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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 71 clients, whose combined assets total approximately $400 million. From its beginnings as a one-man, one-assistant operation, with less than $25 million in assets, Martin Capital is now headquarters for 10 people, including five investment professionals and five persons in supporting roles. See page 63 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 Website at www.mcmadvisors.com.

Frank K. Martin, CFA, Managing Partner
Dennis D. Blyly, CFA, Partner, Director of Research, Analyst, 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, Analyst
Ann Frantz, CPA, Operations Manager
Kristin Antalavits, Assistant Portfolio Manager and Trader
Lynn Stenberg, Client Service and Operations Support
Marsha Miller, RN, Personal Assistant
Stephanie Malcom, Executive 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, my 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 we rarely, if ever, are able to buy a common stock or any other security at its absolute lowest price. So long as we feel our business analysis is sound, further weakness in the market price of a company simply gives us an additional opportunity to purchase shares at an even greater discount relative to its intrinsic value.

- 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.

RISK: NO LONGER AN AFTERTHOUGHT

Executive Summary

The following report is divided into three parts. Part I will be devoted to issues largely internal to our firm: It will begin with where we get our horsepower—our human capital, so to speak—and then move to an account of the stewardship of your assets during these most vexing, yet intriguing, of times. It will then discuss at some length the simple but deliberate filtering process through which we proceed in first selecting and then valuing, purchasing, and ultimately selling the companies that make up your portfolio. From there it will forthrightly present our reasoning in the past, what we believe is rational behavior today, and how we expect to continue to build your wealth well into the future. We will write with a little more specificity about the rationale behind the investment decisions we made over the last year, telling the bad along with a good. Risk, once again part of the investor's lexicon, will be a subject to which we attend next.

Parenthetically, as the result of the decisions made over the course of the last 12-18 months, our star may shine a little more brightly and we may be characterized more in line with the way we've always perceived ourselves. For the record, we have never confused conservatism with conventionalism or uninspired performance. Accordingly, there may be those who will attempt to imitate our actions (in their envy perhaps they forget that even a blind squirrel comes upon an acorn once in a while!). To forestall any such attempts, we will not be so forthcoming as to disseminate to others comprehensive information and insights for free for which you pay a fee! A personal and more concise separate letter will precede this report for that purpose.

Part II will address issues in the world around us. You'll find stories that are emblematic of what may be a new era; perhaps 2000 will be remembered as the seminal stage. The account of the disintegration of two of the largest and most respected hedge funds in America is replete with object lessons from which we all can learn. As for the Internet mania, Drkoop.com is a tragic account of the extent to which the speculative contagion brought both pawns and Knights to their knees. It will conclude with a sequel to last year's discussion of accounting trickery, making this the third year in a row I haven't been able to restrain myself from ranting about the accounting abuses that have spread like wildfire, ingenious new manifestations flaring up in all manner of places. Out of deference to your patience, the annual diatribe is directed largely at technology and Internet companies, although old-economy miscreants are hardly exempt. Look closely, for example, at perennial knaves, like AT&T and IBM, who invariably find the "gaps" in GAAP (Generally Accepted Accounting Principles).

The report will conclude with Part III, an Appendix that is a flashback account of an earlier but comparable time, through the eyes of the grandfather of security analysis, Benjamin Graham, whose observations were, in contemporary parlance, "real time."

Another Benjamin, surname Franklin, writing in 1771 to his son in his autobiography, spoke unblushingly of his rhetorical felicity (of which I make no similar claim) and his desire to make his recollections, as old men are inclined to do, as durable as possible by putting them down in writing for posterity's sake. He proceeded to indulge his inclination "without being troublesome to others who thro' [through] respect to Age might think themselves oblig'd [obliged] to give me a fair Hearing, since this may be read or not as one pleases." I am neither entitled to beg your indulgence because of my age or felicity, nor do I have, like Franklin, a basis for gratifying my own vanity in so public a forum. Your only consolation is that this lengthy missive comes to you by written and not spoken word, leaving you, as Franklin did, the right to read or not as you please! Finally, Dan Shenk, owner of CopyProof, went over the report with his incredible eye for the most subtle of details, making it much easier to read than Franklin's autobiography.

Introduction

The first year of the popularly perceived new millennium began with an ironic twist. The much ballyhooed and widely feared Y2K computer meltdown will be remembered (assuming the acronym so symbolic of the amorphous outreach of the tentacles of technology has not already been erased from your cranial hard drive) as the ultimate non-event. Perhaps Y2K's sole redeeming virtue was in once again giving witness to the nearly incomprehensible power of crowd psychology. On the other hand, the largely unexpected and thus not feared disintegration of the technology and Internet stocks was, by chilling contrast, the cataclysmic incident for which the year will not soon be forgotten. The common thread that ties these two incidents together? The willingness of people to submit themselves en masse so unquestioningly and with such groundless fear in the first instance and with such "irrational exuberance" in the second. The Internet and computer technology are related ideas from the same school of science: The Internet teems with overcapacity, as the economic efficacy of its many entrants is yet, if ever, to be proved, while most stocks pertaining to computer technology are outrageously overvalued, priced as if endless hyper-growth were assured.

At its most rudimentary level, the featured financial story for 2000 was about speculation in certain favored industries, escalating through the process of contagion to preposterous to ultimately self-defeating extremes. It's a phenomenon that has repeated itself throughout all of human history and which necessarily has been examined in these pages in the past. The Appendix is the account of an episode that took place 70 years ago that in many respects is eerily similar to what we now are witnessing firsthand. While it's a little late for those who ventured forth heedless of the teachings of the past, *Devil Take Hindmost—A History of Financial Speculation*, well written by Edward Chancellor and published in 1999, traces this most interesting propensity of *homo sapien* from ancient Rome to the demise of long-term capital management. Moving back to the present, the carnage was pervasive among those who were the darlings of yesterday. In the interest of conservation of verbiage, only a few revelatory exemplars will be offered to convey that message.

If ever iconoclastic rationalism and uncompromising intellectual independence were called for, the year just past was it. Only you can be the judge as to whether we kept our heads when many about us were losing theirs. Here's the hook: If you expect to make that finding, you'll have to read on!

In the midst of all the wealth-destroying "gore" for which 2000 will be remembered by a horde of sheep shorn naked, we trust that you never lost a night's sleep (or even got "bushed") worrying about the safety and security of your portfolio, about the possibility of a crack that threatens to become a chasm in your nest egg. Wealth management, the markets in their own perverse way occasionally remind us, is not just about eating well, it's also about sleeping well. Perhaps our profession is not unlike amateur tennis: It's usually not the number of winners hit but rather the number of unforced errors that determines the outcome. The rather extraordinary and equally humbling absolute and relative performance of last year (see Investment Performance on page 10) was in part the result of good defense—we had only one unforced error—and the concurrent but somewhat unexpected good fortune of the market choosing this particular year to recognize how undervalued some of our companies were, resulting in four outright winners as well.

Enraptured by the majesty of "The Hallelujah Chorus" during our Christmas Eve church service, I realized then why it is the final selection in the cantata: There is no suitable encore. While the analogy is certainly strained, please don't expect an equivalent refrain next year. We don't have a Handel on what's going to play next. While it's our duty to report investment results to you periodically, the advice of one of my wisest, closest friends and mentors is still ringing like "The Messiah" in my ears: "When you lose, say nothing; when you win, say even less."

To be sure, it is not our intent to make light of the breadth of financial trauma suffered in many sectors the past year but simply to remind you of its existence because, like a hurricane in the Caribbean, it rendered its devastation elsewhere. Don't be fooled; the season of storms may not be past. And the winds of destruction could reach places heretofore untouched. Though your experience may be vicarious thus far, the lessons learned from the stories that follow should be taken with the highest degree of seriousness. And the word "trauma" may well understate the magnitude of the markets' giant sucking sound, like the enormous and indiscriminate vacuum cleaner mounted on the sleigh of "The Grinch" (the wonderful Christmas movie starring Jim Carrey) as the town of Whoville unwittingly surrendered all its accumulated material gifts to a thief in the still of the night before Christmas. Suddenly, it seems, billionaires have shrunk like cheap cotton to millionaires, millionaires slipped into the ignominy of being merely well-to-do, and all manner of speculators—big fish and minnows alike—were rendered, for lack of a better phrase, acutely unrich.

Putting numbers to the diminution of paper profits is telling. Overall, it is estimated that the market capitalization of U.S. equity securities fell some $2.5 trillion over the course of the year, against a start-of-year total of approximately $17.4 trillion. The value of all stocks on the New York Stock Exchange, about $12 trillion, was essentially flat for the year, while the Nasdaq lost approximately $2 trillion, compared with a start-of-year total of an incredible $5.3 trillion. From its peak on March 10, 2000, the Nasdaq Composite fell 39.1%. The index itself fell from 5,049 to 3,521 in a matter of 34 days, reaching a low of 2,333 on December 20, which translates to a breathtaking peak-to-trough decline of 53.8%. In the euphoria of a year ago a bear market was thought to be a decline of about 20%. Who, I wonder, was responsible for suggesting such an arbitrary and foolish measure? The market capitalization of the Dow Jones index of Internet stocks fared even worse. From its peak, also on March 10, the market capitalization declined dramatically from just over $1 trillion to $251 billion on December 21, a shocking 76%. The remediation of speculative excess is often as dramatic as it is devastating.

Lest we overlook it, bifurcation was as evident in 2000 as it was the year before, this time in both the equity and the debt markets, as well as between them. With regard to the equity markets, the players simply reversed their roles. While the technology bashing was under way, there was a resurrection of interest of sorts among the old-economy industries. Among bonds, Treasuries prospered, thanks to falling interest rates, while junk simultaneously plummeted because of worsening credit quality. Finally, while stock prices went down, quality bond prices went up.

Not only was paper wealth greatly diminished as the bubble began to burst, what wealth remained (of which there is still plenty) was subjected to a winnowing process known as redistribution. In the relative scheme of things, discerning and prudent investors climbed a rung or two on the ladder of wealth preservation and accumulation, while those who didn't know any better (or if they did, sacrificed rationality at the altar of momentum investing or its variations) dropped a rung or two ... or more. As was noted in last year's report, there are always opportunities, but they are rarely found in the obvious places. As for those who fueled the fires of reckless speculation—the men and women of our profession—we'll have more to say about them later.

PART I

IT ALL BEGINS WITH HUMAN CAPITAL

Perhaps the year 2000, more than any other time in our 13-year history, will be remembered for the power of a group of extraordinary people functioning as a cohesive team. Our organizational structure and respect for the dignity and uniqueness of every person in our firm are designed to empower each individual to be the best he or she can be in pursuit of the goal of serving our clients with integrity, competence, and a spirit of family.

Elsewhere in the report it will be obvious that **Dennis Blyly,** my first partner and Director of Research (among his many other duties, including the management of a number of portfolios), led our team of analysts most effectively and with outstanding results in 2000. While Dennis is an analyst par excellence, he also has developed noteworthy interpersonal and leadership skills, one of which is encouraging others, in part due to his outstanding example, to conduct research of the highest quality.

Todd Martin, my son, inherited his mother's genuine way with people. As Director of Marketing, this year was clearly his best, as noted in the section titled "Final Thoughts." Equally, if not more importantly, his skill as an analyst and portfolio manager continues to grow apace. Two years ago Todd became the third partner in our firm. Acknowledging the growing contribution of these two extraordinary young men, I gladly sold them this year what they have earned: a larger share of the partnership.

Drew Wilson, has been a highly effective and resourceful member of our team since we recruited him from Wyatt Watson Consultants in Chicago in 1995. In the early going he cheerfully filled in wherever needed, wearing more hats than the "Mad Hatter." Over the last several years, thanks to some outstanding additions to our support staff, Drew has been able to focus his energies full time on those functions for which he is ably trained: business analysis and portfolio management. He has assumed portfolio management responsibilities for an increasing number of clients who, given the calls I have received, have benefited greatly from his timely and wise counsel.

As noted last year, we did not take full advantage of the remarkable talents that **Charlie Kirk** brings to our firm. He and I have agreed to remedy that in the new year. Charlie brings a brilliant mind and a well-cultivated and constructive skepticism to our research process. There is no doubt in my mind that the more he becomes involved, the better our research product will be.

Ann Frantz, is one of those outstanding individuals who began her professional career with the top-drawer accounting firm of Crowe Chizek. She joined MCM in August 2000 as our first Operations Manager. She has full responsibility for the support team and reports directly to me. She is one of the finest young women (more a reflection of my age than hers, as she is the mother of three school-age children!) with whom I have ever worked. She is bright, self-assured, and hard-charging, while at the same time being personable and positively delightful.

Another of those outstanding people mentioned three paragraphs above comes in the person of **Kristin Antalavits,** our chief trader and assistant portfolio manager. She epitomizes the spirit of family that is perhaps the most appropriate way to characterize the nature of the relationships within our firm and without. In addition to being wonderfully competent, creative, and enthusiastic, her playful sense of humor makes her a joy to be around.

Lynn Stenberg has been promoted to assume more operational responsibilities. There isn't a client who has passed through our door who doesn't know and like her, but her promotion has taken her to a lower-traffic area. Be sure to seek her out, as Lynn's pleasant demeanor is still very much an office gift. She will be more than happy to lift her eyes from her PC monitor, as she crunches all manner of numbers, to greet you.

Initially a part-time employee, **Marsha Miller,** has been working with the firm since October 1999. As an RN, her initial responsibility was to keep me going: with daily physical and occupational therapy, as well as all other aspects of health management. Her zest for life and positive attitude and spirit are indomitable. It became immediately apparent she is also very bright and took to both our business and the technology that supports it like a duck takes to water. Thanks to her, I feel twice as well and three times as productive as I did a year ago. (I'm on the verge of asking for my first pay raise since founding the firm!)

Stephanie Malcom is the newest and youngest member of our team. In addition to usually being the first voice you'll hear when you call or the first person you'll see when you enter our offices, her primary responsibility is to support Dennis, Todd, and Drew as their "girl Friday."

After 21 years working with me, Jan Gilbert, whom all of you know, by mutual agreement is pursuing a career in graphic design. She is an artist by avocation and expects to use those talents in the commercial arena. We wish her the very best and thank her publicly for her essential role in the growth and development of our firm.

INVESTMENT PERFORMANCE

In the words of Aristotle, "One swallow does not a summer make." Although the decisions we made during the course of the last year led to above-average equity investment returns, we view such decision making as but one brief segment in a long-term continuum. Who knows what tomorrow will bring? We draw some solace from the deeply held conviction that our ideological foundation upon which our security selection and portfolio management practices have been painstakingly built will, at the very least, keep you out of harm's way. At the very best, we may surprise a few people who believe that there is always a correlation between risk assumed and return earned—and that conservative is invariably synonymous with lackluster results. In the meantime, if we continue to adhere to our principles we are likely to avoid many of the temptations that come in the form of folly, greed, and (most critical and sometimes most troublesome) fear, which on occasion precipitates the most irrational and destructive of behaviors. Our approach served us well in the final 12 months of the second millennium A.D., but 2001 will be a new odyssey, to be sure. Again, our convictions will undoubtedly be put to the test. As always, we will forsake the lure of so-called opportunity where the flip side of that coin may result in permanent loss of capital.

Equally important is that we provide you with a full explanation of how the investment returns were earned and what risks were incurred with your capital in the process of earning them. First, as has been disclosed on many occasions in the past, and is stated annually as one of our Investment Principles on page 4, it is our contention that there is great virtue in limiting the horses in one's stable to a relatively small number of thoroughbreds. Empirical testing has proven beyond a reasonable doubt that the "riskiness" of a portfolio of 12-15 diverse companies is little greater than one loaded with 100 or more, as is so often the practice among many institutional portfolio managers. In this instance we define risk as a terribly bad longer-term outcome—and not the extent of annual portfolio price volatility that is the standard by which it is measured according to Modern Portfolio Theory (MPT). We don't subscribe to that popular discipline so much because it is "demented" (in the mince-no-words eloquence of Berkshire Hathaway's Charlie Munger) but rather due to the fact that (1) our investment holding period is ideally very long, and (2) we don't think of ourselves as buying and selling pieces of paper but rather investing in businesses. MPT is simply incompatible with our investment style.

It is here that I greatly acknowledge the pivotal role that you, our clients, have played during these turbulent days (on 75 of 252 trading days last year, the Nasdaq index fluctuated greater than 3%). Your patience and your trust, rare traits in this era of hot and fickle money, have enabled us to pursue a long-term investment approach that has resulted in above-average returns and well-below-average risk. Few investment managers have the luxury of such discretionary freedom. We are indeed most fortunate to attend to our duties without having one hand tied behind our collective backs.

It is also important to disclose that we attempt to further ameliorate risks that may be perceived to be associated with a concentrated approach toward investment by (1) selecting only those businesses that pass through our rigorous filters—discussed at length beginning on page 24—and (2) purchasing such companies at prices that afford us a significant margin of safety, as explained further beginning on page 19. We strongly believe that the supply of great businesses is severely limited and to engage in broad diversification (for the often spurious reasons that others offer as rationale) is dilutive to the implicit purpose of earning above-average longer-term returns. Little that is good comes without cost, however. And the cost of a concentrated approach to portfolio management is (1) much greater relative portfolio price volatility and (2) the possibility that we will look like geniuses on one occasion and dolts on another. Neither is an accurate characterization, but if the eventual outcome is superior to the more commonplace practices, we strongly believe that the end justifies the means, despite the exasperation that may occasionally (and, we hope, temporarily) ensue.

To put real numbers to the abstract concept of margin of safety, the weighted-average, price-earnings ratios at the time of purchase of the companies we acquired was 9.7 times, compared to a price-earnings ratio for the S&P 500 that averaged in the high 20s during most of 2000. Our weighted-average, estimated five-year earnings-per-share growth rate for those same companies is just under 15%, compared with an earnings-per-share growth rate for the S&P 500 of less than half of that.

An additional word on "margin of safety" is warranted here, although it will be discussed in greater detail on page 19. Purchasing a business at a price that provides reasonable assurance of a generous margin for error is an erudite way of saying to ourselves, "Buy low, stupid." While intuitively appealing, this is by no means easy to implement. It requires that we step boldly into the lion's den, that we take decisive action at seemingly the most unpropitious of times. Backed by extensive research and strong convictions, we must purchase the shares of good businesses in the face of the kind of awful news that forces others to throw in the towel as momentum is turning south or when short-term performance mandates do not permit the luxury of endurance. If you look over the Quarterly Capital Markets Reviews received over the course of the last year and compare the prices paid for the companies that you own against the charts included in the reviews, you will readily see that we were true to our word. A significant portion of the favorable outcome achieved in 2000 was little more than taking advantage of discarded mainstream companies as the Nasdaq, the presumed ticket to success, sucked money away from everything else while soaring to new highs in the spring. We purchased the castaways you own at deeply depressed prices, then looked on with satisfaction as they surged upward toward intrinsic value and, in a few isolated instances, slightly above—at the very time the Nasdaq index had its comeuppance.

What happens from here on with several of our portfolio holdings may well depend more on the quality of our research and less on our ability to take advantage of a schizophrenic market, though we have identified a number of possible new investees whose depressed market prices would suggest that the "rubber band" effect might be salubrious. If the intrinsic value of the companies we own continues to grow according to our projections—even though the fluctuation in market prices may from time to time suggest otherwise—the market value of the equity portion of your portfolio should follow suit in due course. Buying businesses on the cheap takes chutzpah born of strong convictions. Forecasting future cash flows and discounting them appropriately (the basis for the calculation of intrinsic worth) requires appreciable knowledge and skill—and fair winds. We think we are above average in doing the former; as for the latter, only time will tell.

The equity portion[1] of a "representative" client's portfolio rose approximately 38% ("dollar weighted"—meaning we actually invested greater amounts of money at lower prices) in 2000. That compares with negative total returns from the Dow Jones Industrial Average, S&P 500, and Nasdaq of minus 4.7%, -9%, and -39.1%, respectively. Over the last five years, our compounded rate of total return has been 22.9%, compared with 18.3% for the S&P 500, the benchmark against which we think it's most appropriate to measure our equity performance. Because of the diversity among our individual clients, the performance of no two clients will be identical. For those clients who (1) have been with us for more than a year and (2) have given us full discretion, the range of total returns from equities ranged from a high of 40% to a low of 24%. As for the risks we incurred in the process (see page 19 for reflections on risk management)—the element of uncertainty that is rarely revealed by investment advisers—we would argue that such risks were and are far fewer than those of the index itself. While our aversion to assuming high levels of valuation risk (to say nothing of the difficulty of pushing technology companies through our filters), penalized us in 1997-99, it had the opposite effect in 2000.

[1] While about 50% of a "representative" portfolio is invested in equities, which approximated our preference for the typical high-net-worth individual account, individual portfolios range from no equities to virtually 100%, depending on client preferences.

