buffett on the Stock Market

Buffett is loath to talk about the stock market, despite his belief in the eventual tendency for prices to converge on value. One would think his confidence in the principle of regression to the mean would have been sufficiently shaken after the ill-timed Berkshire Class B advice and earlier pronouncements that high rates of inflation are endemic to our political economy. And yet on four occasions in 1999 Buffett felt compelled to speak out, giving extemporaneous talks on the subject to private groups. *Fortune* magazine writer and Berkshire Hathaway annual report editor Carol Loomis distilled the contents of the first and the last in a November 22 article titled "Mr. Buffett on the Stock Market." Buffett then edited Loomis. Most of the observations below have their genesis in the article.

Buffett builds a compelling case that today's investors, prone as they are to look at the future through the rear-view mirror, have an unsupportably optimistic view of the returns that common stocks in general can deliver in the years ahead. A PaineWebber and Gallup survey released in July '99 reveals that the least experienced investors—those who have invested for less than five years—expect annual returns over the next 10 years of 22.6%. Even those who have invested for more than 20 years are expecting 12.9%. They seem to be able to disconnect themselves from underlying business and economic realities, and that concerns Buffett.

Going back 34 years, Buffett overlays a sort of biblical symmetry onto the past to observe the sequential appearance of lean years and fat years. For the first half, from the end of 1964 through 1981, the market's return was indeed lean. The Dow Jones Industrial Average started at 874.12 and ended at 875.00. Observed Buffett wryly, "I'm known as a long-term investor and a patient guy, but that's not my idea of a big move." This anemic outcome was even more curious because of a GDP increase of 370% over the 17-year span. Two other developments completely negated the upward thrust on equity prices that would logically be expected from a growing economy. First, the market yields on U.S. Treasury bonds rose from just over 4% at the end of 1964 to more than 15% by late 1981. Since bonds represent direct competition for all other investment assets, the quadrupling of interest rates had the effect of driving bond prices (and therefore the prices of all near substitutes, including equities) sharply downward. Second, after-tax corporate profits as a percentage of GDP—that portion of the total sales of goods and services in economy that ends up in the coffers of the shareholders of American business—tumbled to 3.5%, well below the average indicated on the chart below. So at that point investors were looking at two commanding negatives: subpar profits and sky-high interest rates. Looking forward by extrapolating the past, investors were despondent, a state of mind amply reflected in stock prices.

U.S. After-Tax Corporate Profits as a % of GDP



The next 17 years (beginning in 1982), as fat as their predecessors were lean, were the antithesis of the first. The Dow skyrocketed from 875 to 9,181, a tenfold increase. Interestingly, GDP grew less than in the first period, but the precipitous fall in bond-market yields to 5% and the increase in corporate profit's share of GDP to 6% provided much of the impetus for higher stock prices. Long-term bonds rewarded investors with an annual total return of more than 13%, but stocks stole the show. Their annual total return, with dividends reinvested, reached an astounding 19%. But those two fundamental factors only explain part of the rise. The rest is attributable to the change in investor psychology from the despair of the early '80s to the exuberance of the '90s, bordering on the irrational, to which Alan Greenspan alluded. Advancing stock prices soon became a self-fulfilling prophecy. It is from that psychological framework that the current crop of rosy expectations, which the Gallup organization surveyed, has been formed.

What's Ahead?

Staying with the symmetry of the 17-year cycle, what's likely to be in store between now and 2016? Buffett avers emphatically that for an outcome anywhere close to what investors expect—even those with 20 or more years' experience—one or more of the following events must occur. Government-bond yields, now 6.5%, must fall farther still. (If one has strong convictions about that, bond options are the purest and most profitable way to capitalize on that scenario.) In addition, the portion of GDP destined for corporate profits must increase. Regression to the mean is a force to be overcome if that assumption is to have merit. For corporate investors to eat an ever-growing slice of the American economic pie, some other groups must eat less. Political pressures, to say nothing of competition, will likely keep a lid on the expansion of corporate profits. Of course, corporate profits could rise to new highs as a percentage of GDP, but they obviously cannot grow faster forever.

What about growth in GDP? The assumption of a 3% real growth rate is consistent with historical trends and the expected growth rate in the economy's productive capacity. To that we add inflation of, say, 2%, arriving at a 5% nominal growth rate. To the extent the rate of inflation changes, so will the nominal growth rate.

So here we are. Profits growth under the above assumptions would approximate 5%, to which would be added about 1% for dividends in determining the returns investors can reasonably expect. Dividend yields are at record lows, which can largely be attributed to record-high stock prices. Earnings per share would rise faster than profits because of share repurchases were it not for shares issued in primary offerings and through stock-option plans. They more or less cancel each other out.

If one thinks investors are going to earn 13% a year in stocks, one must assume that GDP is going to grow at 12%, with another 1% coming from dividends. Historical standards, if not the economics of investment, would suggest that little help is going to come from expanding price-earnings ratios. On the contrary, one must acknowledge that future returns are always affected by current valuations. The 500 companies that comprise the S&P composite index represent 75% of the market value of all U.S. corporations. In the last four quarters, earnings for the S&P 500 companies totaled $403 billion; the present market value for the index is $11.7 trillion. Current prices in relationship to earnings are defying history, the laws of economics … and gravity.

Investor expectations are seriously detached from reality today, according to Buffett, just as they were in the mid to late '60s in the final throes of the great postwar bull market. Even though experienced investors expect annual returns of almost 13% over the next 10 years—and novices believe they will get nearly 23%—in the opinion of the greatest investor living today, common stocks in the aggregate will be lucky to return 6%, or 4% after inflation, in the years ahead.

Investing in Businesses Driving the New Economy?

But, you say, I don't invest in staid old businesses that grow in line with the underlying economy. I avoid the mundane; I am not broadly diversified. Perhaps, you argue, there is an alternative to spreading one's bets all over the board in order to avoid the mediocre returns from sampling a little bit of everything? Maybe if we concentrate our portfolios in technology and Internet issues, where growth is sure to eclipse that of GDP for years to come, we can avoid the curse of the broader malaise? Read on and decide for yourself.

By way of proper introduction, we begin by noting that the 20th century has spawned a momentous series of inventions that have changed forever the way we engage in nearly every aspect of our daily lives. Think of how far Americans have progressed from the snail's pace of the horse, buggy, ship, and steam locomotive to the speed, comfort, and convenience of first the automobile and then the airplane. In communications we've gone from the Pony Express to the telegraph to worldwide telecommunications. In media we've progressed from local performances to national book chains and "talking color pictures." Chronicles of the pervasive impact of these marvels of ingenuity on where we live, work, and play would fill a large library. Imagine how different home life would be without the telephone, radio, television, and air conditioning—and white-collar workdays without the high-speed elevators and skyscrapers they made possible.

Consider some of the following effects of past technological improvements on business. Marketplace opportunities went from being confined to local communities to national and international markets, which gave rise to the notion of "economies of scale" of mass production. National media introduced the concept of "branding." Imagine the process of manufacturing widgets without the ability to constantly communicate with your customer base. And now comes the information revolution whose backbone is the diminutive computer chip. Computers revolutionized the volumes and means by which we manage and transport data. The latest iteration, the Internet, will forever change the conduct of commerce, both retail and business-to-business, and the mechanisms we employ to communicate at all levels. More on that in a moment.

Surprisingly, as awe-inspiring and life-changing as these inventions have been—though admittedly those whose novelty has long since passed are now largely taken for granted—almost without exception they were a boon to consumers and a disappointment to investors. At the peak of excitement over the prospects for the automobile there were 2,000 producers in the United States. Now there are three, if you include Chrysler in spite of its recent sale to German carmaker Daimler-Benz. As of year-end 1998 (chosen so that Chrysler would be included), the market value of the domestic automobile companies totaled $118.5 billion. The industry sold $302.9 billion worth of vehicles in 1997 and earned $25 billion, Chrysler included. We can only speculate about the high point in market valuation that the industry excited at the pinnacle of the public's infatuation with the horseless carriage. If it was in the vicinity of $100 million, the average annual increase in market value approximated an unimpressive 7%, to which dividends should be added or capital infusions deducted.

