TABLE OF CONTENTS

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 the SEC filings, including form ADV Part II, are available upon request.) Since then, Martin Capital has grown to serve 84 clients whose combined assets total approximately $510 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 end of report 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 newly raised $5 million minimum family 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
Joseph T. Iams, CPA, Analyst and Portfolio Manager
Ann Frantz, CPA, Operations Manager
Kristin Antalavits, Assistant Portfolio Manager and Trader
Karen Sherer, Client Service and Operations Support
Marsha Miller, RN, Executive Assistant
Stephanie Malcom, Executive Assistant

PRIVACY NOTICE

When Martin Capital Management provides investment services to you, we may obtain nonpublic personal information about you from the following sources:

- from you, orally or in documents, or other materials you provide to us; and
- from others, in connection with the transactions or other matters we handle for you.

We do not disclose nonpublic personal information about our clients or former clients to anyone outside our firm, except with the client's consent, as required for the services our clients request, or as otherwise permitted or required by law.

We restrict access to your non-public information to members of our firm — and to employees of our firm who have agreed to maintain the confidentiality of our clients' information.

We maintain physical, electronic, and procedural safeguards to protect your non-public personal information from inadvertent disclosure.

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 90-95% of all the benefits to be gained from diversification can be achieved with a well-selected portfolio of fewer than 20 businesses.

INTRODUCTION

Hubris and Humility have only one thing in common: They both begin with the letters "Hu." Repeat it three times, and it could be appropriately seasonal — an Oriental version of Santa's jolly greeting. The next letter decisively differentiates the two words: The "b" stands for boastfulness and the "m" for meekness. Our longtime friends and acquaintances know all too well that for us to spike the football in the end zone would border on the farcical, making a mockery of what was little more than a splash of good sense and a bucket of good luck. No false modesty intended here. Sometimes we look dumber than we are; other times we look smarter. The improbability of having a string of two successive years during which we appeared shrewd when others felt skewered should give you pause; suffice it to say, it gives us the willies. Of one thing we are absolutely sure: Gravity cannot be defied indefinitely. Please file away in your cranial hard drive what it feels like to have been angst-free for 24 months. It may be quite awhile before that record is broken.

If there is any security, it is in our commitment to manage your wealth with the same consistency of philosophy and style as we have in the past, of knowing who we are and who we are not. We expect always to be thought of as conservative, but we will be most disappointed if we are perceived as average. By purpose and design, we generally expect our results to be at least one standard deviation away from the Standard & Poor's 500's performance mean. Sometimes it won't be pretty, but over the long haul we hope it will hold up relatively well under the wear and tear of economic and market trials and travails.

Good times or bad, the prose that follows will stick to its all-too-familiar pattern. Writing "pros" will continue to scratch their heads in disbelief. In a self-assessment, 18th-century British writer Samuel Johnson articulated well what critics must generally conclude about these annual ramblings, of which this is merely the latest installment: "I found our speech copious without order, and energetic without rules."

Getting down to business, you may have noticed in the Foreword that we raised our per-family portfolio minimum to $5 million for *new* clients. There may be exceptions when exceptions make business or personal sense. During the past year 13 new families entrusted their assets to our care. That's more than we had planned for, requiring that we take a breather to avoid diluting our service to those who are the reason we are in business. The excitement of new relationships must never come at the expense of underserving those who have been wonderfully loyal to us through thick and thin. (One can, after all, get too much of even a *good* thing.) The only way we know how to moderate our growth, most of which originates from referrals from existing clients, is to raise the crossbar. Although we expanded our full-time professional staff by 25% (don't be fooled by percentages; that's only one person, namely Joe Iams, about whom you'll learn later), carefully controlling the number of families we serve is essential to maintaining harmonious relationships and getting our work done on your behalf in a responsive and competent manner — and having lots of fun along the way.

The meat of the report begins in Chapter I with a twist on the axiom, "People get the government they deserve." No institution, however big or small, can be all things to everyone. By again revealing to you our competitive strategy, we make it clear that there are trade-offs; activities we embrace as within our circle of competence require declining involvement in others that are clearly outside it. If you know where we stand, you'll know upfront whether or not the fit is right for you. "Intellectual Capital," about our outstanding staff, is among the most enjoyable segments I write, and it is followed by Chapter II, "Investment Performance," which has more caveats than caviar. In Chapter III the rather lengthy "Prelude to Our Investment 'Strategy,'" inasmuch as it addresses how we plan to cope with an uncertain future, might be considered a "must read."

Should your eyes become glassy, at least temporarily postponing the copious exposition on the lessons that the immediate past might teach us will not offend the writer. However, do not put it off forever. That's Chapter IV. History has a way of repeating itself for those who ignore its lessons.

Chapter V, "Ledger d'Maim," makes its third consecutive appearance, almost exclusively for the "benefit" of accounting masochists. If you believe that we understand what's happening in the slippery, even unctuous, world of financial accounting, glancing over this section should more than satiate your predilection for pain. If you already know what's going on and want to satisfy yourself that we do too, be our guest and take the plunge. But don't say we didn't warn you.

This report makes a number of references to our 1999 and 2000 annual reports. In the interest of conservation (paper, printing, and postage), those reports — if you don't happen to have the hard-copy versions — can be accessed by calling up our Website: mcmadvisors.com. As you will see, internal cross-referencing is more common in this report than in earlier years, with an eye toward minimizing redundancies.

Sources for factual matter include *The Wall Street Journal, Barron's, Fortune* magazine, *Forbes* magazine, various Internet sources, Bloomberg, and others, along with a number of books. Considering the limited audience for which this report is intended, the abbreviated production window, and because most readers already are familiar with my ideas and writings, my words and those of others are freely mixed, sometimes without formal acknowledgment, particularly in the latter sections of the report. It is not my wish to put forth as original the ideas or words of others. To the contrary, I wish to save them the embarrassment of being associated with me! If you find a really great idea in these pages, and you're sure it could not have come from my semantically challenged synapses, give me a call, and I'll find the source and give credit where credit is due.

Finally, depleting my inventory of traditional excuses for subjecting you to such annual torment, this year I resort ironically to an appeal to your forbearance because of the crunch of time. There was a brief window of about 20 days in the early-morning hours of December, during which I needed to complete my report so it would get to Dan Shenk, copy editor *par excellence,* then the printer, and ultimately to you, dear reader, on a timely basis. As Blaise Pascal, the great French mathematician, so aptly observed, "I have made this letter longer than usual, because I lack the time to make it short." Should I run on again next year, I may run *out* of "figures" (of speech) for finessing my indulgence.

CHAPTER I

A Firm Gets and Keeps the Clients It Deserves

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

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

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

Next is the most skill-based and time- and travel-intensive of our activities — investment research. Collectively, 3,000 to 5,000 hours are dedicated to that vital activity every year. (See 1999 annual report's section titled "Man's Search for … Answers.")

From the portfolio-management perspective, the needs of our clients differ markedly from those of mainstream investors. Most of our activities are tailored to serving those unique needs. As a practical matter, our high minimum-account-size requirement ($5 million for new clients) makes extraordinarily high professional-to-client ratios economically feasible. High-net-worth individuals appear to be more comfortable having their needs attended to by portfolio managers who are intimately familiar with the businesses that populate their portfolios, along with the capital markets in which the companies trade, as only a fully trained and accredited analyst and portfolio manager can be. Some of our more assertive clients ask to see the personal portfolios of those who manage theirs; this request is always granted. That's the first request I also would make were the shoe on the other foot. The second would be to ask for the number of portfolios my manager oversees. We expect to be better portfolio managers because we are business analysts, and we are better business analysts because we are portfolio managers.

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

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

To begin, we are often asked how an independent investment-advisory firm with five analysts can stay on top of the goings-on at the thousands of public companies listed on the major exchanges and/or how we can trade as part of the Nasdaq system, to say nothing of overseas companies whose American Depository Receipts (ADRs) trade here or whose shares trade on foreign exchanges. The short and obvious answer? We can't. To be sure, owing to spectacular technological advances, manifested in a smorgasbord of databases as close as a few clicks of the mouse — including Bloomberg, FactSet, Multex, Dow Jones on-line services, and the rest of the vast Internet pipeline — we have direct access to heretofore unimaginable volumes of data. Of near equal importance, this veritable cornucopia of information need not be physically handled or stored.

Thanks to technology, accessibility is no longer the line of demarcation between the behemoths and the boutiques. For most advisors of reasonable size, a wealth of information at one's fingertips has the potential to greatly leverage a firm's human capital. Such availability, though, is a mixed blessing. Whether folks in a firm realize it or not, a much diluted service offering will result if the apparent trade-offs are not recognized and addressed. Simply put, more of one thing necessitates less of another. Continuing in the lexicon of trade-offs, we believe that "less is more." Despite the enticing appeal of the information revolution, we must constantly guard against being overwhelmed by it. Insidiously, the new information paradigm cultivates the temptation to try to be all things to all people.

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

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

The cornerstone of our overall business strategy, of course, is the education- and experience-based competence, along with the essential companion virtue of honorable character, of our team members. We pledge to our clients to continue to work diligently to be the best we can be, to view what we do as a cause, not just a job. We're aware that our investment in professional development is likely to go unrecognized in runaway bull markets where everyone appears to be a genius. It is only when the tide goes out that you discover who is swimming sans swimsuit. We have prepared meticulously should the waters indeed ebb; our future rests on being exposed! Little did we know when we penned those words in late 1999 that 2000 and 2001 would be the time when the waters in fact receded. (See Chapter II.) Moreover, it hasn't escaped our attention that the best-qualified candidates cannot be expected to join any advisory firm without the chance to thrive creatively, to make contributions that count, and to aspire to eventual ownership. As an independent partnership, we are ideally structured to meet those needs.

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

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

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

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

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

Intellectual Capital

Year after year we have reminded our clients that our assets are not like the bricks, mortar, and equipment of a manufacturing company. Rather, they have bodies and brains, idiosyncratic personalities, preferences, and even quirks — and they "go up and down in the elevator" as a daily reminder of their freedom of choice. By that, of course, we wish to emphasize that we are in the people business, that for a professional-services firm such as ours the 10 people who are Martin Capital Management are the firm's primary "asset." Human beings, to the extent that we think of them as "assets" (as crass as that may sound, it has a better ring than characterizing them as "liabilities," or worse, "overhead!"), are the building blocks on which the firm's present and future rests. Indeed, they are the most exciting, as well as the most challenging, of the "productivity tools" through which the service to our clients is rendered.

Strangely, these assets do not appear on the balance sheet at all, and on the income statement they are listed only as an expense — a large one at that. Even though they don't surface as an asset on our financial statements, not only are they incredibly valuable, their value, properly encouraged and trained, actually appreciates over time, sometimes by quantum leaps. Machines (including computers), by contrast, do not think for themselves and, if well maintained, do precisely what they're told to do — no more, no less. While they are more predictable, they generally depreciate with usage and are sometimes rendered technologically obsolete in a matter of weeks or months by superior substitutes. Their reliability — short of their becoming outmoded by design, style, or function of replacements — is both blessing and curse. The man who oversees a machine may have a look of satisfaction on his face, but never a smile.

People, with all their vagaries and in all their variations of the human psyche, make a business like ours an exciting, magical place to call a home away from home — particularly from my vantage point. To be sure, it is a test of one's abilities or resources in a demanding but stimulating environment. And despite regularly falling short of one's highest aspirations, watching others grow and develop, mature and find their niche, and experience joy and satisfaction in their accomplishments is a reward of the highest order.

Were this a disparate group (despite all the considerable abilities therein) it wouldn't have much to show for itself. Rather, it is these workers' willingness to put egos and special interests aside, to subordinate themselves to the greater good — to labor selflessly and hard as a team — that creates true synergies. The sense of oneness extends to our investment philosophy on which there is universal agreement, a state of communal certitude so strong that we stick to it without faltering even when it isn't producing immediate rewards for sometimes extended periods of time. We have never wavered, and I am confident we never will.

One of my special privileges as managing partner is to give you an annual accounting of the growth in our human capital ….

Our director of research and the first of our group of 10 to join me in 1989 — and the first to be admitted to the partnership — **Dennis Blyly,** 38, continues to demonstrate that a person with a purpose and a great mind knows no limits. Dennis' knowledge of business and businesses is most remarkable, and his able leadership of one of Martin Capital's most important functions — research — has contributed greatly to your investment results and, therefore, the firm's success. In the early going Dennis sometimes came across with a rather abrupt, "suffer no fools" attitude, not uncommon for folks as bright as Dennis. Of his own volition Dennis concluded that such a disposition can at times be deleterious to effective team play. He has become wonderfully empathetic, remaking himself into a most likable fellow. Dennis is no pushover, of course, but he has matured into one of the most effective men I know.

My only son, **Todd Martin,** 35, and my best male friend is a remarkably effective admixture of character, personality, and competence. Those who know him — and most of you do — are aware of what I speak. Those traits, needless to say, come from his mother's gene pool. He is the consummate team player. Like Dennis, Todd spends most of his time doing research and serving clients. With the time he has left he oversees Martin Capital's marketing strategy and plan — and serves on a number of boards.

Drew Wilson, 31, is a rising star in the firm. Having funded his way through Loyola University, Chicago, on a debate scholarship, his superior communication skills may well have contributed to the emergence of a man with an appealing but quiet and unobtrusive self-confidence. Drew has unwavering convictions; with him you always know where you stand. His clients are devoted to him, and his independent insights as an analyst are a great value for Martin Capital and its clients.

Joe Iams, 47, joined our firm in October 2001. Todd met Joe when they were students in Notre Dame's program in Executive Management. Since Joe is the newest member of our professional team, you might peruse his impressive bio at the end of the report. If he is half as good as his many references volunteered, my job may be at risk! At this stage in our brief relationship, I know him to be uncompromisingly intent on making a big success of this mid-life career change. Yet he is most affable — and the closest thing I know to a sponge in soaking up, with almost insatiable curiosity, every nuance of our business.

Charlie Kirk has retired! Rather than let him slip away quietly, I would rather commend him publicly for the tremendous contribution he has made to our firm — and to me personally — over the years. He has been a confidant; an unusually effective "devil's advocate" who always promoted active, friendly debate; and simply a great guy to have around. Charlie's chief cerebral challenge at the moment is tracing his ancestry back eight or nine generations, as well as consuming volumes of history, primarily biographies.

The operations side of a business like ours is as essential as it is inconspicuous. With holiday festivities still ringing in our ears, the following analogy might be apropos: Imagine Santa without his elves.

Chief elf, **Ann Frantz,** is the quintessential personification of this mythical figure: "A small, often mischievous creature considered to have magical powers," according to Webster. Ann is an unusually talented cut-to-the-chase manager whose meticulous check-and-double-check approach to her duties is only exceeded by her capacity to get enormous volumes of work completed in short order. If she didn't have such a positive and affirming attitude, if she didn't wear a smile regardless of the circumstance, if she weren't such a wonderful wife and mother, I would be tempted to conclude she is a machine!

Kristin Antalavits is our chief trader and assistant portfolio manager. She is the ultimate kick-starter, an elf with what *feels* like a size-12 shoe, which she plants with some force squarely on the backsides of recalcitrant portfolio managers moving at a pace she considers sluggish. In truth she is a diminutive dynamo with a great sense of humor and considerable intellectual capacity who, like Ann, is a woman with a mission. She handles millions of dollars of transactions each year with exactitude and diligence. We think she likes being an essential cog in the MCM wheel, and we can't imagine life without her.

Karen Sherer, assistant operations manager, is the newest member of our operations team. As her bio indicates, she brings a wealth of experience to our firm. Unlike Ann and Kristin, though, Karen is relatively quiet and unassuming, particularly for a 5-foot-9-inch elf! However, her mild-mannered demeanor, we are convinced, is a front. Below the surface lies a wry sense of humor and a supple mind. She's one of those people who, the more you get to know, the more you like. With every new task Karen has been assigned, she has promptly exceeded expectations.

Marsha Miller, the nurse who transmuted seamlessly to executive assistant, is an elf (rhymes with health) who wears more hats than the "Mad Hatter." If there is one person to whom I would give the most credit for restoring me to fighting trim and for enhancing my productivity to levels not seen in years, it would be Marsha. Her indomitable spirit, positive attitude, compassion, flexibility, elephantine memory, and thirst for learning anything new make her the consummate team player and an indispensable executive assistant.

Stephanie Malcom is our "elfina." She is one of those characters who lights up any room she graces with her presence. She is demonstrative, gregarious, and animated — simply a joy to be around. Stephanie is also one of the hardest-working elves in Santa's shop.

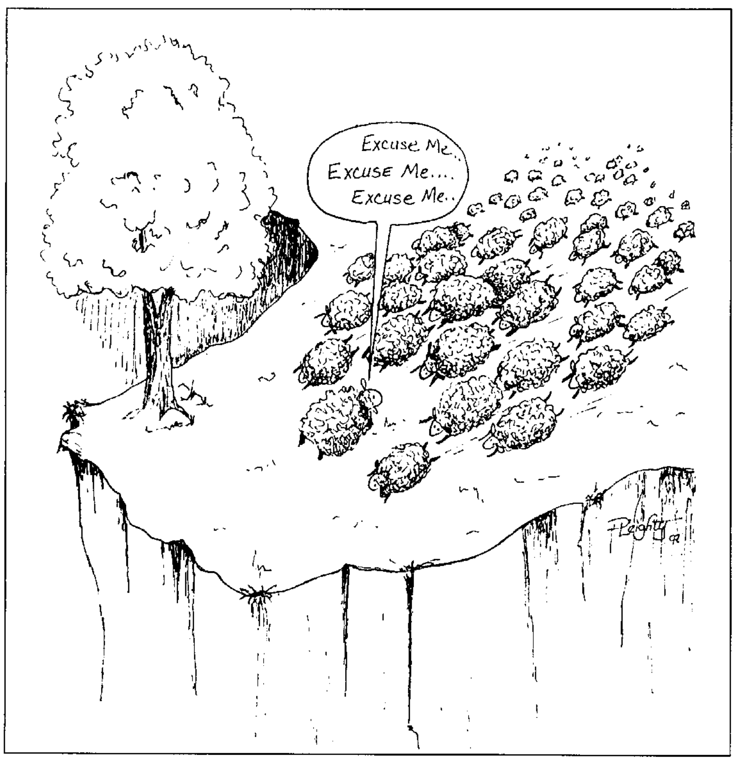
Perhaps the elf allegory was carried to an extreme? If you see some jovial (yet duly chastened) old soul, resplendent in tar and feathers, being wheeled out of town shackled to a rickshaw, you need not wonder who it is. (To borrow from Twain, "If it weren't for the honor of the thing, I'd rather walk.") If threatened with such "re-dress," so to speak, my halfhearted defense will be that I didn't mention the age of any of the elves. Please wish me well or, if you find yourself equally offended, feel free to revel in the satisfaction of knowing I received my just deserts.