The table below represents the "time weighted" returns for the *equity* portion of a "representative" Martin Capital Management portfolio over the last five years, as compared with the S&P 500 index. It should be noted that, for most portfolios during the five-year period, the portion allocated to equities rarely if ever exceeded 50%, except late in 2000—and that was due largely to the bargains finally found in the spring and the appreciation thereafter. (Nasdaq data are provided for the purpose of emphasizing the devastating effect of a single sizable loss on compounded-average annual-growth rates. See "Goliaths Slain" on page 35 if, perchance, you're plagued with lingering regrets for not jumping on the bandwagon in 1998-99.)

	MCM Equities	S&P 500 Index	Nasdaq Index
1996	33.7%	22.9%	22.0%
1997	50.0%	33.0%	22.1%
1998	-11.9%	28.6%	40.1%
1999	18.7%	21.0%	86.1%
2000	33.9%	-9.1%	-39.3%
CAGR	**22.9%**	**18.3%**	**19.0%**

While there were several minor exceptions, generally those few clients who asked that we purchase according to ideas of their own choosing—or who impose certain moratoriums on equity purchases beyond what their Investment Policy Statement stipulated—fared less well than those clients who left us to our own devices. While we don't necessarily encourage such behaviors, we gladly accommodate them in the name of making the investment experience a personalized one for each client. While it cost them (and us!) money last year, next year may be a different story. In the long run, though, if we become redundant, I'm sure you will let us know! We're working hard to see that this doesn't happen.

In 2000 we continued our practice of investing in only the highest-grade fixed-income securities, despite the ever-widening spreads between U.S. Treasury notes and junk bonds (now an eye-catching 520 basis points). One can buy Amazon.com 4.75% convertible debentures due in February 2009 at 35% of par for a yield to maturity of 22%—if they continue to pay timely interest and are able to return the principal at maturity, a wager we have no interest in taking. As Will Rogers so adroitly put it, "I'm more concerned about the return *of* my principal than the return *on* my principal." If junk bonds, which we defined as a convoluted form of equity with limited upside potential and unlimited downside risk, appear attractive, common stocks are likely to be even more appealing.

While we aren't aggressively active fixed-income security managers, we do try to eke out a better return (than a passively managed laddered portfolio would suggest) by managing duration within the context of a relatively short-term portfolio construct. Where we do get very aggressive is in the selection of the highest-quality tax-exempt bonds we own. If you don't know that market well—and how it differs from the incredibly efficient market for U.S. Treasury securities—you can be made to look a fool without even knowing it. While it's not apparent to the untrained eye, we believe we add significant value because of our years of experience and daily activity in the specialized market for municipal bonds.

Another peculiarity of our approach to wealth management is that we see fixed-income securities for the complementary role they play in meeting portfolio objectives and not as a discrete class of security that should be managed by a specialist and measured against a fixed-income benchmark. Our aggregate portfolio benchmark is the S&P 500, irrespective of portfolio-asset class composition, assuming a client has given us discretionary authority to be fully invested in equity securities. In those instances where a client's Investment Policy Statement specifies a maximum commitment to common stocks of, say, 50%, a blended benchmark is obviously used instead. Because of a limited potential for outsized gains, bonds are used primarily for defensive purposes. And yet the crowning indignity for the badly shaken cult of equity worshipers was that stocks in 2000 were left in the dust not only by bonds—the 10-year note was up 16%—but also by ... cash! Sometimes you win by not losing …

Performance Fees

Since the management fees you pay us are in modest but direct proportion to how much your wealth increases, you should be ecstatic about of size of the bills you received in mid-January! It is also helpful to remind you on occasion that our performance-based fees are only assessed on new wealth created—i.e., value added above and beyond the prior high watermark. Furthermore, lest it be forgotten, we pay all commissions, which, for all of 2000, were 10 times greater than our entire occupancy expense at our offices in Elkhart.

Performance fees are a sword that cuts both ways. Please read carefully the discussion on why hedge-fund manager Julian Robertson Jr. (page 35) was forced to close his doors in his own self-interest at the very moment when it was most important for his clients that he keep them open. As you will see, we have never exposed you to those kinds of risks—risks that you may have never even considered.

Shakespeare's Admonition

"Humility is the most difficult of all the virtues to achieve; nothing dies harder than the desire to think well of oneself."

Investment performance, I am occasionally reminded, is never measured in a vacuum, and humility (a dauntingly near cousin to humiliation, I might add) is invariably one's constant companion. In fact, in some unyielding variation of Murphy's Law, one can never avoid finding oneself in the public company of someone whose performance is outlandishly good when one's own is merely good.

In early November my wife, Marilyn, and I enjoyed our first full-week vacation of the year. We cruised the Western Caribbean on a 140,000-ton floating hotel with a passenger manifest totaling 3,100. The ship was resplendent with endless amenities, including a rock-climbing wall, an ice-skating rink replete with professional shows, a miniature golf course and, most importantly—although as common as deck chairs on virtually all such enterprises where people are willingly separated from their money while still smiling—a casino. My aversion to any game of chance where the house controls the odds is intractable. I have never pulled the lever on a slot machine, nor have I purchased a single lottery ticket. My wife's eagerness to cast her limited lot with "Lady luck," however, is not so boringly stick-in-the-mud rational.

In any event, the hour was late, and I was slouched down in an easy chair in our cabin reflecting on a year, as noted above, during which we exercised our stewardship responsibilities with some diligence and prudence in the face of relentless and almost overwhelming temptation to do otherwise. It was not hubris I felt (since a well-cultivated sense of humility, born of long experience, would never permit smugness to rear its head) but rather a fleeting serenity in the brief respite from the ongoing battle on the front lines. All in all, the moment was tranquil if not quietly satisfying when Marilyn burst through the door, summarily bringing that poignant moment of reverie to an abrupt and noisy close.

"I hit the jackpot!" she exclaimed with great enthusiasm and force of voice. Earlier reference was made to her "limited" lot. Translated by her curmudgeonly and tight-fisted husband to dollars-and-cents terms, that means $20 (80 quarters sounds so much more outwardly impressive—sort of like the silliness of a four-for-one stock split). She has always embraced a curious philosophy while occasionally yielding to games of chance: "I keep betting until I don't have any more money!" (It is my moral aversion to owning companies whose social contribution in sum and substance is nothing more than a negative value-added game of chance that restrains me from such investments. It certainly has nothing to do with the economics enjoyed by the house, which I consider nothing short of larceny—particularly given Marilyn's widely imitated credo!) In any event, she excitedly declared that she was down to her last three quarters when (throwing caution to the wind) she dropped all three in the slot and gave one last pull on the beckoning handle of the one-armed bandit. After all the ringing and clanging subsided into silence, her three quarters had magically compounded to 2,500 in a matter of seconds. In other words, from an initial "investment" of $20 she walked off with a cool $625, a 3,125% gain in capital.

In sharp contrast to my state of mind, Marilyn had that cat-that-ate-the-canary look as she stood there in the doorway and smugly inquired, "How does that compare with what you did for your clients this year?" It was one those rare instances when I had the presence of mind to reply with nothing more than a congratulatory smile. In battles where the combatants are reason and whim, reason will eventually prevail! Unfortunately, "eventually" sometimes takes a very long time.

As a postscript—because Marilyn has now ascended to the ranks of the big-money players—she has correspondingly amended her casino protocol. Still committed to her conservative Midwestern quarter bets, she now avers she will keep pulling the lever until she runs out of time, not money. On our next cruise I will discreetly ask for the second-dinner seating. We are making progress!

INVESTMENT STRATEGY

To begin, it might be helpful to review our Investment Principles on page 4. We have not engaged, nor do we expect to engage, in any activity that would contravene those time-honored precepts.

Singles and Doubles

Given unlimited discretion by a client whose return objective is to earn as high a rate of total return as is consistent with preservation of principal, our optimal portfolio would consist of the marketable equity securities of businesses that pass through our rigorous filters, as explained beginning on page 24. This ideal group of companies would have a number of investment attributes in common: (1) They have a long and frequently illustrious history of high returns on conservatively leveraged capital employed; (2) they are businesses we can readily understand and that likely will be performing much the same type of activities in five or 10 years as they are today; (3) they are superbly managed by people we like, admire, and respect; and (4) they sell at market prices that give us an acceptable margin of safety, along with its reciprocal—a reasonable expectation of at least a 15% compounded annual total return over a minimum five-year holding period.

We encountered a number of companies that met those stringent parameters last year. Invariably they were the companies that were castaways, discarded by the hot-money investors who saw what they thought was low-hanging fruit in the technology and Internet orchard. Furthermore, in most cases their earnings had come under pressure for what we believed were temporary reasons. No momentum investor would touch them. Despite the general loathing for them and others of their lowly class, price-wise they were silk purses that only *looked* like sow's ears. Four of them appreciated in one year to price levels that, at the time of purchase, we had expected to take several years to achieve. Subsequently, over the course of 2000 the expected return from our equity portfolio fell rather dramatically. In other words, don't expect an encore performance next year! While we have a near neurotic aversion to saying goodbye to winsome friends, there is little doubt that we'll be making some portfolio adjustments throughout 2001. Taking into account the avoidance of short-term capital gains, our portfolios likely will see some new names, while others are sold.

A consolation for those of us who are sentimental, it's nice to know that goodbyes do not always mean forever. After selling Torchmark in September 1997 when its future investment appeal had declined because the stock had doubled in price, we waited and watched patiently, staying in regular contact with the company in the meantime, then re-established our ownership position in early 2000. Although the Waddell and Reed stock-brokerage operation had been spun off in the interim, earlier this year we were able to reacquire stock in the company at prices nearly equivalent to those paid the first time around. Once again, the stock has doubled. After it has been held for 12 months, we will probably part company again. Each time we sell it, 20% of the capital gain is taxed away. Our preference has always been for very low rates of portfolio turnover, effectively enjoying an interest-free loan from the U.S. Treasury, thanks to the continuing deferral of the ever-increasing and yet untaxed unrealized gains. But on occasion sharply rising market prices (or, on the flip side, estimates of the growth in intrinsic value that prove to be optimistic) require that we take premature action. Likewise in 1999, after doubling in a year when we expected it to take five, McDonald's was sold. It has now fallen back to where we started, and we are buying it again. Land's End, a spectacular performer for us last year, which we sold as high as $66.50 (aggregate cost basis average $18.75), because of acute acrophobia, has collapsed from an Internet-frenzy-spike high of $83 to its current price in the neighborhood of $25. In this case, we have lost confidence in the efficacy of the company's basic business model, particularly regarding filters 2 and 3—and find it difficult to value the business anymore. Unless or until we can become reasonably confident about our ability to appraise the intrinsic worth of the company, we are unlikely to become owners again.

There remains a paucity of companies that meet all of the prerequisites outlined in the second paragraph of this section. As for the traditional growth companies, many remain too expensive for our tastes. Using conservative terminal price-earnings-ratio assumptions, expected returns fall well short of our minimum threshold. We have begun accumulating a position in Gillette (which plummeted from $66 to $30 before we began staking our claim), though adding to our still relatively modest position at prices in the mid- to low $20s would increase our margin of safety, as well as our expected return to levels that are comfortably above our minimums. We are exceedingly patient. Frequently we complete our research and then wait months or even years until the price comes to us. Our enthusiasm to own a company is often inversely proportional to its price. Despite the fact that Coca-Cola, one of the most venerable of franchises extant, is a company we have always wanted to own—and its market price has fallen from a 1998 high of $90 to the current $56—even that price is too high relative to what we think the business is worth.

During the second half of the year we completed research on four or five companies that are clear candidates for purchase in the year 2001. They pass through all of our filters, but they differ somewhat from several of the current portfolio holdings: Their products are a bit more prosaic, their markets somewhat more mature, and their earnings-per-share growth rates average closer to 10% than the 15% average expected from our current holdings. Offsetting that, at their current depressed prices they are correspondingly cheaper (perhaps more traditional "value" stocks) and thus offer expected returns easily over our threshold. While this represents an opportunistic diversion necessitated by a dearth of "inevitables" at reasonable prices, our research objective continues to relentlessly upgrade the overall quality of the businesses in our investment universe.

Is It Time for Technology?

In last year's annual report we said we had demurred after surveying possible investment possibilities in Internet-related companies. Although it never makes the headlines, sometimes a simple "no" is the best choice. What about technology stocks after the bloodbath? Now that Nasdaq has done its splendid imitation of a swan in full dive, we wonder where opportunity might be found. We are convinced that, like the Phoenix of ancient lore, some (we sorely wish we knew which ones) will eventually rise in spectacular fashion from the ashes of ignominy. Since few, if any, pass through our second filter, let me in this instance defer for a bird's-eye view to an observer whose wise and cryptic insights have intrigued me for more than 15 years.

Marc Faber, a man with a truly global perspective and an uncanny knack for not losing sight of the forest for the trees, has made innumerable appearances in *Barron's,* where he first came to my attention. In a recent piece Faber addresses the question of whether Nasdaq, which is dominated by technology companies, is overvalued and, if so, by how much. The answer to the first part of the question (it won't come as a shock to you) is "yes." To get a fix on just how overvalued that wild-and-woolly market is, he recited a little history.

Launched in 1971 with a value of 100, the composite index, he recounts, never topped 200 until 1982. By 1990 it was still below 500. In 1995 it eclipsed 1000 for the first time and, three years later, reached 2000. After that it really went stratospheric, soaring above 5100 this past March.

"Never before in the history of financial markets," notes Faber with a touch of awe, "has there been such a highly priced large market as the Nasdaq."

OK, after that quick background sketch, he gets down to the nitty-gritty of determining what a proper valuation would be for Nasdaq. Based on current earnings of something in the neighborhood of $25 billion, he reckons the index should be valued between 800 and 1500. Faber explains that his forecast assumes that earnings either linger around where they are (which would drop the index to 800) or rise to around $40 billion before suffering some major disappointments (which means Nasdaq would be cut "only" in half from present levels).

Another way to assess the future of Nasdaq, he adds, is to assume that it will give back all the gains garnered in the previous five years. That, as it happens, is the average experience of U.S. stocks in bear markets. If the past is prologue for Nasdaq, Faber figures, the index eventually will drop to around 1000. In sum, by any sensible yardstick, Nasdaq remains incredibly inflated and has light-years to go before it bottoms out. To be sure, the Internet and all that it means in the new millennium is a great aphrodisiac for many investors—and Nasdaq, the Viagra of the financial world, may well stay up longer than it has any right to. And "Yours till Viagra falls" could become the updated inscription of choice in yearbooks as high school seniors "anticipate" their senior years.

While Faber's perspective is tops down—and is helpful to us in framing our investment decisions—at the end of the day we're still most at home in our bottoms-up price-in-relationship-to-value paradigm. If we don't know what something is worth, how can we possibly determine whether the price is expensive or cheap? Is Microsoft a long-term-investment candidate at its current price of $44, down from a high of $119 in 1999? It sells for 27 times earnings, though as the section on accounting explains, those numbers contain both fire and smoke. We ask ourselves, particularly in view of the maturation of the PC market, what will be the growth drivers for the company five or 10 years from now? More fundamentally, will their energizing options-based compensation culture implode, with some lag, along with the share price? Will Bill Gates & Co. be able to acquire and hold the talent that has made them a stunning success story in the information revolution as their industry matures and their rewards systems regress toward the mean? Will they be able to monopolize the new venues, into which they are forced to migrate to sustain their growth, as they have the market for operating-system software?

There is no doubt in our thinking that information technology will remain the fastest-growing segment of the U.S. economy *until* overwhelmed by genetic technology, which is nipping at its heels. Growth, however, is but one component of the value equation. Capitalizing on rapid growth industries, as the Internet speculators have so painfully discovered, is often fraught with more peril than prize. Easy money is an oxymoron. It is most unlikely that we, as wealth managers, will be placing big bets on little companies attempting to find their niche along the frontiers of science. We think hitting a homer once every 100 times at bat, with dozens of strikeouts in between, will not get us an invitation to the Hall of Fame. Mixing metaphors (although staying with sports), it's analogous to driving for show, putting for dough.

Many "Internet" businesses are much closer to traditional media and distribution businesses than their staunchest supporters were willing to admit only months ago. In this context we may be searching the trash heap for viable business models. In most cases, however, we are increasingly finding "old economy" companies dominating the so-called "Internet space." It seems having an established customer base, a brand name, physical infrastructure, and old-fashioned know-how are still of use in the 21st century.

Is There a Snowball Rolling Our Way, Gathering Mass and Speed?

Of more immediate concern is the possibility that the massive erosion of wealth that has occurred in the last nine months will precipitate an unexpected economic slowdown or worse after this longest of peacetime expansions. The plethora of recent earnings downgrades from companies representing a broad cross-section of corporate America gives us pause. The acid test will be how the stock market, and later the economy, will respond to what surely will be a kinder, gentler Federal Reserve policy in the months ahead. While we haven't seen it mentioned in print, we don't rule out the possibility that the Fed may find itself pushing on a string. Make no mistake about it, what may be transpiring is as much about the end game of a once-in-a-generation speculative orgy as it is about the reverse wealth effect. Katie bar the door if they complement one another. The Appendix was not attached to lengthen the report (although that charge has been leveled more than once!), but rather to frame in the context of history the extraordinary metamorphosis that, within the past decade, insidiously transformed mild-mannered investors into wild-eyed speculators. Serious investors would do well to ponder the wisdom of Benjamin Graham (as excerpted in the Appendix). The speculative pendulum is clearly swinging back toward sanity. How far and how long it swings remains the pertinent question. While the catharsis is under way, capital preservation must take precedence over capital enhancement.

Accordingly, despite lower market yields, we will not depart from our practice of owning only the highest-grade fixed-income securities of relatively short duration. We will venture forth from that safe harbor, as we did last year, only when compelling opportunities appear in equity-type investments in which we can reasonably expect to earn considerably higher returns, consistent with our aversion to assuming anything more than moderate risk, as we define it. We will look forward with one eye and backward with the other, keeping close watch on the path and size of the snowball, a metaphor on which we expand as we attempt to debunk the "baby boomer" myth in Part II. Lest we forget, there *is* a contraposition to the aphorism, "A rising tide lifts all ships."

Revisiting Investment Policy Statements

At our upcoming post-year-end individual meetings with all clients, we will carefully review your Investment Policy Statement to make sure our mandate remains reflective of your return objectives and tolerance for volatility, among other issues. We are the hired managers, but you are the Chairman of the Board.

THE ART/SCIENCE OF MANAGING RISK

Before we can attempt to argue that we are capable of managing risk we must first define it. As you will see, there are two conspicuously different definitions in use today. First, *Webster's NewWorld Dictionary* renders precise the meaning of risk (noun) as "the chance of injury, damage, or loss; dangerous chance, hazard." As a verb, "to expose to the chance of injury, damage, or loss." Second, Modern Portfolio Theory (MPT), which emerged out of academia in the 1950s and is highly quantitative in its approach to portfolio management, defines risk as "relative market-price volatility." It presumes that markets are efficient and that investors respond rationally to various stimuli; thus, greater company-specific uncertainty (returning to *Webster's* definition) will be reflected in greater market-price volatility than the norm. The term MPT practitioners use to quantify such volatility is *beta*. The S&P 500, the benchmark, has a *beta* of 1. Stocks with *betas* greater than 1 are considered riskier than those with *betas* less than 1. Obviously, the greater the variance, the greater the risk.

At first glance, reconciling the two perspectives does not appear to be overly difficult. However, upon closer inspection serious questions arise. First, *beta* is deemed to be a constant, regardless of price. Because MPT advocates believe that markets are largely efficient—i.e., the current price is an accurate reflection of the value of the business based on all available information—risk should not be price related. In other words, on March 10 when Priceline.com peaked at $162 per share, it was no more risky than it is at its current price of $1.50. That's where they lost us! To be sure, such extreme volatility leads one to wonder about the presumed rationality of the investors whose buying and selling in the marketplace set the market-clearing price at both extremes and at all prices in between. Is it possible that a company's fortunes can change so drastically in such a short period of time? Or, heaven forbid, are investors inclined to act irrationally on occasion, thus casting doubts about the efficacy of market efficiency as a primary tenet of the widely embraced MPT?

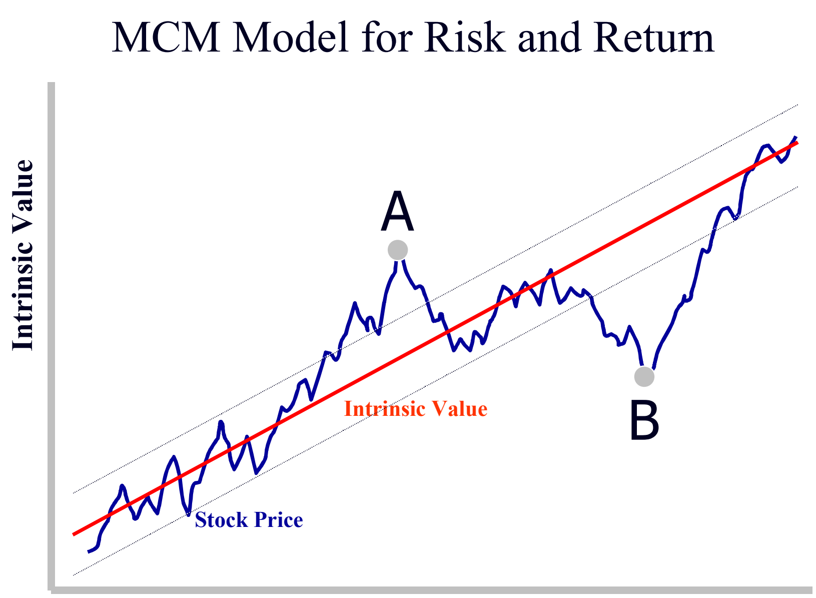
Moving to a more prosaic example, we have long admired Mercury General, an auto insurer that writes the lion's share of its business in California. While its fortunes are tied to the cyclical propensities of the markets it serves, we believe that we can roughly approximate its intrinsic worth, which over time has increased nicely (although not linearly). We think it will continue to do so into the foreseeable future.

