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FOREWORD

Martin Capital Management, a limited liability partnership, is an investment advisor registered with the U.S. Securities and Exchange Commission. After years of preparation, its founder began formally dispensing his brand of investment counsel, which this and earlier missives have recorded, in the months before the memorable autumn of 1987. (All firm publications, as well as the SEC filings, including form ADV Part II, are available upon request.) Since then, Martin Capital has grown to serve 110 clients whose combined assets total approximately $588 million. From its beginnings as a one-man, one-assistant operation, with less than $25 million in assets, Martin Capital is now headquarters for 12 people, including six investment professionals and six 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 $5 million minimum family account size prevents us from helping some people whom we would 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, Analyst, and Portfolio Manager
Andrew P. Wilson, CFA, Partner, Director of Marketing, Analyst, and Portfolio Manager
Aaron J. Kindig, CFA, Analyst
Tom W. Dugan, Analyst
Ann T. Frantz, CPA, Operations Manager
Kristin A. Antalavits, Assistant Portfolio Manager and Trader
Karen M. Sherer, Client Service Representative
June L. Bails, Executive Assistant
Stephanie A. Malcom, Executive Assistant
Christine L. Broadbent, Executive Assistant

PRIVACY NOTICE

Martin Capital Management ("MCM"), LLP, recognizes and respects the privacy expectations of its clients. MCM considers clients' data to be private and confidential, and holds itself to the highest standards of trust and fiduciary duty in their safekeeping and use. MCM has not and will not sell personal information to anyone.

MCM collects non-public personal information about clients from the following sources:

- *Account Applications and other Forms,* which may include a client's name, address, telephone number, Social Security number, and information about a client's investment goals and risk tolerance;
- *A Client's Professional Advisors, such as consultants, attorneys, and accountants,* who may provide financial, investment history, and tax information about a client;
- *Account History,* including information about the transactions MCM has ordered and balances in various accounts; and
- *Correspondence* — written, electronic, or telephonic — between a client and MCM or a client's broker or custodian and MCM.

MCM will not release client account information to any third party unless one of the following conditions is met:

- MCM receives prior client consent;
- MCM believes the recipient to be the client or the client's authorized representative, including the client's attorney or accountant;
- The recipient is a broker, custodian, or other service provider with whom MCM must share information in order to manage or service a client's accounts properly; or
- MCM is permitted or required by law to release the information to the recipient.

MCM will only use information about a client and a client's account(s) to:

- Help MCM better serve the client's investment and financial needs;
- Suggest services or other materials that may be of interest to the client;
- Fulfill our regulatory obligations; and
- Administer MCM's business.

MCM maintains physical, electronic, and procedural safeguards that comply with federal standards to guard the privacy of clients' non-public personal information.

MCM applies the policies and practices described in this notice to both current and former clients.

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

> What is it that characterises the thinker? First of all, and obviously, vision … The thinker is pre-eminently a man who sees where others do not. The novelty of what he says, its character as a sort of revelation, the charm that attaches to it, all come from the fact that he sees. He seems to be head and shoulders above the crowd, or to be walking on the ridge-way while others trudge at the bottom. Independence is the word which describes the moral aspect of this capacity for vision. Nothing is more striking than the absence of intellectual independence in most human beings: they conform in opinion, as they do in manners, and are perfectly content with repeating formulas. While they do so, the thinker calmly looks around, giving full play to his mental freedom. He may agree with the *consensus* known as public opinion, but it will not be because it is a universal opinion. Even the sacrosanct thing called plain common-sense is not enough to intimidate him into conformity. What could seem nearer to insanity, in the sixteenth century, than the denial of the fact — for it was a fact — that the sun revolves around the earth? Galileo did not mind: his intellectual bravery should be even more surprising to us than his physical courage. … Einstein's denial of the principle that two parallels can never meet is another stupendous proof of intellectual independence.

By the time you reach this sentence you may well have surmised that the above quotation is neither original nor autobiographical! Rather, it is the keynote statement of this annual message, prescribing the rigorous perceptual framework from which to view the past and present for what it may portend for the future. At every branch on the decision tree, doctrinaire logic will be challenged with facts and practical wisdom. The quotation above was extracted from *The Art of Thinking*, by Ernest Dimnet, the last of many printings distributed, paradoxically or perhaps prophetically, in 1929. A used copy — it has long been out of print — was procured through Amazon.com, its tattered cover and musty smell conjuring up an image of an amended title more appropriate to commemorating that year: with the noun "Art" preceded by the adjective "Lost." Who would've guessed that the book should've been a best-seller 70 years later? It's obvious the publishers weren't thinking either. British philosopher Bertrand Russell summed up the nature of humankind rather well: "Most men would rather die than think. Many do."