CHAPTER II

Investment Performance

As the table below indicates, we have all made it through the minefields of the last two years looking much more gifted than we actually are, waving aside both pans and the plaudits as a matter of course, taking neither seriously. Metaphorically, just because we carded a 72 … that score is not indicative of our handicap. We'd like to play scratch golf, of course, but that takes practice and persistence, a sacrifice we have willingly made. It also takes a 15th club we very much doubt we have in our bag: a Tiger Woods-like Augusta "master-y."

We must admit that we find it easier to seize an opportunity in the face of generalized fear than to resist temptation while under the seductive and almost irresistible forces of unsubstantiated and illogical greed fomented out of fear of falling behind the pack. The consequences of miscalculations or emotions run amuck in the first instance are far less significant than with the latter, as a surfeit of baneful evidence has made abundantly clear during this increasingly pervasive down cycle of the markets. We tend to frame such judgments in mathematical terms. Even though there is only one correct answer, some wrong answers are closer to being correct than others. Nonetheless, running counter to the majority is a day-in, day-out test of will, determination, and convictions.



Gazing backwards even farther than a year for a moment, 1999 was particularly hard for us to comprehend or endure because of the unconscious allure of the rampant speculative contagion, the clamor from every direction for action, the epidemic of euphoria over ever-rising prices in already grossly overpriced technology and dot.com shares, the rallying cry that everyone jump aboard the bandwagon or look like a fool. To our good fortune, the latter was shouted by nearly everybody *but* our clients. Suffice it to say, the noise was deafening in the face of all that we knew to be true and conservative. There is an expression that gave some credence to our stand: "Someone who thinks logically provides a nice contrast to the real world." We would agree, though we know the injunction is grossly oversimplified. Since the outcome is never certain, the extent of the logic of one's thinking really isn't known until well after it's too late to reverse one's course. Besides, it's particularly lonely without the comfort and encouragement of the crowd. In truth, investment as we practice it is emotionally taxing: In the course of doing what we think is right, we find ourselves stepping into the fray when the current news is awful and the outlook worse, then doing an about-face and exiting when the sky seems to be the limit. This approach can feel contrary to human nature — that is, until we engage our rational mind and seek solace in the wisdom of its ways …

Year	MCM Equities*	S&P 500
1994	-7.8%	1.3%
1995	18.6%	37.5%
1996	32.2%	22.9%
1997	48.2%	33.3%
1998	-12.4%	28.6%
1999	17.4%	21.0%
2000	32.5%	-9.1%
2001	24.3%	-11.9%

* Representative portfolio, net of fees

This is the first annual report where the annual total returns are presented *net* of our performance-based fee. Accordingly, the numbers will not reconcile with those of earlier reports. We should note that the data on the S&P 500, our self-selected benchmark, are *before* any fees. Our performance-based fee arrangement, which has been so well received by our clients, is discussed below.

For the first time we also have included equity performance data going back to 1994. In the early years our focus (and our demonstrated expertise) was primarily in the arena of tax-exempt, fixed-income securities. Beginning in 1994 we felt sure-footed enough to begin prudently ramping up our exposure to good businesses, although in 1998 and 1999 we began to wonder if our disciplined ways would ever be valued in an investment world gripped by a speculative frenzy. Fortunately, the two years that followed allowed us to breathe a sigh of relief.

For comparison purposes, the above numbers are time-weighted. What that presumes is that we began with a specified amount of investment capital committed to equities and neither withdrew nor added additional funds to that asset class during the measurement period. In real life the dollar results can be markedly different than the above performance percentages would suggest. As a matter of course we take money off the table when prices are unrealistically high and, as noted below, we do the opposite when bargains are plentiful. The data above understate the portfolio wealth effects in 2000 and 2001 because of the huge amount of money we at times committed to common stocks during those two turbulent years. For example, in dollar terms the $46.1 million in aggregate equity gains that were just achieved in the fourth quarter of 2001 — precisely because substantial quantities of funds were shifted from fixed-income securities to discarded equities that offered table-thumping expected returns during the panicky sell-off in September — exceeded the dollar value of all the gains earned in the entire year of 2000. And yet the data above would imply that you did better in 2000 than you did in 2001. I guess it depends on how you keep score …

Finally, since we are occasionally asked to provide our one-, three-, and five-year performance history, it shall become a regular addition to the annual report. The performance data below are compounded annually and also are time-weighted.

Period Ending December 31, 2001	MCM Equities*	S&P 500*
Five Years	20.2%	10.7%
Three Years	24.6%	-1.0%
One Year	24.3%	-11.9%

* Compounded annually, MCM data net of fees

For those who are interested in our performance since the end of 1993 to year-end 2001 — eight years — Martin Capital's equities have earned a compounded annual total return of 17.7%, compared to 14.0% for the S&P 500. As discussed in Chapter III, we attempt to purchase individual common stocks at prices low enough to give us the twin advantages of a significant margin of safety and a conservatively estimated five-year expected return of no less than 15%, net of fees, which includes commissions. Although we have exceeded that threshold in each of the above measurement periods, we think the going will be much tougher ahead, as noted in the next chapter.

Far more significant than the numbers themselves is how they were achieved. If the means we employ are irreducible elements of our philosophy, the results will have more weight, possibly more staying power than the will-o'-the-wisp approach practiced by some. While we claimed that 2000 was an aberration, we weren't motivated by some sense of false modesty to make such an assertion. We make the same claim about 2001. We aren't like "Pollyanna" football coach Lou Holtz: Give us enough time, and the full meaning of those words of caution will be known. However, if we stick to the basic elements of rational investing, it is our hope — nay, our expectation — that we won't stray too far from delivering on our goals … over the long haul. As our record indicates, we take "down" years in stride, so long as our longer-term compounded returns are satisfactory. You should know that no sleight of hand, IPOs, or any other tricks of the trade were used to bulk up our results. You will learn more in Chapter V, "Ledger d'Maim," about the nefarious "techniques" of some managers.

The Means to the End

While the ensuing explanations follow no particular order of importance, they are nonetheless interdependent. Not to play on words, but independence of judgment, being free of distracting and often compromised petitions from affiliated parties, is essential for clear-headed thinking. The "Chinese Wall" — so named in homage to the Great Wall of China — that is presumed to exist between the investment bankers and research analysts within the same firm (as noted elsewhere in this report) has a tendency to come tumbling down in direct proportion to how high the stakes rise. Ethics are sacrificed on the altar of greed, market share, and the like. We can never know for sure who is beholden to whom when we receive a pitch from a Wall Street analyst, despite the fact that many are extraordinarily good at their jobs. Are the investment bankers who underwrote the latest IPO clamoring for more upbeat research support to avoid incurring the ire of the issuing company? If not that conundrum, then Wall Street's bias is often of necessity bullish and plays to the public's appetite for the hot story, whereas we are typically looking for the cold fish or the dead duck, at least in terms of the market's despondent pricing of the company's virtues as we see them! Wall Street's *modus operandi* is quite naturally transactions-oriented, the antithesis of ours.

Finally, concluding this line of reasoning, the fact that we are self-owned also fosters independence. The only constituency to whom we are obligated is our clients. Period. That may not seem like much, but when you have trafficked through the corridors and canyons of Wall Street for 35 years, you have witnessed behaviors that you wouldn't discuss in polite circles.

In last year's report we described the process by which we attempt to filter out what we believe are the occasional diamonds in the rough. Again, because of our independence we feel no obligation to pay any attention whatsoever to businesses that have a historically paltry record of profitability, whose future is as uncertain as its past, and that might be managed by people we find difficult to admire or respect. It's shocking how many businesses don't make it through our filters. Far better you buy their products than their shares. It's common among our brethren to own a piece of almost every sector but compensate by underweighting or overweighting various industries — relative to their weightings in the S&P 500 index — so as to get a presumed leg up on the benchmark against which they're measured. In fact, it's almost comical how often outguessing the index backfires.

The only weighting in which we engage is spelled differently: "Waiting" — patiently, sometimes for months, sometimes for years — for companies that make it through our filters to sell at prices low enough to assure us of a significant margin of safety. Just when the technology and dot.com favorites were reaching for the sky in the spring of 2000, many of the companies that we had long wished to own were carelessly discarded as worthless deuces and treys in the frenetic, high-stakes game then under way. Those that were cast aside we picked up at bargain prices. In September 2001 the emotional selling that followed the attacks on the World Trade Center provided similar opportunities, despite the fact that we experienced the same feelings and sensibilities as most other Americans.

Another counterintuitive principle that is often the source of both second or third sigma performance while, at the same time, not necessarily compromising prudence, is that of avoiding portfolio overdiversification. As noted on several occasions in the past, a portfolio consisting of approximately 12 truly dissimilar businesses reduces the portfolio impact of an Enron (see Chapter IV) to within 90-95% of the extent to which such random risk can be mitigated. Once, in our documented judgment and with the weight of empirical evidence in our corner, risk has been managed to well within circumspect limits, the opportunities for outsized performance become apparent.

It bears repeating that broad diversification, so widely practiced today, protects you from one form of risk while concurrently exposing you to another. Specific risk (referring again to the case of Enron where a company goes from brilliant to bankrupt quicker than you can say "sell") may be best moderated through broad diversification. On the flip side of that coin, the same practice puts you squarely and unavoidably into the path of systemic, or market, risk. In its extreme form, investing in an index fund in an effort to replicate a benchmark, such as the S&P 500, your results will be identical to the index — whether up or down. The peak-to-trough decline of the S&P 500 over the last two years has been one of the most dramatic in history. Index fund investors participated fully in that erosion of value. Broad diversification was the cause. So much for total risk management through diversification …

Admittedly pushing the argument to the precipice here, we might postulate that a portfolio, well purchased, with 10 out of 15 companies proving over time to be well above average, may be a safer bet against random risk than an index fund. Not to leave you hanging (over the aforementioned cliff) … but a more complete explanation of this admittedly nonconformist concept can be found in the next chapter, "Prelude to Our Investment 'Strategy.'"

To be sure, the argument is significantly predicated on the ability of the analysts to separate the wheat from the chaff — and to purchase the good stuff at prices that don't fully reflect their value. That is a terribly demanding task, requiring both superior analytical work and the discipline to make purchases often in the face of disturbing news, and it would be utterly irresponsible to suggest otherwise. Therein lies the most significant risk attendant to our investment approach. We are fully cognizant of what could be our Achilles heel. Consequently, our entire research effort is structured to manage that risk within prudent limits.

Little has been said — and little needs to be said — about the performance of our fixed-income assets. Since we never compromise on quality and keep our durations quite short, suffice it to say we generally expect our returns to match the note's or bond's yield to maturity at the time of purchase. We enjoyed a modest bump in total return in the last several years because of falling interest rates, but it was a "borrow from Peter to pay Paul" kind of give-and-take and is therefore nothing to write home about. As noted elsewhere, we attempt to preserve your capital in fixed-income securities and enhance it in equities. It can't get any simpler than that.

By this time you are no doubt appreciating why Elkhart, Indiana, is a perfect base camp for plying our trade. One of the greatest risks all managers face is falling into the trap of the mindless imitation of others. The contagion effect is as destructive as it is beguiling. While we have access to all the electronic and hard-copy pipelines for Wall Street's prattle, we rarely sit across the table from, or rub elbows with, the cognoscenti of our club. Distance from the deafening decibels of Wall Street allows time for thought and contemplation in absolute quiet. Warren Buffett likes it in Omaha; so do we in Elkhart.

The Virtue of the Performance-Based Fee

Because of the way the performance-based fee is structured, it is, above all, a safeguard for clients. The element most responsible for that assertion is the "high-water mark." Once again we enter the realm of the counterpercipient. The U.S. Securities and Exchange Commission publicly worries that performance-based fees might encourage speculative behaviors on the part of managers. Quite the contrary, we would rejoin. The performance-based fee arrangement (with the high-water mark) forces us to be more conservative, more risk-averse — once again in our judgment — than the manager who is paid a flat fee, with no immediate consequences for negative absolute performance. Naturally, therefore, we live in constant fear of doing something really stupid. If we swing at the "sucker pitch," we not only will disappoint you, we will find ourselves eating beans for a long time. We are forced to turn the traditional high-risk, high-return paradigm on its ear. (In the 2000 annual report, see the section titled "The Management of Risk.")

In so doing, our focus has always been on managing risk and letting the returns take care of themselves. It served us unexpectedly but pleasantly well the past two years, but we consider the speed with which the market recognized the inherent value of many of our equities more good fortune than portentous forecasting. (Parenthetically, we occasionally receive entreaties from clients or prospects offering us more money to manage if we simply tell them when the market is ready to "take off." Of course, we respectfully decline. We think it difficult enough to ascertain when good businesses sell below intrinsic worth. To postulate when the market as a whole might return to popularity … on that we wouldn't even hazard a guess. I suppose it's a little like bottom fishing: You patiently dangle your line, without any foreknowledge of when a fish might strike. It is the fish alone that decides when the bait will become its lunch. It's a little humbling, incidentally, to cede such responsibility to a slightly lower life form — but that's the only approach we know of that holds water!)

Following such a "fishy" metaphor, the ensuing remarks may seem less than appropriate. Nonetheless, I must give credit where and when credit is due. One buying technique that has made our clients, collectively, millions of dollars over the last several years I learned from my wife, Marilyn, by simple observation — and not from some highbrow finance textbook on Modern Portfolio Theory.

Many years ago my better half returned from a rather lengthy trip to the mall, and the look in her eyes was that of a conqueror, conveying the finality of victory, the success of a coup borne out only in the creases of conviction that line a woman's face at such a moment. It was abundantly clear that she was indeed more than satisfied with her perspicacity, and she wasted no time in telling me of her cleverness in combing the aisles, proudly announcing that she had purchased everything in the several bags at less than 50% of retail price. "Wow," I retorted, "that means you only spent half as much money as you had originally intended?" "No," she responded matter-of-factly, "I was able to buy twice as much." Admittedly, her response struck me as illogical at the time. Of course, my nickname is Parsimonious, which (although classical mythology is not my strong suit) surely is the moniker of some notable Greek god.

In any event, I began to think about how such reasoning might apply outside the department store, to investments in marketable securities, to intangible assets that presumably would appreciate in value over time. Martin Capital's actions in March/April 2000 and September/October 2001 bear witness to the efficacy of that everyday shopper's technique. Our shopping cart was filled to overflowing with bargains galore. Marilyn's insights are of incalculable value, but — if gestures of gratitude seem called for — she'll settle, like Forrest Gump, for a box of chocolates (not to be picky, but if you're from the local area the Olympia brand is her favorite). ☺

CHAPTER III

Prelude to Our Investment 'Strategy'

Two and a half years ago, following a July 1999 speech by Warren Buffett on the stock market — a rarity for the Oracle of Omaha who is far more interested in companies than composites — *Fortune* magazine (on November 22, 1999) ran what he had to say under the title "Mr. Buffett on the Stock Market." His logic confirmed mine, and so the self-edited speech was profiled in the 1999 MCM annual report. He must have thought the *Fortune* article worth repeating because he attached it to the 2000 Berkshire Hathaway annual report that was mailed to shareholders in March 2001. In July 2001 he gave a second speech at the same site at which, again with the help of *Fortune's* Carol Loomis (who also edits his annual report), he updated his reasoning from the year before. Don't get too excited; Buffett's "updating" is measured in centimeters, not kilometers.

As you may recall, Buffett identified two 17-year periods — first, the lean years and the second, the fat. The first began at the end of 1964 and concluded at the close of 1981; the second was 1981 to 1998. In the first the Dow Jones Industrial Average ended within a fraction of a point of where it began, 875, prompting Buffett to grouse that though he is a patient fellow, *that* tested his limits. In the second span, by contrast, it closed at 9181, almost a tenfold increase. Paradoxically, during the lean years GDP grew by 373%, whereas during the fat years it rose only 177%. But, as you know, stock prices are influenced by variables other than just economic growth. Corporate profits, a residual, have generally ranged in the neighborhood of 4-6.5% of GDP over the last 50 years. Additionally, prevailing interest rates are part of the discounting mechanism that reduces future income to present value. They tell a story that runs counter to the impetus of the economic-growth data. Interest rates on long-term government bonds at year-end 1964, 1981, and 1998 were, respectively, 4.20%, 13.65%, and 5.09%.

There is a fourth variable — besides economic growth, corporate profits as a proportion of GDP, and interest rates — that holds significant sway over the course of stock prices: the aggregate psychological frame of mind of investors.

So, despite robust GDP growth during the lean market years of 1964-81, interest rates rose dramatically, and corporate profits as a percentage of the GDP pie fell to the low end of their historical range. Investors became increasingly despondent over these double negatives and voted with their feet. The opposite proved to be true from 1981 to 1998. While economic growth was less than half the rate of the first 17-year period, corporate profit margins widened, and interest rates moved sharply lower.

Finally, despondency gave way to euphoria through the process known as contagion (see Chapter IV), which transmogrified into an ultimately self-destructive speculative orgy, fueled in its latter stages by little more than rising prices themselves. In my judgment we are in the midst of hearing the air hissing out of the pricked bubble. In an analogous reference (mine) to the late '20s, Buffett observed about the era, "What the few bought for the right reason in 1925, the many bought for the wrong reason in 1929."

Buffett went on to examine the relationship of the economy to the market over the entire 20th century as a harbinger of things to come. Mind you, his view is Gestalt: Over and over again he admonishes investors for looking into the rear-view mirror to see what's ahead. We call it the "availability bias," which is simple extrapolation of the immediate past to forecast the future. Surprisingly, over most 10-year periods in the past century the economy grew rather steadily at an inflation-adjusted 2-3% compounded annual rate. The Dow Jones Industrial Average, however, told an entirely different story. During the 20th century there were three huge, secular bull markets that covered about 44 years, during which the Dow gained more than

11,000 points. Yet there were three long periods of stagnation, covering some 56 years, during which the Dow actually lost 292 points in the face of the country's solid economic progress. From 1900 to 1920 new innovations in electricity, automobiles, and the telephone formed the backbone of solid economic growth, and yet the market moved at a snail's pace: 0.4% per year, compounded, closing in 1920 at 71.95. The market exploded upward during the '20s, advancing 430% to 381 in September 1929. Nineteen years later the Dow stood at half of its 1929 highs, despite record-setting per-capita economic growth of 50% during the '40s. For the next 17 years, coincidentally (the Baby Boom years of 1948-64), the Dow advanced fivefold, a nice move but not "fat" by later standards. That brings us to the 17 lean years, followed by the 17 fat years (as detailed above).