Widening the scope, there are 230 companies in the FactSet transportation grouping. Included are airlines, air freight/delivery services, railroads, trucking and marine transportation—the means by which goods sold on the Internet and everywhere else are transported from the manufacturer, through the wholesaler, and ultimately to the consumer. On 1998 sales of $516.6 billion and earnings of $23.3 billion, the mid-December 1998 market capitalization of the industry aggregated $305 billion. Within that segment, the airline and aircraft-manufacturing industries, which numbered 300 companies in their heyday between 1919 and 1939 (undoubtedly the Silicon Valley of that age), have met an investment fate similar to that of the automobile. If the peak market valuation of the airline industry during that span was $5 billion, its current valuation of $46.7 billion would suggest that investors in the aggregate earned approximately 3% before dividends and capital infusions, of which the latter exceeded the former by a huge amount. Further complicating the process, investment in the industry has regularly required special navigational skills as one makes his way through the minefield of business failures. An unnerving 129 airlines have filed for bankruptcy in just the last 20 years.

Moving a little closer to home, if you had invested an equal amount of money in all of the PC manufacturers in the early 1980s, your return would be 4% as of the end of 1999.

Is the Internet the Answer?

All of which brings us to technology's wunderkind, the Internet. As a firm and as individuals, we are active consumers of Internet services. While there is little doubt about the expansiveness of its utility in any number of venues, its capacity to generate corresponding profits is not so clear. Regardless, investors have developed a nigh-unto-obsessive fascination with Internet stocks like no craze in modern history. In 1996 the fledgling industry, then relatively few in number, sported a market capitalization of

$12.9 billion, while losing $134 million on sales of $4.4 billion. By year-end 1998 the number of players had multiplied many fold, and the industry's market capitalization shot up more than 10 times to $141.9 billion. Sales tripled to $12.4 billion over the two years, yet losses actually expanded, to $2.4 billion. It was throughout 1999 that the Internet fever rose to the point of threatening to shatter the thermometer. For the last four quarters, sales for the 200 public companies that Bloomberg surveys have increased to $21.9 billion, while losses continue to mushroom, to $4.1 billion. Overlooking the nascent industry's lingering inability to make a buck, all manner of investors and speculators continue to relentlessly clamor for Internet stocks. The market capitalization of the industry reached an astounding $823.1 billion by mid-December 1999. Seizing the opportunity, Internet entrepreneurs and promoters have been quick to satisfy the public's insatiable appetite: Of the record 505 IP0s sold in 1999, more than half derived the lion's share of their revenues from the 'Net. Together they raised one-third of the past year's $66 billion in dollar volume. As surely as nature abhors a vacuum, supply rushes in to meet demand.

What do the Internet investors expect for an encore? Taking into account the industry's stratospheric valuations, if the Internet industry earns more profits in 2020 than *all* Fortune 500 companies *combined* earn today, or $334 billion—a most improbable outcome—the survivors must command a terminal price/earnings ratio of 20 if investors in the aggregate hope to eke out even a comparatively pedestrian 10% average compounded return. In all likelihood, you can't get there from here. We, meanwhile, watch from the sidelines with interest.

As for the investment dilemma posed several paragraphs above, I doubt that the Internet will be the answer. Perhaps what we're witnessing is merely the traditional boom/bust cycle for new technologies … at warp—check that—Internet speed … ?

I would be remiss if I didn't tip my hat in a parting salute to the very information technology whose investment merits I question—and to our energetic and savvy research assistant, Shawn Harrison. Together they made possible the compilation of the above statistics in a couple of hours that a few years ago would have taken weeks to gather. On-line databases piped directly into our offices include Bloomberg and FactSet, as well as the omnipotent Internet gateway.

With the weight of experience behind his arguments, Warren Buffett contends that *"the secret to successful investing is not locked up in the knowledge of how much an industry is going to alter the way people live their lives, or even in how much it's going to grow, but rather in determining the competitive advantage of any given company and, above all, the durability of the advantage. Products or services that have wide, sustainable moats around them are the ones that deliver rewards to investors."* Internet investors, please proceed down the "information superhighway" with caution.

What Buffett Isn't Telling Us

Buffett never spoon-feeds those who dine at his table. He expects his guests to use their intellectual utensils to slice, dice, and then consume and digest the repast he offers. For starters, he does not dwell on the obvious, that the return he expects from common stocks going forward is slightly less than the relatively no-brainer alternative: U.S. Treasury notes and bonds with maturities of two to 30 years offer yields around 6.5% today. Of course, taxation of the interest income from bonds is more onerous than capital gains realized from the sale of common stocks. For those investors whose capital is invested in municipal bonds, however, the returns from tax-free interest are comparable to the after-tax returns that Buffett foresees from common stocks.

Equally important, he only indirectly refers to an alternative approach to achieving above-average returns in the future. In all likelihood, the euphoric state of mind that characterizes today's investor will eventually give way to its polar opposite. Persistently high or low valuation markets have never—ever—lingered indefinitely, despite feelings to the contrary at the time they were seducing the investment public at large. Regression to the mean (and often beyond) is likely to manifest itself again, and often when least expected. The Dow Jones Industrial Average will not follow a string from here to 30,000 in 2016. (That's where 6% a year will take you.) The emotional road that leads from "irrational exuberance" to hard reality will most certainly be rocky. Patiently waiting for market prices of the companies he favors to reflect equanimity if not despair rather than unchecked optimism, Buffett will surely again snatch opportunity from the jaws of defeat, just as he did in 1973-74. He speaks confidently of 15% returns for Berkshire shareholders in the future. He will achieve them by buying superior businesses when they sell at prudent prices sometime in the future. And they will, as surely as night follows day. He will avoid the great temptations of the day alluded to above. Meanwhile, he sits on hordes of cash. Buffett had this to say as part of the chairman's letter in last year's Berkshire Hathaway annual report: "At yearend (1998), we held more than $15 billion in cash equivalents [including high-grade fixed-income securities due in less than one year—$36 billion if you include longer-term fixed-income securities]. Cash never makes us happy. But it's better to have the money burning a hole in Berkshire's pocket than resting comfortably in someone else's. Charlie and I will continue our search for large equity investments or, better yet, a really major business acquisition that would absorb our liquid assets. Currently, however, we see nothing on the horizon." How's that for a well-articulated strategy?!

What's a Long-term Investor to Do?

Humankind's recurring propensity to unwittingly fall victim to financial fads, follies, and foibles is like a bad dream that we can't get out of our mind. It's a vague but imposing countervailing force that stands in the way of us unequivocally embracing the new economic and capital-markets paradigm. Add to that the utter absence of anything approaching a healthy respect for risk by a large segment of the investor population and we have more than enough anecdotal evidence to compel us to fly the caution flag—if we truly believe that preservation of capital comes before all other aspirations. In other words, "To win, first you must not lose." The surest way us to press on toward your destination, while at the same time minimizing the risk of a skyjacking when risks of terrorism are running high, is to book you on a train until normalcy returns. Of course, it's not as fast—unless you experience an unexpected detour when traveling by air. A less certain but somewhat speedier alternative is to select another airline and a different route. With short- to mid-term U.S. Treasury notes and pre-refunded municipal bonds coupled with high-quality (but presently unglamorous and unloved) equity securities, we are attempting to keep you on your way via both vehicles. If conditions improve—that is, if prices move closer to value—it will be so much easier and less costly to transfer from train to plane.

INVESTMENT REDEFINED

In the depths of the Depression, chastened by his failure to foresee the stock-market crash and the enormity of the economic aftershock, Benjamin Graham reflected on the meaning of the term "investment" in the 1934 investment classic, *Security Analysis*. Years before the surreal madness of the late 1920s rendered rationality temporarily irrelevant, Graham recalled that an "investor" purchased stocks "at price levels he considered conservative in the light of experience; he was satisfied, from the knowledge of the institution's resources and earnings power, that he was getting his money's worth in full. If a strong speculative market resulted in advancing the price to a level out of line with the standards of value, he sold the shares and waited for a reasonable price to return before reacquiring them.

"Had the same attitude been taken by the purchaser of common stocks in 1928-1929, the term investment would not have been the tragic misnomer that it was. But in proudly applying the designation 'blue chips' to the high-priced issues chiefly favored, the public unconsciously revealed the gambling motive at the heart of its supposed investment selections." Investors' behaviors in the late '20s differed in one vital respect from earlier practices. The buyer made no attempt to determine whether shares were worth the price paid by the application of firmly established standards of value. The market simply made up new standards as it went along by accepting the current price—however high—as the sole measure of value. Continues Graham: "Any idea of safety based on this uncritical approach was clearly illusory and replete with danger." Under that line of reasoning, no price was too high to render a security unsafe.