And while on the subject of thinking, another feature of this annual labor of love is the intention to make every effort to present facts as the primary raw material for thought. Accordingly, now that nearly four years have come and gone since the speculative fabric began to unravel and the famous millennium Bubble started to split at the seams, a number of scholarly books have been written on the subject, several of which I have voraciously consumed. Repeated reference will be made to several of them for the factual backdrop they'll provide in assisting the writer's attempt to "see where others do not see." It is hoped the reader will conclude that the outcome reflects a sincere preference for truth over opinion.

Referring to words from my own pen in the 2001 annual report on the subject of attribution, I again remind the reader that "[c]onsidering the limited audience for which this report is intended, the abbreviated production window, and [the fact that] most readers already are familiar with my ideas and writings, my words and those of others are freely mixed, sometimes without formal acknowledgment. … 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."

Gilbert Chesterton, biographer for Dickens, argued that the French Revolution was predicated on a false notion of "new ideas": "It was not the introduction of a new idea; there are no new ideas. Or if there are new ideas, they would not cause the least irritation if they were introduced into political society; because the world having never got used to them there would be no mass of men ready to fight for them at a moment's notice." While Chesterton died before the great information revolution, I think he was right in one sense. We seem to be slower to embrace new ideas in science — who was not skeptical of the round-earth proposition that Columbus set out to prove? — than reworked variations on old ideas in finance, which we often embrace with reckless abandon. In fact, it is this story of the repetitious reincarnation of financial fancy that is both the essence of this report and the nub of opportunity for those who comprehend it … and the bane of those who do not.

The text of the report begins with the facts of our Investment Performance dating back 11 years. The data will be followed by a suggestion on how performance records should be examined in view of our investment philosophy: differentiated from the majority by the fact that we are an independent, self-owned partnership, enabling us to be free and uncompromised thinkers. Most others follow the standard protocol: They measure their performance against an index, are broadly diversified, and see risk as a constant and markets as efficient. We, by contrast, seek to earn a solid, average absolute return by rational means, avoiding the mythological Sirens' call to follow the relative-return crowd. Diversification is only practiced to the point of containing within reasonable bounds the effects of an outsized random risk. Believing that risk and return are inversely correlated and that the markets can be both efficient and irrational (that will take a bit more explaining later), we insist on a purchase price that offers a compelling margin of safety to minimize the effects of bad judgments and maximize the results of good ones. In the high-volume, wildly popular financial markets of today (tomorrow is always another story), finding equities that are priced far below intrinsic worth — and thus offer the comfort of a generous margin of safety — is extremely difficult.

As for the essays, we have researched financial and economic history in an effort to corroborate or negate the central thesis of Maggie Mahar's recent best-seller, *Bull! A History of the Boom, 1982-1999: What Drove the Breakneck Market — and What Every Investor Needs to Know About Financial Cycles*. Is there, we will inquire, any discernible symmetry to the longer-term ebbs and flows of the capital markets? Are there, as Mahar unequivocally states, "financial cycles"? Next, if we conclude they exist, is it possible to draw real-time and practical approximations about when the metaphorical tide is nearer its high or low point?

Adding to the arsenal of knowledge, understanding, and wisdom hierarchy, we attempt to demystify S&P 500 earnings, in part to counter the often malicious effort that was and is being made to obscure the truth, which, by the nature of the beast, only comes in shades of gray. More to the point, there is pronounced, and equally adamant, polarity about whether the S&P Index is cheap or dear. By seeking to truly understand the strengths, weaknesses, and assumptions that morph into the denominator of the price-to-earnings ratio (P/E), we are likely to synthesize the data and knowledge — with more informed judgments the hoped-for result.

We will develop further an essay from last year, using data on the behavior of the so-called "retail investor" to corroborate other findings above.

Finally, we turn to the question that is highly relevant to us: Is this report's top-down perspective at all relevant to a bottoms-up firm that is known more for picking stocks than for opining on the state or condition of markets? Are we, in reality, on a mission impossible, trying to get our arms around a macro environment so gestalt-like in its complexity that its properties cannot even be known through a summation of its parts? Must we forever be financial agnostics, seekers hopelessly encumbered by the "unknowability" of what we seek?