How can one explain these anomalies? According to Buffett (whose conclusions largely coincide with my own independent study of the history of investor behavior), investors' perceptions of the future are most heavily influenced by their most immediate past experience — "rear view mirror" investing, as he dubs it. Buffett asserts that a book written by Edgar Lawrence Smith, titled *Common Stocks as Long Term Investments,* contains a watershed development in investment theory. We referred to Smith and his contemporary counterpart, Jeremy Siegel, in the 1999 annual report in making a similar (though not nearly as insightful) point as is expressed in the sentences below.

Based on historical data for the 56 years ending in 1922, Smith hypothesized that stocks do better in times of inflation and bonds do better in times of deflation. It was his reasoning, later confirmed and therefore consecrated and expanded upon in 1925 by none other than John Maynard Keynes, however, that was most intriguing. Keynes begins, "These studies are the record of a failure — the failure of facts to sustain a preconceived theory." Concludes Keynes: "The facts assembled, however, seem worthy of further examination. If they would not prove what we had hoped to have them prove, it seemed desirable to turn them loose and to follow them to wherever they might lead."

While Smith's conclusions about the future of common stocks have been credited with providing academia's blessing, helping to fuel the ever-growing speculative bubble in the late '20s, his "thinking outside the box" contribution was quite impressive in and of itself — and more so in that it was entirely contrary to the way most investors viewed the future.

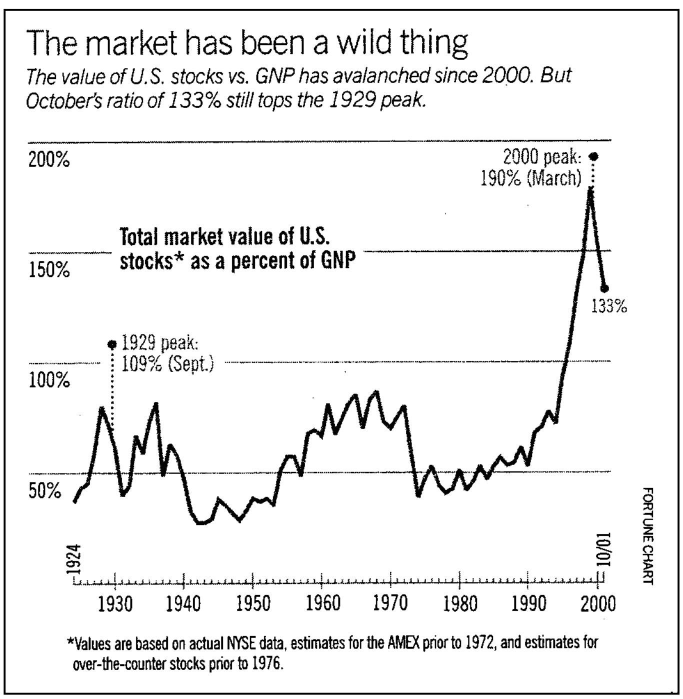
When Smith's book hit the streets in 1922, bond-interest coupons yielded more than stock dividends (a relationship that prevailed throughout most of the next 30-35 years). Keynes rationalized that, since a portion of the company's earnings was retained in the business and therefore reinvested, an element of compound interest existed in common-stock investing, whereas it was absent in the ownership of bonds. The double whammy of a higher-dividend yield at the outset, with the likelihood that it would grow as well, lent credence to the idea of common-stock investing and later stoked the fires of speculative desire. Keynes anticipated in 1925 the potential perversity of carrying this reasoning to extremes: "It is dangerous … to apply to the future inductive arguments based on past experience, unless one can distinguish the broad reasons why past experience was what it was."

Buffett concludes that simple extrapolation of the past is the downfall of most investment follies. Smith's study covered a half-century during which stocks generally yielded more than high-grade bonds. The relationship between bond and stock yields on which Smith's theory was predicated has been turned on its ear since the mid-1950s. Even though conditions nearly identical to those on which Smith built his case existed in the late '40s, investors were so hamstrung by their horrible memories of the '30s that they were blind to the opportunity that lay at their feet. Those conditions have never existed since. We note anecdotally that, according to studies, most investors today assume that bonds have always yielded more than stocks.

Buffett then at length makes the case that such "rear view mirror" investing is not merely the asininity of the small investor. He demonstrates convincingly that the great company pension fund sponsors, actuaries, and portfolio managers repeatedly fall victim to the same malady. The effect on corporate earnings following a 1997 FASB (Financial Accounting Standards Board) ruling is a story unto itself — well worth the telling were space not a constraint.

More to our immediate interest, and in the midst of castigating monolithic corporations for being no more astute than the man on the street, Buffett refers to an article he wrote in 1979 in which he made the case that stocks were at that time a better investment than bonds. Bonds were then yielding 9.5%, and the Dow was selling below book value while earning 13% on its equity capital (known as book value, when reduced to a per-share basis). As we have mentioned many times in the past, common stocks are in many respects similar to bonds — and therefore sometimes interchangeable — differing only in that their coupons are variable and that there is no set maturity date. Despite these similarities, which are more form than substance, Wall Street, much to Buffett's amusement (and ours), treats them as discrete securities. Admittedly, the amount of the Dow "coupon" is far from fixed, unlike that of a high-grade bond. Still, the opportunity to purchase the Dow below "par" with a variable coupon that had a reasonable chance of averaging 13% over the years had to be conspicuously preferential to owning a bond with a fixed 9.5% coupon. Referring once again to Keynes, Buffett reminds us that the superiority of stocks isn't inevitable: "They own the advantage only when certain conditions prevail."

This entire exercise helps to make the case that markets are capable of acting irrationally in the extreme from time to time, and the investor who is forewarned is thus forearmed (see 1999 annual report). Buffett and his alter ego, Charlie Munger, have characterized the widely practiced Modern Portfolio Theory (MPT) as laughable. Though MPT isn't mentioned by name in the *Fortune* article, it is damned by inference in the first sentence of this paragraph. Buffett concludes by offering a simple quantitative antidote that investors can administer to neutralize their often emotional "availability bias" assessment of the future. Referring to the 80-year chart at the left depicting the relationship between GDP and the market value of all publicly traded securities, Buffett suggests that when the ratio falls to the 70% or 80% area, "buying stocks is likely to work very well for you. If the ratio approaches 200% — as it did in 1999 and a part of 2000 — you are playing with fire."



You will observe that the ratio frequently bottomed out at 50% or below. For those ideal bet-the-ranch conditions to exist, there must be a confluence of at least several of the key wet-blanket variables: slow GDP growth, skimpy profit margins, skyrocketing interest rates, and/or pervasive investor despair. Taking a cue from Buffett's behavior in 1973-74, a rational man who *by virtue of his lack of time, skill, or experience has no prudent alternative but to be broadly diversified*, begins buying when the ratio falls to 70% or 80% and, if he is lucky, still has a little money left to invest when it hits 50%. Since the "bottom" is only declared in retrospect, those who wait for it almost always go away empty-handed. According to our calculus, the aforementioned rational diversified investor would be far better off owning a fully invested portfolio with an average cost of 60% or 70% of GDP than the fellow whose congenital state of agitation and anxiety caused by the presence or imminence of real or imagined danger cannot, in the end, pull the trigger, regardless of price. Invariably, he ends up owning nothing but regrets when the ratio returns to 80% or more. No man is more entitled to buy at the bottom than Buffett, and yet no man is more aware of the foolishness in trying.

The ratio was 133% as recently as October (see chart on previous page). Buffett admits that the simple measure has certain minor weaknesses and is hardly precise in terms of timing. But, as a rule of thumb, it's pretty handy. In the long run if the GDP grows at 5% annually, and you expect the 10% returns from common stocks, then the corporate-profit share of GDP must go off the chart. "That won't happen," says Buffett.

Finally, referring back to his July 1999 *Fortune* article (and, again, our 1999 annual report), Buffett ventures that the investing public should expect total annual equity returns (dividends plus price appreciation) over the next decade or two of about 6%, net of frictional costs (such as commissions and fees), of about 1% and inflation at 2%. A year later stock prices are lower and the economy has grown, so he has raised his estimate, accordingly, to approximately 7% for long-term returns. Concludes Buffett: "Not bad at all — that is, unless you're still deriving your expectations from the 1990s."

Making Headway in Headwinds

This exercise in rationality, for which Buffett is renowned and which we also embrace dispassionately, is more than helpful in framing our day-to-day decision making in the context of the prevailing winds. So often investors suffer great anguish and disillusionment because, unlike the seasoned golfer, they don't bother to toss a few blades of grass into the air before choosing a club. This process of adapting to a new paradigm is evolutionary, not revolutionary. Those most firmly anchored in the immediate past are likely to be among the last to come to terms with the new reality.

Of one thing we are quite certain. Marching headlong, with your bets well spread, into headwinds is certain to result in outcomes similar to what Buffett expects. Broad diversification, use of index funds that replicate some measurement standard (such as the S&P 500), or other similar so-called risk-management mechanism simply cannot buck the forces of nature. Those who fathom the shifting secular trend and who correspondingly downsize their expectations will find the broad diversification exercise "not bad at all."

Our inquiry into the nature of markets is based on logical reasoning and has resulted in a style that has been different and will continue to be so. We have set our sights higher, and that requires a different approach to solving the headwind problem. Before an individual company qualifies for purchase by Martin Capital Management, its five-year expected return[1] must exceed 15%. As the past two years have given ample witness, it can be relatively and absolutely productive. No course of action, however, is without trade-offs. The attendant cost of our non-diversified style is greater inherent portfolio-price volatility. While volatility has been in our favor most recently, we can say with near certitude that it will run against our interests at times in the future — some of them likely to be agonizingly protracted. Ever iconoclastic, we do not subscribe to MPT's reliance upon market-price volatility as a proxy for risk. Rather, we measure risk more like a businessman who owns a private enterprise, whose firm is not "marked to market" on a daily basis. Because there is no group of outsiders valuing his business on a day-to-day basis, and therefore no *beta* (MPT's quantitative measure of risk, i.e., relative price volatility) to numerically approximate business risk, the owner must default to a more Main Street definition: the possibility of an outcome detrimental to his best interests — or at least a result that is less than his expectations at the outset.

[1] The expected return is the internal rate of return that reconciles the current price with the estimated future value. The future value, in turn, is the end product of the analyst's estimate of normalized earnings five years hence, multiplied by a terminal price-earnings ratio that itself takes into account an estimate of the earnings growth rate going forward from there.

But, you say, are you not exposing me to inordinate risks, however they might be defined, by limiting my portfolio holdings to 12-15 issues? For that question we have two answers, the first of which is rather straightforward. Most clients come to us having sold a single business that represented a significant part of their net worth. If we propose an investment policy that expands the universe of holdings to the aforementioned number, and if we assume those businesses are at least as inherently profitable and well managed as the one sold (and are purchased at a price that implies a significant margin of safety), does this scheme not represent a significant reduction in risk?

As introduced in the prior chapter, the second answer is not so self-evident and may need to be read two or three times to get its full meaning. It is further complicated by the conditional relationship among several variables; for it to bring about the desired result, it relies on the successful execution of certain key activities. Instead of comparing our non-diversified portfolio strategy, at least as conventionally defined, with a single business, we will in this instance contrast it with the S&P 500, which is roughly made up of the 500 most valuable businesses in America, at least in the market's collective judgment.

For purposes of this argument let's assume that, by number, 75% of the companies that constitute the capitalization-weighted index are average businesses, really not worth owning unless purchased at a true bargain price and that 25% of them are not worth buying at any price above a token amount. That last group would include airlines, steel companies, automobile manufacturers, and the like. Here's where the case could break down. Let's assume that of the 15 businesses that we might select, two-thirds, or 10, prove over time to be well above average and that they were initially purchased at prudent prices. Admittedly, those assumptions are at least moderately heroic! Putting that premise aside for the sake of completing the line of reasoning, were you really more secure in the spring of 2000 buying an S&P 500 index fund at 32 times earnings or the handful of companies we bought at 12 times?

Thus, the question becomes: Do you feel safer — are you safer — with two-thirds of the companies in your portfolio being above average, or with 25%, regardless of whether the number of companies is 15 or 500? Needless to say, if you accept the proposition you might logically conclude that not only are you safer in the first instance, but your chances for better than mediocre results also are greatly improved. That has been our experience in recent years, but we can give you no binding assurance that it will be replicated in the future. Sometimes small is better — and, yes, safer.

More relevant to a discussion of investment strategy, can this approach be repeated time and again in the future? A simple "yes" or "no" answer will not suffice.

First, change, particularly in the fastest-growing industries (such as technology), seems to be happening at an ever-increasing rate. Many of the companies we examine have wonderful records of profitability, but we have no idea what they will be doing five years from now, let alone next year. Even in the more easily understood and less-glamorous industries, countless slips can occur "'twixt the cup and the lip." Competitive rivalries heat up, managers lose sight of their loyalties … the list is as long as the imagination is fertile.

Second, even if we find them, can we purchase them at prices low enough to make it possible for the full benefits of ownership of the asset to actually flow through to us as shareholders? You see, while the market is occasionally wacko in the valuation of businesses, more times than not it is quite efficient, pricing them close to their intrinsic worth, leaving us with little or no margin of safety in the event we are wrong in our estimate of their value. In point of fact, we rarely get to seize a true opportunity unless it appears to be just the opposite, forcing us to act precisely at the moment our peers can't seem to unload it fast enough. Earlier we explained the circumstances under which we were able to make timely purchases of great businesses in the spring of 2000 and then again in the wake of the September tragedy. Our whole investment life is living the antithesis of the lyrics of Debbie Boone's hit tune of the '80s: "It can't be wrong when it feels so right." Running against the herd makes easy copy, but you need only imagine how frightened you would feel if, instead of "running with the bulls" in Pamplona, Spain, you were forced to reverse your direction. Indeed, the Wall Street equivalent of this metaphor has occurred to us more than once. All of us are comforted by the affirmation of others. We at Martin Capital, on the other hand, must conjure up our own sense of well-being. Our "buy low, sell high" credo certainly helps. The job we do also is made somewhat easier because we enjoy a significant advantage: Our clients allow us to be patient in the search for ideas, whereas many of our colleagues live in a pressure cooker, enjoying no such luxury of seeming lethargy. To paraphrase Pascal, most human misfortune stems from "man's inability to sit still in a room."

So, you see, it really isn't a grand strategy at all that we follow but rather a simple pattern of behavior analogous to an imaginary game of baseball. We spend most of our time waiting patiently for pitches that cross the plate precisely at our particular sweet spot. In this chimerical sport we can let pitch after pitch whisk by with no penalty for failing to take a cut at a ball in the strike zone, nor will we be forced to take a base on balls if the bat rarely leaves our shoulder. Sometimes the lumber gets a little heavy, and every now and then we get an itch to take a swing. But most of the time when we get restless, we just step back from the plate, stretch a little, tap the dirt off our cleats, then step back into the box. To be candid, this is a heck of a lot more boring than regular baseball. But the good news is that by changing the rules to our liking, even a minor leaguer can achieve batting averages similar to those that put Ted Williams in the record book.

Our allocation to equities is not dictated by some arbitrary formula, despite the popularity of the practice but rather by the arrival of the transcendent pitch. While one might apply the maxim "a rising tide lifts all ships" — and its obvious corollary to the buying and selling of stocks — it's rarely that simple. As noted in the chapter on performance, we purchased the castaways precisely as the Nasdaq Index was peaking in the spring of 2000. We are far less concerned about a protracted bear market than we are about our ability to identify great businesses and to exercise the patience necessary to purchase them at prices well below what they're worth. Of course, many of the companies we have purchased in the last two years have appreciated smartly, effectively closing the "margin of safety" gap between the original purchase price and intrinsic value. Increasingly, the market price, absent market inefficiencies, will depend on growth in intrinsic value. With many of our holdings, the so-called "easy money" has been made.

We are decidedly agnostic when it comes to acting on the majority forecasts for the economy — in part because prognosticators are, at least in the short run, not paid according to the accuracy of their pronouncements. If they were, there would be no economists. To the point, the "recovery beginning in mid-year 2002" consensus scenario is, if our memories serve us correctly, simply the reincarnation of the "recovery beginning in mid-year 2001." Accordingly, we think it appropriate to partially hedge our portfolios against the possibility, however remote, that the forecasting errors of the last two years will not be the last in this atypical business cycle, if that's what it turns out to be. Rather than cementing our considerable gains by selling companies that no longer go begging for buyers at bargain prices — and in the process incur short-term capital-gains taxes — we will purchase long-term put options on the S&P 100 or other more appropriate index. The insurance purchased will not be used to moderate the impact of minor fluctuations in the value of your portfolio. Those "quotational losses" go hand in hand with investing in marketable securities and are of no concern to us. Rather, we will attempt to partially protect your portfolio from, in the vernacular of the reinsurance industry, "super cat" losses. Think of it as earthquake insurance. For your sake and ours, we hope the options expire worthless.

Interest Rates: It Had Better Be Uphill from Here

Late in November two "marker buoys" in the financial history of the United States were passed, collectively signifying where our economy stands in the grand flow of things.

In September 2001 the U.S. retired a group of Treasury bonds issued in 1981. The bonds carried an interest rate of 15¾%, the highest the government had ever paid on long-term borrowing. It was a nostalgic moment for the undersigned, recalling the 14% *tax-exempt* participation certificates, a hybrid form of municipal bond that we underwrote for the Concord School Corp. of Elkhart. The choice between equity and tax-exempt debt securities was not an easy one.

A month later, on October 31, 2001, with long-term borrowing costs the lowest in a generation, Washington announced that it would "suspend" its issuance of 30-year bonds. Interest rates plummeted, with the yield on 30-year bonds dropping the next day to 4.80% (compared to approximately 5.50% at the end of last year), while the yield on the benchmark 10-year note slid to 4.24% from the 5% range. It seemed that the market was suddenly anticipating the Federal Reserve's decision to lower the federal fund's rate by half a percentage point, to 2%, which actually would come to pass the following week.

After 20 years of declining interest rates (dating back to the aforementioned 15¾% coupon issued in 1981), we have in this country reached the point where we can't reasonably expect rates to fall lower. It's true that the U.S. is in a recession, and rates tend to decline during periods of retrenchment. But for rates to fall from their current level would suggest the darkest of scenarios. The macro-policy authorities are applying fiscal and monetary stimuli like a drunken sailor buying rounds of drinks for every other inebriate at the bar. This combination has never failed to ignite a rebound in the past — but is the past prologue in 2001-02?