Following several years of extremely favorable industry conditions, the stock skyrocketed to $70 in July 1998. When the worm turned, Mercury General's stock plunged to $20. We believed that the extreme volatility in the price was not justified by the at least comparatively steady upward progression in the value of the business itself. We suspected that the manic/depressive nature of investors feeding off each other's disillusionment—or the shortened time horizons of the increasing legions of instant-gratification momentum speculators—had something to do with the aberrant price gyrations. In either event, we concluded that the stock was rationally priced at neither $70 nor at $20.

Accordingly, we determined to our own satisfaction that MPT's definition of risk as a constant did not apply in Mercury's case. Because of our confidence in our estimation of the company's intrinsic worth, we concluded that risk, a la *Webster,* actually declined in lockstep with the falling price. No Ph.D. in mathematics is required to reach that conclusion! When we purchased it at $21 in December 1999 we believed we were assuming relatively little risk at the very time when its *beta* was no doubt being raised by those cloistered mysterious mathematicians who calculate *betas* to more fully reflect the increased price volatility of late. The same reasoning applied to our purchases of Hon Industries, Progressive, Heartland Express, Berkshire Hathaway, Leggett & Platt, Clayton Homes, and Torchmark.

The "chance of loss" can be broken down further into semi-discrete elements. First, there is business risk, which is largely a function of our free-enterprise system. Our economy is designed to compete away excess profits, usually via lower prices and/or product innovation. Mismanagement also can bring no end of trouble to otherwise fine businesses. Further, there is financial risk, the often catastrophic downside of the excessive use of borrowed money to fund the purchase of assets. And there is valuation risk. Realistically, there is absolutely no way that the future growth prospects of EMC justify a price-earnings ratio of 125. Period. On the other hand, if you pay too much for Coca-Cola, the longer you hold it the less you will be penalized for being impetuous. Ultimately, earnings-per-share growth will make you look smart.

The simple diagram below, which should not be foreign to those of you who have endured our computer-driven slide shows, helps to graphically illustrate essential elements of our argument. The left-to-right, upward-sloping, solid linear curve—our approximation of a point value for intrinsic worth over time—is what differentiates our investment approach from those who are inclined toward MPT. It presumes, almost arrogantly, that the marketplace is not the final arbiter of value but that we, and others of a similarly independent and presumably rational bent, are capable of reaching a reasonable conclusion about a company's value without the market's help. To be sure, this is the most critical element of our decision-making model, upon which everything else hinges. It should be no surprise that deriving it places more rigorous demands on us as analysts than any other of our activities or, for that matter, any other analytical approaches should we choose to pursue them. The gap between the "value line"—a representation that in reality is never linear—and the dashed lines on either side are known as the "confidence interval." The wider the gap, the more uncertain we are about our estimate of intrinsic value; in like manner, the narrower the gap, the more confident we are of such estimates. Most companies with high levels of business or financial risk simply don't make it through our rather exacting filters. The confidence interval would be too wide for us to find any practical utility in the idea.



Valuation risk, as implied above, is more problematic. The more linear and upward sloping the intrinsic-value line, the greater the degree of confidence in extrapolating it well into the future, and the tightness of the confidence interval around it mitigates valuation risk for long-term investors. But few businesses offer that optimal package of investment attributes. In reality, most lines are not nearly so straight or steep in slope—nor is the future so certain or the confidence interval so tight. Only government bonds provide similar certainty, and they yield 5.1%, well below our threshold required rate of return for equities. Working under those conditions of more frequently encountered uncertainty is not without its justification and rewards (as described in the following paragraph). That's where the concept of "margin of safety" comes into play. You'll notice that point "B" on the diagram is well below the intrinsic-value line immediately above. The spread between what we think a business is worth and the price at which it sells in the marketplace constitutes what might also be called a "margin for error." If our analysis of business, financial, or valuation risk proves to be optimistic—one of several "biases" and "heuristics" about which Dennis Blyly will be writing in most understandable fashion (you'll enjoy the contrast!) in the next Portfolio Managers' Perspective due to arrive in your mailbox in the middle of March—and it becomes necessary to shift the intrinsic-value line downward or flatten its slope, or both, the discounted purchase price gives us a safety cushion to minimize the consequences of our error. Conversely, Point "A," purchasing a company when it is wildly popular, affords none of the advantages implicit in Point "B."

There is a corollary to the preceding thesis that appears to us to be entirely logical but puts us at risk of being called heretics. If the corollary is to be believed, it turns on its head the tenet that high risk is the only means to high return. In other words, from our perspective the world is no longer flat! For the long-term investor who is sensitive to the relationship between price and value, Point "B" affords not only a margin of safety (i.e., lower risk), the holding-period total return is likely to be greater than the growth rate in intrinsic value as well. As I hope is clear by now, Point "A" promises above-average risk and below-average expected return, unless heroic assumptions are made about an upward shift in the value line. That's what we meant in last year's report when we said, "If we carefully manage risk, the returns will take care of themselves." Comfortable now in our role as non-conformists, we must confess that MPT's use of price volatility as a measure of risk can be for us, as long-term investors, a measure of opportunity. The greater the volatility, the wider the vertical spread between points "A" and "B" is likely to be. If we insist on a significant margin of safety at the time of purchase, above-average volatility may well provide above-average returns. Rather simple, when you ponder it awhile … Please don't tell anybody!

Those engaged in investment activities more closely associated with shorter-term speculation are well advised to operate under the high-risk/high-return paradigm. Of course, last year's aberration in technology and Internet issues proves that it is possible from time to time to have the deadly combination of high risk and low return.

As noted in the section on investment performance, a significant portion of whatever advantage we gained over mainstream thinking last year arose because we were able to buy the businesses we longed to own below their intrinsic value. That doesn't happen every year. As with the CEOs of the businesses we own, we cannot escape the reality that capital allocation is a critical and unavoidable responsibility. If long-term returns are determined by the long-term performance of the asset, then we can logically expect to enjoy above-average returns by allocating capital to businesses that earn superior returns on capital, provided we are careful not to be goaded by the seductiveness of popular sentiment into paying too high a price.

SEPARATING WHEAT FROM CHAFF

The 1999 annual report included a four-page discussion on "The Way We Do Business." It examined the competitive strategy that has been ground ever finer in the crucible of trial and error, then elaborated at some length about how the various activities we undertake fit together in an integral fashion, so that the whole is greater than the sum of the parts. We have unabashedly attempted to mimic the thinking that led to the perennial standout performance of Southwest Airlines, in a homogeneous and chronically unprofitable industry, or Clayton Homes, whose business model, if executed well, virtually ensures that it will long endure, through good times and bad, as the most profitable company in the manufactured housing industry. It is the sustainability of their competitive advantages that spring from the synergistic—and nearly non-replicable—fit between interdependent activities that have effectively erected barriers their rivals have thus far found impossible to surmount.

Closer to home, Fleetwood, Oakwood Homes, and Champion Homes lie beaten and bloodied after their unsuccessful attempt to emulate, by rapid-fire acquisition, certain of Clayton's activities, most recently by purchasing independent dealers. Clayton built its model painstakingly over many years, developing a cultural and managerial infrastructure of remarkable depth and breadth. We are not as surprised by the outcome as that the trio failed to notice the complexity and uniqueness of Clayton's approach to the business. The wounds that may bring down one or more of the struggling competitors were largely self-inflicted.

In July 1998 Dennis Blyly and Todd Martin, my two partners, co-authored a Portfolio Managers' Perspective titled "Considerations for Long-Term Equity Strategy," with the subtitle, "Narrowing the Universe: the Use of Filters." Since (1) last year's report made only passing reference to the use of this technique of security selection, (2) their work was both scholarly and is used with even more discipline today, and (3) so much attention is directed at macro issues (such as the decline in the Nasdaq index) perhaps this is a propitious moment to examine more closely this vital activity.

The Freedom, Rationale, and Means to Compress the Universe: the Use of Filters

Clearly the most time-consuming and demanding of our various activities alluded to above, in terms of the competence and experience required, is the search for, and the in-house and field analysis of, the companies that make up our equity portfolios. Parenthetically, credit for the creative selection and comprehensive analysis of the companies that you and we own goes *entirely* to our research team: Dennis Blyly, Todd Martin, and Drew Wilson. Their bios at the end of this report attest to much of what a prospect or client needs to know about why they are so adept at plying their trade. My role? Mostly I mill about, trying my best to look important while growing gray hairs.

The CompuStat database lists 2,779 publicly traded U.S. companies, with equity-market capitalizations of more than $200 million. The $200 million threshold is not arbitrarily determined. If we, collectively, invest more than $10 million in a given company, concerns about the time involved to acquire our position (and price effect of our purchases and eventual sales) begin to surface when, to make a meaningful difference in your portfolio's performance, we must own more than 5% of a company. As you will soon discover, 2,779 companies is not as imposing a number for a boutique firm such as ours as you might initially think. Imagine the retail investor who has 8,600 mutual funds from which to choose! Come to think of it, that's a ratio of about three mutual funds for every company of the minimum size we would consider appropriate. Next year we'll write about how overcapacity will be remedied in the mutual-funds industry.

Even for the largest brokers, researching and monitoring a list of investment alternatives that number in the thousands is an unmanageable situation, claims (by some) to the contrary notwithstanding. Often those firms that have a large IPO underwriting presence are obligated to maintain research coverage on companies they bring public whether or not (as the last 18 months so clearly demonstrated) they are mature enough to be publicly owned and subsequently promoted in research reports. While there is supposedly a "Chinese wall" between highly profitable underwriting activities, with gross spreads approximating 7%, and the far less lucrative research endeavors, many companies show up on recommended lists for reasons that are not purely altruistic. See discussion regarding Drkoop.com on page 40 for glaring evidence of the conflict of interest that often emerges.

Martin Capital's practice of winnowing the list of potential investment candidates down to a precious few is based on certain assumptions. First, it is our firmly held belief, backed by substantial empirical evidence, that, within reason, "few is better"—or, to put it in the vernacular of sustainability, "less is more." Despite the intuitively popular broad and seemingly redundant diversification so evident today, it is our contention (a view we share with some of the most successful investors extant) that most of the benefits that diversification offers can be achieved with a portfolio of fewer than 15 truly diverse holdings. A corollary to that conviction is that it appears unproductive, to say nothing of illogical (assuming our choices are well reasoned and researched), to add a 16th, 17th, or who-knows-how-many other companies—whose investment merits do not measure up to those we already own—to one's portfolio solely in the name of diversification. In the extremes to which it is frequently pushed, diversification is a defensive measure that relates less to minimizing portfolio risk than it does to reducing the possibility of "tracking error" risk for the manager. That technical jargon, with which some investors are not familiar, measures the extent to which a manager's performance deviates from a popular benchmark index, such as the S&P 500. There is apparently some comfort in appearing average, particularly if *your* bottom line is more important to you than your client's.

Of course, with a focused strategy there are trade-offs. Fortunately, the most obvious is not wealth threatening, even though the angst it occasionally engenders would lead one to think otherwise. We call it the utterly unavoidable "egg on your face" phenomenon. When you place few but large bets, and one or more fails to live up to expectations, such miscreants stand out like a woman of widely acknowledged ill repute in the front pew in church. Among our equity holdings there was only one that produced negative returns for 2000. Despite overall equity portfolio performance that exceeded the popular indices by a wide margin, all eyes tend to rivet on numbers that appear in red rather than black! Textbooks refer to it as "management by exception." The clear success stories are taken for granted; those that fall short consume an inordinate amount of explanation time.

To illustrate, Wabash National is a large holding whose stock price does not mirror gradually improving earnings, though they're well below our expectations. Wall Street's disdain for the company is in part deserved, but only in part. We know we'll never roll very many 7's in a row, so our approach demands that we be prepared for the inevitable questions, fork in hand, ready to consume an ample portion of humble pie. Such aberrations have little to do with the efficacy of the concentration approach; they simply make it a little more difficult to implement when interactions with clients are relatively frequent, as is our preference. Even though we all know that it's the overall portfolio return that's relevant, there will always be more of a focus on those horses that aren't pulling their own weight than those that are. That is human nature, and it is a relatively small price to pay for the objective at hand. The alternative, which we find totally unpalatable, is to own so many companies that the losers will be lost in the crowd, making it easier for the advisor to simply sweep them under the carpet, unnoticed. We are in the business of preserving and enhancing wealth for our clients, period, even if it means taking some heat once in a while!

Having returned not long ago from a mid-December conference for CEOs and managing partners, the ambitious overall title of which was "Leading Your Firm into the Future," the session "Can Technology Be Your Path to Success?" affirmed a belief we have had for some time. Not only have steadily more affordable technological developments leveled the "playing field" on which the giants (as well as boutique firms such as ours) do battle, it has further facilitated our practice of filtering out the best ideas, as we define them, from the thousands available, on a cost-effective basis. Our first filter, discussed below, requires the ability to sift through millions and millions of company financial statistics in search of those businesses that warrant, because of their profitable histories, more careful study. (Parenthetically, as important as the information-technology revolution has been to us as institutional consumers, few of the hardware or software companies make it through our investment filters—for reasons that soon will become obvious.)

Focus on the Economic Return of the Asset

The first filter was developed with an understanding that there is a difference between speculation and investment. Most people have their own notion, however vague, about these two fundamentally different concepts. Our experience would suggest that people often use the terms "investment" and "speculation" interchangeably when times are good. Ben Graham, the founder of modern security analysis and our "featured speaker" in the subsequent Appendix, compares the two investment approaches as follows: "An investment operation is one which, upon thorough analysis, promises safety of principal and an adequate return. Operations not meeting these requirements are speculative." In our view, true investors tend to focus on the underlying asset, while speculators rarely look beyond the price. In other words, investors attempt to profit from growth in the intrinsic worth of the asset or from the cash flow derived from the asset, while speculators attempt to profit by changes in price, irrespective of the growth/decline in value. The distinction between speculation and investment is important, as it relates to drastically reducing the number of potential investments.

You undoubtedly acted like an investor when you purchased your first home. I doubt that it was purchased "sight unseen." Few people would consider buying a real-estate property without first thoroughly investigating the physical condition of the house (asset) and its location (environment). The same logic can be applied to buying private businesses. An inspection of the physical assets, an assessment of the economic goodwill (intellectual capital, brand equity, etc.), an analysis of the competitive environment, a review of the current and historical financial statements, and other due-diligence activities are routinely performed in order to assess the overall value of the business. In this situation, the investor is fully aware that the return he or she will achieve is most likely dependent on the cash flows produced by the investment relative to the cash paid to acquire it. Like the investment you made in your home, the approach to investing in a private business is one with a very long time horizon. The attention is invariably directed to the asset itself, not to the availability of a ready marketplace, with prices quoted daily on the various exchanges or on the Nasdaq. The purchase intention is to buy and hold, not to purchase with the intention of selling at the first uptick in the market price.

If we had a speculator's mindset, our investment universe would be so much larger. After all, every stock has a price, which goes up and down, more or less randomly, around the value of the asset. Bethlehem Steel and McDonald's might be speculative candidates if price was our primary consideration. Indeed, under the extreme version of the speculative paradigm, stocks would trade like baseball cards (unrelated to anything tangible like the underlying profitability of business), only on the chance that someone will take them off our hands later at a higher price. By focusing on the asset (the business) and its capacity to grow and produce cash, we eliminate the vast majority of companies.

Again, for most of the following work regarding Martin Capital's "filters," I'm indebted to Dennis Blyly and Todd Martin.

Filter No. 1: A Record of Superior Economic Returns

Our first filter, therefore, screens out all companies that do not have a record of superior economic returns. After reading hundreds if not thousands of annual reports over the years, we have reached a sobering, even chilling, conclusion: From the investor's perspective, many if not most businesses are simply not worth owning. All executives are duty bound to present their company's story, however moribund, in the best possible light. The ability to distinguish between the good, the bad, and the ugly requires experience, perspective, and skill. Please don't infer that it's an exact science; much of a company's present worth is dependent on decisions and events that take place in the future. Nonetheless, we believe the past is at least in part prologue. Occasionally, companies with abysmal records achieve a reversal of fortunes for which they typically receive disproportionate press. The majority that don't change directions drift into obscurity. Frogs turning into princes are largely the stuff of fairy tales.

The notion of economic profit is different from an accountant's definition of profit in that the calculation of economic profit includes as an expense the (opportunity) cost associated with the capital employed by the business. To the extent that a business earns a return on its invested capital exceeding its cost (the minimum return demanded by providers of capital) the business is said to have created economic value. We naturally gravitate toward those businesses that have a proven track record of creating substantial economic value over time.

While there are various techniques and formulas for measuring the cost of capital and return on invested capital, we typically use some combination or variation of return on assets (ROA) and return on equity (ROE) when measuring economic returns. Prudent use of financial leverage is acceptable to us, but our definition of prudent is, you might say, prudish. Generally speaking, a business is unlikely to penetrate our first filter unless it has a long history of producing an average ROE, very conservatively leveraged, of 15% or more.

Filter No. 2: Understanding the Business

It is relatively easy to assess the economics of a business in terms of historical growth rates and average returns on invested capital, key elements of our first filter. This information is widely available from a number of financial databases; using it effectively requires little more than a working familiarity with financial accounting. The analytical challenge emerges as one attempts to uncover the primary drivers that gave rise to the superior economic results. Thus, our second filter requires that we clearly understand the factors that have been responsible for the superior performance of the business in the past. Such analysis focuses on, among other things, the source and estimated growth rate of the primary demand for the product or service, the competitive construct of the industry in which the company operates, the height of the barriers to entry and exit, the various economies available (including those of scale), the importance of switching costs, the relative power of buyers and suppliers, the intensity of the competitive rivalry within the industry, the price elasticity of demand for the product or service, and so on. You get the idea. From the analysis of these and more, we attempt to determine the extent and sustainability of any competitive advantage the company might presently enjoy.

For most businesses, a quick study of the past can give experienced investors a reasonable understanding of the factors that have been the basis for the business's historical level of growth and profitability. The key to our ability to understand the business from an investment perspective, however, is our capacity to make a reasoned assessment of what the business might look like sometime in the future. Since the past is quite knowable, the key consideration for us is the degree to which the past is useful in predicting the future. Our presumption is always that the future is full of uncertainty and, therefore, estimating intrinsic value will forever be difficult. To be sure, there is considerable margin for error implicit in any calculation of business value. The degree of difficulty in calculating intrinsic value (the present value of future cash flows available to the investor) varies from business to business. Uncertainty grows by an order of magnitude with businesses that are subject to rapid change because of constant innovation, as in technology, and/or that participate in an industry with an unstable overall structure. An ever-changing cast of winners and losers, for example, over time will characterize industries that maintain low barriers to entry or experience short product cycles. Think back over the last 15 years and try to remember the number of companies that were at one time the leader in the PC revolution. By contrast, Campbell Soup, Coca-Cola, Tide, Gillette, Snickers, and Clorox Bleach are firms that have been industry leaders for decades. [Note:

The half-dozen businesses named are only examples; we certainly don't limit ourselves to consumer-products companies and those with mature product lines.]

We have a strong preference for companies that have achieved sustainable competitive advantages, which gives us more confidence about the company's ability to sustain profitability in a competitive industry, and operate in relatively stable and predictable industries, where a careful assessment of the past is useful in attempting to understand the future. If no historical precedent exists, forecasting future events and trends becomes much more difficult and problematic. In this vein Warren Buffett addressed the issue of understanding the certainty of a business model at the April 2000 Berkshire Hathaway annual meeting by suggesting a new way of evaluating a student's grasp of the subject at leading business schools: "For the final exam, I would ask the students to value an Internet company. And anybody who gave an answer … flunks." How incredibly prescient that simple advice turned out to be.

By any measure, Coke and Microsoft are both very successful companies. Take a moment to briefly consider the factors that led to their prosperity. In the simplest of terms, Microsoft's success has been the result of (1) the early adoption by consumers of DOS as the industry standard for the personal-computer industry, (2) adding applications to its operating system, (3) the continued growth and upgrade cycle of the PC industry, and (4) Apple's failure to license its operating system. Coca-Cola's success is largely a function of (1) 70 years of accumulated brand advertising, (2) a universally appealing product, and (3) an unparalleled distribution (bottling) system.