Now that the 1990s have drawn to a close, I wonder what history's verdict will be of these extraordinary times. Will it remember the last decade of the 20th century as the beginning of a new era with fresh rules and modernized standards, or will it expose yet another episode of investment metamorphosing slowly but surely into rank and misguided speculation? Will the children of Generation X learn that their boomer parents were like the rising sun at the dawning of New Age economics? Or, as Jim Grant has suggested, is knowledge in the field of finance cyclical and not cumulative? Why, we ask, hasn't Holland's Tulip Mania of the 1630s slipped quietly into the obscurity of the archives of financial history? Why did Japan repeat in the '80s the destructive behavior that brought the U.S. financial markets and economy to its knees in the '30s? Are speculation and its inevitable aftermath an unavoidable part of the human condition? As memories of the lessons of the past fade over time, is each new and uninitiated herd of speculators little more than unsuspecting sheep being driven into the shearing barn to be periodically shorn? Is the casino capitalism of today, at rock(y) bottom, simply a new variation on an old theme?

It is to state the obvious that prices, particularly those of companies probing the frontiers of the new tech-based information age, have long been detached from traditional benchmarks of value. But it's not just concerns about the relationship between price and value that put a traditionalist on edge. Rather, it's also about how investors attempt to capitalize on what is taking place. Day trading, like Internet pornography, is a diversion with which most of us are unfamiliar. And yet, both thrive right under our collective nose. Encouraged by the apparent disregard for the nature of the relationship between the price of an asset and its underlying value, day traders provide additional anecdotal evidence of the prevailing atmosphere of speculative promiscuity. It is increasingly common to think of stocks not as fractional ownership pieces of a real business, but rather as pieces of gilt-edged parchment (or, more appropriately, formless entries on a monthly statement) that are to be bought and sold with impunity, much like baseball cards. Casino capitalism may, in fact, be a fitting moniker.

The cynic describes a long-term investment as short-term speculation gone horribly wrong. But, in our belief, "long term" and "investment" are as compatible and deserving of one another as love and marriage. Instead, the words "short term" and "investment" are the true oxymorons. Confusion about the difference can be dangerous to one's financial health. It is ironic indeed that the Internet has made possible day trading in, as you might guess, the Internet stocks themselves.

The Internet, of course, is reshaping every segment of the economy, but nowhere does that change occur at a greater pace than in the financial-services sector. Specifically, what's happening in the brokerage industry is a preview of things to come in other businesses. It's happening to brokers first because they aren't selling toasters or cars. Their products are intangible, so the transaction can happen purely electronically. When does affection become infatuation? For some, day trading is simply the new game in town. Conditioned by the lottery, the proliferation of gambling casinos, and now television shows such as Regis Philbin's "Who Wants to Be a Millionaire?" Internet day trading has become the newest "easy money" fad.

The New Tulip Bulbs?

Shortened time horizons have become a fact of investment life. How much has turnover increased? According to *Business Week,* some 76% of the shares of the average U.S. company listed on the New York Stock Exchange turned over last year, up from 46% in 1990 and only 12% in 1960. It was running at 82% through May 1999. On the Nasdaq, home of the greatest proportion of high-tech companies, turnover was three times as high. *Time* magazine's 1999 "Person of the Year," 35-year-old and delightfully affable Jeff Bezos, Amazon.com's founder and CEO, leads a frenetic and exciting life—and so, apparently, do the shareholders of the company leading the e-commerce revolution. The average share in Amazon.com Inc. is now held for *seven* trading days before being sold to someone else. Yahoo! shareholders stick around for all of eight days. As for the more mature technology companies, the holding periods are longer: Dell Computer (3.7 months), Microsoft (6.3 months) and Cisco (8.5 months). Even the consummate hold-it-for-a-lifetime investment, Coca-Cola, sees its ownership turn over every 2.2 years. At the height of Tulip Mania bulbs were not coveted for the beauty to be derived from their eventual blossoming but to turn a quick profit. Most were never planted. Tulip bulbs were simply the fast-buck medium, incidental to the real objective. They could just as easily have been … ah … Internet stocks!

Of course, most of the churning today can be traced to mutual funds, which own a higher percentage of stock than ever. Constantly under pressure to achieve short-term performance objectives, fund managers are quick to change horses, often midstream. For investors in the highest brackets, taxes on the gains from shares held less than a year are double those held more than 12 months. The shareholders of most mutual funds include individuals whose gains are taxable, as well as tax-deferred entities (such as 401(k) plans). Taxable investors get the short end of the stick in this high-turnover performance derby.

More Dollars Than Sense: Day Trading's Day Trippers

The "Day Tripper" of Beatles lore could well have been the precursor three decades ago of this era's day trader. In August of '99 Alan Abelson, the erudite *Barron's* columnist, looked inside the murky world of day trading. He highlighted the findings of the North American Securities Administrators Association (NASAA), which comprises various and sundry state regulatory bodies that had spent months probing the nooks and crannies of the "bucket shop" day-trading world, poking into such delicate subjects as commissions, suitability standards, and the whereabouts of the customers' yachts. (Ameritrade, the on-line broker, recently lost what could prove to be a landmark arbitration case involving an Indianapolis med-school graduate who was trying to speed the payment of his student loans by trading Internet stocks on margin.) One of NASAA's conclusions, which raised many an eyebrow, was that an estimated "70% of public traders will not only lose but lose everything they invest." Another of the report's striking revelations concerned the "annualized cost/equity ratio." This neat little number "measures the amount of profit required on average equity just to pay transaction costs and break even." That ratio is an astonishing 56%. In other words, on a $100,000 account, you have to make a mere $56,000 just to pay your commissions! The fascination with day trading, apparently, is a lot more like gambling than most people think. Fittingly, so are the results.

As long as we're on the subject of illusions, a word or two is in order about the IPO (initial public offering) express train to riches. As anyone who reads *The Wall Street Journal* or watches CNBC is aware, the Boston Chicken-type IPO market is back en masse. You may recall that we expressed our doubts about the Boston Chicken phenomenon in the 1993 annual report. When it debuted in 1993 amid great fanfare, the Chicken's price in the aftermarket rose an unprecedented 150% from the offering price. The Ponzi-like capital structure imploded five years later, and the company, like its stepchild, Einstein's Bagels, sunk into the ignominy of bankruptcy. McDonald's recently purchased the remains of the company for pennies on the dollar. This time it is the Internet that is center stage—and the sellers are more clever than ever. In earlier superheated IPO markets, sellers would be suing their underwriters for under-pricing the issue if the price in subsequent trading rose by the kind of percentages that are widespread today. This is not so nowadays because by intentionally keeping the initial offering relatively small, in the face of supercharged demand, a scarcity premium is created, and the post-sale price often skyrockets. It is on the strength of that price that real money is raised in a subsequent "secondary" offering. The illusion is that there is lots of easy money to be made by investing in IPOs. In reality, the people who take serious money off the table are the sellers. As for the buyers, recently disclosed secret "pot lists" indicate that institutions, who carry nearly as many sticks as the commission dollars they spread around like so much grease on the wheel, receive 70% to 80% of the allocation of the first round. In all probability many of the retail buyers who bite the bullet in the aftermarket or in a secondary offering will be the first to scramble for a chair once the music stops.

As to the seductive appeal of greed and folly mentioned early in the report, need more be said? Finally, when an epidemic of high-turnover speculation has displaced long-term investment as the standard of conduct in the financial markets, the end game is almost never pleasant.

LEDGER D'MAIM

A segment in last year's report elaborated on the disquieting changes taking place in the financial accounting of American business and industry ("It's a Numbers Game"). The practice of "managing earnings" is so widespread as to be considered the new standard. All too frequently as analysts we find it necessary to summon our skepticism, to turn a vigilant eye toward financial disclosures so that fact may be separated from fiction in order to avoid being led astray. While we think the subterfuge is most unbecoming of those whom we'd expect to trust unconditionally, we are stimulated, like Sherlock Holmes, by the search for the truth.

Regression analysis leaves no doubt that *earnings growth is the single most important driver of stock prices (and, conveniently, stock-option profits) over the long haul*. The tone of the discussion in the 1998 report was firm, though hopefully short of sounding judgmental. When the Berkshire Hathaway annual report hit the Internet two months later, however, chairman Buffett's demeanor was not so circumspect or mild-mannered when he turned to the subject of accounting abuses. Admonished Buffett, with neither sympathy nor charity: "Clearly the attitude of disrespect that many executives have today for accurate reporting is a business disgrace. And auditors, as we have already suggested, have done little on the positive side. Though auditors *should* regard the investing public as their client, they tend to kowtow instead to the managers who choose them and dole out their pay." Buffett, perhaps to use his bully pulpit as Bernard Baruch might have to speak out for the culture of capitalism (as well as his own playing field), lashed out at recalcitrant managers in general who, like the environmental polluters of old, appear to have little regard for the damage they are doing to the foundation of the ideology that has served the American dream so well.