We will not dwell excessively on the possibility that the cyclical recession in which we find ourselves will not be arrested by the application of traditional palliatives, that it will disintegrate (in the face of repeated denials from economists of all stripes and from far and wide) into something more serious. We are loath to draw parallels with Japan because the dissimilarities are as striking as the similarities. Most importantly, while our readings in classical economic theory would suggest that the possibility for an apocalyptic event is perhaps more likely now than at any time since the Great Depression, there are simply too many variables to assimilate, most of which are unknowable as to the likelihood of their occurrence, to say nothing of how they might interact with other equally unknowable variables. Playing chess with World Champion Vladimir Kramnik would be much easier. The best minds in the world cannot put this puzzle together; we will not attempt to give you a false impression of our acumen, which could lead to either complacency or fear. Neither is warranted.

Rather, in the face of this shadowy threat we will respond in the only rational way we know how: with an extra degree of caution. As for fixed-income securities, we will continue our longstanding practice of owning only the best — direct obligations of the U.S. Treasury or tax-exempt municipal securities backed by similar Treasury obligations (pre-refunded or escrowed-to-maturity bonds). We will not even think about junk bonds. If the yield spreads get to be so great that they make the headlines, chances are that equity securities will be even cheaper. Because bond yields are relatively low, particularly when compared to the five-year expected returns from some high-grade common stocks, we will rarely extend maturities beyond five years in this environment for fear of getting "locked in" to a security we would prefer not owning for a long period of time.

We read extensively on the bond market. What we find is that most specialists in this area are merely splitting hairs, an exercise we find unproductive. Whether the benchmark 10-year-bond yields eclipse the lows of 4.16% (hit at the depths of 1998's global financial crisis) by a few basis points strikes us as utterly irrelevant, akin to speculating about how many prima donnas can dance on the head of a pin.

Still, we shall flavor these pages with a bit of history about the bond cycles, largely for the purpose of venturing a guess as to their future course, not so much because we are likely to buy long-term bonds but, rather, because of the effect of interest rates on the valuation of equities.

In a November article in *Barron's,* Richard Sylla, professor of financial history at New York University's Stern School of Business and co-author with the late Sidney Homer of *A History of Interest Rates,* says the market's actions suggest that the two-decade decline in long-term rates may have run its course.

Another self-proclaimed expert and CNBC commentator, Larry Kudlow, head of Kudlow & Co., thinks that if the Fed were to explicitly target the market indicators — commodity prices, the dollar, the slope of the yield curve, and changes in the 10-year Treasury yield — yields could fall back to the 3½-4% range. But absent a change in the mindset of Greenspan & Co., a deeper recession, or a Japanese-style asset deflation (none of which Kudlow sees on the horizon), the benchmark note likely will trade between 4½% and 6½% "over the next bunch of years."

Martin Barnes, editor of the Bank Credit Analyst whose service we have read for many years, thinks 4-5% on the 10-year Treasury seems "reasonable." But Barnes believes that corporate bond yields are likely to remain far higher. "Don't expect corporates to return to their old [historical] average" of around 4% and change in the 1960s, he says. Top-grade corporate bonds, which now yield around 7%, are back near where they stood three decades ago. Lending credence to our concerns about credit risk, Barnes comments: "Corporate balance sheets are much worse today, requiring the greater risk premium that has been evident since 1998 and limiting the scope for corporate yields to fall."

Neither is it only corporate America's balance sheet that is less than rock-solid. Northern Trust's Kasriel sends a cold chill up my spine when he notes that the federal government faces huge unfunded liabilities. "Whatever happened to the debate over Social Security?" he asks. "It's gone the way of the Chandra Levy story." Paying those future obligations will mean either higher taxes or increased borrowing (most likely the latter). And Ed Yardeni, chief investment strategist of Deutsche Banc Alex Brown, who made his mark in the early '80s by predicting "hat size" bond yields (7-8%) when they were nearly twice as high, thinks the long slide in rates is "pretty close to over."

With the overall economy (current-dollar gross domestic product) on a long-run growth path of around 4-5% a year (3% real growth and 1-2% inflation), 10-year Treasury notes should approximate the same. That leaves scant room for long yields to decline. Indeed, Yardeni uses a 5% 10-year Treasury rate in his long-term stock market valuation model.

Turning more to the anecdotal, if you believe that markets know better than government bureaucrats, there's another clear sign that interest rates have bottomed out: By issuing bonds 20 years ago, Uncle Sam locked in the highest-cost debt in the nation's history; today Washington eschews borrowing long term, even though rates are the lowest in a generation.

One observer in *The Wall Street Journal* also offered this oversimplified analogy: "To understand the movement of interest rates over the decades, it's important to note that long-term market trends are defined by a series of cycles with ascending (or descending) peaks and troughs. Think of it as a shoreline. Tides go in and out each day. But if the high-water marks move farther and farther up the beach, there is a definite trend. If the high-water marks start moving down the beach, that trend has reversed. It now appears that the trend of the past 20 years of the tide going out has reversed with a low tide higher than the last."

As for the bottom line, we would be somewhat surprised if interest rates moved dramatically either upward or downward over the immediate future from where they are today. Longer term, we are not so sanguine about subdued rates, more the result of a gut feeling than something concrete we can point to. Accordingly, while we feel reasonably confident we have a temporary respite from concerns about rising interest rates impacting our earnings-discounting model, that specter may be a reality with which we must deal in the years ahead.

CHAPTER IV

Why History Repeats Itself

History is a perplexing teacher, its lessons often are obtuse, bewilderingly intricate, and complicated. Were they otherwise, the mistakes in the past would not repeat themselves so irritatingly often. And yet, there is much to take away from this school of "hard knocks" for the student who is able to organize the lessons into a variety of models that can be applied in general to events of the future. Unfortunately, what you learn will be of little use tomorrow — or even next year. No sinner is more repentant than one whose transgression is fresh in his or her mind. As noted in the "Prelude to Our Investment 'Strategy'" chapter, this is a variation of the "availability bias," the penchant to be disproportionately influenced by more recent events as one gazes too raptly into the rear-view mirror.

What we write, therefore, has about the same immediate value as closing the barn door after the horses are already out. Be that as it may, we record the lessons so that you might file them away for future reference in times of recurring grand delusions, recognizing that there is nothing really new in the world of economics and finance. The dismal science is inherently cyclical, bound to repeat itself again and again, with the span between episodes a simple function of the length of memories. By contrast, in scientific endeavors, knowledge is cumulative. Think only of the evolution of the personal computer to gain some appreciation for the difference.

The Power of Popular Delusions

Nothing is more central to the dissection of investment manias than to study those human proclivities common to them all. The capacity for human beings to be readily deluded, to be made to look the fool, is the point of origin from which every seeming behavioral absurdity, at least with the benefit of hindsight, naturally follows. This section is on the long side — even by this report's standards — because it is the fulcrum upon which the lever of insight rests.

In ancient times (October 1989, to be specific) the undersigned wrote an essay published as a Portfolio Managers' Perspective under the above title. The repetitious pattern of human behavior has always aroused my interest. Dusted off and revised, with the addition of a few recent illustrations, it appears again (on the succeeding seven pages) as a reminder — 12 years later — that the more things change, the more they stay the same.

* * *

One of the endlessly fascinating aspects of our participation in the capital markets is the opportunity to witness human behavior in a highly charged environment, under conditions that would make a social scientist salivate. On Wall Street one can readily observe individuals whose actions are often the result of especially powerful motivators, such as greed and fear. Further, the abundance of data collected on the transactions that take place permits relatively thorough analysis of those behaviors. While we find the study academically intriguing, our interest relates more to how we can use the information as we ply our trade. We simply think an attempt at understanding the psychology of the marketplace will give us a competitive edge.

Quite pragmatically, much of the practice of psychology is directed toward serving the emotional needs of the individual. (It's difficult to imagine how a psychologist would bill a crowd for his services!) Years ago, having read *Moral Man and Immoral Society* by theologian Reinhold Niebuhr, my interest was captured by Niebuhr's different perspective on the study of human behavior. Instead of examining the individual in isolation, he looked at a gathering of individuals and the peculiar impact the group had on the thinking and behavior of its individual members. This was predicated in no small measure by his experience of living through World War II. The general idea certainly is not new. What has great relevance to us as investors, however, is the special nature of that transformation.

Years later, in a search for information on the legendary investor and statesman, Bernard Baruch, I came across the book *Extraordinary Popular Delusions and the Madness of Crowds* by Charles Mackay, LLD; the book was originally published in 1841. Baruch wrote the foreword to a reprinted edition in 1932, as the country reached the depths of the Great Depression. Mackay gives an excellent account of many of history's extraordinary delusions, from the Mississippi Scheme that swept France in 1720 … to the South Sea Bubble that ruined thousands in England at the same time … to the tulip mania of Holland when fortunes were made and lost on single tulip bulbs. On the other hand, *The Crowd,* penned by a Frenchman, Gustave Le Bon, in 1895, delves into the nature of a crowd that makes human beings vulnerable to its powers. According to the authoritative *Handbook of Social Psychology* (published in 1954)*, The Crowd* is "perhaps the most influential book ever written on social psychology."

Of what significance is all of this to us? In 1932 Baruch observed in his foreword: "Some years ago a friend gave me a copy of *Extraordinary Popular Delusions.* In a vague way I had been familiar with the stark facts of these events, as who is not? But I did not know ... the astonishing circumstances of each of the greater delusions of earlier eras. I have always thought that if in 1929 we had all continuously repeated 'two and two still make four,' much of the evil would have been averted."

But still one is likely to question the relevance, arguing that 1929 was truly an exceptional period, one not likely to be repeated during our lifetime. And in fact, much to our good fortune and to the preservation of our capital, most popular delusions of the financial variety never reach the pervasiveness of the spectacle in common stocks that ran rampant in the late 1920s. It is interesting to note, however, that Mackay offered in the preface to the 1841 edition the observation that "Popular delusions began so early (in recorded history), spread so widely, and have lasted so long, that instead of two or three volumes, *fifty* would scarcely suffice to detail their history." We have taken the position that if we become the victim of a lesser-known delusion we'll feel not one whit better than if we were swept up in the folly of one of extraordinary notoriety. (One bolt of lightning is of no great national consequence, but it may more than command your personal attention if you are directly between it and the ground!)

In 2000 a week's worth of evenings was consumed reading Robert J. Shiller's just-released and well-written book *Irrational Exuberance*, its title lifted from a phrase for which Alan Greenspan was roundly castigated (see 1999 annual report) until eventually a crashing market silenced his critics. Were the Fed chairman to author a book it might be titled *From Castigation to Vindication*. Shiller, an economics professor at Yale and author of *Market Volatility* and *Macro Markets*, which won the 1996 Paul A. Samuelson Award, was generally right — and for the right reasons. I commend him for his scholarly and timely work. The final sentence on the inside cover of the book contains both an admonition and a note of uneasiness; it reveals a shadow of doubt about a future that is never certain: "It will be studied by policymakers and anyone from Wall Street to Main Street who doesn't want to be caught sitting on the speculative bubble if (*or when*) [italics added] it bursts." In truth, we never know, but we do become more confident as the weight of evidence gets heavier and heavier.

An Ounce of Prevention …

Knowledge of the psychology of crowds thus is today the last refuge of those who wish not to govern them — that is becoming a very difficult matter — but at any rate not to be too much governed by them. Because of the incredible gains in communications technology in the 20th century, individuals no longer need to enjoy physical proximity to function as a crowd. Despite their disparate locations, investors around the world can become, thanks to modem technology, an instantaneous and homogenous lot, to which October 19, 1987 (and, more recently, 1998, 2000, and 2001!), painfully attests. Our past and our future have been and will be filled with popular delusions to which many will fall prey, ranging from the inconsequential to the extraordinary, and the challenge to us is to learn more about how people become such unwitting victims. Indeed, "An ounce of prevention is worth a pound of cure."

Before turning to the "how" and "why" of our apparent capacity to be collectively deluded, let's recall several episodes from the recent past in the security markets. Such an exercise should lead us to the obvious conclusion: We are as susceptible as our forefathers were (and our children will be) to the suggestions, however reasonable or unreasonable, of the crowds with which we allow ourselves to become joined at the "lip." Each new generation throughout history, armed as it is with more accumulated knowledge than any generation before it, proves with the same certainty as the march of time itself that knowledge is not necessarily wisdom.

During the summer of 1987 the stock market was on a roll, having built a strong base in the second half of the '70s and having been further stimulated by an injection of easy money in the fall of '82. The popular averages were assaulting new highs with reckless abandon, with stock prices advancing almost exponentially. The market prices of companies seemed gloriously uncoupled from the plodding performances of the underlying businesses themselves. The Dow Jones Industrial Average reached its zenith of nearly 2750 and Bob Prechter, author of a popular investment letter who had captured the imagination of Wall Street during the '80s much the same as Joe Granville did some years before, confidently declared that the Dow would finally peak at 3600 before the party ended.

The stark reality of the fundamentals permitted only one rational conclusion, but the steamroller of sentiment, unmindful of the quiet warnings that history had to offer, crushed under its weight and momentum the logic and reason that stood in its path. While we're aware that averages, particularly in this instance, can be deceiving, examine the following statistics and see if the message that the fundamentals told should not have at least raised some serious questions.

Standard & Poor's 400 Stock Industrial Index

Measurement	Average (annual) (1950-87)	High (1987)
P/E	11.90 - 14.90 *	19.4
Price/Book	1.66	2.93
Yield	3.54 - 4.43% *	2.20% (low)
T-Bond Yield	6.28%	10.50%

* Average of annual lows and highs

One must wonder why most participants did not seek a safe harbor when the storm flags flew. Or why so many allowed themselves to get caught up in the riptide of popular sentiment that carried them to a turbulent sea when surely they must have known better …

Fools' Gold

In the late 1970s and early 1980s there were two popular delusions that grew, at least in part, out of the virulent inflation of that period: gold and oil. Gold, which traded as low as $100 per ounce in 1976, skyrocketed to $850 by January 1980. Except for an aborted rally in late 1980, it fell relentlessly to $300 by the summer of 1982 and currently trades around $360 [in early 2002 it languishes around $278]. Rereading popular periodicals of the era helps one gain a sense of time-and-place perspective. *U.S. News & World Report* carried an article on October 8, 1979, titled, "Gold Craze — It Sweeps the Country." The author wrote, "Modern day gold fever is gripping the nation as jittery Americans grope for ways to beat inflation. Every day, thousands of people are flocking to coin shops, jewelry stores, and gold dealers to put their cash in precious metals. Consumers who waited in gas lines only months ago are now in line to buy gold coins, bullion, and bracelets in hopes of protecting their savings." "This is the biggest gold rush since 1931," said the president of one of the largest gold dealerships in New York, whose "customers have lately been overflowing into the hallways of the Empire State Building."

The speculation in gold in the late '70s is an interesting case study. The yellow metal is difficult to intrinsically value (and in that respect is similar to collectibles) since it does not grow internally as a business might nor does it provide any current cash return to its owners. Conveniently, the very absence of a benchmark freed the speculators from having to deal with an ever-present fundamental reality. Many elements of crowd psychology can be found in the study of that modem gold rush.

Oil Slick?

Oil, which itself rose in price 1,500% from late 1973 to 1981, was an even more interesting and economically widespread delusion. In February 1980 *Forbes* magazine carried an interview with Kenneth Arrow, Stanford economist and Nobel prize winner, who confidently predicted "we are heading into a world of higher (oil) prices. It will have a major impact on housing by 1983, and I'd be surprised if gasoline is less than $2 per gallon plus whatever inflation adds ... Whether Saudi Arabia will be around in four years I can't predict. It is a very uncertain world."

The oil-rig count, according to Hughes Tool, was up to 2,600 at Christmastime in 1979. "Just about everywhere you go you stumble over someone pushing a drilling rig," said the senior vice president for land and production at Chevron USA, who went on to observe that Chevron had not been this busy since the great Texas oil boom in the '50s. The fever was not confined to Texas. Penn State's petroleum engineering classes saw their enrollment surge from 65 to 220 in three years. Most of the major companies in the industry were optimistic, some forecasting the price would hit $90 per barrel by 1990. Why, even conservative Standard Oil of Indiana raised its exploration budget three times in 1979. Money-center banks, active in financing the exploration, were no less upbeat. Chase Manhattan estimated domestic exploration at $15 billion for 1977, $28 billion for 1980, and a whopping $60 billion for 1985. Unfortunately, the widespread bullishness quickly gave way to despair. By 1986 the price of crude had fallen below $10, to less than 25% of its high. Idle rigs and befuddled oil industry executives [including a Texan named George W. Bush], investors, and bankers were more plentiful than politicians at a pig roast.

We may be witnessing today a number of delusions that have not run their course. The takeover mania will surely go down as one of the great delusions of the 20th century. It could even prove to be the ultimate financial excess — making for a dramatic, if not tragic, end to the great post-World War II credit boom. When we finally conclude that the old rules no longer apply, they invariably do! In the same vein, one wonders whether a $50 million price tag for a splash of paint on a piece of canvas will not be remembered as a flight of fancy …

[Fast-forward to the late 1990s. The mania in technology and Internet stocks is simply the latest iteration of this timeless phenomenon. The exponential price curve of the Nasdaq Index leading up to its peak in March 2000 was a near carbon copy of those for gold and oil two decades earlier. To investors with a devil-may-care attitude, comparing the 1987 data in the above table to the S&P 400 valuation metrics today should at least raise an eyebrow. For those who are in the game, don't dash for the exits but reread Warren Buffett's predictions in "Prelude to Our Investment 'Strategy,'" Chapter III. Above all, take solace in fact that the Treasury-bond yield today is half of what it was then, and that makes a big difference.]

The Blockhead

Let's turn now to the somewhat surprising metamorphosis we experience as we become one with a crowd. The poet/dramatist Johann von Schiller once said, "Anyone taken as an individual is tolerably sensible and reasonable — as a member of a crowd he at once becomes a blockhead." That is a provocative statement, one that Le Bon examined with great clarity. He suggested that the most striking peculiarity presented psychologically by a crowd is the following: "Whoever be the individuals that compose it, however like or unlike be their mode of life, their occupations, their character, or their intelligence, the fact that they have been transformed into a crowd puts them in possession of a sort of collective mind which makes them feel, think, and act in a manner quite different from that in which each individual of them would feel, think, and act were he in a state of isolation."

Le Bon further observes, as does Schiller (though Le Bon stated it more delicately), that we are likely to function at a lower level — intellectually, morally, and emotionally as a result of submission to the will of the crowd. "Men the most unlike in the matter of their intelligence possess instincts, passions, and feelings that are very similar. From the intellectual point of view an abyss may exist between a great mathematician and his bootmaker, but from the point of view of character the difference is most often slight or non-existent."