Obviously, both companies meet our first screen of having an enviable record of extraordinary economic returns. Moreover, the past is reasonably understandable in terms of attributing the financial success of each company to the business fundamentals and sources of competitive advantage. The crux of the second filter, however, is our ability to "peer" into the future. Does the past provide any useful guidance about the sustainability of competitive advantages and growth rates? With Microsoft our crystal ball gets cloudy. If we were certain that personal computers would be the core of the next technology platform, our confidence would be much higher. Technology platforms, however, change with revolutionary speed, and history suggests that new winners and losers are created in the process. Microsoft may continue to be a great company, and Bill Gates & Co. could be well positioned for the future age of information and digital commerce. The point is, we don't know. What we do know is that the company will need different skills and capabilities in the future if it is to match past successes. Microsoft's future success is far from a sure thing.

Coke's future, on the other hand, is relatively certain if management simply keeps doing what it has always done. Consumers' need/desire for refreshment will not go away. Advertising, marketing, and availability (expansive bottling system) will still be very important determinants of consumer choice, and there is little chance that a competitor will unseat Coca-Cola as the leader in these critical success factors.

Coca-Cola clearly passes through our second filter. There are too many questions about Microsoft that, when combined with a limited understanding of leading-edge developments on the frontiers of technology, make the future too unpredictable for us. For those who believe they know with some precision the direction in which the information revolution is heading and, more importantly, the identity of the companies likely to be at the forefront, Microsoft, or a couple of its thousand successors, may have some investment allure. For us as investors, the odds are not appealing.

Filter No. 3: Managerial Competence and Loyalty

Our final general filter (other filters are industry specific) is an assessment of the keepers of the castle. We are primarily concerned with two telltale signs: the performance of the business that is attributable to the business savvy of those who manage it and their attitude toward their shareholder constituency.

Distinguishing Business from Managerial Performance

We are convinced that business performance, when measured against the average for all businesses, is largely determined by the competitive characteristics of the industry in which a business competes. Indeed, much of our analysis of the factors leading to corporate profitability is directed toward industry characteristics and trends. As such, it isn't always easy to distinguish between the skillfulness of those who set the vision and execute the plan over against the general profitability of the industry when examining the profitability of a business. Perhaps the easiest and most straightforward analysis of management performance is to compare the relative performance of various companies in the same industry. If companies "A" and "B" are in the same industry, and Company "A" consistently gains market share and earns higher economic returns, you may be able to make judgments about differences in managerial capabilities. On this basis, it seems fairly clear, for example, that Coca-Cola has managed its soft drink business more intelligently, with a clearer sense of purpose, than Pepsi over the last several years. Likewise, Nike's management has outdistanced Reebok's in the race for which the consumer's choice of brand signifies victory. It would be difficult to make judgments about managerial decision making, however, by comparing the business performance of, say, Nike with that of Pepsi. Relative performance within an industry can be a useful tool for gauging managerial performance.

Corporate Governance and the Allocation of Capital

The issues of corporate governance and the allocation of capital, while functionally distinct are often similarly influenced by the board's and the CEO's behavioral response to a fundamental question: Whose company is it? There are many constituencies to which the managers of a company feel varying degrees of obligation. They include its owners, employees, suppliers and customers, communities in which the company operates, and management itself. Increasingly, we are seeing evidence that the order of priorities is being reversed. We read SEC-required proxy statements with a keen and often skeptical eye. It's the easiest place to spot a pickpocket. The most widely practiced form of corporate theft takes the form of stock options, about which more will be said in the section on accounting (see page 43). Some are quite acceptable—actually appropriate—while others are brazenly egregious. While not of that extreme, the stock-option program at one of our investees, Belden Wire and Cable (despite the fact that it was "blessed" by a compensation consulting firm), has cooled us considerably toward the company as a long-term investment.

Absolute judgments about executive competence are highly subjective and time consuming—although frequently quite rewarding on a personal basis—and yet are more often than not critical to our evaluation of the contribution of the decision makers to individual companies' success. At risk of failure to recognize others of similar ilk, of which fortunately there are many, Russ Gerdin, chairman and CEO of one of our largest holdings, Heartland Express, an Iowa-based truckload carrier, is a man we have come to know. From that familiarity we have grown to like, trust, and respect him greatly. In an industry whose service appears monotonously identical to the traveler who sees an endless stream of semi-tractor trailers pouring past on the expressways of America, the person calling the shots can be the differentiating factor. Men like Russ, and a few others in an industry that must be characterized as other than glamorous, are the reason why all trucking firms are not equally profitable. The fact that we have some sense of Russ's values, how he approaches the business, and how he problem-solves helps us better understand why Heartland is consistently among the most profitable companies in the industry. We often go beyond inferring that managers must be competent simply by virtue of the financial results. This approach—"getting to know the quarterback" personally and well—to the evaluation of management is employed with virtually all the companies we own, save for the very largest (e.g., Gillette and McDonald's, where accessibility to the executive offices is severely limited). As investors who take large positions, developing a high degree of confidence in those managers in whose hands our financial destiny rests, results in both peaceful sleep and indifference to the fickle vicissitudes of the marketplace. And as noted at the outset of this paragraph, it's a lot of fun to get to know people like Russ.

Perhaps the most important strategic measure of a chief executive's competence is his or her vision, with leadership taking a close second. Vision gets translated to observable behaviors as decisions are made about the reinvestment of the cash/borrowings the company generates. For simplicity's sake, the CEO of the company—aided by a board that presumably wisely exercises its powers of checks and balances—that earns 15% on its equity capital annually and pays no dividend must reinvest an amount of money equal to more than 100% of its current worth every five years. That is a tall order. If the growth in product or service demand (or ideally the funds needed to capitalize on it) in the company's primary business does not offer reinvestment opportunities of that order of magnitude, the chief decision makers must spread cash flow into new and often unfamiliar venues and ventures—and/or return money to shareholders through stock repurchases or dividends. For the manifold reasons discussed in last year's annual report, it's frequently the former of the two alternatives, the "corporate imperialism," that impels otherwise reasonable men and women to engage in sometimes impulsive and irrational behaviors as they seek, like conquering warriors, to expand their empires. Remember imperialism and the British Empire ...

Returning once again to Russ Gerdin, last year he demonstrated the disciplines that reveal the clarity of his vision as a capital allocator. Being familiar with his historical behavior, we have been aware that he is always on the outlook for a strategic acquisition as a means of redeploying an ever-growing $122 million cash hoard as of September 30, 2000 (Heartland generates oodles of real cash). Finding no acquisitions during the course of the previous 18 months that met his demanding standards for price, operational fit, and value, he was accosted one day by a nameless institutional investor, apparently anxious for more action elsewhere, who offered the company 11.7% of its stock (3.5 million shares) at a price slightly above the low for the year of $12.75. At year-end the stock sold at just under $23. My hunch is that my friend Russ did not deliberate long before saying, "To whom do I make my check payable?" The purchase cost the company $45 million. Likewise, it appears Freightliner was rather anxious to reduce its inventory of diesel tractors. Russ, apparently, was only too willing to cooperate on terms, we suspect, that were not contrary to the interests of Heartland shareholders. He purchased 1,200 tractors. Under somewhat similar circumstances he ordered 2,200 new Wabash Duraplate trailers, essentially replacing his entire fleet in the two transactions. As for the details of the Wabash transaction, he didn't tell and we, for obvious reasons, didn't ask! Our threshold for pain is low. We give Russ high marks as a shareholder-oriented allocator of capital. Of course, as the owner of 53% of the company's common stock, he is playing with his own chips. That's no ironclad guarantor of success, but it *is* of shared misery if the judgments he makes are eventually proven misguided.

From our experience, relatively few businesses make it through the aforementioned filters. Those businesses that preliminarily pass through the screens possess characteristics that are worthy of more detailed due diligence. In the end, we maintain an inventory of 60 to 70 investment ideas to which we can commit capital at a price of our own choosing, ranked in descending order of five-year total expected return. The small universe of businesses that make it through our filters is highly complementary to, and interrelated with, our thinking on efficient diversification as one means of reducing risk, as *Webster's* defines it. If you recall, another was discussed in the section starting on page 19, "The Art/Science of Managing Risk."

PART II

CAPITAL MARKETS

With the proliferation of media sources for financial and market information, rather than regurgitate what has already been digested (as is the excepted protocol for reports such as this), in this section we will devote more space to our assessment of the "whys" than the "whats."

It is a generally accepted orthodoxy within the profession of money management to categorize firms as specialists in this or that, like so many different toy soldiers, some with torch to cannons' wicks and others with bayonets in place, some on horseback, others afoot. The list of possible subsets of investment specialists must number in the hundreds. Those who control the distribution channels to individual and institutional investor alike call the tune, and it's a medley of choices, enough to boggle the mind. It's been a burgeoning market. We hope the investors themselves ultimately prosper to the same extent as the promoters.

Our inclination is to look at all the pieces as parts of a bigger puzzle. As has been argued on these pages in the past, a bond is nothing more in its essential form than a stock with a fixed dividend and a specified maturity date and price. Accordingly, as wealth managers, we view stocks and bonds as interchangeable substitutes. Since relatively short-term highest-grade fixed-income securities are, as risk is defined elsewhere, the safest marketable securities available to us, we treat them as the "default class." Nonetheless yielding, with some reluctance, to convention, we will discuss the debt and equity market separately.

Fixed-Income Securities

Despite a similarity in form with common stocks, a bond's designated purpose is to protect capital and produce income. Keeping things simple for the moment, a bond purchased at par promises no chance for profit beyond the coupon earned. Of course, we understand that fluctuations in interest rates or upgrades or downgrades in the credit quality of the instrument will affect the market price, and profitable (or unprofitable) trades can be made to capitalize on those changes. In point of fact, declining interest rates in 2000 resulted in rising prices for fixed-income securities, precisely the opposite outcome experienced in 1999. The interest-rate forecasting record of economists has been so abysmal over the years that we think it unwise to make big interest-rate bets. In addition, there are esoteric fixed-income security-management techniques designed to juice out a slightly higher total return or meet a defined purpose. We have created synthetic annuities where the fit was ideal, but generally we leave the exotic stuff to others.

The long-term investor might be well advised to think of a bond as a security that offers no upside (assuming it's not a convertible bond) and unlimited downside. The best a bond can do is provide timely interest and principal payments; at its worst, it can default and leave you with little or nothing (long after the courts and the attorneys are through). To realize the full benefit of the semi-annual coupon and the ultimate redemption at par—all the bond indenture promises—we make no compromise on credit quality. Almost without exception, every fixed-income security we have purchased is either a direct obligation to the U.S. Treasury or, in the case of pre-refunded or escrowed-to-maturity municipal bonds, it is backed by U.S. Treasuries. If we should choose to compromise on credit quality, we (in effect) would be taking equity-type risks with little chance of a big payoff that common stocks have the potential of providing. When we assume equity-type risks, we do so in equity-type securities. Period.

Falling interest rates were especially kind to the owners of the highest-quality fixed-income securities in 2000, as the total returns from your U.S. Treasury and pre-refunded or escrowed-to-maturity municipal bonds exceeded their coupon income. Despite the more favorable interest-rate environment, owners of instruments of lower quality were rendered a cruel judgment by the markets, with prices reacting negatively to deteriorating credit quality. As evidence of another market dichotomy, market yields on junk bonds rose while prices fell when, simultaneously, Treasury securities yields and prices were marching in precisely the opposite direction.

The creditworthiness of U.S. corporations has been in nearly as steep a free fall as the Nasdaq—and for much the same reason: earnings that have failed to meet investors' previous heady expectations. That points to a rising tide of defaults, especially among junk companies. "We've seen a notable decline in credit quality and an excess of downgrades versus upgrades in the last couple of years," says economist John Puchalla, one of the authors of a new report from Moody's Investors Service. The report adds that even better-rated companies have become vulnerable, having borrowed heavily for equity buybacks, mergers and acquisitions, and capital spending.

Barron's Editor Alan Abelson makes these observations, with more than a dollop of satire:

> *As it happens, corporate buybacks lagged as the year wore on, but that's easily explainable: Companies like to buy back stock only when its price is soaring. Otherwise, the reminder of how the value of their options is shrinking is too painful for the sensitive officers and directors to bear. That billions of dollars of earlier buybacks they authorized are now underwater may have had something to do with the reduced pace of repurchasing, too, although such picayune considerations never stopped them before.*

Default rates are in fact rising, and there has been no sign of a letup this year, especially from shakier issuers that sold debt in the more relaxed credit environment of 1997 and 1998. By the end of 2001, Moody's predicts, 8.4% of the junk debt now outstanding will default.

Standard & Poor's also has issued a report forecasting record corporate defaults this year. "Due to the volume of outstanding debt by financially weak companies, we expect defaults to remain high for the next year and the best part of 2002," the company says. So far, $37.7 billion of debt is affected, and S&P expects the total to grow.

The junk-bond market, accordingly, calls for issuers to cough up roughly 13% on their new offerings, as well as throw in equity kickers composed of units with warrants for the issuing company. Even investment-grade companies have found borrowing more expensive. The Morgan Stanley Dean Witter Industrials index, which tracks spreads on five-, 10-, and 30-year investment-grade bonds, stood at 2.17 percentage points over Treasuries in the latest week, up from 2.10 percentage points the previous week. The index is now well above the 1.80 percentage-point spread evident during the 1998 global financial crisis. At year-end the 10-year Treasury note yielded 5.11%.

Risk tolerance by investors is wearing thin. An extreme example of the current travails is NorthPoint Communications Group, whose acquisition by Verizon was canceled last week after the DSL provider had to restate its third-quarter earnings to reflect non-payment by its customers. As part of the deal agreed to on August 7, Verizon was to make an $800 million cash investment in NorthPoint, of which it has already made $150 million. With that no longer happening, NorthPoint's $400 million of 12 7/8% senior notes due 2010 plunged 52 points last week to just 10.5 cents on the dollar. As recently as the end of October, NorthPoint's junk bonds were quoted at 94.

There are similar horror stories in the low-grade sector of the municipal-bond market as well. We'll save them for another time.

Common Stocks

For the year, the Dow Jones Industrial Average was down 6.2%, its biggest drop since 1981. For all the volatility in other markets, the average actually traded in a fairly narrow band between 10,000 and 11,000 for much of 2000. The Standard & Poor's 500 stock index dropped 10.1%, its biggest drop since 1977's 11.5% decline. Microsoft's impact on the S&P was huge last year. The stock's 63% plunge accounted for nearly 30% of the index's decline, owing to its market-leading weighting at the start of 2000. Despite the S&P's loss last year, some 249 out of 444 stocks that were in the index at the start of 2000 had actually advanced through December 27, according to analysts at Ned Davis Research, in Venice, Florida. The Ned Davis calculations don't include the 56 stocks added to the index this year. Excluding technology stocks, the S&P was down just 0.3% through December 27, and the median stock gained 10.2%. And the Nasdaq Composite Index, home to the most exuberant stocks, fell 39.1% in 2000 to end the year at 2,470, less than half of its March 10 high of 5,049—and its worst showing ever since the index's founding in 1971. At its low of 2333, the Nasdaq had given back most of its prodigious gains achieved over the last two years (it had closed 1998 at 2193).

The market action last year amounted to the reverse of what happened in 1999, when the Nasdaq soared 85%, and technology was about the only place to be. During 1999, the S&P 500 rose 19.5% but was up just 4% when tech issues were excluded, says Ned Davis Research. And despite the index's strong performance, the breadth in the S&P was worse in 1999 than 2000: Fewer than half the stocks in the index rose during 1999, while the median stock fell 2.1%.

Foreign stocks, long ballyhooed by financial intermediaries as an essential ingredient for diversified portfolios, did little to further that argument in 2000. As a representative of Latin America, Mexico's Bolsa index declined 21.5% in dollars. As for Europe, Bloomberg's European 500 index fell 10.2% in dollars and 17% in the faltering Euro. The Pacific Rim's largest market, Japan, saw its Nikkei 225 index plunge 27.2% in dollars, 34.7% in Yen, to 13,785. Those with long memories will recall that the Nikkei peaked in 1989 at 39,000. We've always been homebodies—and find life easier and our wallets thicker as a result. Besides, mindless imitation of others has never been our style ...

The relationship between the total market value of all U.S. common stocks and GDP, until recently, was off the charts, paralleling the Japanese stock market and underlying economy in the late '80s. Such extreme valuations cause us to shiver just a little. What the data tell us is that despite the great damage done to various and sundry sectors, this American market by any historical or rational yardstick is still no bargain.

The Stock/Bond Dichotomy

We simply can't shake ourselves of the compulsion to view the capital markets as a whole. The corporate-bond market is pricing in a rather high probability that companies will default. The stock market, despite its recent slide, continues to boast historically high valuations. Something doesn't compute here, obviously, since the same earnings that go to equity holders can be used to service debt payments. The quixotic differences in the actions of stocks and bonds tell very different stories.

But it also occurs to us that some of the most robust performers in the equity markets are not overly burdened with earnings either, so their high valuations may be accompanied by equally high probability that they'll default on their obligations. Bridgewater Associates, a highly regarded research firm that invariably asks "why," recently cited Amazon.com as an example of a company on which the stock and bond markets awarded strikingly different valuations. The company had a market cap of some $10 billion ($6.4 billion at year-end), down from $50 billion, but still quite noteworthy.

Amazon had around $2 billion in corporate debt outstanding. Of that tidy sum, its non-convertible obligations due in 2008 were trading at nearly 50 cents on the dollar, offering a yield of over 16.5% (which, as noted above, is somewhat above that on the 10-year Treasury yield).

Observes Bridgewater: "The bond market is saying, in effect, that there's a 54% chance 'the company goes bellyup.' Which isn't exactly consonant with the stock market's insistence that Amazon.com is worth $10 billion." In a sense, Bridgewater commented, in seeking to explicate the paradox of such contradictory valuations, Amazon is a "microcosm of what's happening in the overall equity and debt markets. The debt markets are pricing in significantly high probabilities of default, while the equity markets show little concern." As the year wore on, the equity markets became a little more observant!

Baby Boomers: Wither Thouest?

Undoubtedly the most common and adamantly expressed argument I have heard over the last several years in justification of a perpetual cornucopia of stock-market riches has as its central thesis the ever-expanding flood of money from the coffers of the Baby Boomers flowing into the stock market. While generally considered even-tempered and understanding, I found that the absurdity of that notion usually was enough to get my juices flowing. Most of the time I was composed enough to bite my tongue. First, it focused entirely on demand, with no regard for supply. That most elementary of economic equations, as apparently was overlooked, has two sides. It is price that reconciles the two. Second, and a bit more subtle, is that, metaphorically speaking, in pushing an ever-growing snowball up a hill, it takes more and more muscle for each inch of new territory gained. At some point, the snowball's mass is greater than the muscle behind it. If new muscle doesn't arrive soon, the monstrous snowball may, well, snowball and start rolling back down the hill. That, perhaps, is the question of the moment. Early returns would suggest that you stay out of its path.

According to *The Wall Street Journal* articles, new cash flowing into stock mutual funds dropped 54% in November—the biggest monthly decline in nearly two years—as investors, stung by falling stock prices, started voting with their wallets. The decline in new stock-fund money was the steepest since February 1999, when the market was still recovering from the global financial crisis.

The preference for safety was underscored by investors' growing attraction to money-market funds, conservative vehicles that gain about 5% or 6% a year, regardless of gyrations in the stock market. That is especially appealing this year with the average stock fund down 5.8%, according to Morningstar Inc., the Chicago fund tracker. In November, for the second month in a row, investors stuffed more money into the cash-like funds than they put into stock portfolios. The final figure came out to $56.19 billion, more than double October's $26 billion total and the highest intake for money-market funds since January 1999.

Indeed, enthusiasm for the stock market appeared to be fading fast in December too. "We're ending the year on a low-key note," said Steve Norwitz, a spokesman for T. Rowe Price Associates Inc., a Baltimore fund firm. In both November and December, he said, the pace of new money coming into the company's stock funds slowed to a crawl. The firm expected the figures to end December flat, meaning that no net new money will have come into the stock funds.

One area out of favor and staying that way is international funds. Stock funds that invest abroad lost $2.88 billion to investor desertions in November, up from $206 million in October, according to the ICI (Investment Company Institute).