Paying tribute, with profound personal pleasure, to our treasure trove of "intellectual capital" and to those who constitute our *raison d'etre* brings the report to a close.

As an editorial aside, readers sometimes inquire about how much effort goes into these annual missives. Typically, I have responded that the writing is done in the early-morning hours and the weekends of December. This year, however, I must confess to laboring much harder and longer. Not only that, but I was aided and abetted as well by associates Aaron Kindig and Tom Dugan, whose research assistance and constructive debates were invaluable. The depth and breadth of this year's subject matter was such that no amount of research could do it justice. Having read at least 2,000 pages of text in preparation, I made the researcher's common discovery that the deeper I dug, the deeper yet was the hole. Moreover, the farther I plumbed the depths, the smaller the hole appeared through which I had descended. In those depths I discovered (to my dismay) the heart of synergism — namely, that the *hole* is greater than the sum of its parts. I might also note that the essence of Martin Luther's admonition was taken seriously — although, regrettably for the long-suffering, in the end not *too* seriously(!): "The fewer the words, the better the prayer."

Frequent references are made to annual reports of prior years. On the outside chance that original hard copies may not be at your fingertips☺, please avail yourself of the Library on our Website, www.mcmadvisors.com, and download them as Adobe files.

INVESTMENT PERFORMANCE

Period Ending December 31, 2004	MCM Equities*	S&P 500*
Ten Years	17.1%	12.1%
Five Years	14.0%	-2.3%
Three Years	6.6%	3.6%
One Year	4.7%	10.9%

* Compounded annually, MCM data net of fees

Year	MCM Equities*	S&P 500
1994	-7.5%	1.3%
1995	19.1%	37.6%
1996	31.8%	23.0%
1997	45.1%	33.4%
1998	-7.4%	28.6%
1999	18.8%	21.0%
2000	29.3%	-9.1%
2001	22.7%	-11.9%
2002	-13.6%	-22.1%
2003	33.9%	28.7%
2004	4.7%	10.9%

* Net of fees

In 2003 the prices of our equity securities outperformed the underlying businesses by some margin. For the year ending December 31, 2004, the opposite was true. Aggregate weighted-average reported earnings per share of our portfolio holdings increased by an estimated 22%. Be careful, as that reported number overstates the true economic value added. Using "normalized" earnings (the more consistent measure), the weighted-average growth rate approximated 12-14%, with the difference between the two numbers indicating that some of the growth in reported earnings for several companies was from depressed levels the prior year.

Barring an economic contraction,[1] the weighted-average, anticipated earnings-per-share growth rate for our current portfolio companies for the next five years is expected to be in the range of 12-13%. Once again, we offer a caveat — although this one will have a favorable bias. As of this writing, we are in the process of selling all or part of three of our holdings that have appreciated to prices that no longer provide an adequate margin of safety. We estimate that the weighted-average earnings growth rate of those companies will be less than the ones that remain in the portfolio. Accordingly, the continuing portfolio's estimated earnings growth rate should modestly increase.

The year 2004 was the first since 1999 that our equity returns, while positive, did not match the benchmark S&P 500. We bring this shortfall to your attention — assuming you didn't make note of it in the table above — to re-emphasize the importance of focusing on our primary investment strategy: purchasing superior businesses at prices that assure us of a generous margin of safety. Such a strategy is likely to lead to above-average results over time, but certainly not each and every year.

Another issue, and a key element of this report, is the valuation of businesses in the main. As noted in the section "Fully Deluded Earnings," the S&P 500 closed the year at about 20 times trailing (2004 estimated earnings), well above the historical *average* 15-16 times and about 23 times S&P's newly devised "core" earnings. Just as price-earnings ratios are currently above the historical average, at other times they have been far below. Factors that influence the level of price-earnings ratios include returns on competing investments — specifically bond yields — as well as the extent to which earnings are above or below the aforementioned "normalized" levels (somewhat analogous to the long-term earnings trendline) and the prevailing investors' mood of enthusiasm or disenchantment with equity securities in general.