Membership in the crowd brings an egalitarian leveling to the ignorant and educated alike, largely because of the substitution of the unconscious behavior of crowds for the conscious activity of individuals in isolation. Le Bon also describes crowds as emotional and says that, when in them, the individual begins to feel and express the emotions of a "primitive being."

The Monster with the Pea Brain

Individuals often become "lost" in crowds and perform acts they wouldn't perform were they alone. In addition to having a collective mind, a crowd is irrational. Moreover, it is worth repeating that the process of capitulation downgrades an individual's capability for intellectual processing to the diminished level of the crowd, effectively the lowest common denominator. The crowd is a mighty monster — usually with a pea brain!

According to Le Bon, three mechanisms are responsible for creating this monster. First, because the individual is anonymous, he or she loses the sense of individual responsibility and thus participates in acts in which he or she would not normally engage. Second, the process known as contagion leads to the reduction of an individual's inhibitions, making it acceptable to behave as a role model behaves. And third, people become more susceptible to suggestion in crowds; the crowd effectively hypnotizes the individual, who then follows the suggestions of other members or the crowd's leader. Behaviors become impulsive, emotional, and difficult to terminate. Simplicity of suggestion is mandatory and paves the way for exaggeration of the sentiments — the throngs are burdened neither by doubt nor uncertainty.

Deindividualization

The process known by contemporary social scientists as "deindividualization" takes place, partly because of the aforementioned group anonymity and a heightened state of arousal. (Remember China's Tiananmen Square in 1989.) These conditions lead individuals to become submerged in the group, losing their own sense of identity. When this loss occurs, people no longer feel responsible for their behavior; their attention is drawn to the group and behavior becomes regulated by fleeting cues in the immediate situation.

The Mind of Crowds

A crowd thinks in images. It accepts as real the images evoked in its collective mind, though these images generally have only a very distant connection to the observed fact. Bob Prechter unintentionally encouraged the easily grasped and seemingly boundless image of vast riches with his prognostication of 3600 for the Dow during the summer of 1987. The collective observations of the crowd frequently are erroneous and most often merely represent the illusions of an individual who, by the process of contagion, has influenced his fellows.

Another example of the difference between image and reality can be found in the proposed acquisition of UAL, Inc. Do we for a minute think the United Airlines pilots see anything beyond images of great wealth as they assume the awesome responsibility of repaying $7 billion in debt. Marvin Davis, Carl Icahn, and others have created the appearance of a fantasy from a very serious business. The pilots show every sign of being caught up in the crowd. They have risked much — their pension assets, salary cuts, and no-strike clauses. The risks that these people have assumed, we fear, are more foolish than calculated. The pilots have no doubt allowed themselves to believe that the transaction has been legitimized by the presence of Citibank and Chase, who have committed to lend $3 billion and have promised to raise another $4.2 million from others. But some of us remain skeptical. For the pilots' sake we hope the bankers know more about the airline business than they did about oil, real estate, and Latin America. Some of us can still recall when the airline business was considered cyclical.

[As a postscript, after three failed efforts (beginning in 1987), the employee unions of United Airlines finally gained ownership control on July 12, 1994. Despite smatterings of dissenters among sectors of each of the unions, the employee stock-ownership plan was pushed through and approved by shareholders. Employees received 55% of UAL's stock in exchange for $4.9 billion in wage and benefit concessions. The buyout was aimed at enabling United, which lost $50 million in 1993, to better compete with lower-cost airlines.

After 2½ years, the transaction seemed to be a success. Adjusting for stock splits, shares had risen from $22 to nearly $60, but it appeared as though the honeymoon were over. In early 1997 pilots voted down a contract offer and demanded a 10% wage increase over four years. Similar deals also were rejected by other United Airlines unions. As is the case with most deals made under financial duress, all parties seemed to regret concessions they made under pressure. It seems as though the pay cuts employees agreed to while they were deindividualized in the group became quite personalized when the new compensation program came home to roost, so to speak.

United Airlines stock began to steadily fall in the fourth quarter of 1997. While the stock has languished around $10 following the tragic events of September 11, 2001, terrorist activity is not the only factor that has contributed to UAL's downfall. The U.S. Department of Transportation ranked United last in service in 1999 and second to last in 2000. Due to ongoing labor disputes with its pilots, mechanics, and flight attendants, United had the worst on-time arrival percentage in 2000: a dismal 61%. UAL's three biggest rivals — American, Delta, and Northwest — all ranged from 73% to 77%. United was next to worst in mishandled baggage and in customer complaints filed with the DOT. Perhaps the shared imagery of impending riches that spurred on the union members in the early going grudgingly caved in under the weight of reality: Collective dreams turned to individual despair, and group enthusiasm fizzled into apathy.

The Enron debacle, described in Chapter IV, is just the most recent illustration of an image, mindlessly embraced by institutions large and small, that had only a remote relationship to reality.]

Might May Not Be Right

If we subscribe to Le Bon's findings and conclusions, we can see the crowd for what it is, rather than for what it appears to be. Despite the persuasiveness inherent in numbers and the implied power of size, the crowd may be a toothless tiger when it comes to certain tasks that require something other than brute force. Le Bon leads us to believe that as individuals we may in fact be functionally superior in many important respects to the collective mind of the crowd. We are apt to think on a higher plane — and to do so more logically. We are likely to weigh with greater care the consequences of our actions. Our problem-solving capabilities will no doubt be at their best, leading to decisions that reflect our optimal level of reasoning. We will operate more on the conscious level, being better able to control our emotions. Facts, not images, will tend to take precedence as we problem-solve.

To be sure, we're quick to acknowledge that separation from the crowd does not protect us from thinking and acting quite stupidly. However, as part of a crowd we have little or no opportunity to be the best we can be. We need not be intimidated by crowds if we only understand the transformation that takes place in the functioning of the individuals that compose them. Indeed, crowds have their rightful place in history — and they are capable of incredibly heroic deeds, as the young Chinese students at Tiananmen Square demonstrated. However, investing is a cerebral endeavor, dependent on intellect and not force, reason and not impulse, self-control and not high emotion.

Sometimes when we observe uncharacteristic behavior from someone with whom we're acquainted we say, "He's just not himself." When we see people we respect taking on the telltale behavior patterns of a crowd we are probably justified in reaching a similar conclusion. They may be particularly competent when functioning as individuals but as members of the crowd they may become … well, blockheads, a state of mind to be avoided, not admired. During the second half of the 1980s the junk-bond scam reached a feverish pitch. The takeover crowd was populated with grand and powerful names, busily, if not blindly, leveraging everything in sight. The end to that unfortunate debacle was as predictable as rain in April.

Because of the crudeness and undisguised greed for which it will be remembered — from big cigars to puffed-up egos — and because the episode is relatively fresh in our memory, as are its trademark characters Michael Milken, Ivan Boesky, and a host of other "*Barbarians at the Gate,*" we won't rehash that ignominious moment in economic history here. Those who would not do it were it not "the thing to do" are likely to be its hapless victims. We may be no smarter than they — except that we possess a little knowledge about "The Power of Popular Delusions"!

No Chain Is Stronger Than Its Weakest Link

Turning now from the abstract to the concrete, we see how crowd theory applies to everyday activities.

Not beholden to anyone but our clients, we can utter heretical declarations with equanimity and without fear of reprisal. One of the great myths born of the long bull market is that middlemen — in their many iterations, from financial planners to the institutional consultancies — actually add value in the aggregate. What they add, without a scintilla of equivocation, is another layer of costs. Even investment managers, among which we must be counted, in total are more of a cost than a benefit. Referring once again to the section (Chapter III) on investment strategy, if Warren Buffett's prognosis of 7% returns from equities over the next decade or two proves portentous, the overhead burden of 2-3% in frictional costs will soon gleam brightly on investors' radar screens. During the '90s that cost, while still considerable in an absolute sense, was more easily buried in the aberrant and therefore unsustainable performance results of that decade.

There are, of course, exceptions to the rule that costs exceed benefits up and down the entire food chain; otherwise, the mean, median, and mode would be one and the same. For our sake, I hope you conclude that a bell curve exists and that we are an "outlyer"! If we expect to continue to hold our position, we must be vigilant in avoiding mechanistic imitation of others. We must always think counterintuitively, as we again do in the paragraph immediately following.

The middlemen helped create another myth that "more is better." The proliferation of mutual funds of every imaginable stripe and the bewildering boardroom rationale to "downstream" decision making regarding retirement-plan investments to those least qualified is part of the grand masquerade. Again, see Chapter III for our challenge to the popular custom of diversification among asset classes, styles, and stocks of so many varieties that they defy description in an essay of this length. We have never understood the truism that most first-generation wealth is created on the strength of one idea or company, then concludes with the dubious (in our judgment) assumption that in order to preserve it, it must be spread among a thousand other companies. There's more money than truth in that widespread practice. Compelling financial motives for free(fee?)-loaders up and down the food chain, coupled with often gullible investors, make for a most profitable exchange, at least for one of the parties. If you've been in the game for more than five minutes and haven't yet identified the patsy … guess what? You're it.

Perhaps most grating to us is the issue of accountability. Because we're investment managers, that subset of our services falling under the quantitative descriptor, investment performance, is incontrovertible in its factuality. It is what it is, and that's that. Not so with the fuzzy notion of value added by the middlemen. Playing adroitly to the well-cultivated illusion that safety is found in the sampling of a smorgasboard of choices, the middlemen cleverly avoid being accountable for anything beyond taking the naïve, yet hungry, client to the table spread with enough variegation (almost rhymes with vegetation) to choke a horse. To be sure, justice may not be swift, but it is sure. If the tide continues to ebb, they will in due course be exposed as a liability for which the value is *de minimus*.

Surprisingly, those who are seemingly most astute are equally eager to embrace this negative-value-added proposition. Almost every endowment fund for a college, university, or community foundation within range of our offices (to say nothing of other pools of organizational money, big and small) uses the consultancy model. The common denominator is the committee structure. As indicated above in the section titled "The Power of Popular Delusions," a committee is an odd potpourri of people whose collaborative idiosyncratic behavior is often in no way reflective of the brilliance or sagacity of any of the individuals of which it is made. A person's capacity changes, and usually not for the better, when he or she submits to the will of a group. Thus, what is said below applies only to committees and not to those of whom it is composed. Members of our firm serve on a number of committees and boards in which we respect and admire every single member. Put them in a blender, however, and too frequently you get mush. The problem is structural, not personal.

Continuing in this vein, after years of firsthand observation I am convinced beyond a shadow of doubt of the counterintuitive notion that one astute individual has five times the investment decision-making capacity of a committee of five persons who, individually, are equally endowed intellectually. This metamorphosis — from incisive, decisive individual to mealy-mouthed group member — is not without explanation. No single member shoulders the ultimate responsibility, so a CYP (cover your posterior!) decision-making cloud hovers over the group and often disrupts collective clear-headed thinking. (Parenthetically, it's no accident that most of Martin Capital's clients are individuals, not groups.)

The lowest-common-denominator syndrome, given enough time, will assert itself. The meeting rarely begins before the last and most harried member arrives, and the tenor of the deliberations is usually established by the member who is both least knowledgeable and most vocal! The group, rarely self-selected and ever-changing, is often so diverse as to talent, level of interest, and amount of experience that effective decision making is rendered nearly impossible. The idea of laying off responsibility to a third party as an antidote to the inherent structural ineptitude of a group of individuals (attempting to carry on business as a unit) often gains respectability by default. Add to that the obligatory consultant's flippant use of the vernacular of Modern Portfolio Theory, dropping such terms as negative covariance, the efficient frontier, *beta,* and the esoteric math that ties it all together (none of which most consultants could explain with much lucidity), and you have the perfect prescription for a group that looks and functions more like the Three Stooges than what the grand theoretical design would have you believe. What more susceptible prey could a consultant hope for?!

Pay close attention to the next consultant's presentation. The charts and occasional histrionics aside, consultants are in the business of collating and cataloguing massive quantities of historical data and trying hard, sometimes almost desperately, to impart some sort of unique spin to other consultants' warmed-over and rehashed verbiage. The sheer amount of material is intended to convey an image of the consultant's facility for thought and reason — and the committee frequently finds the comfort it needs buried in those numbers. Conspicuous by its absence, though, is any subjective reference to the future. Most consultants have a propsensity for looking backwards, citing the performance of yesterday's darlings who, by the very nature of the ebb and flow of investment fashion, are likely to be tomorrow's dogs. In so doing, they do little more than perpetuate the herd mentality, about which the only cartoon to grace these pages speaks volumes (you may wish to revisit page 15).

While some of the above may seem unkind, you need only hear Charlie Munger rant on the subject to realize that we are in fact falling all over ourselves trying not to offend!

The Enron Enigma

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

At its core Enron is an enigma, pure and simple. To be sure, Enron was a creature of the bubble, and victim of the bubble's demise. It also is not beyond plausibility to imagine Enron as the canary in the coal mine, its fate foreshadowing a long winter's night of economic discontent and a bear market not unlike that which enveloped Japan. The U.S. isn't Japan, and Enron may not be a precursor of bad things to come. Still a canary, if not *the* canary, is no longer on its perch. Those dark forebodings aside, there is much more to Enron than what the press chooses to write.

For example, one sometimes sees a modicum of virtue when others see only vice. For prone as Wall Street is to pick the bones of the once powerful but now vanquished with vindictiveness approaching rapacious fervor — particular those who mocked the ostensibly astute Wall Street gang, exposing analysts and brokerage firms as frightfully gullible and superficial, nay, I say incompetent — there was virtue of idea before there was villainous intent at Enron. More on that in the paragraphs below.

Like last year's "poster company" for the Internet craze that we profiled, DrKoop.com, Enron wins that dubious distinction in this year's derby of downtrodden, dying or dead. In fact, it was the model of financial engineering, new-economy style, the demon dabbler in derivatives. Much bigger than life — "a really, really big" story, as Ed Sullivan would have said — Enron's fall from grace was from on high, scattering the debris far and wide. It will be perhaps years before the wreckage is untangled, let alone put back together. There was no flight recorder.

In the political realm certain factions have always been uncomfortable with the rollback in government power that deregulation represents. This contentious minority took the misbegotten version of deregulation that afflicted Californians with an electricity shortage, followed immediately by a glut, as proof that free markets can't work. The long-term decline in the prices of electricity and natural gas, where choice and competition have supplanted the local monopolies of yore, say otherwise.

Enron Corp. CEO Kenneth Lay, despite the contradictions of his character and the arrogance of some of the company's senior officers that rose apace with the stock price, led the fight for competition — from the halls of Congress to the state legislatures across the country. His target was monopolies in the business of electricity transmission, striving to loosen the stranglehold on electricity markets of those who controlled the transmission lines and therefore were able to beat back threats from independent generators. He fought for the right for military installations to buy energy from low bidders rather than be forced to buy from the utility serving their areas and, perhaps most importantly, he fought to allow consumers and suppliers to strike whatever bargains they found mutually advantageous, rather than be required to buy and sell energy to the monopolies that control transmission facilities.

Enron created markets where none existed and replaced monopolies with competition, reducing the need for regulation, thereby lowering the cost of energy for consumers and businesses. Ken Lay has sometimes been likened to another financial revolutionary, Michael Milken, of whom we have written disparagingly in the past. By making substantial amounts of debt capital available to large numbers of American companies with whom banks would not do business, Milken enabled a group of anti-establishment entrepreneurs to wrest control of sleepy companies from "corprocrats" who felt little obligation to maximize the value of the assets that their shareholder owners entrusted to their management. Make no mistake, Michael Milken was many things, but altruistic was not one of them, and capitalism certainly doesn't require that he be. Yet there was a fatal dark side to this revolutionary. He was an "Adam Smith" capitalist in drag, lacking the all-important moral fiber, without which Smith's form of economic system simply doesn't work.

Just as Milken attacked the financial system that protected entrenched managements, Enron assaulted the regulatory quagmire that protected electric and gas monopolies. When "the establishment" is under siege it responds by exposing the iniquitous means of the rebels, of which in both cases there were many, rather than to reduce the conflict to the legitimate core issues that started the struggle in the first place. Deregulation and free markets are among the key elements of the eternal struggle between entrenched interests and those whom Austrian economist Schumpeter described as the agents of "creative destruction." The technology and information revolution — whose benefits are more obvious and whose methods and misdeeds less so — challenged the conventional way of doing business with far greater and more enduring success.

It has been and continues to be a revolution that will maintain American capitalism as the envy of the world. It is the sometimes unscrupulous revolutionaries who sadly sully the process, as in the case of Enron, and thereby take the public's eye off the virtue of what was being attempted. An analogy with some of the original motivation for U.S. involvement in Vietnam is possible here, but neither time nor space permits us to go there.

Thus began the Enron story. In its inspiring rise from a run-of-the-mill, regulated, natural gas pipeline operator into what was (until recently) the nation's most admired energy company, a global energy conglomerate, and premier trader — on the Internet yet — of oil, gas, and electricity, Enron garnered accolades by the score … and not only from adoring analysts. *Fortune* magazine hailed it as the most "innovative" company in America, and no doubt it was, perhaps aided by the practices of inflating profits and concealing debt. The CEO (once departed and now back again) had boasted to adoring authors, "There is a very reasonable chance that we will become the biggest corporation in the world." Lay proved nearly prophetic, neglecting only to enlarge the sentence to read: "… the biggest corporation in the world to go bankrupt."

At its high of nearly $90 a share, Enron's stock commanded a market capitalization of something like $70 billion. After a shotgun marriage with Dynegy was called off in early December by the prospective bridegroom, Enron's stock fell to 36 cents a share in early December, which (while a mere three-tenths of 1% of its high) still was not cheap, at least so far as we knew. The bankruptcy filing proved that. Since the S&P 500 index is capitalization-weighted (a company's hierarchial position on this most popular of benchmarks is determined by its total market value — outstanding shares multiplied by its market price), Enron's violent implosion took it from among the largest 35 companies in the S&P 500, when it was sought after by all manner of mutual funds hither and yon, to last place in early December. The loss of 99.7% of its market value was enough to prompt one inordinately alert analyst to downgrade the stock to "Hold" (no kidding; you can't make this stuff up).

DrKoop.com's peak market capitalization, by comparison, was a mere pittance: At its zenith it commanded a value of $1.3 billion; today it is trading "under the counter" in the pink sheets, fetching one-tenth of a cent, for a total market capitalization of $54,000. Everything is relative. Anyone want to be a dot.com baron?! At the bargain price of a little over 50 grand, perhaps a belated Christmas gift for someone special? We make light of a truly tragic story, one so depressing that to treat it seriously would cast a pall over the rest of the report.