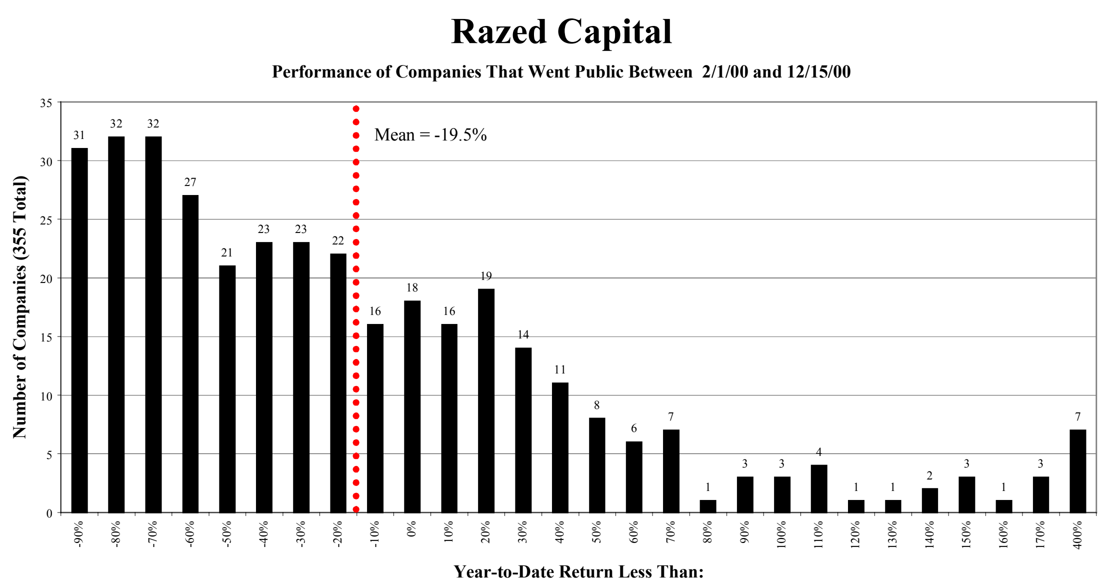
What About the 'Smart' Money?

Steve Leuthold, sage of the Leuthold Group, reports that through July 2000, insider selling of big blocks of stock, which he defines as at least $1 million worth (or 100,000 shares or more), weighed in at $43.1 billion. That's twice as much as sold in the comparable spans of '98 and '99. As a matter of fact, Leuthold notes, this year's insider dumping in the first half tops the record $39 billion similarly disposed of in all of 1999. And, he warns, judging by filings with the SEC, there's plenty more where that came from: "Mother always told us, 'Don't fight the Fed or bearish insiders.'"

The Internet and IPO Frenzy

Internet analysts were the newest masters of Wall Street's universe. With stunning regularity, they would make an outrageous prediction that, within a year, a stock would double or triple or better—and watch gleefully as the stock sometimes did that in a month. This encouraged the analysts to make even more eye-popping forecasts, which many did (to their great embarrassment today), as most of those stocks now sell for a tiny fraction of the price when the predictions were made.

Then there was the great IPO frenzy. Despite warnings that initial public offerings are risky by their very nature because most IPO companies are so new, investors clamored for them—not just some IPOs but almost all of them. And why not, given that many were doubling on their first day? Many of those highfliers have since imploded, with about two-thirds trading below their offering price—and lots of them way below. See the woeful account of Dr. Koop.com, beginning on page 40. As for the chart below, keep in mind that the performance indicated is recorded from the initial-offering price. Many doubled or tripled or more from the offering price as money from neophyte investors jumped aboard the train pulling rapidly out of the station. The overall losses, therefore, were far greater than the chart suggests.



Fool's Gold

Last year, taking stock for payment from dot-com start-ups seemed like the path to Internet riches. Maybe it wasn't so brilliant after all. Not long ago, Web designers, lawyers, executive recruiters, landlords, celebrities, professional athletes, and others with goods or services to offer technology start-ups were accepting—in some cases demanding—stock in lieu of, or on top of, cash for their services to up-and-coming companies. Many of those taking the stock figured it was almost riskless because they were selling picks and shovels to the gold miners. It turns out that many ended up with fool's gold. This and the two paragraphs above remind us of two things: (1) Memories are short and (2) an axiom as old and inviolable as death and taxes: "There is no free lunch."

Are There Underwater Mines Everywhere?

In a word, "no." We were able to find opportunities—or perhaps it was their falling prices that found us during a year with more crosscurrents than a competitive kayaking course. We believe that generally it will be the headwinds that will prevail, and we will respond accordingly. In the discussion on investment strategy that follows, we will explain how we hope to tack gingerly and cautiously upwind. We would prefer a howling broad reach, but the winds have shifted. We can't control the gales, but we can trim the sails.

GOLIATHS SLAIN

"Many shall be restored that now are fallen, and many shall fall that now are in honor."
– Horace in *Ars Poetica*

Thus appeared the prophetic keynote quotation on the first page of the first edition of the investment classic, *Security Analysis*, written in 1932 by Benjamin Graham and David Dodd, and published in the darkest depths of the Depression in 1934. The Appendix to this annual report attempts to capture Graham's assessment of what human foibles precipitated that most devastating of financial and economic contractions to befall the American public—investor, speculator, and worker alike—in the 20th century. A little color will be added by several brief excerpts from Graham's memoirs as well.

That preamble aside (and you may attend to the Appendix at your leisure), the following contemporary eulogy is better framed in the context of the backdrop described in the preceding paragraph. It is brimming with insights about how money has been managed—or mismanaged—by the biggest and most prestigious hedge funds in the world. It is also a cautionary tale of the rise and fall of two famed financial-market luminaries who are likely to be as familiar to those with even a passing interest in the goings-on in the investment world as Sammy Sosa and Mark McGwire are to me, a man far more comfortable with P/Es than RBIs.

To begin, these two men—Julian Robertson Jr. and George Soros—are not contemporary scoundrels, nor were they poured from the same mold as the robber barons of old. To be sure, they were major league speculators, both as bright as they were bold and sometimes brash, yet not so superhuman in the end as to be invulnerable to the risks inherent in those high-stakes and even higher-profile games of chance for which they were so well known.

Julian Robertson Jr.

The first is a man brought to your attention in last year's annual report. Value manager Julian Robertson Jr., the courtly 67-year-old North Carolinian, guided Tiger Management to resounding success since its inception in 1980 (nope, no connection to golf's Tiger Woods). Twelve months ago we had this to say about the value manager's dilemma, quoting from his December 1998 letter to the clients of Tiger Management: "... [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 the 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."

A few momentous months later, on March 30, 2000, the same week the market sounded the death knell for DrKoop.com (see story beginning on page 40), Julian Robertson shocked the investment world as he closed down his hedge funds after 18 years of stellar returns and two years of disaster. Following an inspired decision made years ago, he called his company Tiger Management and named his funds after members of the cat family (Jaguar, Puma, Ocelot). His lifetime record will always be remembered with awe. Robertson turned his original grubstake of $8 million in 1980 into a personal fortune estimated at a billion dollars, even after the April setbacks. His investors reputedly enjoyed annual returns over that period of 25% (or so he says). Then, in the 18 months preceding his announcement—an agonizing time for value investors—Tiger proceeded to give back half of the gains it had built up over the previous 18 years. While

Wall Street neophytes and veterans alike cleaned up in technology issues, Tiger shunned the Internet and stuck largely to old-economy stocks such as General Motors, Unisys, and US Airways.

His decision to close up shop has occasioned a great outpouring of commentary, much of it finding fault with one thing or another. Nobody, though, seems to find fault with his indignant refusal to participate in the bull market for technology stocks. Rather, he has been treated as a tragic hero because his adherence to the "value" rule went unrewarded, while money managers who shamelessly chased tech stocks were treated to vast returns. Instead, he is castigated for letting his $22 billion fund get too big to move in and out of companies without roiling the share price, for neglecting good opportunities because they were too small to make a difference, for forsaking stocks to dabble in the occasional bet on interest rates or currencies … though his "macro" performance was no less mixed than the other victim of whom I will write shortly.

In announcing that he would liquidate his funds and give back his investors' money, Robertson admitted that he is "out of step with a world in which Palm, the maker of the hand-held Palm Pilot, is valued at more than GM and in which Priceline.com (which sells airline tickets but has neither earnings nor planes) was valued at more than US Airways [a company that brought Berkshire Hathaway acute although ultimately temporary pain and in which he held a commanding 22% interest] and most of the other publicly traded airlines combined."

Sadly, for those investors who embraced the Priceline.com story as evidence of both the despair and disillusionment that had overcome Robertson at that moment, the prophetic insights that he so often exhibited were disregarded. The price line that Priceline.com stock tracked has not been unlike the attitude of a plane before and after it "stalls." The stratosphere-bound shares of the popular and creative auctioneer of airline tickets, hawked on television by celebrity spokesperson William Shatner, perhaps selected because of the public's familiarity with him as an icon from the era of science-fiction fascination, in the end proved that some ideas are, indeed, more fiction than fact when profitability is used as the standard of measure. During the very same week when a disheartened Robertson capitulated and bemoaned the irrationality of the market, Priceline.com stock's exponential ascent finally slowed to stall speed at the altitude of $163. From there, in little over a year's time, it sped toward Earth in a death spiral, currently languishing around $2 per share, $22.5 billion in market value simply disappearing into thin air during the tailspin.

"There is no point in subjecting our investors to risk in a market which I frankly do not understand," Robertson wrote. What's more, he went on, "there is no quick end in sight … of the bear market in value stocks." That conclusion, sadly for Julian Robertson, was not prophetic.

At the end of 1996, Tiger had roughly $8 billion in capital, 1,000 times its initial outlay but still a manageable pool of money. Then, in 1997, Tiger had its best year ever—up 70%. Overnight, Tiger became Wall Street's sensation—just as Long-Term Capital was … and just as high-tech funds are today. Tiger's gaudy results attracted billions of dollars from new disciples. "It was fickle money," according to a spokesman for Tiger. "You could say hot money." By August 1998, Tiger's capital had burgeoned to $22.8 billion.

Perhaps intoxicated by his record, Robertson allowed the fund's leverage to balloon to 3 to 1, meaning total assets topped $60 billion. (Of course, leverage also had helped inflate returns on the way up.) With such a bloated portfolio, Robertson knew, as he admitted to a *Wall Street Journal* reporter, that some of his biggest holdings were illiquid. He learned of the terrifying capital erosion at Long-Term Capital, which blew up just as Tiger began to run into trouble. Nonetheless, Robertson apparently was surprised by how fast his fund came undone.

In the fall of 1998, he dropped $2 billion on Japanese yen—a misplaced speculation—and then $600 million more on Russian treasury bonds. Meanwhile, Robertson's cheap stocks kept getting cheaper. In

1999 Tiger had its worst year, losing 19%. In the first two months of 2000, it fell another 14%. The hot money that had so recently pursued Tiger took a flying leap. Some of its old money followed suit. In a relatively brief span, Tiger was forced to redeem $7.7 billion—roughly equal to its total investment and retained profits over its first 16 years. With money running for the exits and losses compounding due to leverage, Tiger had no choice but to sell favored stocks at depressed prices.

Tiger made three mistakes, dangerous in isolation and fatal in combination: It got too big, it got too exposed to withdrawals from hot-money investors, and it got too leveraged. Despite Robertson's miscalculations, his final letter proved to be prescient: "The current technology, Internet and telecom craze, fueled by the performance desires of investors, money managers and even financial buyers, is unwittingly creating a Ponzi pyramid destined for collapse."

Value investing never becomes irrelevant; it merely goes out of fashion from time to time. Price and value are ultimately reconciled, so the principal attribute required is patience. The flip side of adversity is opportunity. Value investing is more than just purchasing low price-to-earnings stocks as it is conventionally defined but rather purchasing low price-to-value stocks (a big difference) and, if properly employed, it also imposes a longer time horizon on the investor's expectations for rewards. Julian Robertson grossly abused the value concept by piling on leverage and by not discouraging hot money from investing in his so-called value-based hedge fund. Robertson's excessive use of leverage as a value strategy was, in a business sense, a contradiction in terms. Robertson gave the impression of conservatism, vaunting his so-called value approach, but in fact was a speculator because of the use of leverage and taking large bets in marginal companies or macro ideas. In the wake of the disaster, there have been some long faces lately in Mister Robertson's neighborhood.

Last year two of the same factors (leverage and size), coupled with intellectual arrogance, felled another storied hedge fund—the aforementioned Long-Term Capital Management—whose collapse seemed on the verge of toppling all of Wall Street until the Federal Reserve hastily organized a private bailout. To be sure, there are vast differences between the two funds. Long-Term's equity was virtually wiped out, though the fund sputtered on after getting an emergency injection of capital. Tiger is liquidating at its leisure. Even with its losses, a dollar invested at Tiger's inception has grown to a total of $82 (after fees), a sensational compound rate of 25% a year, according to the firm. Robertson's funds are so far underwater that it would likely be years before he would exceed the high watermark and earn performance fees again. His high-overhead operation would surely have exhausted his personal fortune before that day arrived.

All this brings to mind the words of Paul Simon in the song "Mrs. Robinson" (at one point we paraphrase): "… God bless you, please, Mr. Robertson, Heaven holds a place for those who pray … Laugh about it, Shout about it, When you've got to choose, Every way you look at it you lose …" We express these musical sentiments with sympathy, not scorn. The financial world can be a daunting place indeed.

As an aside and for your comfort as well as ours, we don't live so close to the edge. Our expense budget is never greater than our minimum level of expected revenues, notwithstanding the fact that we have ample reserves. It would be a terrible injustice to our clients to be forced to close our doors to preserve our personal assets at the very moment when a once-and-a-lifetime opportunity to invest our clients' assets simultaneously appeared.

Nonetheless, Tiger's recent meteoric growth and subsequent implosion harbor a dire warning for today's investors, especially momentum-following mutual-fund investors who are crowding into ever-fewer high-tech growth funds. If you think your favorite "dot com"-laden mutual fund is immune, thanks to the new money that continues to pour into its coffers, remember that a short time ago Tiger was all the rage—and that was precisely its problem.

Where does this lethal combination of sizzling profits, followed by astronomical fund flows and huge, concentrated holdings exist today? For many months, tech-heavy mutual funds have been using their outsized gains to attract new money that they promptly reinvest to drive up portfolios and attract still more new money. To cite one example, Janus Capital collected $10 billion (one-fourth of the industry total) in February alone, managing $229 billion by year-end, up from $80 billion at the start of 1999. Unlike Tiger's limited partners, who could take money out only every quarter, thus facilitating an orderly closeout, mutual-fund shareholders are free to sell every day. Will these turnstile investors be any slower to exit than Tiger's were restricted to do, once the performance of growth funds inevitably cools? Put it this way: When it happens, I wouldn't want to be standing in the doorway. For an investor in inflated new-economy issues, bailing out will be the only logical move, because once momentum isn't there to hold these issues up, nothing else—surely not earnings or revenues or even voodoo hocus-pocus—will be. Janus, despite poor performance this year, is still sticking to its guns. As recently as October, its average price-earnings ratio was 48. We'll revisit this evolving story next year.

George Soros

If Julian Robertson is the Sammy Sosa of hedge-fund managers, George Soros is the Mark McGwire. No pedestal was higher than that of Mr. Soros. A Hungarian refugee from the Holocaust, Soros, now 70 years old, started as a stock-picker in the late 1960s, moving on to "macro" investing, or betting on the broad trends that move stocks, bonds, and currencies around the globe. His style was to wait for big changes in the markets, then take advantage with aggressive moves. Although he turned over the reins of Soros Fund Management to Stanley Druckenmiller in 1989 to concentrate on philanthropy, he continued to keep close tabs on the funds. The firm kept racking up huge gains, creating amazement, even awe, among competitors. Its funds grew so powerful, using borrowed money to magnify their results, that their investments moved markets, and their giant bets could be self-fulfilling. For example, in the summer of 1992 it became known that Soros funds were selling the British pound short, betting on a decline. Hearing this, other investors quickly started doing the same. The short selling foray in the pound earned Soros the label of "the man who broke the Bank of England." He profited greatly from buying Peru's currency and from selling the Malaysian ringgit, which prompted the most insulting of political outcries from none other than the prime minister himself. Paradoxically, Druckenmiller has since said that the Soros funds actually were buying, not selling, Malaysia's currency during that time. Beginning a couple of years ago, though, this outsize influence began to wane. As global markets swelled, Soros assets—even at the $22 billion they then totaled—no longer could move markets so easily, nor necessarily give the firm access to the best information. Power shifted toward money managers, such as the previously noted Janus Capital, once a third-tier mutual fund group but now a huge one because of its hot performance in technology stocks.

To be sure, the Soros funds had some fumbles and stumbles. They lost more than $1 billion in 1998-99 betting that Europe's new common currency would rise. Instead, the Euro has fallen 24% since its introduction Jan. 1, 1999. In addition, despite their big-picture focus, the Soros funds haven't profited from the doubling of world oil prices over the past year or so. Out of necessity Soros migrated to the newest hot game in town, the venue that catapulted Janus into the big leagues: technology and the Internet.

Despite larger-than-life images and egos to match, the intrigue surrounding the goings-on within the offices of the great hedge funds was almost palpable—and, at root, most predictably human. Desire for the power and prestige that massive wealth confers can quickly transmogrify into the fear from which no one, no matter how high or low his station, is immune. According to *The Wall Street Journal,* "For months, through late 1999 and early 2000, the Monday afternoon research meetings at George Soros' hedge-fund firm centered on a single theme: how to prepare for the inevitable sell off of technology stocks. Druckenmiller, in charge of the celebrated funds, sat at the head of a long table in a room overlooking Central Park. Almost as if reading from a script, he would begin the weekly meetings with a warning that the sell off could be near and could be brutal. For the next hour, the group would debate what signs to look for, what stocks to sell, how fast to sell them. 'I don't like this market. I think we should probably lighten up. I don't want to go out like Steinhardt,' Mr. Druckenmiller said in early March as the market soared, according to people present at the time. He was referring to Michael Steinhardt, who ended an illustrious hedge-fund career in 1995, a year after suffering big losses."

Soros himself, often traveling abroad on philanthropic endeavors, would regularly phone his top lieutenants, warning that tech stocks were a bubble set to burst. For all the months of hand-wringing, when the sell-off finally did start in mid-March, Soros Fund Management wasn't ready for it. Still loaded with high-tech and biotechnology stocks and still betting against the so-called old economy, Soros traders watched in horror when the tech-heavy Nasdaq Composite Index plunged 124 points on March 15 to 4,583 (that, of course, was only the beginning; by year-end it had fallen nearly 2,000 more points to close at 2634), while the once quiescent Dow Jones Industrial Average, also on March 15, leaped 320 points. In just five subsequent days, the Soros firm's flagship Quantum Fund saw what had been a 2% year-to-date gain turn into an 11% loss.

Continued *The Journal*: "'Can you believe this? This is what we talked about!' cried a senior trader amid the carnage. Others on the firm's gloomy trading floor busied themselves calculating how much they had lost by aping Soros investments in their own accounts."

Soros pressed Druckenmiller to bail out of some swooning Internet stocks before they sank even farther, while Druckenmiller insisted that the funds hold on.

By the end of April, the Quantum Fund was down 22% since the start of the year, and the smaller Quota Fund was down 32%. Soros had stated in a 1995 autobiography that he was "up there" with the world's greatest money managers, but added, "How long I will stay there is another question." Now came an answer. Both Druckenmiller and Quota Fund chief Nicholas Roditi resigned. Soros unveiled a new, lower-risk investing style—completely out of character for him—and conceded that even he found it hard to navigate today's murky markets. "Maybe I don't understand the market," a reflective Soros said at an April 28 news conference. "Maybe the music has stopped, but people are still dancing." George Soros may have exhausted his supply of useful insight when he wrote: "I used to get particularly excited when I picked up the scent of an initially self-reinforcing but eventually self-defeating process. My mouth began to water … "

It is paradoxical that neither of these hedge-fund giants were able to capitalize on the most spectacular speculative bubble in modern market history. In fact, Julian Robertson's principle-based and disciplined reluctance to participate in the public's fascination with technology did as much to savage his fund as Druckenmiller's reluctance to withdraw from the same high-tech game before it was too late.

"Many shall be restored that now are fallen, and many shall fall that now are in honor."

DOCTOR DOOMED

Sometimes a single event can be emblematic of an era. The story I am about to tell may well capture in one singular episode the character of the dizzying spiral of speculative irrationality that ballooned into the excesses of 1999 and early 2000. The flight of fancy was embraced by an enthusiastic public only too willing to believe—and enabled by investment bankers who know only one spelling for the word "principal." The final chapter, the predictable bust, follows a pattern replicated throughout history of excess gone unchecked until it plunges back to earth by the weight of its own intrinsic absurdity.

No doubt you will remember the likeness well. His white beard and dignified bearing gave him the air of an Old Testament prophet delivering the word from on high. His name is C. Everett Koop, M.D. The good doctor was a 64-year-old pioneering pediatric surgeon in Philadelphia when President Ronald Reagan appointed him to the post of Surgeon General in 1981, back when many of today's 'Net executives were still in knickers. After eight years of public service—during which the bowtie-bedecked, uncompromising, fixed-jaw physician stared down senators as he crusaded against tobacco companies—he became known as "America's doctor." His principled stands on divisive issues (like AIDS) and his proselytizing on behalf of public health made "Koop" a symbol of integrity. Concurrently, in the parlance of the business world, "Koop" had become a "brandable" name, his commercial value as an icon thereby greatly exceeding any of the more pedestrian undertakings (such as practicing medicine or even preaching the gospel of good health) in which he might engage.