In the spirit of fairness, it also should be noted that Berkshire Hathaway is an investor in two prominent companies, American Express and Coca-Cola, at which certain accounting practices may be skirting the edge of propriety. At a recent American Express analyst conference, chairman Harvey Golub admitted that the gain-on-sale accounting employed in securitizing credit-card receivables is used in part to "manage earnings" during a period of time when the company is incurring heavy expenses in developing an Internet presence. Berkshire is American Express's largest shareholder. More directly, during Buffett's tenure on the board of Coca-Cola, the company's accounting of its relationship with affiliate Coca-Cola Enterprises, according to some accounting professionals, may have been stretched to the point where it violates the spirit, if not the letter, of the law. Furthermore, both companies embrace the use of stock options, a practice that Buffett generally abhors. In the end, he no doubt finds the economics of the businesses so compelling that he is willing to overlook troubling imperfections. In any event, emboldened by his annual-report invective, I respectfully submit a sequel.

(Besides, the genie is out of the bottle. We whose job it is to dig through the minutiae of accounting to discover what's at the economic core of businesses are aware that the media already smell a conspiracy. Cover stories like that from the September '99 issue of Bloomberg's *Corporate Finance* magazine, "The End of Earnings As We Know Them?" or Carol Loomis's August 2 *Fortune* magazine feature, "Lies, Damned Lies, and Managed Earnings—The Crackdown Is Here," or *CFO* magazine's December issue "The Party's Over—FASB Is Ready to Turn the Lights Out on the New Economy's Favorite Accounting Practices" … all illuminate the goings-on behind closed doors and beneath green eyeshades. Filtered and synthesized, it is passed on to you.)

To properly set the scene, it is helpful to remember that aggressive if not opportunistic accounting practices must be viewed in the context of the larger theater. The market's valuation methodology of businesses in this new economy has shaken free of traditional, even archaic, ties to tangible assets. Without the cathartic effect of occasional serious recessions (the last steep contraction was in 1974-75, and the last shallow but long one was in 1981-82), attention has drifted away from the presumed reassurances that tangible assets provided in the past. In point of fact, physical assets, particularly in this information-driven age, are not very good stores of value anyway. What the valuation link to tangible assets subtly accomplished before the roaring '90s, however, was to keep flights of fancy within the bounds of reason. No longer are those safeguards in place in a valuation scheme that knows no bounds, benchmarks, or (therefore) limits. All is now antiquated, except for an upward-sloping earnings-per-share trend (or the distant prospects thereof in the Internet's cyberspace). The latest iteration is "cash earnings," about which more in a moment. Accordingly, it should come as no surprise that the corporate executive who is in step with this new-era thinking "reverse reasons" his decision-making toward the ultimate goal of achieving a straight-as-a-string and ever-rising earnings curve. Such an end certainly doesn't excuse expedient and often borderline means, but it may make such transgressions more understandable.

In Acquisition Accounting, Two Plus Two Can Equal Five

My friend and former associate, Albert Meyer, was a bit more specific than Buffett. Albert, as a number of you may like to know, has found a home that suits him well at David T. Tice & Associates in Dallas. Tice publishes *Behind the Numbers,* one of the few independent research services in the industry that provides in-depth "Quality of Earnings Warnings and Sell Recommendations" on U.S. equities. On October 14 of last year, following some frustratingly dead-end forensic accounting research, Albert published a report posing rhetorical questions about the acquisition accounting practices and methods of financial disclosure at Tyco International. (Officially based in Bermuda but managed from Exeter, New Hampshire, Tyco is a diversified conglomerate with interests in electronics, disposable medical supplies, undersea cable, fire and security systems, and other businesses.) CNBC took the kernel of doubt alluded to in Albert's report and threw it into the hot grease of a skittish investment public still bubbling from the Cendant, Oxford Health, Sunbeam, and other celebrated sleight-of-hand disasters. The CNBC story was followed by a chorus of adamant denials from Tyco's chairman, L. Dennis Kozlowski, and a phalanx of Wall Street brokerages caught in the cross fire of divided loyalties. By mid-December the stock was halved, surrendering some $40 billion in market value. (It has since recovered some of the lost ground.) The erosion of wealth that Tyco shareholders suffered understandably is unsettling to Albert Meyer. And yet he only raised the question.

We have not singled out Tyco to be a whipping boy with malice aforethought. We have no familiarity with its CEO or anyone else on the board and no reason to point a righteous finger at Tyco beyond the easy access to fact and opinion about its alleged improprieties. Rather, by putting the spotlight on Tyco, we may help to illuminate the universe of possibilities for accounting legerdemain. Of course, the Tyco tale may prove to be nothing more than a witch hunt by an overzealous media and SEC chairman. In any event, a recent SEC inquiry may imply that per-share earnings growth has been more synthetic than real. On December 9, two months after the fur first flew, the company announced that the SEC's enforcement arm has requested documents supporting the way it has accounted for charges and reserves related to its acquisitions in the last six years. The avaricious Tyco had gobbled up more than 120 firms at a cost of more than $30 billion and had taken about $3 billion in restructuring charges in conjunction with those deals.

Pushing the limits on creative-acquisition accounting, Tyco has not only established "cookie jar" reserves of its own, but it has been asked by the SEC to provide documents related to charges taken by companies acquired by Tyco in the six months prior to completion of the deals. AMP and U.S. Surgical Corp., two well-known targets, took substantial charges just before being folded into Tyco. The charges allowed Tyco in later periods to show higher profits and growth rates than it would otherwise have achieved. Accelerating asset write-offs prior to a pooling works wonders in the post-acquisition period. It's not too bad in a purchase transaction either, except that such write-offs inflate the goodwill number, but a 40-year write-off period makes it considerably more tolerable.

Tyco executives have said that the charges were taken for legitimate reasons and conformed to proper accounting practices—and that sophisticated investors have discounted any resulting distortions in its growth rates. Perhaps, but it's hard to express full confidence in a management whose other activities give rise to legitimate questions about their motives. (See discussions on stock options below.) One of the more intriguing challenges before an analyst is to verify internal consistency among all the pieces of the corporate puzzle.

Apart from Tyco, what may be the unspoken motives behind the acquisition binge in corporate America today? To be sure, there are countless good, even commendable, rationales for buying rather than building. Gaining market share (to achieve economies of scale, spread automation costs, strong-arm rivals), vertically integrating (forward or backward), extending product lines, or filling in the gaps are among them. Many are rooted in the basic need to redeploy retained earnings if internal investment opportunities simply don't exist or fail to meet threshold-return minimums. A board of directors can opt to distribute redundant resources to shareholders through dividends and share-repurchase programs. Such passive behavior, however, is rarely consistent with the conquistador image that likely catapulted the CEO into the executive suite in the first place. Most managers tend to be temperamentally predisposed more toward action than reflection. If demand for one's products or services is stagnant or growing only modestly, these executives are inclined to look elsewhere for initiatives to put a shine on a tarnished corporate image—in effect, corporate makeover by takeover. Again, such actions can be and often are worthy of praise. As apparently was the situation at Tyco, though, the temptation to find shortcuts in order to curry Wall Street's favor may have become too much to resist. Acquisitions can provide a plethora of opportunities to better manage earnings, if not actually spur their growth.

Growth accomplished through acquisitions sometimes can be likened to the flavor of instant coffee. By contrast, well-conceived and painstakingly executed internal growth has the aroma and taste of a hand-ground, freshly brewed pot of Starbucks premium blend. The differences are as subtle as they are significant. As for organic growth and its consequence, deferred gratification, it is common for investments to be made and expenses incurred long before the first dollar of new revenue is recognized. Until assets are fully utilized, the cost of internal growth can weigh heavily on overall corporate results. The time between investment and payback can be, and often is, years. Depending on the characteristics of a publicly traded company's business, as noted below, the market's valuation response can range from supportive to harsh. And as pointed out above, an ever-expanding majority of CEOs is acutely sensitive to the judgment of Wall Street analysts on such matters—and regularly find growth through acquisition to be more compatible with both corporate and personal aspirations. Although rarely highlighted, the perceived business risk to the CEO of buying an up-and-running business is obviously less than starting one from scratch. It seems to matter not that embedded in the purchase price is a premium to compensate the seller for start-up risks assumed and overcome. The favored horse offers the lowest payoff. What, we wonder (as we think about ends and means), is the ultimate objective of Kozlowski's almost frantic external-growth strategy?