Collapse of the deal with smaller rival Dynegy shortly in advance of Enron's bankruptcy filing (the deal, with the expert guidance of Goldman Sachs, in a miracle of due-diligence efficiency, took all of three days to discover everything it needed to know about Enron before making its original $9 billion bid) was precipitated by the egregiously tardy degrading of Enron's credit status to junk by the rating agencies.

Vision Gave Way to Arrogance, Which Mutated into Greed

Creative capitalists rightfully expect their just rewards — if not "desserts." Ken Lay, the man who built the company into what it is today — scratch that, make that what it was last summer — reportedly laid claim to some $300 million over the past decade from the exercise of stock options. While we have been witness over the years to the evolution of stock options as a form of compensation, it is no secret that we find the once pedestrian practice not much to our liking. It is now the most clandestine form of corporate skulduggery, made particularly loathsome because it is so common as to almost be considered proper. What offends us is not so much the amounts (perhaps because they are so large as to be beyond our comprehension) but rather the manner in which they are rationalized.

From our vantage point as investors we realize that any commitment we make might result in a return of several or even many times on our money, but it's also well within the realm of possibility that our investment could be a big goose egg. Options are a free lottery ticket that need not (indeed, *will* not) be presented unless it's to the holder's often considerable advantage to do so. Pure and simple, investment without the possibility of downside is not investment at all, any more than baseball is not baseball if the umpire never calls strikes.

That aside notwithstanding, Lay created a company whose services were of significant value to its customers. Hardly a layman at what he did, the Enron CEO earned the right to be very well compensated, the amount of which is not for us bystanders to judge. It is only with Enron's "the most you can lose is nothing" form and structure that we quibble. In our capitalistic system enormous-slice-of-the-pie anomalies like Michael Jordan or Tiger Woods are to be expected, even encouraged.

While some Enron executives still held big chunks of stock until the bitter end, according to Thomson Financial/Lancer Analytics, insiders still managed to unload 1.75 million shares in 2001 — and they sold as the stock fell, which for us would generally raise an eyebrow. Among the biggest sellers: Lay, who unloaded 408,000 shares at prices ranging from $81 last winter to $43 in July. Enron said sales were related to the pending expiration of options. In fiscal 2000 Mr. Lay did pretty well, options notwithstanding: His paycheck that year was $12 million. To repeat ourselves, compensation is a board's duty and responsibility, part of the capitalist's credo, but if Ken Lay was saying one thing and doing another, that's a deadly combination, a hearse of a different color. Read on, for as recently as September 17, *Fortune* magazine quoted Lay giving assurances that could lead the reader to conclude either he was ignorant of what was going on or, more likely, culpable. We call him Uncle Unctuous, a CEO who was anything but avuncular to the Enron (aka Oil o' Lay) minions who lost millions on his watch.

Though certain members of the financial press, of a non-conservative bent, are having a field day with the above statistics, we don't take umbrage unless, of course, they are the unjust rewards from a shell game. And quite possibly they are …

… for as we wonder what might issue from the Enron fiasco, the unwinding of what now looks like a reckless commodity trading firm may lead to a mad planetary scramble by the broad legions of counter parties — the folks on one end or the other of the trades arranged by Enron — to rehedge their positions. The comparison (so freely bandied about by the media) with Long-Term Capital Management, about which we wrote in the 2000 report (page 37), isn't very apt in the case of Enron. For their inordinate sense of their own superiority, which ultimately undid them, the Long-Term fellows were quite smart and organized, so their complex web of trades could be systematically unraveled. By contrast, the muddle created by the young hotshots who did Enron's trading, exacerbated by the company's ceaseless management turnover, stacks up as a truly daunting untangling process.

As for the aggressive accounting so common to fast-trackers, Enron engaged in a technique involving the front-loading of profits, or losses, on long-dated trading positions based on estimated future results. The problem with these profits is that no cash accompanies them, making the company vulnerable if its projection is wrong. Enron also booked a sizable amount of mark-to-market profits, prompting suspicions that Enron booked gains on winning trades and hid losses on losing trades. A coterie of sub-prime lenders got into a lot of trouble using this type of gimmickry.

Perhaps what is most disquieting about the Enron mess is that none of the authorities' fail-safe mechanisms was triggered. The assurances passed on by the Federal Reserve, the commodities regulators, and sundry other official repositories of wisdom and knowledge implied there's nothing to worry about. Nor, for some strange reason, are our concerns entirely allayed by the intelligence that the billions lent by the generous giants, Chase and Citibank, to the fallen trading Goliath were laid off in sizable chunks to a bunch of other banks. But then, banking is a business that has always given us pause. Each day the "majors" are presented with opportunities to do something really stupid, and occasionally they simply can't resist, whereupon the lesser lights seem to follow closely behind like so many lemmings. One month before the bankruptcy Enron announced it had secured commitments for $1 billion in financing from units of J.P. Morgan and Citigroup, both of whom presumably had much better access to the inner workings of the company than almost any outsider. It was only one week before the bankruptcy that the rating agencies finally downgraded Enron debt from investment grade to junk status. For reasons unbeknownst to us, the public's watchdogs were either asleep or muzzled whilst Enron stalked the village.

The estimable publication, *Fortune* magazine, was somewhat less bamboozled. "One reason Lay's job is so tough," said *Fortune* in March (see "Is Enron Overpriced?"), "is that Enron's financials are on the dim side of opaque." Later in the year, on September 17 to be exact, *Fortune* published "Enron's Power Crisis — Wall Street Will No Longer Take the Company's Word on Financial Performance," authored by Bethany McLean. She opined that "the task of restoring Enron's glory falls to Ken Lay, the company's chairman and former CEO." In the article she noted that the task will not be easy. Quoting UBS Warburg analyst Ron Barone: "'Enron's overall quality of earnings has deteriorated, its level of behind-the-scenes financial engineering has increased, and its overall standing with the Street has plunged.'" McLean was quoting from a recent Barone report — and Barone is one of the bulls. She went on to say that "despite Lay's insistence that there aren't any 'accounting issues, trading issues, or reserve issues' at Enron, investors are hesitant to bid the company back up. Indeed, Enron now trades at around $38, down some 60% from its 52-week high." That was just 75 days before the bankruptcy. Because of all the smoke and mirrors, even the journalists given to skepticism had little idea what "lay" ahead.

Many companies could be hurt by the Enron collapse. The insurance industry could lose $2 billion, Fitch Investors Service estimated in early December. Among the hardest hit by the fallout could be John Hancock Financial Services, Inc. Colin Devine, an analyst at Salomon Smith Barney, said that at about $320 million, Hancock has the largest exposure among the life insurers that Devine covers. About a third of the exposure is secured, and Hancock likely will take a $120 million write-down in the fourth quarter, he said. Other large exposures include $172 million at Principal Financial Group, $62.6 million in long-term bonds at MetLife, Inc., about $24 million in unsecured direct-debt holding at UnumProvident Corp., and $22.9 million at Allmercia Financial Corp., according to Devine.

"Lincoln National Corp. has $25 million in exposure and $70 million at two Enron subsidiaries that are still rated 'investment grade,'" added Devine. Alice Schroeder of PaineWebber said Ambac Financial Group Inc. has insured $37 million of bonds for Portland General Electric, an Enron subsidiary, while MBIA, Inc., has about $40 million of exposure to that enterprise. While such losses in themselves pose no serious threat to either municipal bond insurance company, on another occasion we will explain why insured municipal bonds are, in our judgment, not nearly as secure as their ratings imply and why, without exception, we avoid them.

The end game for Enron is problematic. According to *The Wall Street Journal*, Enron's debt is considerable, and its transactions were so complex that few know exactly how much it owes. Bankers involved in the restructuring discussions estimate that liabilities total $40 billion, including $13 billion in debt on its balance sheet — $4 billion owed to banks and $9 billion owed to bondholders. The other $27 billion in liabilities includes off-balance-sheet transactions, such as an additional $3 billion in bank loans and $7 billion in bonds, these bankers said. That leaves an additional $17 billion in other kinds of complex transactions, including energy-market derivatives, letters of credit, and other kinds of debt instruments.

Many of Enron's physical assets, such as its natural gas transmission pipelines, already have been pledged as collateral against sizable loans, which means they could be claimed by creditors or sold to pay off borrowings. Figuring out the extent of the liabilities is so complicated that many so-called vulture investors, who buy distressed assets, declined to trade the bonds even as the value of the debt plummeted from 100 cents on the dollar to less than 20 as bankruptcy appeared imminent.

Enron also ties nicely into Martin Capital's risk-management philosophy. Referring to a piece Dennis Blyly wrote last year, "Judgment Calls," we believe that as uncertainty grows, humans tend to become less well calibrated. By comparison, evaluating the risk of a U.S. Treasury note, where risk is close to nonexistent, calibration is precise. Enron is a perfect example of why *beta* is such a poor method of defining and measuring risk. Credit-monitoring firms, analysts, and bankers obviously read the footnotes and were unable to figure them all out (perhaps the dearth of reliable information made such an exercise virtually futile anyway?). There was too much uncertainty. Yet, irrespective of whether you were Moody's, a sell-side or buy-side analyst, or a banker, you had to make a judgment (that's what they're paid to do) where a rational judgment was impossible. To return to our beloved baseball analogy, the cognoscenti were forced to swing at low-and-away sliders that were well out of the strike zone. Ahead they went, falsely reassured by a relatively benign *beta* that all was well. Risk, as they learned to their chagrin, has a subjective element as well. At Martin Capital, if we're unable to define the risk, we simply say, "We don't know" and take a pass.

Enough Already

The "lay" reader must be befuddled by this point, assuming we still have his or her attention. Rest assured, one need not be a seasoned financial analyst (as if such training proved to be of any utility at Enron) to spot an impending disaster. A sports fan with a keen eye for observing the dissimilarities between haughtiness and humility would stand a far better chance. Two years ago, outside a half-built baseball stadium, Enron Corp. Chairman Kenneth Lay announced that the high-flying energy giant would pay roughly $100 million over 30 years to put its name on the new home of the Houston Astros.

That was well before fatal questions arose about Enron's questionable finances. But after that, Enron never had a chance. It was destined to join Fruit of the Loom, Inc.; Trans World Airlines; PSINet, Inc.; Conseco (Conseco Fieldhouse, Indianapolis); and countless others that spiraled downward after emblazoning their brand name on a sports stadium. It's as if putting a corporate name on a stadium is an act of such hubris that the sports gods demand retribution. Call it the stadium-naming jinx. "As soon as you put your name on something, you might as well go to the lawyers and draw up the bankruptcy petition," jokes Paul Swangard, managing director of the Warsaw Sports Marketing Center at the University of Oregon.

In Houston a longtime Astros season-ticket holder proposes that Enron Field be renamed "'Enron Folds.' That way you'd only have to change a couple of letters." My personal favorite is "End Run Field."

To be sure, stadiums have carried corporate monikers ever since William Wrigley Jr. and August Busch put their names on stadiums used by teams they owned. But the commercial name-game really picked up momentum in recent years and, as the deals have multiplied, the jinx has spread. Beyond bankruptcies and other brushes with death, corporate stadium-namers are frequent takeover targets. Arco, Pacific Telesis, Shawmut National Corp. are among them. The Philadelphia arena formerly known as the CoreStates Center morphed into the First Union Center and will become the Wachovia Center as soon as next summer. In small towns or big cities, bank signage has been a growth industry for years. How we missed seeing that one is beyond me. And it was right before our eyes!

The deteriorating financial health of airlines imperils naming deals at six indoor arenas. The former chief executive of UAL Corp., whose United Airlines unit named the arena in Chicago, raised the prospect of filing for bankruptcy next year. Some analysts believe the parent of America West Airlines, namer of the arena in Phoenix, may have to file sooner, if it doesn't get requested government aid.

Some companies say they've learned to shy away. "It's very expensive," says a spokeswoman for Southwest Airlines, one of the few major airlines that doesn't have its name on an arena. The Southwest business model is one of our favorites, and her response is precisely what we would expect from the most perennially profitable airline. "We would rather be able to charge our passengers lower fares so they can afford to fly to games and still have money in their pocket to buy a foam finger or eat out."

For us, due diligence on Enron was embarrassingly simple. If we don't understand the accounting, we move on to the next opportunity and don't look back. Martin Capital doesn't *have* to own anything, and we almost never buy a piece of a business that sits atop the pop charts. Something that signals the existence of something else, such as an edifice complex, as was ostentatiously flaunted in any number of ways by the former CEO of Conseco, is often enough to send us packing before we even attempt to understand the business model. Disconfirming evidence occasionally just jumps out at you! Consider "keeping our eyes open to those behaviors or activities that are but tips of icebergs" as part of our qualitative filtering process!

'What Price Do You Want to Pay for a Matisse?'

No, that is not a metaphysical question that might be debated by two friendly patrons at a Sotheby's auction. Rather, it was a direct quotation in March 2000, as the stock market was peaking, from Joseph Battipaglia, head of investment policy at Gruntal & Co., who said stock valuations weren't excessive, because leading companies continued to remake themselves.

In a sense, though, he might have been onto something, as such art-auction reasoning might be applied to many technology and most dot.com ventures, with one notable exception that Mr. Battipaglia apparently overlooked: The supply of original Matisse paintings is finite. A shocking number of the "new economy" companies in the limelight then neither had nor have earnings, and many barely reported any sales. And among those that did actually report profits, a conspicuous number resorted to accounting practices that were as "state of the art" as the products on their drawing boards (see Chapter V for the incriminating details). That the "dot.commers" pushed the envelope of credulity to the limit may be the greatest understatement in this report. Perhaps, like art, the value of those companies was not tied to anything tangible but more to the ego of the fellow making the highest bid. As the appendix to the 2000 annual report left no doubt, however you might characterize that behavior, investment would not be among your choices.

Whatever Happened to the 'Chinese Wall'?

The "Chinese Wall" that separates a brokerage firm's research division from its investment-banking operations has generally been dismissed by the regulatory authorities with a "hear no evil, see no evil" indifference. Having been a partner at a fine regional broker/dealer, I saw firsthand that the wall was little more than an illusion. Not attempting to dodge the issue of culpability, I am certainly aware that the first question that companies contemplating an IPO would put to the investment bankers bidding for their business is "what kind of research coverage will we get?" Imagine how much business an investment banker would write were his responses straightforward, honest, and candid!?

Despite our reluctance to tread on sacred ground that was staked out eons ago, the rumble of lawsuits from disgruntled (no pun intended as regards the firm that employed the strategist who uttered the mad Matisse analogy) investors has registered on the U.S. Securities and Exchange Commission's Richter scale and thus begs for comment from us. What is unshakably obvious is that conflicts between analysts and investment bankers — who long have known that negative research will hurt their chances of winning corporate-finance work — have drawn unprecedented attention for much of this year in the wake of a meltdown in technology stocks. Many prominent research analysts, including several highlighted below, remained wildly optimistic on stocks, particularly tech shares, long after those stocks crashed, as investors were saddled with large losses.

One day after the SEC disclosed to Congress that it had found widespread conflicts of interest among analysts at the nation's largest brokerage firms, Congress and others declared that they would be examining the issue, asking Wall Street to justify the way it comes up with research recommendations. Critics say the biggest obstacle to independent research is Wall Street firms that seek investment-banking business from companies their analysts follow — and that pay analysts partly based on how much banking business the firms get. Duh! Is there any other way to spell "conflict of interest"?

Among other things, SEC acting Chairwoman Laura Unger noted the breakdown of the supposed line separating analysts from investment bankers, particularly as analysts routinely got involved in corporate-finance deals and participated in pre-offering "road shows" for institutional investors.

There is, however, redress — at least in the Empire State. Under a New York state law known as the Martin Act☺, the state attorney general's office has far-reaching powers to charge Wall Street players with either criminal or civil securities fraud. And in recent years, the New York attorney general increasingly has used the Martin Act to crack down on securities-related improprieties. Reference to the New York law is coyly included at least in part because the undersigned thought the name of the act has a nice ring to it.

The Fall of the King and Queen of the 'Net

While the two erstwhile analysts characterized below are likely to be less familiar to our readers than hedge fund managers George Soros and Julian Robertson,[2] who were profiled in last year's report, they are still deserving of a deprecating note — only to make the point with appropriate emphasis. Our interest is not in personally castigating them, as they were simply among the more visible and were obviously caught up in the crowd mentality as well.

Investors who say they were burned by bullish Internet-stock calls made by Mary Meeker (coincidentally and ironically, the adjective *meeker* means "easily imposed on; submissive") — once dubbed by *Barron's* magazine Queen of the 'Net — sued the high-profile Internet analyst and her employer, Morgan Stanley, in August. Conflicts or not, impropriety is often assumed. That is one of the issues in a recent lawsuit. Amazon and eBay investors accuse Meeker in their suits of issuing positive recommendations on the companies' stocks to generate investment-banking business for Morgan Stanley. The suits, which seek class-action status, also contend that Meeker's reported 1999 pay package of $15 million was directly linked to her ability to secure investment-banking fees for the firm.

A spokesman for Morgan Stanley said the company hadn't seen either lawsuit but believes that the complaints are without merit and will be dismissed. "Morgan Stanley research is thorough and objective," the company said in the statement. "Mary Meeker is one of the most respected analysts on Wall Street. The allegations are unfair, inaccurate, and cannot be supported in court." For the sake of the already tarnished names of Ms. Meeker and Morgan Stanley, let's hope so. As for the investors, what may not be proven in a court of law should not, nonetheless, be forgotten.

The suits filed in a New York federal court by investors in Amazon.com, Inc., and eBay, Inc., follow an arbitration case by a former client who claimed he was misled by a bullish stock call by Merrill Lynch & Co.'s Internet analyst Henry Blodget, once dubbed King Henry.

According to *The Wall Street Journal,* the cases have been widely watched on Wall Street. Ms. Meeker and Mr. Blodget were perhaps Wall Street's two most famous Internet analysts, based largely on a series of "buy" recommendations during the tech-stock bull market. But since the Internet bubble burst last year, many tech stocks have been pummeled, and investors have reviled research analysts and the brokerage business for their rosy stock calls, allegedly arising from myriad conflicts.

Henry Blodget, who also became a lightning rod for critics of conflicts involving Wall Street analysts, exited Merrill Lynch & Co. through the front door with a still hefty $5 million paycheck — but not without the New York state attorney general's office close behind. Blodget and his firm are part of a broad probe of analyst conflicts of interest, according to people with knowledge of the matter.

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[2] Julian Robertson's prescience proved to be pinpoint accurate in the spring of 2000, though his confidence flagged in the enveloping despair. He abandoned ship at the precise moment when the tide was beginning to turn. Heavy use of leverage and a high-cost organization supported by performance-based fees, which were then in deep water, forced his hand.