The impressive skills that Koop so ably demonstrated, first as a doctor then as a public-health advocate, apparently did not transfer automatically into the business realm. In 1996, in his first business venture after leaving public service in 1989, a health videotape series backed by Time Life collapsed into bankruptcy. He had trusted in business associates, whose motive was profit, as he continued his public-health mission. Shortly thereafter he was to team up with Donald Hackett, a 20-year veteran of the health-information industry, and the entrepreneur John Zaccaro, neither of whose résumés are particularly distinguished. It was this trio that gave birth to Drkoop.com to capitalize on the public's fascination with the Internet, coupled with its reverence for the good doctor.

Fast-forward to March 1999. Koop, now 82, is about to prove that you're never too old to cash in on the Internet craze, that there is no generation gap when it comes to greed (admittedly, perhaps an unkind and unfair characterization in this instance). The company DrKoop.com, of which the respected physician was nominal founder, filed a $50 million IPO less than a year after it was formed. To give you some idea of the humbleness of its beginnings, Drkoop.com earned a paltry $16,000 in ad revenue in 1998 while ending the year with a $15.2 million retained earnings deficit. In its offering document the company attempted to lend credence to its half-baked marching orders: "Our business model is primarily to earn advertising, subscription and the commerce transaction revenues from advertisers, merchants, manufacturers, and health-care organizations who desire to reach a highly targeted community of health-care consumers on the Internet."

How valuable was his name? Koop signed a five-year contract with the company, granting it authority to use his name and image to market the site and its products. He was to receive 2% of the revenues from current product sales and up to 4% of the revenues from the sale of future products. He received consulting fees of $100,000 in 1998 that escalated upward from there. But Koop's big money was likely to come from a successful IPO. He held more than 1 million shares in Drkoop.com, or about 11% of the pre-offering stock.

On June 8, 1999, Drkoop.com made its public debut and the octogenarian former Surgeon General C. Everett Koop became a millionaire 56 times over, reaping the cascade of riches that has become *de* *rigueur* in the Internet Age. The company's stock was priced at $9 and closed the first day at $16.44. Three weeks later it peaked at $45.75, soaring to a total market value of $1.3 billion. Not bad for a company that had taken in only $1.5 million in revenues in its entire short history, while at the same time losing buckets of money. Investment banker Bear Stearns underwrote the offering, raising $84 million for the fledgling company while raking off a tidy $6 million in fees for itself and two secondary underwriters, Hambrecht and Quist and Wit Capital. It was a coup for Bear, a perennial underdog trying to break into the first tier of tech underwriters. At what price principle, one must ask? Regardless of where you're inclined to lay the blame for the bloodbath that followed, the investment bankers are the presumed knowledgeable and informed party.

Purchasing a security is not like buying a car: You can't kick the tires. Unfortunately, ethical standards seem to play second fiddle all too often to avarice during manias such as the one through which we are passing. Our industry has been called some ugly names from time to time, and from time to time those names are richly deserved. Where, might someone someday ask, are the customer yachts? In another era, the virtual absence of revenues or corporate history, the massive losses, and the less than legendary management might have scared off underwriters, but not in the spring of '99. Besides, next to sex, health was the single most popular topic on the Web and, perhaps most important of all, greed was the creed.

There were some early signs that DrKoop.com's managers were not the sharpest scalpels in the bag. Almost from the start the upstart company cut extravagant promotion and distribution deals with AOL and Disney's Go Network. In April it agreed to pay Go Network nearly $58 million over three years to be the exclusive provider of health content for the Network and related Websites. In early July, less than a month after the IPO, Drkoop.com announced it would pay AOL an incredible $89 million over four years in exchange for a non-exclusive yet primary role in providing AOL's health-care content. The AOL deal was for more money than the company raised in its primary offering! The massive expenditures were rationalized as being "critical to growing our brand, building traffic, and establishing market leadership." Investors bought the party line. On the day the AOL deal was announced the company stock rose 50% to its ultimate and fateful high. Both Bear Stearns and H&Q, as they were "morally" obligated to do (who says there is no honor among thieves?) as a condition of landing the deal in the first place, initiated research coverage in early July, rating the company a "buy" at a price three times that of its initial offering price of $9 a month earlier. The investment bankers were perhaps in some small way drumming up new and presumably less sophisticated buyers who enthusiastically relieved the favored original-offering customers of the burden of ownership. Indeed, Ponzi schemes come in an intriguing array of guises.

A few weeks after initiating coverage, the Bear Stearns analyst released a 57-page report curiously (and quite erroneously) titled "The Doctor Is In," openly suggesting that there was further upside in the stock driven by the execution of DrKoop.com's business plan. The stock was then $25. The analyst was right on one account: There was going to be an execution. The games these people play are fast and furious. As a general rule of thumb, if in five minutes you don't know who the patsy is, you'd better look in the mirror!

Without overwhelming you with the details, during the third quarter of 1999 (following the public offering) expenses totaled $24 million—much of the money going for promotion and advertising—but revenues came to just $2.9 million. In the fourth quarter sales rose to $5 million, but expenses added up to another $26 million. Six months after the offering more than half the IPO proceeds were expended.

The die was cast, despite the toolmakers' (and crapshooters') denials. After the restriction on selling shares lapsed in February of 2000 and the fourth-quarter results had been released, insiders began to unload stock at prices that averaged about $10. Dr. Koop walked away with a mere fraction of his earlier paper profits, a paltry $912,186. The company filed its annual 10-K report with the SEC on March 30 (the SEC requires that this important corporate document—which, as a matter of practice, we scrutinize in great detail for those companies of which we are owners or prospective owners—be filed within 90 days of year-end). Buried in the document was a warning from the company's auditor, PriceWaterhouseCoopers, that shocked investors. "... [S]ustained losses in negative cash flows from operations created substantial doubt about the company's future." On March 31 the stock closed at $3.69; by April 4 it had sunk to $2.

Despite the popularity of the Website, DrKoop.com underscores the turmoil afflicting advertising-dependent health sites as the on-line health industry shifts toward e-commerce and the delivery of medical services. As one unaffiliated analyst noted, "There's not enough advertising to blacken the bottom lines of all the content on six sites out there." Observed another: "DrKoop.com has a good brand name and a good amount of traffic, but they haven't figured out how to make money." As noted at the outset, it is also symptomatic of the difficulties in generating profits in this fledgling industry where barriers to entry, until the capital dried up, were nonexistent.

Epilogue

While Dr. Koop remains as titular company chairman, a group of venture investors led by former ExciteAtHome executive Richard Rosenblatt injected $27.5 million into the company in late August and took over management in an ongoing effort to salvage the franchise. On November 3 the company acquired DrDrew.com for $1.6 million in cash and stock. My, how prices have come down. Once momentarily wealthy and proud, Dr. Koop is now a defendant in a lawsuit alleging that he and other officers fraudulently sold stock by failing to disclose to shareholders the company's worsening plight. The financial hemorrhaging continues unabated. For the nine months ending September 30, 2000, revenues totaled $9.3 million versus $4.3 million the year before. Losses, however, were a mind-boggling $95.7 million compared with $36.2 million for the first nine months of 1999. Because of the infusion of additional capital, shares outstanding doubled to 33.8 million from 17.6 million, presumably reflecting part of the dilution from the additional capital. We'll probably have to wait for the next 10-K on March 31, 2001, to learn the full extent of the dilution that the new investors exacted. The stock languishes at $.75 a share, the better part of $1.3 billion gone up in "smoke"—an ironic outcome indeed for the man who put warning labels on cigarette packs.

LEDGER D'MAIM

With the bloom off the rose, many technology companies have growing concern about the ability to sustain current levels of profitability, given the extraordinary effect of "hidden" compensation programs, more popularly known as stock options, whose pivotal role in this merry-go-round will be addressed below. The cynics among us would call this one of the most diabolically devious Ponzi schemes ever conceived—or, more aptly, evolved.

Please don't misinterpret our intent. The revolution in information technology has been nothing short of a bonanza for a vast and diverse segment of the world's population. Here at this investment management firm, for example, we have derived incredible benefits from the almost infinite accessibility to information heretofore practically beyond our reach. Those kudos don't even mention the speed and convenience of the data's acquisition and storage—the plaudits that all of us could offer the pioneers in the industry stagger the imagination. This annual report would not exist—at least at its present length (for which seductive technology, and not its author, by all rights should be severely chastised!)—were it not for Dragon NaturallySpeaking voice-recognition software on high-speed processors.

However, as the fruits of these seemingly endless and equally incredible developments migrate from the scientific sanctity of the creator's cubicle—from the engineering or programmer geniuses, from whose fertile minds these inventions spring, toward commercial application and eventually the public stock-market payday—they seem to lose their innocence, their scientific purity. Money talks louder than ideas as they move from creation to commercialization. Greed and avarice insidiously muscle their way to the fore. The creativity of those talented men and women who are at the root of this most remarkable of revolutions is nearly matched by the inventiveness of those who ride their coattails in search of unparalleled riches, without regard for the wisdom behind Mahatma Gandhi's first of the "Seven Deadly Sins," which is "wealth without work." The true inventor or artist sees a vision; others farther up the value chain are more likely to see a stack of greenbacks reaching for the sky. We are not making a judgment about the relative merits of contributions by innovators and capitalists. Both have essential roles if an idea is eventually to be transformed into something consumers can actually use.

But when promoters and opportunists, a fringe group who sully the good name of capitalism—like polluters who surreptitiously stain the air, land, and waters we all inhabit—by engaging in scurrilous accounting machinations, attempting to exploit the public, my ire is aroused to the point of taking "Dragon" (see above) in hand. I admit it. I get ticked off enough about accounting "Ledger D'Maim" that I become a fire-breathing dragon about this time every year.

How do I know what I'm talking about? Well, in our line of work, one of our jobs is reading the fine print. What follows about accounting practices isn't pretty, as you will soon discover.

'Other Income'

For several quarters last year, cosmic investment gains from venture investments in Internet companies ballooned income statements of, yes, technology companies. Venture capital investing has historically been the purview of a group of specialty firms for which ferreting out tomorrow's superstars has been their primary business. Not so anymore. With the public's fascination with the Internet and the billions of investor dollars thrown at anything thus related—seemingly irrespective of price or prospects—the Microsofts, Intels, and many others, with abundant cash, jumped onto the easy-money bandwagon. Stock-market profits contributed handsomely to earnings at the aforementioned technology industry leaders' companies and overwhelmed the trivial contributions to profits from operations at such companies as Alliance Semiconductor or Lycos. "Other income" became, essentially, the primary source of profit in that topsy-turvy environment. To be sure, there is more to what's going on than simply scrambling for new sources of earnings to support a Ponzi scheme. Corporate venturing has become a way to outsource research and development and to stay at the leading edge of technological innovation. Change is a constant; innovate or perish is the imperative. At certain firms, like Scient and Adobe Systems, a venture fund also has allowed top executives to get in on the action as limited partners themselves. Comments from skeptics notwithstanding, every corporate venture program affirms that it's after business synergies, not quick-flip profits. Dell Computer, Exodus, and Compaq all staked Storage Networks, an outfit that recently completed a successful initial offering. "Their returns were great," says Storage Networks' chief executive, Peter Bell, "but our relationship is what's important to them." Unfortunately, when such schemes implode, prices and expectations drop like the proverbial hot potato.

Recent quarterly results at financiers like Goldman Sachs and Morgan Stanley Dean Witter show losses from venture-capital operations. Non-financial firms too are finding themselves in a catch-22 conundrum, with the growth and operating profits slowing or in some cases falling. In reporting its latest quarter, Intel says its investment portfolio shrank 31% over the three months ended July 1, from $10.8 billion to $7.5 billion. That shrinkage came in equal parts from the slump in tech shares and from the chipmaker cashing in its chips on holdings worth $2.1 billion, after tax.

Investment winnings have been so good that certain companies run a peculiar risk: The Securities and Exchange Commission could theoretically declare them an "investment company." That would require them to report their income statement "upside down," to show that investment gains were its primary business. Although such a declaration is unlikely, that happy predicament has threatened other firms—like Yahoo!—when success at Internet investing nearly inverted their P&Ls.

Pooling and Fooling

Accounting sleuth Abraham J. Briloff is a distinguished professor emeritus at Baruch College in New York. He's a man whose work we have admired for many years, who sniffed out the deception at Carmel, Indiana-based Conseco long before the company was brought to its knees, has dubbed Cisco Systems as Wall Street's "New Economy Poster Child" (our own appellation might be the "Cisco Kid," but you saw that coming). No better illustration of investors' vast esteem is that in the spring of 2000 they graced the company with a cool $500 billion market capitalization (now $317.6 billion). In a November article in *Barron’s* Briloff uncharitably avers that …

> Cisco might also just as well be designated as the New Economy Creative Accounting Exemplar. It merits that sobriquet thanks to its ability to exploit some of the more questionable, even dubious, accounting concepts—all of which it should be noted are presently enshrined in the Good Book of GAAP (or, in formal financial parlance, Generally Accepted Accounting Principles).

Indisputably high tech, Cisco Systems describes itself as providing networking solutions that connect computing devices and computer networks, allowing information to be accessed or transferred without regard to differences in time, place, or type of computer system. The leading supplier of networking equipment for the Internet, the company boasts a truly global reach, selling its products in more than 100 countries. Again quoting Briloff:

> But it is less its vaunted technological prowess than Cisco's inordinate addiction to arguable notions of accounting for business combinations, as well as for stock options, and its occasionally obscure disclosure standards that especially intrigue me, as a critical observer of corporate accounting and accountability.
>
> Cisco's accountings for its fiscal years ended July 1999 and 2000 furnish vivid demonstration of the causes of my concern. Let us start with pooling-of-interest accounting. Just to refresh your memory, under the pooling method of accounting for a business

> combination, if Company A acquires Company B paying, say, $100 million in stock, it would show as its cost a mere $10 million, assuming that was the amount listed on Company B's books as its shareholders' equity.
>
> In consequence, $90 million of costs actually incurred by A will never pass through A's income statements. Company A thus will be able to realize $90 million of revenues derived from the acquired properties without those revenues being burdened with even $1 of cost. And, a safe bet is, A's earnings will be correspondingly engorged.
>
> Nor does it matter one whit whether that $90 million cost suppression is related to real estate, plant and equipment, inventories, intellectual properties (copyrights, patents or other intangibles) or a pool of Nobel Laureates. The sole aim of the exercise is to add to the glory of A's bottom line.

Pooling, about which we wrote at length in the last two annual reports, is bad stuff. Continues Briloff:

> By my reckoning, in the two fiscal years ended July 2000, Cisco has suppressed a grand total of $18.2 billion of costs by using pooling in accounting for its acquisitions. Even in today's wondrous financial world, when billions are commonplace, $18 billion of costs not taken is mind-boggling. Manifestly, the handmaiden of pooling is fooling.

As noted in earlier reports, we are not of the general opinion that in all instances the entire purchase price in excess of tangible assets must be written off, whether the transaction is accounted for as a purchase or a pool. Often purchased goodwill is, well, permanently "good." In the case of Cisco, however, extraordinarily high price-earnings ratios give license for all sorts of aggressive, if not borderline, practices.

Stock Options—Not Again!

But pooling is not the only accounting device that Wall Street's favorite company uses to enhance its operating results. Another, equally egregious, involves stock options and the way Cisco accounts for them.

Briloff echoes our sentiment:

> How to account for options has been the subject of agonizing reappraisals in boardrooms, among scholars in academe, at the FASB and even in Congress. The crucial questions are: Can options be valued and, if so, should they be entered into a company's accounts and when? Further, if they were to be recorded, should it be as a cost of doing business or merely a capital transaction?

Again, sparing you the intriguingly gory details, which for those of us who find financial accounting more exciting than the Super Bowl, Briloff concluded that because options are not treated as an expense Cisco's pretax income in fiscal '99, should be reduced by $2.5 billion; its income tax cost would be cut by $837 million. Net income, accordingly, would be slashed by a whopping $1.6 billion, or by nearly 80%, from the reported figure of $2.02 billion, to $423 million.

The impact of options on Cisco's fiscal 2000 results was even more pronounced and even more stunning. If Cisco had treated the exercise of options as they should be treated—that is, as a charge to income—the company would have reported not the $2.02 billion in earnings it did report, but a loss of $363 million (excluding $531 million of net gains on minority interests).

Figures don't lie, it is said, but liars, in fact, figure. Go figure.

The result of Cisco's accounting aggressiveness, both in its energetic use of pooling and its treatment of exercised options, then, has been to enormously inflate reported earnings. And enormously inflated earnings have played no small role in elevating the company—and its stock—to the pinnacle of investor esteem.

Commerce-Partner Relationships: When Stock Is Classified as Cash

Amazon.com is an Internet icon. Jeff Bezos, the company's founder and *Time* magazine's "Man of the Year" for 1999—an accolade that is unquestionably the most reliable indicator of when an idea or concept has reached the pinnacle of public acclaim so that its downfall is virtually assured (and about whom we wrote in last year's annual report)—is a most bright and charming fellow, who epitomizes the entrepreneurial if not reckless zeal of the new-economy pioneers. But in a desperate attempt to keep his dream alive, his company has engaged in accounting practices which, to say the least, push the envelope of credibility.

Ravi Suria is the convertible-bond research specialist at Lehman who in June did a masterful job of analyzing Amazon's finances and business in a well-crafted 27-page report. The essence of that analysis is that the company seemed incapable of generating cash flow, much less profit, from its sales. That was likely to prove quite inconvenient in the light of mounting debt and the growing indisposition of the markets to accommodate more financing from the company. For Amazon, Ravi mournfully concluded, the "party is over." And, as it turned out, it sure was.

"Burn rate" is a term of particular relevance to Internet start-ups. Fledgling companies with concepts that are months if not years from commercial viability have been able to sell billions of dollars of stock, in the aggregate, on the promise of a wing and a prayer. The burn rate, then, is the amount of cash the company is consuming on a monthly basis sans any cash flow from operations. *The Wall Street Journal* publishes tables of how long hundreds of Internet start-ups will stay in business absent another infusion of cash from external sources: common stock or debt offerings. The burn rate has taken on special meaning of late as the market for Internet offerings has virtually dried up. Cash has become king.

Amazon.com has signed agreements with commerce partners that resulted in large payments that well-known Morgan Stanley analyst Mary Meeker classified as "cash," when in fact they were largely in stock. As has become abundantly clear, stock in Internet companies is not the same as cash. Morgan Stanley, we note with undisguised embarrassment, was the leading underwriter for several of Amazon.com's convertible-debt offerings. And yet Amazon.com continues to classify the stock of its various partners as cash, even though its value has shrunk dramatically. The sleight-of-hand is exceedingly fascinating but too complex to explain in detail here. For those readers who would like to delve further into the intrigue, I suggest you search *The Wall Street Journal* archives under Amazon.com to gain a full appreciation for the chicanery in which a company desperate to survive will engage. The SEC is investigating.

'Puts' Are the Pits

Among the creative revenue-generating ideas that have proliferated among technology stocks, the sale of "put" options on its own stock is among the more interesting. For example, at the end of its July quarter, Dell had puts outstanding on 107 million shares, struck at an average price of $46. Puts give the holder the right to force the company to repurchase shares at a predetermined price. Dell, as the seller, must buy the stock at a predetermined price even if the market price is far lower.

Dell, like several of its brethren (including Microsoft), has sold puts in recent years without getting burned because ever-rising stock prices rendered the puts worthless while the company collects the premium on the option. Dell says it sells puts in order to finance its purchase of calls, which it uses as part of its share-repurchase program. With Dell at 17, its put-option liability is huge at around $3.4 billion. Dell had written puts on 127 million shares struck at an average price of $44 at the end of its latest quarter. Dell, however, can wait to make good on those puts in stages until 2004, hoping a rally in its stock will extinguish its obligations.

Here's where the accounting gets a bit evasive. Because Dell's stock price has plummeted, it faces a hefty liability from such sales whenever rising stock prices turn south. Don't look for Dell's put liability on its balance sheet, because the puts are structured in a special way that allows the company to pay off the puts using either cash or stock. That's right, stock. If the puts are "in the money" at maturity (that is, if the stock price is below $44), Dell can issue stock equal to the put value. If stock is issued, the only effect on Dell's results is the profit dilution stemming from the equity issuance. The current put liability is substantial, representing almost half of Dell's cash position of $4.3 billion and nearly a year's worth of net income.

Microsoft also was sitting on a hefty put liability. It had 157 million put options outstanding on June 30 with strike prices ranging from $70 to $78. At its year-end price of $44, the put liability totaled more than $4 billion (assuming an average strike price of $74). Microsoft has ample ability to pay off the puts with cash if it chooses, given that its cash position totals almost $25 billion.

The Dell and Microsoft situations show that put sales don't amount to "free money" for tech companies. It's possible that Microsoft and Dell will rise enough so that the puts will again expire worthless. But if the technology sector collapses, and both stocks fall sharply, the puts will exact a punishing toll, especially for Dell.

All that glitters is not gold ...

PART III

FINAL THOUGHTS

As noted in the Foreword on page 2, the assets we now manage exceed $400 million, an encouraging (although unlikely to be replicated again anytime soon) increase over last year's ending total of $335 million. The change in total assets reflects a number of factors in descending order of importance to us and our clients: the increase in existing client wealth due to capital gains, interest, and dividends; assets committed to our care by new clients; fewer withdrawals from both for everything from taxes, charitable gifts or purchase of tangible assets, to living expenses, etc.