Although the following notion is both vague and utterly imprecise as to its timing, we feel the opportunity set of "tomorrow" — ideally, although with no certainty, sometime within the next two or three or so years — may be more propitious for long-term investment in general than it is today. This might even be termed the central thesis of this report. However, we have no idea whether it will be "marginally propitious," casting doubts on why we would forgo today's relatively marginal opportunities for tomorrow's, which may not be much better — or whether it will appear as "magnificently auspicious." It has not escaped our attention that you hired us to attend to such matters! Unlike flowers, opportunities to invest in great businesses at prices that imply a generous margin of safety (i.e., high expected returns and low risks), don't always come in bunches. When we see "magnificently auspicious" investment flowers, we will pluck them one by one, in hopes of eventually presenting you with a beautiful bouquet! If investment flowers should bloom *en masse,* we will be busily plucking with both hands. Either way, we expect to reach the desired goal.

FINANCIAL CYCLES OR RANDOM EVENTS?

A Rhythmic Pattern to Mind and Matter?

In the financial markets are there such identifiable phenomena as boom-bust-boom-bust cycles, or is history little more than a series of random events that we try to put into neat and tidy boxes, stereotyping and compartmentalizing them for our own deluded convenience? Turning to a metaphor from physics, is a child on a swing at the park, once in motion, similar to the seemingly cyclical nature of markets? Is the invisible "magnetism" of gravity comparable in effect to the tendency of financial markets to regress to the mean, though in the latter case the relationship between cause and effect is imprecise in the extreme? If we assert that the interaction of exaggerated supply-*or*-demand forces occasionally and, sometimes for protracted periods, causes the price of virtually anything to depart from its mean (or, more subjectively, intrinsic worth),

[1] We continue to benefit from the longest relatively uninterrupted peacetime expansion of the past 100 years and, according to most economists, no ominous storm clouds loom on the horizon. As a result, a potentially dangerous hubris is in evidence as most commentators and prognosticators seem to suggest that the long-standing trend will continue indefinitely. While we are in no position to forecast the future of the U.S. economy, we think it foolish to deny the existence of business cycles as though they are antediluvian, a relic from the past. Unfortunately, we can be no more precise than to suggest that they are not antiquated — and that such cycles still have relevance in the 21st century.

is the opposing inclination for price to ultimately regress toward its underlying value equally valid? In the process, can it be presumed that the emotional impetus behind the pricing imbalance often fades (feelings being much more fickle than facts) in favor of rationality? Is it time and dispassionate thinking that overcome and ultimately reverse the prevailing mass sentiment that has been set in motion, pulling it back toward its position at rest, that theoretical state of psychological balance? In the process of returning to normalcy, does the reversal of sentiment accelerate such that its velocity and mass, analogous to the properties of a physical object — called momentum, which refers to both the physical and emotional realms — carry it to the other extreme of its arc? Is there a reason why the pusher of the swing always lingers well back from the center of the arc (the worn area in the grass that we who are mathematically inclined call the mean), never rushing forward but rather patiently allowing the swing to come to him? Does experience not tell him painfully that in one's enthusiasm to impetuously advance to where the swing normally resides at rest is to risk getting knocked down? And thus does it go, cycle after cycle? If you agree that the action of the swing on which the gleeful child sits is comparable to the waxing and waning flow of investor sentiment at a margin, is it also reasonable to assume that the harder you push the child — analogously, the more extreme the prevailing sentiment — the greater is the arc of the swing of sentimentality?

How many long paragraphs do you recall reading where each sentence ends with a question mark?!

If, as you read on, you find yourself open to using this simple and observable metaphor from physics as a perceptual framework, the discussion of the subject for which this section is titled will be all the easier.

The Reluctant One Steps into the Batter's Box

Switching from the park place to the marketplace (I'm thinking Monopoly, you may be thinking … monotony?), Warren Buffett, the epitome of "to win, you first must not lose" rationality, overcame his celebrated reluctance to opine on the stock market and stepped uncharacteristically out of his bottoms-up enclave into the often ruthless public spotlight in 1999, giving his own brand of carefully crafted commentary to the concept of financial cycles. As the capitalist's icon of probity, Buffett may have worried that by not putting forth his feet-firmly-planted-on-the-ground cry for reason he might be giving tacit approval to the madness that had become the new reality. Not unexpectedly, his appeal to rational thought, a veritable straw in the wind, blew by unnoticed. Applying the reasoning of Bertrand Russell, one of the most important logicians of the 20th century, Buffett's appeal was destined not to move the sentiment needle a tick, for the audience was and is infinitesimally small: "It has been said that man is a rational animal. All my life I have been searching for evidence which could support this." A careful rereading of pages 15 through 20 in the Martin Capital Management 1999 annual report is recommended. Those pages include "Warren Buffett on the Stock Market" and "What Buffett Isn't Telling Us." Ample evidence will be found of Buffett's capacity to not only retrospectively, but also concurrently, identify "secular" (in this context meaning "occurring once in an age") trends amid all the distractions of shorter-term, so-called cyclical fluctuations. (It may be helpful to imagine the comparable and equally confusing motion of the sea: The inexorable, and admittedly incremental, ebbing/flowing of the tide is often unnoticed by the bleary-eyed fisherman, transfixed instead by the relentlessness of the crashing waves and foaming surf. Behaviorists have a fancy phrase for this phenomenon: the "availability bias.")