In fairness it should be mentioned that Blodget did issue generic warnings that prices were too high, saying that "…75% of Internet companies will fail; we believe that the majority of today's pure-play Internet companies will never make money and won't exist in five years," he said in a speech in March 2000. Henry was generally right and specifically noncommittal. Safe ground for a man in his shoes, I'd say. Since Blodget's compensation is based in part on his ability to bring in deals, that he might avoid biting the hand that feeds him strikes us as glaringly self-evident.

Analysts soon became federal officials' focus of possible regulation. Congress conducted hearings on conflicts of interest involving Wall Street research and had planned to follow up with legislation if firms didn't do a better job policing themselves. The SEC, the securities industry's top regulator, launched an examination of conflicts in the summer of 2001. Big Wall Street firms began to institute their own policies to clean up conflicts. Merrill, for one, said it would bar research analysts from buying stock in the companies they cover. Convoluted reasoning, we would argue. Analysts (*and* their recommendations) should be stewed in the same pot as their clients.

But this past fall, particularly after the September 11 terrorist attacks, the issue lost much of its steam. As reported in *The Wall Street Journal*, some on Wall Street expect that Harvey Pitt, the new SEC chairman, will take the commission in a new direction, one more friendly to Wall Street than his predecessor, Arthur Levitt Jr. The commission's enforcement staff has yet to launch a formal investigation into the findings of a broad examination of analysts' conflicts, these people say.

Mr. Pitt, people with knowledge of the matter say (and so confides *The Journal*), recently met with officials from the New York Stock Exchange and National Association of Securities Dealers, for a progress report on the steps they're taking to address conflicts. Instead of enacting new rules, Mr. Pitt wants the securities industry to come up with its own rules to deal with analysts' conflicts.

Such spurious blather is "the pits," Mr. Pitt. The Wall Street lobby is big and powerful, and the SEC knows full well the harsh realities: Research and investment banking are essential pieces of the same puzzle. Imagine how one might unbundle the two in a sales-driven brokerage firm. If the public demands investment research, how else would we propose that analysts be paid? The ethical conundrum is that the two activities are rife with conflicts, particularly during any self-perpetuating market mania. Admittedly, this was a long explanation for why (if we are to fill your portfolio with uncompromised research ideas and avoid the "Pitt"-falls and pratfalls of our institutionally conflicted brethren) we must arduously perform our own due diligence. And to do that, we must remain an independent firm! No ifs, ands, or buts … If the problem can't be fixed, at least it can be avoided. Next time a glossy, upbeat Wall Street research report crosses your desk, make sure you determine for whose benefit it was written.

As a postscript, Mr. "Matisse" Battipaglia still hasn't thrown in the towel. He predicts the market will soar during the months ahead, as investors see a recovery for profits in 2002, sending the Nasdaq up more than 55% before year end and the S&P up 40%. By contrast, Warren Buffett is far too savvy and seasoned to opine on the market's course in the short run. Mr. "Matisse" suffers under no such strictures. While Buffett would certainly allow that Battipaglia could be right, I'd hang onto your wallet or purse, so that if "Mr. Matisse" persists in purveying his heretofore misbegotten advice, your error will be in acting overly cautiously! Better to keep your chips to play another day.

CHAPTER V

Ledger d'maim

What follows is the third consecutive now-annual harangue against the pandemic scourge of accounting abuses across corporate America. Do I have some feelings about this issue? You bet I do.

For starters, many if not most companies, including (with one minor exception) all those we own — at least insofar as we have been able to discern in our due-diligence process — walk on the right side of the legal and ethical line. However, we entertain no illusions whatsoever that what we write, or have written, will cause the recalcitrant out there in Financial La-La Land to be penitent. There is way too much long green to be raked in by bending the rules or by applying a crowbar to widen the GAAP (Generally Accepted Accounting Practices) for moral suasion or an appeal for fair play to fall on anything but deaf ears. GAAP, for the record, is the nominal standard of financial accounting in whose face the miscreants flaunt their deceit.

We feel it is our obligation to inform you about some of the more egregious infractions and how we compensate for or neutralize them. A recurring theme throughout this report is that there has been a sea change in corporate governance standards. We consider it a product of the tenor of the times, and our expectation (hope, anyway) is that it will be cyclical. Regardless, it helps us to know the games people play, and we trust (by pointing out a few of the more blatant breaches) your skepticism will be activated as well. Navigating through deep, calm waters is much less challenging than through shoal-ridden shallows. While there is always risk that we will run aground, we keep our navigational charts up to date in order to enhance our chances for a safe passage.

We understand the inherent limitations of standardized accounting — and that a certain segment of the business world seems to believe that every rule exists primarily to see if it can be broken. Thus, we are far less concerned about the behaviors of others that we can't control than our own behaviors, which we can. While we moan and groan like our public-accounting friends as each new rule is handed down, were it not for a garden that needs constant hoeing to keep the weeds at bay we might both be out of work!

We often suspect malice aforethought and find such behavior both repugnant and disgraceful. From the broader systemic point of view, we consider these actions a serious threat to the very institution of capitalism itself. Adam Smith's "invisible hand" welcomed the self-centered propensity of humankind as an essential motive without which the system would not work. It's when someone willfully attempts to vitiate the unwritten but indispensable code of conduct upon which this most productive of economic systems depends in pursuit of his or her own ends that the rancor of Mr. Smith's partisans begins to make itself known.

While this censure may tend toward the long-winded, be comforted in knowing that I will not go after my favorite "whipping boy," stock options, beyond the brief reference in the Enron story — and for good reason. As noted in last year's report, stock-option abuses escalated hand in hand with ever-rising stock prices. With deflation in prices the new norm, stock options are bound to lose favor — unless they are reconstituted in the form of "put" options. (Puts profit the investor only if the price falls!) Truly ingenious CEOs would have considered that "option" two years ago. However, since the ostensible justification for stock options in the first place was to encourage managers and, increasingly, board members to "think and act like owners," it seems rather disingenuous to have them place their bets on the company's demise!

First, though, welcome to the vernacular of the numbers game. What follows is a handy-dandy thumbnail glossary of accounting terms, both official and unofficial, that companies are commonly using these days to describe their earnings — or what they will try to convince you *are* their earnings.

Operating earnings: This is another name for "pro forma" earnings, in which companies present their financial results "as if" certain ordinary items (usually expenses) didn't exist. Also sometimes called "core income," "economic earnings," "ongoing earnings," or "earnings excluding special items." None of these terms have any particular meaning under GAAP.

Operating income: Sounds like operating earnings, but it has a strict definition under GAAP: revenue less cost of goods sold and related operating expenses stemming from a company's normal business activities. It excludes, for example, interest income and expenses, dividend income, taxes, and extraordinary items.

Income from continuing operations: Also sounds like operating earnings, but this, like operating income, has a real meaning under GAAP. This comprises revenues and expenses stemming from a company's ongoing operations, after taxes. It includes interest income and expenses and other non-operating gains and losses. It excludes only three things: discontinued operations, cumulative effects of changes in accounting principles, and extraordinary items.

Extraordinary items: This is another real term under GAAP, meaning items that are both unusual in nature and infrequent in occurrence, such as earthquake-related losses in an area where quakes are rare. Extraordinary items count when calculating net income, though not when calculating "income from continuing operations."

Special charges: A term companies use for expenses that are ordinary costs of doing business but that companies want investors to exclude when valuing their stocks. Also sometimes called "one time," "unusual," or "exceptional" charges. These terms have no standard definition under GAAP, and the items don't meet the GAAP test of an extraordinary item.

Cash flow: What self-employed people complain about a lot. Also, a GAAP term meaning cash receipts minus cash disbursements for a given reporting period. It's separated into three categories on a financial statement — cash flow from operating activities, cash flow from financing activities, and cash flow from investing activities.

Ebitda: "Earnings before interest, taxes, depreciation, and amortization." Most companies stick to this definition. But some use the term to refer to earnings figures that exclude not only these expenses but others as well, such as start-up costs for new ventures and other cash charges. Though often described as cash flow, ebitda isn't the same. For starters, it doesn't necessarily reflect changes in companies' liquidity.

Goodwill: An intangible asset — a plugged figure — that causes the balance sheet to, you know, balance. Goodwill can arise from any number of activities, but in the name of brevity one example will suffice. If Company A acquires Company B for more than the stated value of its assets, an asset line item known as "goodwill" must be created to reconcile the difference between the purchase price and the value of the assets purchased for the assets and liabilities (plus shareholders' equity) to sum to the same amount.

Book value: Shareholders' equity (assets minus liabilities) presented on a per-share basis. To the extent that any asset is augmented in value, including goodwill, shareholders' equity and therefore book value increase accordingly.

Bubble Goodwill

In the old economy, book value was often backed by assets that could be converted to cash and thus was frequently used as a benchmark in the valuation of businesses. Banks, because of the composition of their assets, were generally priced relative to book value. As recently as 10 years ago, Eugene Fama,[3] the University of Chicago mathematics of finance professor who years ago was credited with conceiving the concept of *beta*, a measure of relative price volatility, as Modern Portfolio Theory's proxy for risk, did an about-face. After years of back testing, he changed his mind and concluded that the price-to-book value ratio was the best indicator of relative attractiveness of a common stock and, therefore, its riskiness. Academia, because it depends on historical data to scientifically (and, heaven forbid, not anecdotally) prove its point, is usually well behind the reality curve. No sooner did Fama proudly announce the new unit of measure than the new economy rendered it, in the blink of an eye, obsolete. Easy come, easy go — or, as they say in "Roma," such is the price of Fama …

The new economy is light on hard assets and heavy on intellectual property. The trend toward the creation of intangible assets is a prominent feature of the information-driven economy. At least in terms of assets, the best of them being human, our firm would be characterized as "new economy." If there is a problem, it is in the valuation of the intangible assets. Unlike income-producing physical assets, no two are the same. The acquisition binge in technology — in pointing out the extremes to which valuations can be inflated like the prices of rare art at an animated auction — has exposed the soft underbelly of the valuation of intellectual or intangible property and thus has effectively enfeebled book value in many industries as a valuation benchmark.

The following is a litany of acquisitions where either the value of the acquiree's economic goodwill proved to be worth far less than the acquirer assumed at the time of the acquisition and/or the "currency" (stock) of the acquirer was so absurdly overpriced that when rationality returned goodwill dissipated like so much hot air. See for yourself.

Nortel Networks' giant $12 billion goodwill write-off, which was announced recently as part of its $19 billion second-quarter loss, could be followed by similar actions from other corporations that have copious goodwill on their balance sheets and weak stock prices.

Other candidates include JDS Uniphase, Worldcom, Cisco Systems, Lucent Technologies, Aetna, AOL Time Warner, among a plethora of others. Goodwill write-offs are apt to become more frequent because many companies, especially in the tech sector, now have stock prices far exceeded by their goodwill-laden book values. There is no causal connection between the market value of a company that is well below the carrying value of purchased goodwill and eventual write-downs of that goodwill. However, when such disparities exist one should not be surprised if a write-down soon follows. As noted in the glossary above, goodwill is generated from mergers when companies buy other firms at prices that exceed the acquired firms' assets. Enormous amounts of goodwill have been created in tech acquisitions because most technology concerns lack substantial, tangible asset bases.

JDS Uniphase, an acquisition vehicle in the optical components industry, has plunged in value as its revenues and profits have collapsed. It trades for $8.53, down from a peak of $143.69 in 2000, shrinking its market value to $11.3 billion. The company has a stated book value of nearly $50 a share, but nearly all of

[3] Eugene Fama and Kenneth French declared that "*Beta* is dead" in the spring of 1992 in a paper titled "The Cross Section of Expected Stock Returns," which appeared in the *Journal of Finance*.

that is goodwill (an enormous $58 billion stemming from its purchase of SDL last year, of which it is seeking to write off $40 billion as impaired).

Worldcom had $46 billion of goodwill on its books on March 31 while Cisco and Lucent Technologies have about $5 billion each. Worldcom's goodwill exceeds its current market value of $42.3 billion. Its shares, at $14.35, once commanding a price of $64.50, trade below stated book value of $18.73 a share. Aetna also could be vulnerable to a write-down because its goodwill of $7.6 billion, largely stemming from its purchase of U.S. Healthcare, is more than double its market value of $4.73 billion. Aetna, at $32.86, down from a high of $42.69, trades at less than half its stated book value of $70 a share. The company's tangible book value, excluding goodwill, is around $17 a share.

"I'm getting a lot of question on the goodwill issue," Lehman Brothers tax expert Robert Willens said. "People want to know whether write-offs will matter for the stocks." Willens added that he doubts that even big write-downs will have an impact unless companies violate net-worth tests of loan agreements. Indeed, stocks might rally if investors figure the worst is over.

Willens' declaration, like that of the "Death of Equities" that graced the cover of *Time* magazine in the early '80s just as the greatest bull market in the 20th century dawned, is likely to be equally ill-timed. Because the information industry is now an infrastructure staple, for which we are most pleased, hard-asset book value will never be what it once was. Accordingly, investors are likely to be increasingly leery about placing full stock in acquisitions that result in the creation of immoderate tallies of goodwill.

Since the displacement of Fama's grand discovery of price-to-book ratios as a valuation metric, stock-price volatility is sure to be more pronounced. Out of necessity, attention must focus on earnings as a residual that, as the recent past makes clear, are the most unpredictable of corporate profitability measures. While the ride will be a little bumpier, the opportunities will be correspondingly greater for those who find roller-coasters thrilling rather than terrifying. We loathe the chicanery that has become the new standard of conduct but, thanks to some perverse logic, margin-of-safety-driven investors, such as those of us at Martin Capital, welcome the mercurial market price ups and downs that are its first cousin.

Pouring fuel on the fire, a new rule enacted this year by the Financial Accounting Standards Board drastically alters the way companies account for purchased goodwill. The result of the rule change will be a big boost in earnings for many acquisition-minded companies for years to come. We have always been intrigued with the notion that, by destroying the value of assets, earnings can be artificially enhanced. In the old economy, assets (in their many forms) were the source of earnings.

To illustrate the impact of the rule change, AOL Time Warner says it expects to boost its profit by as much as $6.8 billion next year, which would double the bottom line that analysts had forecast. Bank of America anticipates adding $600 million. Wells Fargo envisions reaping another $560 million. These companies must be awfully astute — or brave — to forecast such growth while weathering a slowing economy, right? Guess again. They merely are estimating what a change in the accounting rules will mean.

What exactly is changing? Under current accounting rules, goodwill must be written down every quarter over periods as long as 40 years. Under the new rule, which for most companies took effect January 1, companies won't be allowed to amortize goodwill until it becomes impaired (see Enron in Chapter IV). In other words, a company won't be able to take the write-off until it decides that an acquisition no longer is worth the purchase price.

While the rule change will help some companies engineer huge jumps in earnings, we believe that such expectations are largely imputed in current stock prices. We have long adjusted for how the amortization of goodwill affects earnings, and the new rule isn't likely to change that.

As noted above, we agree but shudder at the thought of what the new rule implies. If a company is somehow not held accountable for paying outlandishly lavish prices to acquire a prized jewel (beauty, of course, is in the eye of the beholder), acquisitive managers may give away shareholder wealth in the pursuit of an artificial stimulus to earnings.

To our way of thinking, the FASB changes may be a good thing. It seems to us that the underlying issue relates more to paying way too much, rather than the methods companies employ to account for them. Paying an inflated price for a business, whether for tangible or intangible assets, delivers equally bad results for shareholders. We are of the belief that the market "sees through" goodwill amortization now. It was no surprise to the market that these giant write-offs occurred. The stocks crumbled long before the write-offs were announced. We would argue that companies are held accountable in the form of lower ROIC (return on invested capital), which is the mother's milk of long-term earnings growth. FASB has finally decided to allow companies to do with goodwill what we have always done, which is add the amoritization charge back to reported earnings.

Even if investors are confused by the accounting change, it's necessary. If earnings rise as a result of the rule change, but share prices don't, the result will be lower price-to-earnings ratios. Low P/E ratios could make stocks look cheaper, even if there hasn't been any change in the company's profit potential. Moreover, the ongoing corporate accounting gamesmanship further mars the already suspect image of reported earnings.

Recent filings with the SEC demonstrate just how much of a profit bonanza the accounting-rule change could be. For example, because Bank of America won't have to amortize the more than $12 billion of goodwill it carries on its balance sheet, it expects earnings to increase by about $600 million, or 37 cents a share, by next year, presuming that none of its goodwill becomes impaired. That would add 7% to the $5.44 a share that analysts estimate the Charlotte, North Carolina, bank will earn in fiscal 2002, according to Thomson Financial/First Call. A Bank of America spokeswoman says the company disclosed its estimate because many other big banks, such as Wells Fargo of San Francisco and Cleveland's KeyCorp, also are doing it. I remember using that excuse when I was a kid.

The windfall could be even greater for AOL Time Warner. The New York media giant, which has had losses of more than $2 billion in 2001 due in part to the burden of amortizing $127 billion of goodwill, said in an SEC filing in December that it expects to generate as much as $6.8 billion in additional profit next year because of the accounting change. As noted above, that would double the amount of profit that analysts have predicted.

Managed Earnings

To reiterate a point made previously, earnings are a residual. That is, they are whatever is left over after all expenses are deducted from revenues. In the case of companies in certain industries — some capital-intensive, others skilled-people-intensive — a large portion of their expenses are fixed, at least in the short run. Thus, a relatively modest swoon in revenues can easily result in a disproportionately dramatic decline in earnings. This phenomenon is known as "operating leverage," a concept hardly unfamiliar to corporate managers. Through deft accounting, for lack of a more appropriate word, they do their creative best to smooth out the bumps in the earnings road. And creative they are …

But there is something going on that is far more nefarious. Beyond a comparatively innocuous "smoothing out the bumps," many companies are engaging in practices with an effect similar to the enhancements sometime sought by members of the fair sex who seek artificial "redress" for the problem of a loose-fitting sweater. Granted, the analogy is contrived, but I'm sure you get the point!

The Wondrous Uplift from 'Pro Forma' Earnings

There is a huge disparity between two sets of published earnings figures that result in extraordinary differences in how the market's P/E is calculated. Increasingly, companies are steering investors away from their actual earnings and toward some other numbers. Most common is "operating earnings." Another name for it is "pro forma" or "as if" earnings. Some companies speak instead of their "economic earnings" or "core earnings" or "ongoing earnings." Such earnings figures typically are higher than net income, because the companies label certain expenses as "special" or "one time" or "exceptional" or "non-cash" — and leave them out of the calculation.