As for the second factor, special mention needs to be made of what has become a trend that is most reassuring and rewarding for those of us who serve you. As is common in any business, there is turnover among clients, a sort of purging process where those who for a variety of reasons, some totally unrelated to investment issues, withdraw their funds while, at the same time, those who are attracted to our approach to wealth management find their way to our doors. Net of one departure, six new clients joined our ranks in the last 12 months. Those numbers are a little on the high side for maximum comfort, so we'll rein in our marketing efforts somewhat next year. Managing the growth in the number of clients we serve is key to our capacity for continuing to provide the quality of service to which you have grown accustomed. As we are getting better known, as well as becoming more skilled in making a quick determination as to the likely fit between a new client and us, our client base is growing stronger and stronger. More importantly, because of the increasing closeness of the fit—and the rapport and bond of trust that naturally follow—the quality of the relationship between the client and his or her portfolio manager has never been better. The enthusiasm evident in our offices that flows directly from the satisfaction thus derived is both palpable and contagious. I have never had so much fun.

Over the last several years, continuing a tenor of some duration, the new clients who have entrusted their assets to our care are a remarkable lot. You know who you are, and to you I tip my hat. Getting to know you is a gift for which no amount of money could be a substitute. To be sure, the fastest-growing segment of the investment management business is the institutional side: mutual funds; 401(k), profit sharing, pension plans; and the like. Not only do they add lots of money, those who are actuarially young also take very little out. Despite the apparent easy-money allure of the institutional trade, it has been an easy choice for us to opt for quality over quantity. Institutional relationships are woefully impersonal and formal—and often involve consultants and large committees whose membership rosters are a revolving door of new faces and beliefs. Speaking for myself and not for my younger partners and associates (who spend as much time looking forward to the opportunities of the future as I do to the memories of the past), it's a steep price to pay for incremental assets to manage when you are at that stage in your life where the wise distribution of acquired wealth becomes a principal preoccupation. (The genesis of a book addressing that rarely discussed, often denied, but nonetheless unavoidable obligation has been taking shape in my mind for several years. If I can find the time and the energy, it may begin to take tangible form this year.)

We do enjoy several out-of-town individual client relationships where an able intermediary bridges the geographical and communications gap. As good fortune would have it, these men, all experienced and wise—and who know us and how we think as well as they know their clients—add immense value to the portfolio management process. They appear to function best as the staunchly independent entrepreneurs that they are; otherwise, we'd love to have them as part of our team.

Finally, having the opportunity to become deeply involved in the lives of our individual clients, in developing close friendships with them and their children, is a reward without equal in our industry. As for me and my partners and associates, we have chosen to take "the road less traveled" where the joy and any success are in the journey; we'll let the destination take care of itself.

Quoting from one of my (and hopefully your) favorite authors, Viktor Frankl, who wrote *Man's Search for Meaning* in nine consecutive days after spending three years in Nazi concentration camps during World War II:

> Don't aim at success—the more you aim at it and make it a target, the more you are going to miss it. For success, like happiness, cannot be pursued; it must ensue, and it only does so as the unintended side effect of one's dedication to a cause greater than oneself or as the by-product of one's surrender to a person other than oneself. Happiness must happen, and the same holds true for success: you have to let it happen by not caring about it. I want you to listen to what your conscience commands you to do and go on to carry it out to the best of your knowledge. Then you will live to see that in the long run—in the long run, I say!—success will follow you precisely because you have *forgotten* to think about it.

Frank K. Martin

APPENDIX

The More Times Change, the More They Remain the Same: 1927-33 Through the Eyes of Benjamin Graham

Despite the periodic celebration of new eras in investment and finance, the verdict of history is not so complimentary to man's capacity to elevate his thinking and behavior in such endeavors beyond the primal states that inevitably lead to follies and flops. To the open-minded and clear-headed student of history (admittedly a characterization this observer is on thin ice in laying claim to), it is a truism that defining moments in finance have a cyclical tendency and, in their essence at least, are rarely without conceptual precedent. If the reader doubts the proposition, he or she need only make note of concrete examples of real progress over the millennia in those human endeavors where emotion did *not* play second fiddle to logic. If the list is as short as I expect it will be, for further confirmation one might repair to one's library, remove the 1998 Christmas-in-July book *Extraordinary Popular Delusions and the Madness of Crowds* from the shelf, and read page after page of foolish notions at their repetitious and "sheepish" best. Fear and greed, most notable among counterproductive emotions where money is the object of human desire, can and often do compromise the capacity for rational and orderly thought. In stark contrast, advancement in science is cumulative, and progress is evident even to the untrained eye—where today's successes soon become the building blocks for tomorrow's innovations. To understand why the same person can be calculatingly dispassionate in one instance and blindly irrational in another may well be worth a king's ransom.

One finds few more dramatic examples of the difference between the apparent inability of humankind to learn from earlier behavioral mistakes and the record of steadily increasing technical achievement than in the conduct of war. The act of war is itself a formal and recurring indictment of man's incapacity to better his deportment from generation to generation. From 1939 to 1945 the first-ever atomic weapon was developed—and used, thereby bringing down the curtain more quickly on the Pacific Theater of World War II. The issues involved in President Truman's decision to drop "the bomb" can certainly be debated, but the human details are horrific: More than 70,000 Japanese men, women, and children were killed instantly on August 6, 1945, in Hiroshima when a crude 20-kiloton warhead (equivalent to 20,000 tons of TNT) exploded above the city, releasing what scientists believe was only one-tenth of 1% of the weapon's power. Ultimately more than 200,000 people died in the first nuclear bombing, including the tens of thousands who died in subsequent days, weeks, months, and years, primarily from the lingering effects of radiation. (Three days later, Nagasaki was next.) And yet the first atomic weapons were mere firecrackers compared with the 200,000- to 300,000-kiloton nuclear weapons that proliferate around the globe today. It is estimated that the U.S. has more than 7,500 warheads of various capacities in its arsenals, the former Soviet Union more than 6,450.

It is daunting to contemplate the lunacy of 21st-century man: He has the scientific genius to create weapons of mass destruction that are both ubiquitous and devastatingly powerful—a perverse tribute to scientific accomplishment—and yet the final arbiter for resolving international disputes stubbornly remains the barbaric solution of war. Even during the Manhattan Project, scientists (including Albert Einstein) began to speak out against the utter and seemingly irreversible madness their brainchild had unleashed. For the first time in the 500,000 years since *homo sapiens* evolved, humankind's mastery of the technology of war has "advanced" to the stage where we now have the weaponry to vaporize all living creatures on the planet in a matter of minutes. Nuclear weapons in silos and submarines are a constant reminder of the ominous division between power and reason.

Fortunately, the consequences of emotional intrusions that sometimes impede the course of rational and dispassionate analysis and decision making in the financial markets are not so grave unless, of course, the love of money itself becomes emotionally destructive. Nonetheless, no matter how far technology takes us, nothing has thus far displaced greed and fear as behavioral constants for the investor. To return to a quotation that appears earlier in the report, what separates earnest and intelligently applied effort from avarice? Mahatma Gandhi spoke of "Seven Deadly Sins," the first of which was "wealth without work," of getting something for nothing. If we look beyond outward appearances, we will see that much of what motivates speculators today is little more than thinly disguised greed. On occasion even we find the urge powerful to take a bite of the apple, masquerading as a "free lunch." Sometimes investors forget the undeniable law of nature that is as old as humanity itself: "As you sow, so shall you reap." In the normal course of human events, greed is eventually overpowered by its counterpart, the fear of loss. Humanity has made little or no real progress over the centuries in developing ways to manage these opposing and potentially destructive impulses. It stands to reason, then, that they will recur time and again.

It would appear obvious, therefore, that some grasp of history's abundant lessons becomes especially relevant in the examination of the goings-on in the capital markets where emotions, particularly at extremes, run high—and reason often is overwhelmed. Careful study of the past would suggest that it's quite appropriate to argue that there are no "new eras" in finance, only "new errs." An old French maxim may be apropos: "The more things change, the more they remain the same." I modified the aphorism slightly for the title of this Appendix. A systematic attempt to study past events to isolate cause-and-effect relationships—so as to apply them to gain a better understanding of the present—is more than simply worthwhile, it's obligatory. No two episodes are alike, but there is often a common thread or two woven through them.

Following the prelude, we now turn to the astute observations of Benjamin Graham who had a front-row seat from which he observed the cyclical nature of happenings in finance:

> *That enormous profits should have turned into still more colossal losses, that new theories should have been developed and later discredited, that unlimited optimism should have been succeeded by the deepest despair are all in strict accord with age-old tradition.*[i]

Much of what follows, then, originates in the real-time analysis of the distinctive character of the financial and economic events during the 1927-33 period. Most of what Graham had to say appears in the form of direct quotations from the 1934 edition of *Security Analysis* by Benjamin Graham and David Dodd. While one might argue with such heavy dependence on verbatim observations, our goal is to identify pronounced and often primal patterns of investor behavior unique to exaggerated boom-and-bust cycles, of which that era provided ample supply. Forearmed with such knowledge, we may be able to muster the courage to keep our heads when all those around us are losing theirs, as well as (importantly) the audacity to answer the bell when the majority has thrown in the towel. We also may be able to better understand and avoid the lingering fallout of despair that characterizes the aftermath of booms gone bust if, in fact, that is what is in store: *"The swing of a speculative pendulum during this period was of such unprecedented amplitude as to warrant the belief that it will not recur in similar intensity for a long time to come."*[ii] Graham's conclusion was wise in the extreme, and yet investors remained leery of stocks until the 1960s, some 30 years later. To the extent that 70 years is sufficient time for memories of bygone days to have long since faded—and in the belief that there are obvious, more than randomly coincidental similarities with today—the lessons thus learned can and should be respectfully applied by a manager of wealth to present-day realities.

We also would do well to note that simply because so many years have passed since the last episode of extreme speculative excess it does not necessarily follow that the risk of recurrence is therefore quite low. On the contrary, to the extent that financial events are cyclical, like a pendulum (in part because the lessons of the past lose poignancy over the years), the mere passage of time actually increases the likelihood that the seeds of a speculative mania will again take root. Witness the outbreak of World War II barely two decades after the conclusion of World War I, "the war to end all wars."

The possibilities for error in endeavors such as these are many. They include the matter of ineffective timing. (The curse of premature caution is one with which this writer is acutely familiar.) Still, when all is said and done, leaving the party early may be better than leaving late. In fact, that is our contention, though it was made almost laughable by a riotous celebration that until 2000 seemed without end. But in 1999, when neither the mountaintop nor the valley had been seen, all that was known was that lots of easy money was being left on the table for those who sat on the sidelines and watched and wondered. In addition, there is a clear risk that judgments will be biased in any number of ways. The search for historical precedent can all too readily compromise objectivity. Our passion in seeking cause and effect may well jeopardize our conclusions. Our minds are calibrated to look for similarities, and our tunnel vision may cause us to overlook critical dissimilarities. If we attempt to limit the primary thrust of our investigation to the attitudes and behaviors that are unique to such highly agitated episodes, we may reduce somewhat the intrusion of unwanted biases. Fortunately, the reader is in all probability not beset with biases that are as threatening as those with which we who present the argument must deal. Thus he or she may be able to absorb what follows with constructive detachment. Therein lies its value to the second party.

Parenthetically, the management of biases is so important to us that an upcoming Portfolio Managers' Perspective, written by Dennis Blyly, will delve into those fascinating and regularly counterproductive forces. I also might note that in the trenches at Martin Capital Management we frequently engage in lively (even trenchant) exchanges, thereby checking our biases and allowing collective wisdom to temper them—yet another reason that cohesiveness and rapport among the members of the MCM team are so vital. In a word, we talk to each other!

Ben Graham Only Human

At the quarter-century mark of 1925 the great bull market was under way, and Benjamin Graham, then 31, developed what he later described as a "bad case of hubris," as he admitted in his memoirs. In early 1929 Graham had a conversation with business associate Bernard Baruch, of whom he disapprovingly observed, *"He had the vanity that attenuates the greatness of some men ..."*[iii]

> [Nonetheless they] *both agreed that the market had advanced to inordinate heights, that the speculators had gone crazy, that respected investment bankers were indulging in inexcusable high jinks, and that the whole thing would have to end one day in a major crash.*[iv]

Several years later Graham lamented: *"What seems really strange now is that I could make a prediction of that kind in all seriousness, yet not have the sense to realize the dangers to which I continued to subject the Account's capital."*[v] In mid-1929 the equity in the "Account" was a proud $2,500,000; it had shrunk to a mere $375,000 by the end of 1932.[vi] Of the dismay and apprehension that Graham experienced during those three long years, he summarized by saying:

> *The chief burden on my mind was not so much the actual shrinkage of my fortune as the lengthy attrition, the repeated disappointments after the tide had seemed to turn, the ultimate uncertainty about whether the Depression and the losses would ever come to an end.*[vii]

Graham's memoirs also shed light on his propensity toward delusion, if not a modicum of vanity itself. As noted just below, after the crash in late 1929, a knee-jerk 50% recovery in prices extended until March 1930. While in St. Petersburg, Florida, in January 1930 visiting his wife, Graham was introduced to her elderly friend, 93-year-old industrialist John Dix. Graham recalled the conversation:

> *I visited this Mr. Dix at his home in St. Petersburg and found him surprisingly alert for one so close to the century mark. He asked me all about my business, how many clients I had, how much money I owed to banks and brokers, and innumerable other questions. I answered them politely but with smug self-confidence. Suddenly John Dix said, with the greatest earnestness: "Mr. Graham, I want you to do something of the greatest importance to yourself. Get on the train to New York tomorrow; go to your office, sell out your securities; pay off your debts, and return their capital to your partners. I wouldn't be able to sleep one moment at night if I were in your position in these times, and you shouldn't be able to sleep either. I'm much older than you, with lots more experience, and you'd better take my advice." I thanked the old man, a bit condescendingly no doubt, and said I would think over his suggestion. Then I hastened to put it out of my mind. Dix was not far from his dotage, he couldn't possibly understand my system of operations, his ideas were preposterous. As it happened he was 100 percent right and I 100 percent wrong. I have often wondered what my life would have been like if I had followed his advice. That it would have spared me much worry and regret I am sure; but whether my character and later career would have formed as they did after my ordeal by fire is another question.*[viii]

The Years 1927 to 1933: an Aberration

That the six-year span, 1927-33, was a historical aberration is beyond question. From early 1927 until October 1929 the Dow Jones Industrial Average rose from approximately 150 to exactly 381.17, a gain of 120% over 34 months. During the October-November crash it fell almost 50% to 198.69. Few people are aware that it regained half of the loss by March of 1930, rising to 294.07. But with the Depression settling in, the market once again dropped, this time sinking relentlessly, hitting its nadir of 41.22 in the summer of 1932, little more than one-tenth of the 1929 peak. (As an aside, one might say Al Gore hit *his* "Nader" in mid-December 2000.) At mid-year 1932 the Dow was no higher than where it had been in January 1897, some 35 years earlier. It's important to differentiate the violent crash of 1929 (and 50% retrenchment by March 1930) from what followed. With the benefit of hindsight, the crash was the natural consequence of the speculative frenzy that preceded it, whereas the seemingly endless attrition in stock prices that ensued might be attributed primarily to the emerging business depression.

Falling Fixed-Income Security Yields Abetted the Equity Rationale

> *It was the natural disaffection with their experience as bond owners which predisposed investors to embrace the new doctrine of common stocks as the superior form of investment□a doctrine which had a real validity within a limited range of application, but which was inevitably misapplied, with consequences too harrowing to dilate upon.*[ix]

The Dow Jones bond average fell from wartime high of 96.25 in 1917 to a low of 71.96 in 1920, only to rise again to 99.48 in 1928. By the summer of 1932 the bond index had lost a third of its value, plummeting to 65.78, reflecting in large measure the impaired creditworthiness of many issues. As to Graham's reference to the "natural disaffection" investors had with bonds, I must conclude that, at least in the intermediate term, he was referring to the steady decline in bond yields, as the bond average rose in lockstep with the Dow Jones average throughout the 1920s. The concurrent rise in bond and stock prices during the great bull market is not unlike the experience of the last 15 years.

Lowered Standards of Investment Banking Houses

Traditionally, the investment bankers had been able to successfully combine the sometimes conflicting functions of protecting their clients' interests and making money for themselves. They properly thought of themselves as having a quasi-fiduciary relationship with their clients. *"The public was safeguarded as much for business as for ethical reasons, since a firm's reputation and continued existence depended on the soundness of the merchandise which it sold."*[x] Graham traced the relaxation of standards to two causes: (1) the ease with which all issues could be sold and (2) the scarcity of sound investments available for sale. In previous years investment bankers had the choice between selling good securities and bad, and they generally opted for the good, sometimes at reduced underwriting profit.

> *But now they had to choose between selling poor investments or none at all—between making large profits or shutting up shop—and it was too much to expect from human nature that under such circumstances they would adequately protect their clients' interests.*[xi]

The Element of Crowd Psychology

> *One of the striking features of the past five years has been the domination of the financial scene by purely psychological elements. In previous bull markets the rise in stock prices remained in fairly close relationship with the improvement in business during the greater part of the cycle; it was only in its invariably short-lived culminating phase that quotations were forced to disproportionate heights by the unbridled optimism of the speculative contingent. But in the 1921-1933 cycle this "culminating phase" lasted for years instead of months, and it drew its support not from a group of speculators but from the entire financial community. The "new-era" doctrine—that "good" stocks (or "blue chips") were sound investments regardless of how high the price paid for them was at bottom only a means of rationalizing under the title of "investment" the well-nigh universal capitulation to the gambling fever. We suggest that this psychological phenomenon is closely related to the dominant importance assumed in recent years by intangible factors of value, viz., good-will, management, expected earning power, etc. Such value factors, while undoubtedly real, are not susceptible to mathematical calculation; hence the standards by which they are measured are to a great extent arbitrary and can suffer the widest variations in accordance with the prevalent psychology. The investing class was the more easily led to ascribe reality to purely speculative valuations of these intangibles because it was dealing in good part with surplus wealth, to which it was not impelled by force of necessity to apply the old-established acid test that the principal value be justified by the income.*[xii]

The Rise and Fall of Security Analysis

> *But the "new era" commencing in 1927 involved at bottom the abandonment of the analytical approach; and while emphasis was still seemingly placed on facts and figures, these were manipulated by a sort of pseudo-analysis to support the delusions of the period. The market collapse in October 1929 was no surprise to such analysts as had kept their heads, but the extent of the business collapse which later developed, with its devastating effects on established earning power, again threw their calculations out of gear. Hence the ultimate result was that serious analysis suffered a double discrediting: the first—prior to the crash—due to the persistence of imaginary values, and the second—after the crash—due to the disappearance of real values.*[xiii]

The Concept of Intrinsic Value

One of the many fascinating features of the flashback to 1934 is the absence of any reference whatsoever to Modern Portfolio Theory and, in particular, efficient markets. Those mathematical concepts came into being many years later. In fact, that frequently there was a difference between price and value was central to Graham's thinking. How foreign such thinking must be to the minds of the efficient-markets theorists.

> *... [I]ntrinsic value is an elusive concept. In general terms it is understood to be that value which is justified by the facts, e.g., the assets, earnings, dividends, definite prospects, as distinct, let us say, from market quotations established by artificial manipulation or distorted by psychological excesses. But it is a great mistake to imagine that intrinsic value is as definite and as determinable as is the market price. Some time ago intrinsic value (in the case of a common*

stock) was thought to be about the same thing as "book value," i.e., it was equal to the net assets of the business, fairly priced. This view of intrinsic value was quite definite, but it proved almost worthless as a practical matter because neither the average earnings nor the average market price evinced any tendency to be governed by the book value. ...

Hence this idea was superseded by a newer view, viz., that the intrinsic value of a business was determined by its earning power.[xiv] *Since the trend in earnings is far less certain than book value, the concept of intrinsic value thus derived lacks precision and is prone to considerable error.*[xv]

No Automatic Relationship Between Value and Price

Investment theory should recognize that the merits of an issue reflect themselves in the market price not by any automatic response or mathematical relationship but through the minds and decisions of buyers and sellers. Furthermore, the investors' mental attitude not only affects the market price but is strongly affected by it, so that the success of a commitment—properly considered—must depend in some part on the subsequent maintenance of a satisfactory market price.[xvi]

And George Soros thought he had an original idea.