Pool's Closed

The Financial Accounting Standards Board (FASB) is attempting to curb the abuses common to acquisition accounting. Last year in this report we wrote about the two principal methods by which companies account for mergers and acquisitions and, accordingly, will touch on them only briefly here. In the case of pooling, the books of the two companies are simply blended as if they had been joined forever. As explained above, if the transaction is accounted for as a purchase, the acquiring company adds the freshened-up value of the assets acquired to its own balance sheet, with the remainder of the purchase price debited to goodwill. The acquirer is then obligated to amortize that premium (and thus reduce reported annual earnings by such non-cash charges) over a period of up to 40 years. By way of recent example, last year Internet navigator Yahoo! in a pooling transaction paid about \$3.6 billion in stock for GeoCities (whose own assets totaled a relatively paltry \$130 million at the time), a company that helps people create their own Web sites. Had Yahoo! officials accounted for the transaction as a purchase, the company would have needed to write off \$3.4 billion against its future earnings.

In a display of righteous indignation, FASB has proposed that the pooling option be terminated effective January 1, 2001. Pooling, to put the practice in a global context, has never been practiced in Europe. By contrast, U.S. companies have completed more than $1.6 trillion in deals by using pooling in the last 10 years, according to the Securities Data Company. With purchase accounting likely to become the only game in town, a frontal assault on goodwill is at hand. As if to add insult to injury, the accounting standard-setters also have proposed shortening the goodwill amortization term to 20 years. Yielding to the kind of shortsighted, special-interest-group pressures that make Buffett's blood boil, FASB is likely to soften the blow.

Cash Earnings

No sooner had accounting rule makers made their case against pooling when there appeared out of thin air a redefined term that seems to have mollified the protesters who resent being required to recognize goodwill in future-purchase transactions. "Cash earnings" may be destined to supplant Generally Accepted Accounting Principles (GAAP) earnings—the standard since FASB was established in 1973—if the current wave of sentiment continues to gain momentum, as now seems almost certain. Intel, a wonderful company that has innovated and prospered as few companies have, has sadly lent its good name to the rickety concept of "cash earnings." The shorthand definition of "cash earnings" is GAAP earnings with amortization charges added back. In those instances where the reporting company is not an active acquisitor, there may be no goodwill amortization to add back, but in others, such as IBM, it starts to get serious ("cash earnings" exceed GAAP earnings by 38%).

The devil is in the details. An acquisition-driven company that is sensitive to the earnings impact of its actions may establish "cookie jar" reserves with deceitful intent. Reversing surplus reserves conveniently exaggerates GAAP earnings, which are further embellished when amortization charges are added back to arrive at "cash earnings," all the while cash is being expended in implementing the restructuring (plant closings, personnel severance costs, and so on). "Cash earnings" must not be evaluated apart from the cash-flow statement. So much for shortcuts ...

Moreover, if proponents of the scheme prevail—if goodwill is to be amortized, but the charges that result are immediately added back to profits to arrive at "cash" earnings—Siegfried and Roy may be dethroned as the masters of illusion. Under this sleight of hand, goodwill can be made to gradually disappear on the balance sheet while the process of writing it off actually enhances reported "cash" earnings on the income statement. The increasing reliance on gimmickry, which we see as most unfortunate, probably assures a savvy analyst of a steady paycheck. Nonetheless, if we had our druthers, we would prefer spending less time ferreting out such skulduggery. The charade may be having an unwanted consequence. In the broader sense, if many of the costs (both past and future) incurred in the pursuit of growth need not be acknowledged by an acquisitive company, why would any ambitious CEO choose to pursue growth Smith-Barney's old-fashioned way?

As a practical matter, if our research leads us to conclude that purchased goodwill is a perpetual asset (like an unassailable competitive advantage or brand identity), we see no reason to systematically reduce its carrying value through amortization charges. The cost of the acquisition will appear in the denominator in the calculation of return on investment. Whether it issues debt or equity, the buyer's future earnings, presumed to be enhanced by the acquisition, will be measured against a larger capital base. That is why we examine return on equity and earnings growth under the same microscope. Admittedly, those companies that issue high-priced stock to fund their acquisitions enjoy a significant, albeit often temporary, advantage in the takeover game. Eventually, though, water seeks its own level. The proposed America Online acquisition of Time-Warner has brought discussion of the issue to the fore. For those of us with long memories and an appreciation for the cyclical patterns in finance, the names of the erstwhile conglomerateurs of the 1970s, Jimmy Ling and Charlie Bludhorn, come readily to mind.

Parenthetically, the market-price toll that Wall Street exacts for the cost of growth is inversely proportional to the degree to which the potential is deemed to be without limit. Amazon.com, seemingly hell-bent on becoming the Wal-Mart of cyberspace, is such a company. (Wal-Mart, never asleep at the switch, has the same idea with its spin-off, as you might have suspected, called Wal-Mart.com.) According to a recent "20/20" network television interview with CEO Jeff Bezos, the 5-year-old Amazon.com has yet to make a profit. In fact, it was expected to lose a record $200 million in 1999, to be eclipsed in 2000 by red ink of $500 million. Market capitalization? A mere $30 billion and rising. Earlier it was mentioned that American Express, the less surreal and thus more predictable financial-services behemoth, was chastised by an analyst for pushing the envelope on its gain-on-sale practices—in order to offset the start-up costs associated with developing an Internet presence and thus avoid offending earnings-growth-conscious Wall Street!

The Restructuring Charge

According to the 1998 Berkshire Hathaway annual report, the "restructuring charge" is well-nigh ubiquitous: "A preliminary tally by R.G. Associates, of Baltimore, of special charges taken or announced during 1998—that is, charges for restructuring, in-process R&D, merger-related items, and write-downs—identified no less than 1,369 of these, totaling $72.1 billion. That is a staggering amount as evidenced by this bit of perspective: The 1997 earnings of the 500 companies in Fortune's famous list totaled $324 billion."

The restructuring charge is so commonplace that "big bath" disclosures rarely turn an analyst's head anymore. It remains the most subtle and effective way to manage earnings. With deft use of the restructuring charge, the earnings trendline can be made steeper and straighter.

We'll not again mention the marquee companies for whom the practice of using the restructuring charge has become a way of life, beyond this update: They remain steadfastly unrepentant.

Stock Options and the Keeper of the Castle

It was implied above that there is room to doubt Tyco Chairman Kozlowski's allegiance to shareholders. For whom, in other words, is the monarch working? Albert Meyer also provided detail on the CEO's compensation. Lest there be any doubt, managed-earnings growth, rising stock prices, and stock-option programs are cut from the same "regal" cloth. I'll describe the compensation package and let you decide if it amounts to a king's ransom. If you conclude that his behavior toward the company's absentee owners is at least open to question, it should come as no surprise if the SEC in the fullness of time concludes that he might have been playing a little fast and loose ... with perhaps less than an altruistic end in mind.

Acquirer Kozlowski's cash salary/bonus compensation for both 1997 and 1998 was $3.7 million. We have no basis to judge whether that amount is fair and reasonable. However, the 5.2 million share-option grant, as well as the 380,000 shares of restricted stock (both issued during the two-year span), did catch our attention. Before "the fall" brouhaha, the value of such self-bestowed largess exceeded $200 million. Come to think of it, the salary/bonus payment doesn't seem so big after all! What do you think?

Despite the difficulty these days in finding a company proxy statement that doesn't feature a generous executive (and with increasing frequency, a board of directors') stock-option program, we think the extensive use of options as compensation raises legitimate questions about motives. The first brings us back to the practice of managing earnings. Kozlowski's options, whatever their value at the time of issuance, never appeared as an expense on an income statement. CEOs intent on putting their best earnings foot forward—to say nothing of positioning themselves for a possible bonanza in stealth compensation—will invariably opt for the kind of compensation that isn't counted … by the auditors (or laid bare before the shareholders). And that's the second point. Where, we wonder, are the shareholders' principal advocates—the board of directors—when all this till-dipping is going on? Maybe it wasn't a board member who thought up the idea of options for directors any more than it was a fish that discovered the ocean … ?

Stay tuned.

THE FOUNTAINHEAD OF EFFECTIVENESS: INTELLECTUAL CAPITAL

The efficacy of an investment advisory firm flows from its intellectual capital, from the competence and character of the people who attend to its clients' needs and who decide what and when to own or avoid. Last year, perhaps more than ever before, the truth of that statement became clear to me. I watched with admiration and respect as Dennis, Todd, and Drew assumed greater responsibilities with dedication equally matched by enthusiasm. Under Dennis's purposeful tutelage, our growing and maturing research capabilities have become one of two essential building blocks in our commitment to continually enhance the satisfaction of those whom we serve. Todd, working side by side with Dennis, has been a tireless proponent of an increased commitment to client service, in addition to shouldering his share of the research duties. The transfer of custody and trading to Merrill Lynch is but one of the more obvious initiatives in that area. Our mutual investment in high-profile MBA programs, while a little imposing at the time, has paid rich dividends. Drew, who wore more hats than anyone else last year (and he looked good in all of them), is quickly training our able new trader, Kristin Antalavits. Drew will, forthwith, assume much greater portfolio management and research responsibilities, for which he is well-educated and trained. Shawn Harrison, our "interned" intern, if you will, is giving as much as he is getting in his stint as an apprentice.