In 1999 Buffett flashed back 34 years to overlay a sort of biblical symmetry onto the past to highlight the sequential appearance of lean years and fat years. For the first half, from the end of 1964 through 1981, the market's return was indeed lean. The Dow Jones Industrial Average ended the 17 years within 5 points of where it began. The next 17 years, ending in 1999, were the antithesis of the first, as fat as their predecessors were lean, the Dow skyrocketing from 875 to 9,181, a tenfold increase. Buffett's analysis in our 1999 report of the "why" is an essential segue into what follows.

As you will read … Relying on a coldly rational look at history through the eyes of an investor whose unequaled record is visible to all, Buffett concluded that stocks, for the first 10 or 15 years of the new millennium, on average, would likely provide anemic returns compared with the stellar but terminally unsustainable record of 18.4% compounded annually for the prior 17 years (or even the long-run average return for the S&P 500 of 10.4% dating back to 1926). Quantifying his conclusions, he found it difficult to justify stocks returning more than 6% before inflation, 4% after, including dividends. All he knew was that speculation was rampant, and stocks were therefore dangerously overpriced relative to the underlying economy from which they sometimes become detached. Armed with that knowledge and his belief in the irrefutable tendency of price and value to converge over time, Buffett needed nothing more to conclude that if one expected a bountiful harvest some years hence, 1999 was not a propitious year for sowing — unless one was in the market for wild oats. His remarkable record of compounding wealth at more than 20% for nearly 50 years (the second-wealthiest man in the world was not an overnight success, nor did he get there by riding a one-trick pony!) would suggest that he must work his money pretty hard. Right? Wrong. Nothing could be farther from the truth. Buffett is a man who is in touch with what's important by staying *out* of touch with the insignificant, and often distracting, noise that's so endemic to the information revolution. He owns a computer — but largely so he can play Internet bridge with his friends. As for a Palm Pilot, that would be like asking him to trade in his heavy, plastic-framed eyeglasses for a pair of lightweight contemporary specs or, heaven forbid, contact lenses or laser surgery! Might eyewear from antiquity be in some sense symbolic for this nonconformist? "If principles can become dated," he says, "they're not principles." Using his now-legendary baseball metaphor, he insists that no matter how long it takes he will wait for perfect pitches to cross the plate at his "sweet spot." Buffett's investment style is as boringly predictable as it is productive. For baseball fans, there's more to come.

Maybe the Markets Are Not Random?

Is it coincidental that Buffett has identified two sequential bust-boom secular cycles of similar length? More important to the present case, he uses oblique language that provokes thought but lets the reader's level of understanding determine how deep to dig. It doesn't, in my judgment, require much of a leap to conclude that in 1999 Buffett foresaw, at least in a comparative sense, another secular bust. Please reread "What Buffett Isn't Telling Us" in the 1999 annual report. While he carefully avoided any forecast, I doubt that the collapse in the Nasdaq index from 5000 to almost 1000 came as any great surprise to him. Although "one swallow does not a spring make," three might give a person pause. Neither Buffett, I am quite sure, nor I would be implying that 2016 — or any other date — will mark the start of the next secular upswing. History is not so neat and tidy. Parenthetically, as wealth is misallocated and thus often squandered — while simultaneously being redistributed from strong (and sometimes dishonorable) hands to weak ones during these apparent sweeping cycles — it's not a stretch to argue that such cycles are as natural as the seasons. To be sure, the economy would be much more efficient over time if it could be cycle-free, but such an outcome is inconsistent with the nature of humanity … or perhaps the nature of nature. Excess capacity and low prices are the very conditions indigenous to the bust that makes the season ripe for sowing. The wise crocus sticks its neck out before the last snow. It instinctively knows the seasons. On the other hand, booms result in reckless spending and high prices, begging those who have sown wisely to harvest while fools plant. Neither booms nor busts are inherently bad if viewed in the larger cyclical context; the same could be said for rainy or sunny days. The trick is understanding the order of the seasons.