There are, however, no official guidelines for what goes into operating or core or pro-forma earnings and what can be left out. Operating earnings and the other terms aren't concepts under GAAP. Nor is there any standard definition for what companies call special or one-time items. The items they cite rarely meet the strict accounting test for "extraordinary items." As such, it's more important than ever for investors to understand the details of a company's accounting, particularly in the context of the company's activities and overall trends of the business. While many analysts tend to lump all "charges" into one category, the source or type of charge is manifestly important. For example, it matters whether the charge comes from a write-down of inventory or receivables — or stems from future plant closings and severance pay or a write-off of goodwill. We will treat each circumstance and each company differently. Those firms that make the phrase "non-recurring charge" an oxymoron are toast!

Pro-forma earnings are the infraction *du jur.* This practice didn't get out of hand, though, until the start of the Internet boom, namely with Amazon and Yahoo. Three years ago, for instance, Amazon.com, Inc.'s sales were growing at breathtaking rates, but its net losses remained a red flag for some investors. In the second quarter of 1998, Amazon began using new pro-forma profitability standards for itself. It was in the red even by those forgiving measures, but the shift made Amazon shares, then trading at 21 times trailing revenue, seem more palatable to investors. Amazon, which had been buying other companies with its high-priced stock, explained that its quarterly expenses to write down acquired intangible assets — so-called goodwill — were so large that they created too much accounting noise for investors to follow. Where there is a reprehensible end of sufficient import, there will always be a means, however contrived, to see to it happening.

According to *The Wall Street Journal,* at First Call, a unit of Toronto-based Thomson Corp., research director Chuck Hill said he first noticed the pro-forma trend when Yahoo, Inc., began highlighting its own pro forma measures in its financial news release for the fourth quarter of 1998. After that, he says, the floodgates opened. "Once some of these companies realized that people were accepting that, they said, 'Let's push the envelope a little further,'" said Hill. "It just became an easy way to slide stuff under the rug."

Soon hundreds of tech companies were excluding other types of regular expenses, such as stock-based compensation and even some payroll taxes, which must be included in net income under GAAP. Many old-economy companies saw analysts embrace the pro-forma numbers and began expanding the boundaries of "special" and "one time" charges. Today the practices can be found in companies in nearly every industry (e.g., Honeywell, Staples, and Corning's earnings reports).

According to First Call, Honeywell International, Inc.'s operating earnings were $2.52 a share during its most recent four quarters, for a "trailing" P/E ratio of 15. That excludes a bevy of charges, such as losses on various customer contracts and expenses from its aborted merger with GE. Honeywell's net income actually was 77 cents a share, producing a far higher P/E of 49. Office-supplies retailer Staples, Inc.'s P/E is 27 based on operating earnings, but 132 based on its net income, which has been dragged down by write-downs of Internet investments. Corning, Inc., trades for 11 times operating earnings. But factor in the fiber company's $4.8 billion worth of charges last quarter to write off overvalued intangible assets, and Corning has no P/E at all because it has no earnings.

In all of these cases, the more eye-pleasing profit and P/E numbers became the most widely cited ones as the companies trumpeted them in their news releases and conference calls, while downplaying their actual results. Many securities analysts, who often are reluctant to pick fights with the companies they cover (see "Chinese Wall" in Chapter IV), simply pass on the same spin to investors. And it's up to investors to evaluate for themselves the earnings and the resulting price/earnings ratios. This we do, though our skepticism borders on cynicism.

P/E Problems

According to a recent *Wall Street Journal* article, "Few investors know it, but the U.S. stock market today is, by one way of looking at it, the most expensive it has ever been. How could that be, after the numbing slide since the market peaked in early 2000? It turns out that for all the pain, the stock market now is far out of whack with historical norms by one common measure, the price-to-earnings ratio." Keep in mind, as noted above, the price-to-book value metric was neutered when the fudge factor, goodwill, lost all meaning.

While not suggesting the market is cheap, we don't think a standardized accounting convention or rulebook can possibly do the job of an analyst, which is to make judgments regarding normalized earnings power, often on an annualized basis. Warren Buffett has addressed the issue of assessing a single year's worth of earnings. He writes: "We continue to feel that the ratio of operating earnings (before realized gains/losses) to shareholders' equity (with securities valued at cost) is the most appropriate way to measure any single year's operating performance ... [I]t is just [that] their (gains/losses) impact is often extremely capricious in the short run, a characteristic that makes them inappropriate as an indicator of a single year's managerial performance." He goes on to point out that you nonetheless must take them into account over the long run. Thus, whether one is looking at 2001 "earnings" of the S&P 500 or Computer Sciences Corp., analysts should properly take into account what is unusual or not representative of core earnings power in their understanding of this year's earnings number. What do you think is more representative of Staples' earnings power, the figure used to arrive at 132 times earnings — or the 27 times earnings, as noted above.

Neither pro-forma earnings nor unvarnished GAAP earnings would give us a sense of the true earnings power for many companies and the market in general for calendar year 2001, so we wouldn't infer too much from the S&P's P/E based on 2001 GAAP earnings. But for a different opinion, read on.

The P/E ratio measures how companies' share prices compare with their profits, showing how much value the market places on each dollar of a company's earnings. The lower the P/E relative to its historical range (and assuming neither the company's fortunes nor interest rates have changed materially), the cheaper the stock. Though this guide to value has lots of exceptions, it remains a venerable market benchmark.

The Standard & Poor's 500-stock index of large companies, according to Thomson Financial/First Call, finished the year with an overall P/E ratio of 24. While that is well above the long-term historical average of 14.5, it strikes some pros as reasonable in view of such factors as low interest rates and chances for a profit comeback.

But there's a catch. In recent years P/E ratios have become increasingly polluted. The "E" in P/E used to refer simply to earnings as reported under generally accepted accounting practices — or GAAP. That's what it means when the historical average is cited. But in First Call's figure, the "E" relates to something fuzzier, something called "operating earnings." And that can mean just about whatever a company wants it to mean. Based on earnings as reported under GAAP, the S&P 500 actually finished late in December with a P/E ratio of 36.7, according to a *Wall Street Journal* analysis. That is higher than any other P/E previously recorded for the index. This suggests that the overall stock market could be farther from recovery than many suppose. "I don't think most people realize that the market is as overvalued as it is," said David Blitzer, chief investment strategist at S&P, a unit of McGraw-Hill Companies. "There probably are a lot of people who would sell some stock if they realized how overvalued the numbers are saying the market is."

So Many Puppets on a String

Typically, Wall Street analysts go along with the numbers trotted out by the companies they cover. From there, the rosier numbers tend to get repeated throughout the financial-news media — from cable TV to newsletters to Websites.

More than 300 companies in the S&P 500 now exclude some ordinary expenses, as defined by GAAP, from the operating-earnings numbers they feed to investors and analysts, a *Wall Street Journal* analysis shows. In fact, for every dollar of operating earnings that S&P 500 companies reported for their most recent three-month period, 60 cents wouldn't be there if they hadn't excluded costs that are ordinary business expenses under GAAP, according to *The Journal's* comparison of First Call data with corporate SEC filings and news releases. The resulting confusion can skew perceptions of value for even relatively sophisticated investors. Novices often are left bewildered.

Once companies' earnings numbers are crunched by analysts, they enter a vast information food chain, where they are repeated, often without explanation, in hundreds of news outlets, including wire services, newspapers, investment newsletters, cable news channels, and financial Websites. Using a fax service that's free to journalists (but operated by a third-party contractor), First Call distributes lengthy summaries of companies' historical and projected results, not all of which explain the basis for analysts' calculations.

Responding to the increasing use of so-called pro-forma earnings, the nation's accounting rulemakers said they will consider launching a new project that explores ways to better standardize companies' financial statements. The FASB, however, most likely will do nothing to regulate the practice of issuing pro-forma earnings reports in corporate news releases because the board has no jurisdiction over the content of such releases. Most of the controversy about pro-forma earnings measures centers on companies' publicity materials, not their official financial statements. "We have no authority or responsibility for press releases or information that's provided to analysts other than through the presentation of full financial statements," FASB Chairman Edmund Jenkins claimed recently. Specifically, the FASB said the effort would focus on the ways in which companies calculate and display various financial measures in their official financial statements. The board also said it would consider the need to create common definitions for some earnings data.

Take Computer Sciences Corp. The technology consulting company this year has announced a series of charges, covering costs ranging from severance payments to write-offs of software. They totaled $156 million, cutting Computer Sciences' net income for the past four quarters to $184.9 million … or $1.08 a share. But check the company's earnings in analysts' research reports and many financial databases, and things don't look nearly so bad. Computer Sciences steered Wall Street analysts to ignore the big expenses, which it dubbed "special items." Looked at in this more favorable way, the company over the past year had operating earnings of $340.9 million, or $2 a share. That would give the stock, which closed on December 24 at $ 46.99 a share, a P/E of about 34, making it seem a reasonable value. And if the special items are included in the earnings? The shares suddenly appear far pricier, with a P/E ratio of about 51.

Sometimes the results are nothing short of surreal. The aforementioned JDS Uniphase Corp. in September announced that for the fiscal year ended June 30, it had pro-forma earnings of $67.4 million. Yet the fiber-optic company actually had a stunning $50.6 billion full-year net loss. JDS' pro-forma earnings excluded 98% of the company's $52 billion of operating expenses. These were mainly write-offs of assets JDS bought for inflated prices during the tech bubble. In explaining its pro-forma results, JDS said the charges for those acquired assets "in no way impaired our financial health or strength" because it had bought them with stock instead of cash. Sadly, this is no joke …

Wall Street analysts almost without exception went along with the company line. The JDS effect is so large that if the company were excluded from the index, the S&P 500's P/E ratio based on GAAP earnings would be more than 5 points lower, at 31.2, *The Journal's* analysis shows.

"A lot of companies take their numbers and present them in the best light possible," notes Don Bunnell of West Chester, Ohio, a retired General Electric Co. manager and an active investor. "Most of the analysts can see through this. But most of us lay people can't." The operating-earnings focus has grown so widespread that some market pros fret that Wall Street analysts' earnings measures have lost much of their meaning. "The only thing the consensus agrees on is arbitrary accounting methodologies," says Tom Galvin, chief investment officer at Credit Suisse First Boston.

Companies that stress operating or pro-forma earnings say they aren't trying to mislead anyone — just trying to help people understand the ongoing nature of their business by breaking out items they consider unusual or unimportant. And while those items are usually expenses, companies occasionally also break out certain "one time" gains from their financial results. In addition, companies note that investors are free to look at whatever numbers they want and can ignore any non-traditional financial presentation they deem irrelevant.

Historically, pro-forma financial statements were used to allow for comparisons of financial results when some extraordinary event, such as a merger, had occurred between the reporting periods. By trying to analyze the performance of two merging companies as if they had been operating together for years, analysts sought to assess future earnings power. With the same goal, they would sometimes exclude expenses or gains they deemed to be non-recurring. Over the past decade or so, some industries began designing their own alternative profitability measures. Radio-station operators had "broadcast cash flow." Real-estate investment trusts had "funds from operations."

On Yahoo Finance, a free service that's the most heavily used financial Website, First Call's operating earnings statistics — including those for Yahoo itself — are displayed as actual results with no further explanation. A Yahoo spokesman said Yahoo Finance "is currently working to provide better labeling as to whether that information is pro forma or GAAP."

The problem, we contend, is that the clean numbers may be whitewashed versions of reality. That's because the excluded charges can signal that past profits were overstated. For instance, when companies take big charges to write off assets, this often means they weren't depreciating those assets quickly enough in previous years. And when companies write off bad loans they had made to customers to finance purchases, it can mean the previously recorded sales and profits generated by those loans existed on paper only.

Scant Consistency

"It's scary," said Douglas Carmichael, an accounting professor at Baruch College in New York. "Since there's no uniformity as to what goes into pro-forma earnings, there's no comparability. It's just an undisciplined number that's at the heart of the calculation." To critics such as Carmichael, analysts employed by Wall Street securities brokerage firms provide anything but an accurate reflection of the broader investment community, given their well-chronicled bullishness and frequently conflicting investment-banking interests. "You're getting a view through rose-colored glasses," he said.

First Call's Hill is a longtime critic of aggressive pro-forma accounting. But he explains that First Call's mission is to gather and publish consensus earnings targets whose accounting reflects the accepted view of the overall investment community. Whatever accounting method a majority of the analysts covering a stock want to use for their earnings estimates, First Call will use. "Certainly over time, I'd rather listen to the collective wisdom of these analysts than I would some anointed earnings pope," said Hill. Besides, "they're the only ones that'll give them to us."

At the Financial Accounting Standards Board, which sets GAAP, Chairman Jenkins said he would like to see First Call collect GAAP-based earnings estimates for all the companies it follows. According to Hill, that would be nice, but noted that he would be "shocked if you had any meaningful numbers of contributors." SEC officials also have warned investors not to get suckered by "earnings before bad stuff" news releases. But an SEC official admitted it has little if any authority to clamp down on pro-forma calculations in news releases, as long as they are mathematically accurate.

Please refer to the Chapter IV conclusion, which refers to the "Chinese Wall." It applies directly to this discussion as well.

FINAL THOUGHTS

On December 7, 1941, just over a year before I was born and two years after World War II first raged in Europe, President Franklin Roosevelt responded to the unprovoked attack on our naval base in Pearl Harbor by announcing to the world that it was a date that would "live in infamy." Nearly six decades later, on September 11, 2001, President George W. Bush uttered similar words in the wake of the out-of-the-blue strike by radical Islamic terrorists at the New York City symbol of capitalism and commerce, the World Trade Center, as well as the U.S. monument to military power, the Pentagon.

Tragedy is indigenous to the human condition, visited upon us in all manner of forms and with timing that is wholly unpredictable. Human beings can paint beauty or bestiality, and everything in between, on the canvas of life in the exercise of their God-given free will.

As 2001 opened on a clear, crisp day, none of us was aware of the uncertainties and stunning developments that lay ahead. In fact, even though the collapse of the Nasdaq Index was disquieting to some, the kind of angst that pervaded the public consciousness the year before as preparations were made for the possible Y2K fallout was absent. The collective mood was tranquil. There is an old Wall Street adage that says, "As January goes, so goes the year." In a world where change is a constant and where uncertainty is the only certainty, a generalized truth is not always a specific truth. So it has been in the 12 months just past.

In striking contrast to the chaotic world, once remote, that has unexpectedly enveloped us, relationships that bind people together as family, friends, and even nation seem to be able to endure trauma and even tragedy unfazed, if not, paradoxically, actually strengthened. The outpouring of patriotism "from sea to shining sea," as Americans watched heroism manifest itself in so many ways, brought us back to our roots and helped to restore the pride of a nation that is a beacon of hope to much of the world.

And so it is with us. Perhaps with more heartfelt conviction this year than any other in recent memory, I express my gratitude to those of you who are clients or friends of our firm. Your good cheer, your encouragement — the friendship often bordering on love that you have shown to all of us — is so uplifting and empowering to each of us at Martin Capital. Often I am asked why I don't take life easier, stopping more to smell the roses along the way. When I reflect on my day, as I do often, I appreciate that roses come in many different colors and fragrances. Clearly, one of my favorite roses can be seen in the faces of those with whom I work. Being surrounded by bright, creative, resourceful, optimistic, and energetic younger people has a wonderful palliative effect on my demeanor, to say nothing of my outlook.

Another source of inspiration is found in the expressions on the faces and nuances of body language of our clients who were, or who have become, friends — most of whom I have admired and respected for many years. You have invited me into your lives and into your thoughts. The bond of trust that has developed between us turns a business relationship into one that is intensely personal and emotionally rewarding.

So at the end of each day I give thanks for another one filled with roses … roses of all kinds. Since I have been blessed with the privilege of doing most anything I wish with my life, the fact that this is what I have chosen says all that really needs to be said. As I look forward to each sunrise, I lean heavily on "a-corny" aphorism: "Oak trees and great Bordeaux keep getting better until they die."

Frank K. Martin, CFA
Managing Partner

THE MARTIN CAPITAL MANAGEMENT TEAM

Frank K. Martin, CFA, Managing Partner

Frank has 34 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. He is founder and chairman of the board of DreamsWork, a mentoring and scholarship program for inner-city children. After publishing a biography of his father, William F. Martin, in 2000, he began preliminary work on a proposed book, *In Temporary Trust*.

Dennis D. Blyly, CFA, Partner

Dennis has 16 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, he was an investment officer for NBD Bancorp. Dennis graduated with honors from Grinnell College in Iowa with a major in economics and is 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.

Todd B. Martin, CFA, Partner

Todd has 13 years of investment industry experience. He has been with Martin Capital 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, Greencastle, Indiana. 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.

Andrew P. Wilson, CFA

Prior to joining Martin Capital in 1995, Drew was an employee benefits consultant with Watson Wyatt Worldwide. Specializing in qualified retirement plans, Drew had clients that included several FORTUNE 500 companies. He graduated *magna cum laude,* with membership in *Beta Gamma Sigma*, from Loyola University, Chicago, where he majored in finance. Drew earned the CFA designation in 1998. He is currently a member of the Indiana University at South Bend School of Business and Economics Advisory Board.

Joseph T. Iams, CPA

Joe, who joined Martin Capital in October 2001, had 18 years of experience as the Chief Financial Officer of Universal Bearings, Inc., a bearing manufacturer serving the automotive industry. Prior to joining UBI in 1983, he practiced public accounting for six years with McGladrey & Pullen in South Bend, Indiana, and earned the CPA designation in 1982. His undergraduate degree is from Xavier University, Cincinnati, Ohio, where he majored in accounting. Joe graduated *cum laude* from the MBA program at the University of Notre

Dame in 1997. He is a member of the American Institute of Certified Public Accountants and the Indiana CPA Society.

Ann T. Frantz, CPA

Ann began her career in public accounting with Crowe Chizek, Elkhart, in 1983. Prior to becoming Martin Capital's Operations Manager in August 1999, she was the Benefits Manager for Crown International, Inc., Elkhart. Ann graduated in 1982 from Indiana University at South Bend with a BS in business and earned the CPA designation in 1986. She is a member of the Indiana CPA Society.

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 the firm, she was employed by Northern Trust Bank, Chicago, as a senior representative in the investment managers liaison group.

Karen M. Sherer

Karen has more than 20 years of experience in the financial services industry. Before joining Martin Capital in June 2001, she was employed by Compass Financial Advisors as a Registered Representative. Karen also was employed for 16 years with Bank One where she held various positions. She worked in the Trust Department for 10 years; in 1996 she was promoted to Trust Administrator, then to Trust Officer in 1998. Karen earned her BS in organizational management from Goshen College in 1995.

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 2000 as an executive assistant. She graduated from Elkhart Memorial High School and has attended various seminars on office management. Stephanie came to the firm from the Elkhart-based Energy Management Systems.

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