In recognition of their growing contribution to the firm, Dennis and Todd will be offered the opportunity to increase their ownership interests in the partnership. As has been mentioned in the past, my sense of security is inversely proportional to the size of my slice of the ownership pie. Moreover, it is proportional to the number of committed and able partners among whom the ownership is shared.

We did not use Charlie Kirk's considerable talents as effectively as we might have last year. Although we looked hard, few mouth-watering private investments came across our desks. If the drought continues, we expect to avail ourselves of Charlie's wise and experienced counsel in the assessment of investments in marketable securities. As always, he will adroitly offer the counterviewpoint when he feels it is needed.

The hub at the center of our spoke-and-wheel structure continues to be in the persons of Jan and Lynn. They do the heavy lifting, leaving the light work for the rest of us. Their goal is to be error-free. I only wish the professional team could justify entertaining such lofty aspirations!

THE WAY WE DO BUSINESS

We keep no secrets from our clients. As an open-book kind of place, we invite you to inquire any time about anything in our business that may not be self-evident. We welcome questions about what we consider to be our most important responsibilities in tending to your needs, how we manage risk in the search of return, how we choose the benchmarks against which we hope to be measured, and what are the ends for which our day-to-day activities are the means. We also invite inquiries about how we have limited our reach to strengthen our grasp—how the conscious choices we have made about the activities we can and cannot perform define our niche in the competitive arena of investment management. In the meantime, we willingly offer the following look at the way we conduct our business.

Martin Capital Management's client-related activities fall into three primary functional areas: client service, research, and portfolio management. First, we are in business to provide investment-management services to a very narrow segment of the investment-advisory population. Our clients are typically wealthy individuals who have full responsibility and authority for their own portfolios. It is at their desk where the buck stops. Most have entrusted us with nearly all of their investable assets. We also manage endowment funds, often for organizations where an individual or a small group of people has predominant influence over the decision-making process. The total-return orientation of high-net-worth individuals and endowment funds is surprisingly similar, though the taxation of income and gains is quite different. The intensive rather than extensive service orientation is closely associated with the process of asset management, which carefully matches portfolio actions with personalized investment goals and objectives.

Everything we do and are begins with the notion that serving those who have placed their trust in us is the reason we exist. Period. Without unswerving allegiance to that conviction, nothing else really matters. We expect every person who is part of our team to be totally absorbed with meeting and exceeding the expectations of those we are privileged to call our clients. That commitment mandates the first of several trade-offs that our specialized niche requires. The ratio of competent professionals to clients must be very low, a fraction of the accepted industry norm. Every client has a name—and no one has an account number, a relationship manager, or anything else that gets in the way of open, direct, and effective communication.

Next is the most skill-based and time- and travel-intensive of our activities—investment research. Collectively, 3,000 to 5,000 hours are dedicated to that critical activity every year. (See section titled "Man's Search for … Answers.")

From the portfolio-management perspective, the needs of our clients differ markedly from those of mainstream investors. Most of our activities are tailored to serve those unique needs. As a practical matter, our high minimums ($2 million) make extraordinarily high professional-to-client ratios economically feasible. High-net-worth individuals appear to be more comfortable having their needs attended to by portfolio managers who are intimately familiar with the businesses that populate their portfolios, along with the capital markets in which the companies trade, as only a fully trained and accredited analyst and portfolio manager can be. Some of our more assertive clients ask to see the personal portfolios of those who manage theirs; this request is always granted. That's the first request I also would make were the shoe on the other foot. The second would be to ask for the number of portfolios my manager oversees. We expect to be better portfolio managers because we are business analysts, and we are better business analysts because we are portfolio managers.

Further, we recognize the importance of the "experience curve" in constantly improving our capacity to serve our clients. The combination of concurrent academic preparation and front-line experience cannot be easily or quickly replicated by others. We estimate that it takes eight to 10 years to develop a skilled analyst. Post-graduate education (CFA, minimum three years; MBA, minimum two years) alone consumes five years of evenings and weekends. Of course, the lengthy learning curve places a cap on the rate of growth in new clients that a firm such as ours can sustain. And that suits us just fine.

While it might not be obvious at first glance, an advisory firm's culture and business strategy play a pivotal role in enabling and empowering a whole range of complementary activities, including a narrowly defined research focus that implies additional trade-offs to which I'll turn in a moment. Even the minuscule slice of the American business pie to which the MCM search/research effort is dedicated dictates who will perform the work, under what circumstances, and through which processes. Consciously limiting a firm's equity-idea generation to businesses with presumably high and stable returns on capital is itself critically dependent on several conscious choices that an investment advisory firm makes with regard to how it conducts all the various activities that are essential parts of its business makeup.

To begin, we are often asked how an independent investment advisory firm with five analysts can stay on top of the goings-on at the thousands of public companies listed on the major exchanges or trade as part of the Nasdaq system, to say nothing of overseas companies whose American Depository Receipts (ADRs) trade here or whose shares trade on foreign exchanges. The short and obvious answer? We can't. To be sure, owing to spectacular technological advances, manifested in a smorgasbord of databases as close as a few keystrokes on our PCs—including Bloomberg, FactSet, Multex, Dow Jones on-line services and the rest of the vast Internet pipeline—we have direct access to heretofore unimaginable volumes of data. Of near equal importance, this veritable cornucopia of information need not be physically handled or stored. Thanks to technology, accessibility is no longer the line of demarcation between the behemoths and the boutiques. For most advisors of reasonable size, a wealth of information at one's fingertips has the potential to greatly leverage a firm's human capital. Such availability, though, is a mixed blessing. Whether a firm realizes it or not, a much diluted service offering will result if the apparent trade-offs are not recognized and addressed. Simply put, more of one thing necessitates less of another. Continuing in the lexicon of trade-offs, we believe "less is more." Despite the enticing appeal of the information revolution, we must constantly guard against being overwhelmed by it. Insidiously, the new information paradigm cultivates the temptation to try to be all things to all people.

We have chosen, instead, to tap into the information pipeline very selectively, recognizing that our objectives with regard to investment-idea generation are so narrow and specific that staying small and tightly focused creates an excellent fit between our intellectual capital and the purposes to which it is put. By staying clear of the superfluous and the irrelevant, as well as the downright ugly, we are able to commit the necessary time and talent to learn a great deal about a relatively small number of high-return businesses. Ready access to a vast supply of company data simply makes the process more efficient and us more productive. Our willingness to commit large amounts of capital to a relatively small number of companies in which we have high confidence—and then to hold them so long as the growth in their intrinsic per-share worth is satisfactory (and the market price does not advance to unreasonable heights)—fits hand in glove with our search/research activities.

Furthering the fit, our clients often bring a businessman's perspective to the process of investment selection. Since they have typically accumulated their financial resources in one business, the idea of eventually diversifying among 10 to 15 others that often enjoy competitive advantages equal or superior to what their own company has or had can be quite appealing, as well as comforting. It's a natural extension of a lifetime of thinking and doing. They can continue to view wealth management as a businessman does, rather than from the less-familiar vantage point of a stock-market trader.

The cornerstone of our overall business strategy, of course, is the education- and experience-based competence, along with the essential companion virtue of honorable character, of our team members. We pledge to our clients to continue to work diligently to be the best we can be, to view what we do as a cause, not just a job. We are aware that our investment in professional development is likely to go unrecognized in runaway bull markets where everyone appears to be a genius. It is only when the tide goes out that you discover who is swimming sans swimsuit. We have prepared meticulously should the waters indeed ebb; our future rests on being exposed! Further, it hasn't escaped our attention that the best-qualified candidates cannot be expected to join any advisory firm without the chance to thrive creatively, to make contributions that count, and to aspire to eventual ownership. As an independent partnership, we are ideally structured to meet those needs.

Turning again to the issue of trade-offs, our conscious choices mean that we have little appeal to those whose modus operandi in the capital markets would cause them to be identified with the ever-growing speculative contingent. We only invest in those businesses that both we and our clients will feel quite content holding for a long time. Imagine how exclusionary that practice is. We are not in the business of buying rising prices; most often the opposite is true. Nor, in another arena, do we have anything to offer those who wish to speculate in the bond market. We limit our purchases of fixed-income securities, both taxable and tax-free, to the highest-quality credits, minimizing worry about the next interest check. Portfolio growth, we have long contended, is best accomplished through the ownership of businesses whose intrinsic worth is growing—purchased at prices that ensure a comfortable margin of safety—not by rolling the dice with fixed-income securities of substandard creditworthiness.