Buffett: One 'HelluvAnomaly'

Before "slanging" (yes, it rhymes with the appropriate word "hanging") — with a title like the one above, surely I can turn a noun into a verb — on Buffett's philosophical coattails much farther, it's time for my annual disclaimer. Trusting that those who know me well don't consider me a shameless sycophant (is there a reason why I would, or even could, curry Buffett's favor?), might it be argued that my apparently slavish devotion to Warren's World is nothing more than blind imitation, showing no originality? I'll not attempt to answer my own question — or the question others may have on their minds that they have yet to articulate to me. I'll present the evidence and let you be the jury. I'm comfortable and trust you are too.

To be sure, opinions on Buffett run the gamut, largely depending on how long and how well someone has known him. Bill Ruane, among Buffett's many longtime friends and one of the original 1950s "Superinvestors from Graham-and-Doddsville" whom you'll meet in the paragraph following, climbed out onto the thin branches of the heretic's tree when he uttered: "[Graham] wrote what we call the Bible, and Warren Buffett's thinking updated it. Warren wrote the New Testament."

Nassim Taleb, in his provocative yet vituperative book, *Fooled by Randomness — The Hidden Role of Chance in Life and in the Markets*, is not so willing to buy into Buffett, whom he dubs a "random statistical anomaly." My reaction is to match fire with fire, igniting my response with statistics of my own. Nowhere does Taleb mention, let alone attempt to reconcile, the six-sigma records of the other "Superinvestors from Graham-and-Doddsville," all nine of whom studied under Benjamin Graham at Columbia in the early 1950s. In a speech at the University in 1984, Buffett turned to statistics himself to refute the generally held claim that his performance record was a random occurrence, comparing coin flipping with the benchmark-beating records of his fellow superinvestors as proof. As an aside, I was instantaneously attracted to the logic of Buffett's price-versus-value philosophy years ago after studying Graham's famous textbook as an undergraduate at Northwestern in the mid-'60s. Buffett has said, "I've never seen anyone who became a gradual convert over a 10-year period to this approach. It doesn't seem to be a matter of IQ or academic training. It's instant recognition, or it is nothing." Equally important, the "Superinvestors from Graham-and-Doddsville" gave me adequate empirical assurance that I have picked a mentor who's *not* a statistical anomaly. Three of the superinvestors ended up at two geographically far-flung firms, Tweedy, Browne Partners and Ruane Cuniff. We keep track of both of these fine organizations, exchanging ideas on occasion with Bob Goldfarb, managing partner of Ruane Cuniff. Their stellar records remain intact. If you don't take the path of least resistance in this exciting and challenging profession, if you can shake yourself free of the almost irresistible pull of conformity, the logic of the best teachers will find you. As this report and others before it make abundantly clear, I never stop learning from those who never stop teaching. It's no more than the application of common sense: If I wanted to learn how to hit baseballs, I'd buy a copy of Ted Williams' *The Science of Hitting* long before I picked up a bat.

Despite Taleb's off-putting and condescending style, as well as wrong-headedness regarding Buffett on several fronts, his observation that past events will always look less random than they were (the "hindsight bias") should not be dismissed out of hand. While I think it not true (at least insofar as it might apply to me!), he prefers to look at people in the investment world as if they were "deranged subjects." He argues that much of what appears as someone's discussion of the past is nothing more than just "backfit explanations concocted *ex post* by his deluded mind." Taleb's book will sit on my desk throughout the writing of this report as a constant reminder to be vigilant in seeking to discern the difference between skill and chance.

Back to Buffett. A few years later, in the 2002 Berkshire Hathaway annual report released in late February 2003, he lamented: "Despite three years of falling prices, which have significantly improved the attractiveness of common stocks, we still find very few that even mildly interest us. This dismal fact is testimony to the insanity of valuations reached during the great bubble. *Unfortunately, the hangover may prove to be proportional to the binge*" [italics added]. "The aversion to equities that Charlie and I exhibit today is far from congenital. We love owning common stocks — if they can be purchased at attractive prices. … But occasionally successful investing requires inactivity."