The Importance of Price

In the field of common stocks, the necessity of taking price into account is more compelling, because the danger of paying the wrong price is almost as great as that of buying the wrong issue. We shall point out later that the new-era theory of investment left price out of the reckoning, and that this omission was productive of most disastrous consequences.[xvii]

Graham makes a distinction between the untrained and the trained securities buyer by way of analogy:

[The principles that governed their behavior are] *applicable to all kinds of merchandise, viz., that the untrained buyer fares best by purchasing goods of the highest reputation, even though he may pay a comparatively high price. But, needless to say, this is not a rule to guide the expert merchandise buyer, for he is expected to judge quality by examination and not solely by reputation, and at times he may even sacrifice certain definite degrees of quality if that which he obtains is adequate for his purpose and attractive in price. This distinction applies as well to the purchase of securities as to buying paints or watches. It results in two principles of quite opposite character, the one suitable for the untrained investor, the other useful only to the analyst.*

1. Principle for the untrained security buyer: <u>Do not put money in a low-grade enterprise on any terms</u>.
2. Principle for the securities analyst: <u>Nearly every issue might conceivably be cheap in one price range and dear in another.</u>[xviii]

Forces That Mitigate Against the Indefinite Continuance of a Trend

Abnormally good or abnormally bad conditions do not last forever. This is true not only of general business but of particular industries as well. Corrective forces are usually set in motion which tend to restore profits where they have disappeared, or to reduce them where they are excessive in relation to capital. Industries especially favored by a developing demand [e.g., personal computers] may become demoralized through a still more rapid growth of supply.[xix]

Distinctions Between Investment and Speculation

... [T]he cynic's definition [is] that an investment is a successful speculation and a speculation is an unsuccessful investment. ... [T]he failure to properly distinguish between investment and speculation was in large measure responsible for the market excesses of 1928-1929 and the calamities that ensued.[xx]

Income vs. Profit; Safety vs. Risk

Certainly, through many years prior to 1928, the typical investor had been interested above all in safety of principal and continuance of an adequate income. However, the doctrine that common stocks were the best long-term investments resulted in a transfer of emphasis from current income to future income and hence inevitably to future enhancement of principal value. In its complete subordination of the income element to the desire for profit, and also in the prime reliance it placed upon favorable developments expected in the future, the new-era style of investment—as exemplified in the general policy of the investment trusts—was practically indistinguishable from speculation. In fact this so-called investment could be accurately defined as speculation in the common stocks of strongly situated companies.[xxi]

To be sure, what constitutes safety is highly subjective.

The race-track gambler, betting on a "sure thing," is convinced that his commitment is safe. The 1929 "investor" in high-priced common stocks also considered himself safe in his reliance upon future growth to justify the figure he paid and more.

The concept of safety can be really useful only if it is based on something more tangible than the psychology of the purchaser. [The investor of 1912 relied on established standards and purchased bank stocks] *at price levels which he considered conservative in the light of experience; he was satisfied, from his knowledge of the institution's resources and earning power, that he was getting his money's worth in full. If a strong speculative market resulted in advancing the price to level out of line with these standards of value, he sold his shares and waited for a reasonable price to return before reacquiring them.*

Had this 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. These differed from the old-time bank-stock purchases in the one vital respect that the buyer did not determine that they were worth the price paid by the application of firmly established standards of value. The market made up new standards as it went along, by accepting the current price—however high—as the sole measure of value. ...

It is unsound to think always of investment character as inhering in an issue per se. The price is frequently an essential element, so that a stock (and even a bond) may have investment merit at one price level but not at another.[xxii]

History of Common-Stock Analysis

Finally, an impressive theory was constructed asserting the preeminence of common stocks as long-term investments. But at the time that the interest in common stocks reached its height, in the period between 1927 and 1929, the basis of valuation employed by the stock-buying public departed more and more from the factual approach and technique of security analysis, and concerned itself increasingly with the elements of potentiality and prophecy.[xxiii]

Analysis was vitiated by two types of instability: instability of tangibles and dominant importance of intangibles.[xxiv]

Speculation Characterized by Emphasis on Future Prospects

In the pre-war period it was the well-considered view that when prime emphasis was laid upon what was expected of the future, instead of what had been accomplished in the past, a speculative attitude was thereby taken. Speculation, in its etymology, meant looking forward; investment was allied to "vested interests,"—to property rights and values taking root in the past. *The future was uncertain, therefore speculative; the past was known, therefore the source of safety.*[xxv]

Buying Common Stocks Viewed as Taking a Share in a Business

If investors would think about buying common stocks in the same manner they think about buying a private business, much trouble would be avoided.

This meant that he gave at least as much attention to the asset values behind the shares as he did to their earnings records. It is essential to bear in the mind that a private business has always been valued primarily on the basis of the "net worth" as shown by its statement. ... An interest in a private business may of course be sold for more or less than its proportionate asset value; but the book value is still invariably the starting point of the calculation, and the deal is finally made and viewed in terms of the premium or discount from book value involved.[xxvi]

"It is a significant confirmation of this point that 'watered stock,' once so burning an issue, is now a forgotten phrase."[xxvii] Notice how contemporary analysis has moved away from virtually any consideration of book value, even with private companies.

The New-Era Theory

During the postwar period, and particularly during the latter stage of the bull market culminating in 1929, the public acquired a completely different attitude towards the investment merits of common stocks. Two of the three elements above stated [(1) a suitable and established dividend return; (2) a stable and adequate earnings record; and (3) a satisfactory backing of tangible assets] lost nearly all of their significance and the third, the earnings record, took on an entirely novel complexion. The new theory or principle may be summed up in the sentence: "The value of a common stock depends entirely upon what it will earn in the future."

From this dictum the following corollaries were drawn:

1. *That the dividend rate should have slight bearing upon the value.*
2. *That since no relationship apparently existed between assets and earning power, the asset value was entirely devoid of importance.*
3. *That past earnings were significant only to the extent that they indicated what changes in the earnings were likely to take place in the future.*

This complete revolution in the philosophy of common-stock investment took place virtually without realization by the stock-buying public and with only the most superficial recognition by financial observers.[xxviii]

The revolution had some basis in fact. The old and established businesses, long thought to be stable, fell upon hard times, whereas upstart businesses, with no records, became the most popular. The old standards of measurement could not easily be applied to these new businesses. Without dividends and significant assets relative to market price, "future earnings" was the only *variable at which analysts could look. Railroads, along with street railways for streetcars, lost markets to competitive substitutes. Electric and gas companies were harmed both by the war and the postwar inflation.*[xxix]

... [T]here emerged a companion theory that common stocks represented the most profitable and therefore the most desirable media for long-term investment. This gospel was based upon a certain amount of research, showing that diversified lists of common stocks had regularly increased in value over stated intervals of time for many years past. The figures indicated that such diversified common-stock holdings yielded both a higher income return and a greater principal profit than purchases of standard bonds.[xxx]

Stocks Regarded as Attractive Irrespective of Their Prices

The notion that the desirability of a common stock was entirely independent of its price seems incredibly absurd. Yet the new-era theory led directly to this thesis. If a public-utility stock was selling at 35 times its maximum recorded earnings, instead of 10 times its average earnings, which was the preboom standard, the conclusion to be drawn was not that the stock was now too high but merely that the standard of value had been raised. Instead of judging the market price by established standards of value, the new era based its standards of value upon the market price. Hence all upper limits disappeared, not only upon the price at which a stock could sell, but even upon the price at which it would deserve to sell. ...

An alluring corollary of this principle was that making money in the stock market was now the easiest thing in the world. It was only necessary to buy "good" stocks, regardless of price, and then to let nature take her upward course. The results of such a doctrine could not fail to be tragic. Countless people asked themselves, "Why work for a living when a fortune can be made in Wall Street without working?" The ensuing migration from business into the financial district resembled the famous gold rush to the Klondike, with the not unimportant difference that there really was gold in the Klondike.[xxxi]

Investment Trusts [Mutual Funds] Adopted This New Doctrine

Another irony of the late '20s involved investment trusts.

[They] *were formed for the purpose of giving the untrained public the benefit of expert administration of its funds*.[xxxii]

It was understood that managers of investment funds were to buy in times of depression and low prices, and to sell out in times of prosperity and high prices.

[They were to diversify and to] *discover and acquire undervalued individual securities as the result of comprehensive and expert statistical investigations. The rapidity and completeness with which these traditional principles disappeared from investment-trust technique is one of the many marvels of the period. The idea of buying in times of depression was obviously inapplicable. It suffered from the fatal weakness that investment trusts could be organized only in good times, so that they were virtually compelled to make their initial commitments in bull markets. ...*

But most paradoxical was the early abandonment of research and analysis in guiding investment-trust policies. However, since these financial institutions owed their existence to the new-era philosophy, it was natural and perhaps only just that they should adhere closely to it. Under its canons investment had now become so beautifully simple that research was unnecessary and statistical data a mere encumbrance. The investment process consisted merely of finding *prominent companies with a rising trend of earnings, and then buying their shares regardless of price. Hence the sound policy was to buy only what everyone else was buying—a select list of highly popular and exceedingly expensive issues, appropriately known as the "blue chips." The original idea of searching for the undervalued and neglected issues dropped completely out of sight. Investment trusts actually boasted that their portfolios consisted exclusively of the active and standard (i.e., the most popular and highest priced) common stocks. ...*

[The final irony was that the] *man in the street, having been urged to entrust his funds to the superior skill of investment experts—for substantial compensation—was soon reassuringly told that the trusts would be careful to buy nothing except what the man in the street was buying himself.*[xxxiii]

A Sound Premise Used to Support an Unsound Conclusion

While the exponential ascension in stock prices during the late '20s was in large measure a self-fulfilling prophecy, it was not without scholarly explanation, however tenuous. *Common Stocks as Long-term Investments* by Edgar Lawrence Smith, published in 1924, was often cited as justification for the ownership of common stocks. Unfortunately, the sound premise was rendered unsound by virtue of prices escalating to speculative levels in the late '20s. In practical terms, Smith's supposition was as sensible at 10 times earnings as it was ill-advised at 30 times.[xxxiv] Coincidentally, Professor Jeremy Siegel's book with the nearly identical title, *Stocks for the Long Term*, is the contemporary iteration of the same phenomenon. I listened to Siegel present his case at a conference in December 2000 for the CEOs of investment advisory firms, and he has softened his position somewhat. While he now thinks technology stocks are overpriced, he believes that the S&P 500, exclusive of technology issues, is reasonably priced.

Parenthetically, I remain perplexed that most investors seem predisposed to extrapolating the past in forecasting the future of common-stock price movements. When referring to Roger Ibbotson's comprehensive statistical analysis of common-stock returns dating back to 1926, why do pundits invariably cite recent or long-term average returns from common stocks as the basis for predicting future returns? Would not a projection based on the post-1928-29 experience be more relevant? It is a fact, whether we like it or not, that as of the spring of 2000 (and, for that matter, even today) for many stocks the relationship between price and value is more like the late '20s than at any other time in modern history.

Average vs. Trend of Earnings

There are several reasons why a trend in earnings might not continue into the future.

In the broad economic sense, there is the law of diminishing returns and of increasing competition which must finally flatten out any sharply upward curve of growth. There is also the flow and ebb of the business cycle, from which the particular danger arises that the earnings curve will look most impressive on the very eve of a serious setback. Considering the 1927-1929 period we observe that since the trend-of-earnings theory was at bottom only a pretext to excuse rank speculation under the guise of "investment," the profit-mad public was quite willing to accept the flimsiest evidence of the existence of a favorable trend. ... The prevalent heedlessness on this score was most evident in connection with the numerous common-stock flotations during this period. The craze for a showing of rising profits resulted in the promotion of many industrial enterprises which had been favored by temporary good fortune and were just approaching, or had already reached, the peak of their prosperity.[xxxv]

... [O]ne of the paradoxes of financial history, viz., that at the very period when the increasing instability of individual companies had made the purchase of common stocks far more precarious

than before, the gospel of common stocks as safe and satisfactory investments was preached to and avidly accepted by the American public.[xxxvi]

Price an Integral Part of Every Investment Decision

The price must have a rational basis.

This criterion of reasonableness is vital to all investment methods, and particular to any theory of investing in common stocks. The absence of this controlling test constituted the fatal weakness of the new-era doctrine.[xxxvii]

An issue is attractive only if the indicated value amply justifies the price paid; hence the price is an integral part of any investment decision. This is true not only at the time of purchase but throughout the period of subsequent ownership. While the expectation may be to hold the issue indefinitely for income and enhancement in value, it will often prove desirable from the investment standpoint to dispose of it should it cease to be attractive—either because its quality has deteriorated or because the price has risen to a level not justified by the demonstrable value.[xxxviii]

Disturbing Influence of Market Fluctuations

The wider the fluctuations of the market, and the longer they persist in one direction, the more difficult it is to preserve the investment viewpoint in dealing with common stocks. The attention is bound to be diverted from the investment question, which is whether the price is attractive or unattractive in relation to value, to the speculative question whether the market is near its low or its high point.

This difficulty was so overshadowing in the years between 1927 and 1933 that common-stock investment virtually ceased to have any sound practical significance during that period. If an investor had sold out his common stocks early in 1927, because prices had outstripped values, he was almost certain to regret his actions during the ensuing two years of further spectacular advances. Similarly those who hailed the crash of 1929 as an opportunity to buy common stocks at reasonable prices were to be confronted by appalling market losses as a result of the subsequent protracted decline.[xxxix]

The Danger of Speculative Contagion in Common-Stock Investment

We doubt, however, whether many individuals are qualified by nature to follow consistently such an investment policy without deviating into the primrose path of market speculation. The chief reason for this hazard is that the distinctions between common-stock investment and common-stock speculation are too intangible to hold human nature in check. ... But when the investor employs the same medium as the speculator, the line of demarcation between one approach and the other is one of mental attitude only, and hence is relatively insecure. It is not likely to keep him immune from speculative contagion, especially when this is rampant in the very issues in which he has made his investment. Prior to 1926, a fairly definite separation could be made between investment common stocks and speculative common stocks. The former fluctuated over a much narrower range percentage-wise, since their prices were determined largely by their established dividend rate. ...

Hence the issues which the common-stock investor dealt in served to set him apart from the speculative public and make it easier for him to maintain his conservative viewpoint. The new era was marked by a concentration of speculative interest on those issues which had formerly deserved an investment rating. This made for an extraordinary confusion in the mental processes *of the entire financial community, and the straightening out of this confusion may be a matter of many years.*[xl]

Stock Watering Reversed

The new policy of writing off fixed assets bears an interesting relationship to the recent conceptions of stock values. It is a direct outgrowth of the ignoring of asset values and the monopolizing of attention by the reported per-share earnings. A generation ago, when investors consulted balance sheets to ascertain the net worth behind their shares, this net worth was artificially inflated by writing up the book value of the fixed assets far above their actual cost. This in turn permitted a corresponding overstatement of capitalization at par. "Stock watering," as this practice was called, constituted at that time one of the most severely criticized abuses of Wall Street.

It is a striking commentary on the change in our financial viewpoint that the term "stock watering" has practically disappeared from the investor's vocabulary. By a strange paradox the same misleading results which were obtained before the war by overstating property values are now sought by the opposite stratagem of understating these assets. Erase the plant account; thereby eliminate the depreciation charge; thereby increase the reported earnings; thereby enhance the value of the stock. The idea that such sleight-of-hand could actually add to the value of a security is nothing short of preposterous. Yet Wall Street solemnly accepts this topsy-turvy reasoning; and corporate managements are naturally not disinclined to improve their showing by so simple a maneuver.[xli]

Current Earnings Should Not Be the Primary Basis of Appraisal

The market level of common stocks is governed more by their current earnings than by their long-term average. This fact accounts in good part for the wide fluctuations in common-stock prices, which largely (though by no means invariably) parallel the changes in their earnings between good years and bad. Obviously the stock market is quite irrational in thus varying its valuation of a company proportionately with the temporary changes in its reported profits. A private business might easily earn twice as much in a boom year as in poor times, but its owner would never think of correspondingly marking up or down the value of his capital investment.

This is one of the most important lines of cleavage between Wall Street practice and the canons of ordinary business.[xlii]

Other Relevant Topics

For those readers who would like to delve further into this most extraordinary of accounts, I might suggest purchase of *Security Analysis* (1934 edition) from Amazon.com—despite my disappointment with their accounting conventions, as noted earlier—and read the following sections (pages indicated in parentheses).

The hazard of tardy adjustment of price to value (22)
Balance-sheet analysis (485)
Practical significance of book value (491)
Prevalence of stocks selling below liquidating value (498)
Stock-repurchase programs (518)
Officers and directors—summary and conclusion (521)
Discrepancies between price and value (585)
Bargains in a bull market (589)
Mergers and segregations (590)

Conclusion

Of the many factors that contribute to setting the price for a given stock (including management; competition; trends in unit volume, price, and costs; earnings; dividends; assets; capital structure; and terms of the issue), the often emotional attitude of the public in response to those fundamental factors, expressed through their bids and offers in the marketplace, sometimes results in prices that are at significant variance from intrinsic value. By contrast, revolutionary advances have been achieved in communications, the medical sciences, computers, and the whole range of other technologies precisely because they call upon sectors of the brain where emotion does not encroach. To understand the difference is crucial if one is to avoid falling victim to the euphonic contagion common to great speculative booms—and the prolonged despair that invariably follows in their wake.

THE MARTIN CAPITAL MANAGEMENT TEAM

Frank K. Martin, CFA, Managing Partner

Frank has 33 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 manufacturing companies, as well as a variety of social service organizations. He is currently a member of the boards of the Elkhart General Hospital Foundation; Fourth Freedom Forum, Goshen; Sauder Stewardship Foundation, Inc., Archbold, Ohio; and The Frank and Marilyn Martin Family Foundation. Frank has written regularly on the subject of investments since 1971.

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Dennis has 15 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., Bristol; Hertzler Systems, Goshen; Pleasant Street Homes, LLC; and The Elkhart Chamber of Commerce.

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Todd has 12 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; The Frank and Marilyn Martin Family Foundation; Trinity United Methodist Church Foundation; and St. Joseph Capital Bank, Mishawaka.

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Prior to joining Martin Capital Management in September 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 of 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., an Elkhart-based 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. He serves on the board of Patriot Homes and the advisory board of Sensant Corp., San Jose, California.

Ann T. Frantz, CPA

Ann started her career with Crowe Chizek, Elkhart, where she earned her CPA designation. Prior to joining Martin Capital in August 1999 as our new operations manager, she worked for Crown International, Inc., Elkhart. Ann majored in business and graduated from IUSB where she earned her BS in 1982.

Kristin Antalavits

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

Lynn M. Stenberg

Lynn joined Martin Capital in September 1995 as an administrative assistant. She graduated from Penn High School, Mishawaka, 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. She held various management positions within the consumer loan division and most recently was an assistant vice president in the indirect lending group.

Marsha Miller, RN

Formerly a nurse at Elkhart General Hospital, Marsha joined the firm in October 1999. She graduated from Southwestern Michigan School of Nursing in 1991. She serves as personal and executive assistant to Frank Martin, in addition to performing a host of other support roles within the firm.

Stephanie Malcom

Stephanie joined Martin Capital in November 1999 as an executive assistant. She graduated from Elkhart Memorial High School and has attended various seminars on office management. Stephanie came to us from the Elkhart-based Energy Management Systems.

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Endnotes

[i] Graham, Benjamin, & Dodd, David T. (1934). *Security Analysis*. New York, N.Y., and London, England: Whittlesey House, McGraw-Hill Book Company, Inc. p. 3.
[ii] Ibid., p. 6.
[iii] Graham, Benjamin. (1996). *Benjamin Graham: The Memoirs of the Dean of Wall Street.* Chapman, Seymour (Ed.). New York, N.Y.: McGraw-Hill Book Company, Inc. p. 251.
[iv] Ibid., p. 252.
[v] Ibid.
[vi] Ibid. p. 259.
[vii] Ibid., p. 262.
[viii] Ibid., pp. 257-258.
[ix] Graham, Benjamin, & Dodd, David T. (1934). *Security Analysis*. New York, N.Y., and London, England: Whittlesey House, McGraw-Hill Book Company, Inc. p. 5. (Note: The header of the next section is lifted directly from *Security Analysis*, as are all subsequent *italicized* headers.)
[x] Ibid., p. 9.
[xi] Ibid., p. 10.
[xii] Ibid., pp. 11-12.
[xiii] Ibid., pp. 14-15.
[xiv] Ibid., p. 17.
[xv] Ibid., p.18
[xvi] Ibid., p. 12.
[xvii] Ibid., p. 29.
[xviii] Ibid., pp. 31-32.
[xix] Ibid., p. 35.
[xx] Ibid., p. 50.
[xxi] Ibid., p. 52.
[xxii] Ibid., pp. 53-55.
[xxiii] Ibid., p. 300.
[xxiv] Ibid., p. 301.
[xxv] Ibid., p. 305.
[xxvi] Ibid., p. 306.
[xxvii] Ibid., p. 308.
[xxviii] Ibid., pp. 306-307.
[xxix] Ibid., p. 308.
[xxx] Ibid., p. 309.
[xxxi] Ibid., p. 310.
[xxxii] Ibid.
[xxxiii] Ibid., pp. 311-312.
[xxxiv] Ibid., p. 312.
[xxxv] Ibid., pp. 314-315.
[xxxvi] Ibid., p. 316.
[xxxvii] Ibid., p. 318.
[xxxviii] Ibid., p. 321.
[xxxix] Ibid., pp. 321-322.
[xl] Ibid., pp. 322-323.
[xli] Ibid., pp. 418-419.
[xlii] Ibid., p. 432.

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