Our clients have a decided preference for maximizing *after-tax* returns. Highest-grade, tax-exempt bonds and long-term capital transactions that avail us of the favorable 20% tax rate on assets held for at least a year are two of the more obvious alternatives. The after-tax predisposition of our clients is well-accommodated by our long-term, low-turnover, portfolio-management style that itself naturally flows, as noted above, from the kinds of companies we seek out as investments.

Strategic fit among most if not all corporate activities is essential in forging business advantage, as well as in sustaining it. The highest order of activity interaction results in "optimization of effort." This requires coordination and information exchange across activities to eliminate and minimize wasted work; this is the most basic type of effort optimization. Our small size and corporate commitment to leading-edge computer technology greatly facilitate the internal exchange of ideas and tasks. It is most difficult for a rival to match an entire set of interlocking activities. Such interdependency creates pressures and incentives to improve operational effectiveness, which makes imitation that much more difficult. We are keenly aware that such a strategy requires that we do many things well and that we integrate them with precision and purpose. No mean feat ...

Incidentally, our research is produced exclusively for internal consumption. We are self-owned and have no investment-banking or other affiliations that might attempt to compromise the independence of our judgments. Furthermore, we do not sell or give away indiscriminately something that is really not ours—the product of our search for investment ideas. Our concerns about the objectivity of Wall Street research leave us no option but to generally avoid it. The benefit is that our staff is not inundated with reams of research reports on companies in which we have absolutely no interest, not to mention a steady stream of phone calls from sales reps who are trying to hawk the same. Of course, since we don't engage in the common industry practice of using assets from your portfolio to pay commissions that, in turn, can be used to purchase sell-side research, we have nothing tangible to offer in exchange, even if we were so inclined. Again, there are trade-offs. Because of our choices, we don't have access to many sell-side analysts who are singularly good at what they do. Even if we did, though, we would surely think twice before taking their advice. First, we would have to satisfy ourselves that the purveyor's loyalty is uncompromised, a difficult task at best. Second, we would still have to know the company well enough to appreciate any significant biases that might skew the analyst's judgment.

A package that consists of keeping the roster of clients small, service levels intensive, research narrowly focused and in-depth, and portfolio-security quality extraordinarily high and rationally diversified is what MCM offers its clients—all performed by talented people whom you know personally. Everything else we gladly leave to others.

MAN'S SEARCH FOR ... ANSWERS

If your eyelids are beginning to feel heavy as you enter this report's homestretch, picture this. Those of us who labor in your service began 1999 with the ambitious plan for all analysts to read the 1998 annual reports of all of the companies that make up the S&P 500. We confess to coming up a bit short of our goal, in large part because we didn't appreciate how many oil, utility, and mining companies there are in the index (71 companies, if you're curious). Irrespective of one's love for business, there are only so many mundane companies in mediocre industries on which a busy analyst can stay focused. Nonetheless, our goal was essentially accomplished. We learned a lot.

Even though we were reading "annual" reports, we are always interested in the financial history of a company, if for no other reason than to frame the current results in the context of time. We were struck by the numerous "hockey stick" growth patterns in earnings per share (EPS). After plateauing in the late 1980s and early 1990s, EPS growth resumed impressively in the last five years or so, while profit margins surged to the high end of the range that has historically defined the boundaries in the tug of war between capital and labor. The typical chairman's letter was a little long on hyperbole and a little short on forthrightness. One might infer from the upbeat letters in the annual reports of some downbeat companies that the business cycle has been deemed obsolete. Corporate profits will not overtake GDP, however. There will be some disappointments.

We found that many companies are doing more than talking about business focus. There has been an increasing amount of attention directed to the efficient allocation of resources, driven by the goal of enhancing return on invested capital. The end result is often the sale or divestiture of underperforming divisions or subsidiaries. These business initiatives are often explained by terms such as "core competency" and "economic value added" (EVA). Whatever buzzwords may be used to depict the changes, we wholeheartedly endorse the general practice of allocating capital to the businesses that are most likely to achieve threshold-or-better returns for shareholders. Thus, we must conclude (notwithstanding the often more-visible exceptions) that while business in general has had the wind at its back, the managers of corporate America are also leaner and meaner. Competition forces us all to get better or get out.

Somewhat unsettling in the midst of truly impressive corporate performance is the increasingly omnipresent "restructuring charge." Those companies that have not restructured are the exception rather than the rule. Of course, many of the restructuring charges legitimately reflect the costs associated with changes in strategy and focus discussed above. It has not escaped our attention that EVA targets are more easily accomplished after restructuring charges shrink the capital base! While acknowledging that restructuring charges often go hand in hand with corporate makeovers, the seeming ambivalence of the board and "the street" toward the corporate mistakes that gave rise to the charges in the first place is a bit disconcerting. Moreover, the ethically challenged manager is often inclined to try to make a silk purse out of a sow's ear. (See above for the discussion of the "big bath" restructuring charge in the section titled "Ledger d'Maim.")

The facts depicted in the financial statements obviously warrant careful inspection, but we find no other part of the annual report as illuminating as the chairman's letter. This part of the report gives you the best chance to view the business through the eyes of the chief decision-maker.

Chieftains Beating a Drum—or a Dead Horse

We found enormous differences in the messages of various corporate chieftains. The CEOs of companies in economically anemic industries are inclined to measure performance relative to others in the industry. If you don't know the industry, you can easily misconstrue the investment meaning of a vigorous and impassioned message. Others will cite tangible accomplishments relative to hurdle rates or other corporate benchmarks. Still others skip the quantitative and go right to obfuscation. These annual reports nearly always begin the same way: "1998 was a year of great progress," or "1998 was a year of transition." That's when we reach for the 1997 report!

Some CEOs give evidence that it is the shareholders to whom they are first obligated, whereas others seem to confuse the issue by giving priority to other stakeholders. Many chairman's letters reveal a proactive mindset, clearly articulating well-conceived business plans, while others leave you with the impression that the chairman is a corporate cheerleader who is deft with the pompoms but has no idea of the score. One of the analyst's tasks is to reconcile the brilliance or the blather with the bottom line.

More Than One Way to Skin a Cat

As many of you know, the research process at MCM culminates with an in-depth report on a company. After company visits, conversations with competitors, suppliers, and customers—as well as extensive searches on everything that has been written on the company or its industry—a 10- to 20-page research report is written and distributed to many of our clients (if you aren't receiving these reports but would like to, let us know). Less familiar to our clients, perhaps, is the ongoing work required to stay informed regarding the 60 companies on which we converge.

Following careful study of the last 10 years of financial history, we compile our own custom-made spreadsheets of annual financial data for at least the last three years, along with two years of quarterly data. In addition, comprehensive five-year forecasts are prepared for each company; these are presented as pro forma financial statements. Obviously, the analyst's confidence in the finished product varies markedly from company to company. The degree of uncertainty determines the margin of safety required at the time of purchase.

The SEC requires public companies to report their financial condition to shareholders on a quarterly basis. Increasingly, companies make their executives available via quarterly telephone conference calls with analysts. Senior executives (usually the CEO and CFO) will comment on the results, highlight key trends, and respond to analysts' questions. We participate in all conference calls and frequently talk to the executives in the intervening months. After each company reports, our spreadsheets are updated. The financial data are always reconciled with the commentary. The company's primary analyst then e-mails a quarterly progress report to the firm's other analysts. That's roughly 240 progress reports for us to process per year. For the companies we have purchased we also call on a monthly basis to receive an update on order patterns and to check on other developments at the company.

Generally, we will try to visit all the companies on our list every other year. If we own the company, we visit at least once per year. On many occasions we meet with the CEO and CFO. Many of the really big companies (McDonald's, Disney, etc.) hold analyst conferences once every year or two, which is really the only time we get a chance to meet and interact with the CEOs. There are also industry conferences hosted by our trade group, the Association for Investment Management & Research (AIMR), and brokerage firms that make it possible for us to efficiently compare and contrast the CEOs, their competitive strategies, and the relative performance of many companies within an industry. Dennis and Todd, for example, recently returned from a four-day, 14-hours-a-day, Merrill Lynch-sponsored conference at which 17 retailers from Wal-Mart to Wild Oats presented their stories.