Twenty months later — November 5, 2004, to be exact — in a *Bloomberg News* article that hit the wires just prior to the release of Berkshire's hurricane-depressed third-quarter earnings, reporter David Plumb reasoned that low returns on the company's growing cash hoard that was $40.2 billion as of June 30 would contribute to the disappointing results. The company's later SEC filing indicated the cash balance was $38.1 billion, but the comparison may not have been apples to apples. Regardless of a paltry return of approximately 2% on liquid funds languishing longingly for a permanent and productive resting place, Buffett said he was "willing to wait years for an opportunity," according to an August interview to which Plumb referred in the article. In that same interview Buffett allowed that the $19 billion in foreign currency forward contracts that Berkshire owns serves as a hedge against a dollar weakened by the ballooning U.S. budget and trade deficits. This reflects a long-standing apprehension about the continuing exportation of claims on America's wealth. "That's a long-term position," Buffett said. "I have no idea what currencies are going to do next week or next month or even next year. *I think I know over time*." [Italics added to place additional emphasis on this unusually prophetic sentence.] The SEC filing showed the contracts worth $20 billion at the end of the third quarter. Buffett is never seen running with the herd — and for good reason. "Madness is the exception in individuals but the rule in groups," observed Friedrich Nietzsche, the 19th-century German existentialist philosopher.

A 'Robbing Peter to Pay Paul' Macro Policy

Is it any wonder that Warren Buffett continues to sit on his hands? My guess is that he sees both the Fed's action and the Bush tax cuts, as discussed a page or so hence, as no more than a futile attempt to forestall the inevitable — to rob Peter to pay Paul.

The investment community may not have taken Buffett's words of reality seriously in 1999, but it is doubtful that Fed Chairman Alan Greenspan turned a deaf ear. And, going full circle, when the world's most influential central banker unsheathes his mighty sword, Buffett, intent on keeping his head, does not turn a deaf ear either. This long aside into the secretive world where trade-offs are constantly being weighed and macro policy is formulated is essential for understanding why Buffett, despite the passage of time, is yet loath to place an unmistakably bullish bet, indicating that we have arrived at the once-in-a-generation barrel stocked with fish. By way of background, and thanks to various articles in the *Wall Street Journal,* in 1998 Greenspan was feeling intense pressure within and without the Fed to prick the stock market bubble. He demurred, reluctant to second-guess millions of investors on the right value for stock prices. Moreover, it is believed he was concerned that permanently ending a bubble required rates so high they'd also wreck the economy. Those who think Greenspan's job description includes direct intervention to rescue investors from their periodic episodes of lunacy have studied neither the man nor his job description.

The bubble began to deflate — perhaps too many people had taken the English fairy tale "Jack and the Beanstalk" literally — in the spring of 2000. According to the *Wall Street Journal*, "When the economy weakened, the Fed cut rates sharply, following Greenspan's analysis of what the Fed did wrong in 1929. It cut rates twice in January 2001 and five times more through August. After the September 11 attacks, it cut four more times, and did so again in 2002 after corporate scandals undermined investor confidence. In 2003, when the Iraq war and threat of deflation hung over the economy, the Fed cut rates again. By June 2003, the Fed's key rate was at 1%, the lowest in 45 years." This time, however, debate still rages over Greenspan's strategy. For now, it appears to have worked. The U.S. escaped with a mild recession instead of a 1930s-style Depression or Japanese-style stagnation.

According to the *Journal*, tax revenue, which for 50 years had usually fluctuated between 17% and 19% of gross domestic product, surged to 21% in 2000. Greenspan apparently didn't appreciate how much of that would reverse once the stock bubble burst. Shortly after the first Bush tax cut passed in May 2001, which Greenspan supported based on the above miscalculation, tax collections fell short of projections. Still quoting the *Journal*: "By 2004, after a recession and three rounds of tax cuts, tax revenue fell to a 45-year low of 16% of GDP. In the past three years, the budget swung to a projected 10-year $2.3 trillion deficit from a projected surplus of $5.6 trillion with no prospect of a turnaround.

"Greenspan's grasp of economic data and his political instincts came up short this time. Instead of accelerating productivity growth acting as the main driver of higher tax revenues, the most significant contributor was the 1990s stock bubble, which produced a tidal wave of [capital gains] taxes from stock-trading profits, Wall Street bonuses and [taxable] withdrawals [liquidations] from retirement savings plans."