If it sounds like we might become a nuisance for some of these companies, you could be right. In practice, however, we rarely get the cold shoulder and are encouraged by how often we're able to develop a direct line of communication with the CEO. Wall Street's orientation is very time-condensed and often unforgiving of even a single hiccup while ours, according to a number of CEOs, is more in keeping with how they actually run the business. We have been told that our perspective is more like that of an interested and informed board member. We often find ourselves playing the role of a confidant rather than an adversary. Our interest in the shorter-term quarterly data is akin to that of a parent who insists on seeing his or her child's report card at the end of every grading period to minimize the risk of surprises in June.

After we have completed our initial research and if and when the market eventually presents us with a purchase price that meets our requirement for a sufficient margin of safety—a wait-and-watch discipline that sometimes puts us on the sidelines for several years—we thereafter turn our intentions exclusively to the operations of the business itself. If we have a running idea of what it's worth, the decision to add to or sell out our position is straightforward. Getting to know a business well enough to value it judiciously is the most rigorous and intellectually challenging aspect of our work, whereas tracking its price is something anyone can do.

FINAL THOUGHTS

Stealing a few hours on New Year's Day, I was sequestered in my home office dictating these "Final Thoughts" when my wife, Marilyn, poked her head through the open door. We chatted about our new grandson, Lucas, born to daughter Shannon and her husband, Drew Wilson, just a couple of hours before the turn of the millennium. The conversation then turned to the work at hand. Seeing the thick pile of papers on my desk, Marilyn smiled knowingly in a way that only she can. Perhaps, she wondered, there are similarities between what Shannon experienced and what your clients must endure when reading the annual report. Shannon, she added, actually had it easier. While she suffered through 20 hours of hard labor, at least *she* had an epidural.

High technology has invaded our lives like ants at a Sunday picnic. We find ourselves in a confusing and distracted state where we worship technology while at the same time fearing it. John Naisbitt, author of *Megatrends*, observes in his latest thought-provoking book, *HIGH TECH · high touch*, that Americans have become technologically intoxicated: We are softened by the comforts it brings into our lives, fascinated with its gadgetry, reliant on its constant companionship, addicted to its steady delivery of entertainment, seduced by its promises, awed by its power and speed. Technology has led to quantum leaps in communications technology, while little progress has been made with content.

The electronic gaming industry, practically unknown to anyone over 30 who didn't grow up with it, has been transmuted from benign Pong to unimaginable mayhem. Violent and satanic games now account for 70% of the market—because that's what kids prefer. And the market is huge. Last year about 27 million casual players and 6 million hard-core gamers spent $16 billion on video games in the U.S. alone, more than twice that of Hollywood's box-office gross of $7 billion. The video game "Doom" helped to inspire Columbine in Colorado. In another venue, genetic technologies will overwhelm all others, including information technologies, in this century. It is estimated that within two to three decades humankind will have the power to direct its own evolution. While germline gene therapy offers great promise in the fight against some of the most pernicious diseases, it may also present us with the most vexing theological and ethical question of our age: Are we created in the image of God ... or the image of man? Will designer children not soon follow? We are moving faster—but to what end? Can we as living, breathing humans keep pace with technological change? Are we "cats" in danger of being trapped by the "mouse"? ☺ We're not suggesting that you put on your hiking boots and head for Walden Pond, but we do think reflection is warranted.

In the face of such ambivalence, one thing remains certain. Couched in the midst of our high-tech world of investment management is a "high touch" element that brings refreshing order, direction, purpose, and meaning to what could be an otherwise cold and mechanical process. It is in the service of those people who have put their confidence in us—who are relying on us to be competent, diligent, and trustworthy—that the spice to our lives is added. It is for them that I arise each day with a sense of mission and a feeling of excitement. We have been given a high honor, and it is in living up to it that much of our satisfaction comes. The people we are privileged to call our clients are not digits on a computer monitor, they are real. Each of you is unique. This is "high touch" at its redeeming and invigorating best. Because of all their differences, preferences, and even idiosyncrasies, getting to know our clients over time as singular individuals is an experience with no equal in the world of high-tech. It is an extraordinary excursion into the nature, complexity, and wonder of humanity. It is that part of our professional activity for which we are paid in currency far more valuable than money.

It has been said that a man is known by the company he keeps. We can't think of a higher compliment than to be known by the clients we keep. As for me, there is no other group of people for whom I'd be happier to devote my days. When St. Francis of Assisi, while hoeing his parish garden, was asked by a fellow priest what he would do if he learned he was going to die tomorrow, he responded: "I'd finish hoeing the garden." How few can say that. Thank you. **-Frank Martin**

THE MARTIN CAPITAL MANAGEMENT TEAM

Frank K. Martin, CFA, Managing Partner

Frank has 32 years of investment industry experience. He founded McDonald Capital Management, Inc., in 1987, and the firm was reorganized as a partnership in 1991 and renamed Martin Capital Management. Frank graduated from Northwestern University in 1964 with a major in investment management and earned an MBA, with honors, including membership in *Beta Gamma Sigma*, the honor society of collegiate schools of Business, from Indiana University at South Bend in 1978. From 1964 to 1966 he served as an officer in the U.S. Navy. He is a Chartered Financial Analyst. Frank has served on the board of directors of several area manufacturing companies, as well as a variety of social service organizations. He is currently a member of the boards of the Elkhart General Hospital Foundation, Elkhart County Community Foundation, Fourth Freedom Forum, Sauder Stewardship Foundation, Inc. (Archbold, Ohio), and Frank and Marilyn Martin Family Foundation. He also is on the advisory board of Akey Products Corporation (Dayton, Ohio). Frank has written regularly on the subject of investments since 1971.

Dennis D. Blyly, CFA, Partner

Dennis has 14 years of investment industry experience. He was an associate with Martin Capital Management and its predecessor firm for six years before being admitted to the partnership in 1994. Prior to joining Martin Capital Management, he was an investment officer for NBD Bancorp. Dennis graduated with honors from Grinnell College in Iowa with a major in economics and is also a Chartered Financial Analyst. He earned an MBA, with honors, including membership in *Beta Gamma Sigma*, from Northwestern University's Kellogg School of Management. Dennis is currently a member of the boards of ADEC, Inc., Hertzler Systems, and the Elkhart Chamber of Commerce.

Todd B. Martin, CFA, Partner

Todd has 11 years of investment industry experience. He has been with Martin Capital Management as an associate since 1993, and was admitted to the partnership in 1997. Prior to that time he was an investment officer with First Chicago Corp. His undergraduate degree is in economics from DePauw University. He earned the Chartered Financial Analyst designation in 1993 and graduated *magna cum laude,* with membership in *Beta Gamma Sigma*, from the MBA program at the University of Notre Dame in 1997. Todd is currently a member of the boards of Child Abuse Prevention Services, Elkhart Rotary Club, Frank and Marilyn Martin Family Foundation, and Trinity United Methodist Church Foundation.

Andrew P. Wilson, CFA

Prior to joining Martin Capital Management in 1995, Drew was an employee benefits consultant with Watson Wyatt Worldwide. Specializing in qualified retirement plans, Drew had clients that included several Fortune 500 companies. He graduated *magna cum laude,* with membership in *Beta Gamma Sigma*, from Loyola University, Chicago, where he majored in finance and economics. Drew earned the CFA designation in 1998. He is currently a member of the board of the Elkhart County Symphony.

Charles R. Kirk

Charlie has 28 years of experience in plastics manufacturing. He was employed by Industrial Plastics Corp., a profile extrusion company, for 18 years, the last 10 of which he served as president. For the next four years he worked for operating units of Trinova Corp., IPC's acquirer, as general manager of the IPC division and as group vice president. From 1993 to 1995 he was president of Elkhart Plastics, Inc., a custom rotational molder. Charlie received a BA in 1963 and an MA in 1964, both from the University of Akron. In 1968 he received a PhD from Temple University.

Janet S. Gilbert

Jan is MCM's operations manager. She graduated from Bremen High School and the South Bend College of Commerce. She has taken several additional college courses, along with passing the Series 7 Securities Basic Study Course in 1991. She worked as an executive secretary and office manager in the recreational vehicle industry. In 1978 she joined McDonald & Company where she was office manager for nine years. Jan has been MCM's operations manager since 1987.

Lynn M. Stenberg

Lynn joined Martin Capital in 1995 as an administrative assistant. She graduated from Penn High School and has earned several diplomas from the American Institute of Banking, as well as completing various management and computer courses. Prior to joining MCM, she was employed by KeyBank of Indiana for 17 years. Lynn held various management positions within the consumer loan division and most recently was an assistant vice president in the indirect lending group.

Kristin Antalavits

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

Shawn Harrison

Shawn started out as our summer intern in 1999 and decided to stay on as a full-time research assistant. He graduated from Penn State in 1999, earning a BS in finance.

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