Greenspan also may have miscalculated the gap between himself and Republicans in the White House and Congress over the deficit's significance. Republican politicians embraced Greenspan's endorsement of tax cuts but ignored and sometimes undermined his nagging about the deficit. Greenspan has repeatedly urged Congress to renew a rule first implemented under Bush's father that required tax cuts be offset with spending cuts. It expired in 2002. Greenspan's fellow Republicans defeated his renewed efforts on a party-line vote. In a statement that may haunt Republicans for years, Committee Chairman Jim Nussle, an *Iowa Republican*, rationalized: "We don't believe that you should have to 'pay for' tax cuts." (Until I read that statement, I always thought there could be no one more conservative than a corn-fed Iowa Republican. George W. Bush, irrespective of the true extent of his commitment to federal budget deficit reduction and the presumed power of a congressional majority, will have an uphill fight in making Greenspan's job, as well as that of his successor, easier.)

The U.S. Current-Account Deficit

Finally, in a speech on November 19 in Frankfurt, Germany, Greenspan joined his central bank colleagues in appraising an increasingly important issue — the globalization of trade *and finance*. He noted that "the volume of trade relative to world gross domestic product has been rising for decades, largely because of decreasing transportation costs and lowered trade barriers. The increasing shift of world GDP toward items with greater conceptual content has further facilitated increased trade because ideas and services tend to move across borders with greater ease and speed than goods."

Greenspan framed the U.S. current-account deficit in the following context: "Foreign-exchange trading volumes have grown rapidly, and the magnitude of cross-border claims continues to increase at an impressive rate. Although international trade in goods, services, and assets rose markedly after World War II, a persistent dispersion of current-account balances across countries did not emerge until recent years. But, as the U.S. deficit crossed 4% of GDP in 2000, financed with the current-account surpluses of other countries, the widening dispersion of current-account balances became more evident. Previous postwar increases in trade relative to world GDP had represented a more balanced grossing up of exports and imports without engendering chronic large trade deficits in the United States, and surpluses among many other countries.

"So far, foreigners are willing to lend the U.S. money to finance the current-account imbalances," Greenspan continued. "The worry, however, is that at some point foreigners might suddenly lose interest in holding dollar-denominated investments. *That could cause foreigners to unload investments in U.S. stocks and bonds, sending their prices plunging and interest rates soaring* [italics added]. Moreover, the persistence of bloated U.S. trade deficits over time can pose a risk to the thus-far-resilient U.S. economy." Buffett's vision of the world is not as narrow as some think. His actions speak volumes about his awareness of both the micro and the macro environments.

Never Lose Sight of the Forest for the Trees

Standing amid the giant sequoias, one can easily lose one's bearings, unlike the eagle soaring and surveying overhead. As an earthbound creature, I must depend on my trusty compass. Moving from the forest to the sea (and mangling a metaphor en route), if the tide truly is ebbing, the overarching tidal wave of macro stimulus seems to have lifted the spirits of the majority, at least until (or if) it crashes on the beach. Excluding the drag of the still-way-down-in-the-dumps Nasdaq Composite Index companies, the inclusive Dow Jones Wilshire 5000, defined below, is at or near all-time highs. But Buffett's not buying, so to speak. Steering clear of "mindless imitation of others" has kept him out of harm's way many times in the past. How will we judge his actions five years from now? (Though it may be dated, we at Martin Capital, along with our clients, owe him more than a debt of gratitude for the insights he shared five years ago. When you wonder if you're way out in left field, a smile from "the Oracle of Omaha" in the stands can make all the difference. While many of the conclusions reached in the 1999 MCM annual report were not directly attributable to Buffett, his imprimatur was clearly in evidence.)

Returning to an earlier utterance in 2003: "*Unfortunately, the hangover may prove to be proportional to the binge*." Buffett suspects, as I believe the last sentence confirms (and made all the more certain by his interpretation of the last-trump-card-played desperation implied by the monetary and fiscal policy initiatives outlined above), that the tide has turned, that the game — like the earlier swing metaphor — may once again come to the patient, those who know the market's herd-like psychological proclivities and its tendency to regress to the mean and beyond. What we do know is that he will take advantage of the waves of investor sentiment from which occasional short-term (but presumably long-term for capital-gains-tax purposes) opportunities arise, but he never takes his eyes off the stage of the tide. His foray into \$8 billion in junk bonds in 2002 and his flirtation with silver a number of years ago are but a few examples. What Buffett really longs for, though, are times like 1974 when he can throw caution to the winds and fill his plate to overflowing with bargains. To switch metaphors, those who know the difference between wheat and chaff will likely reap harvests an order of magnitude greater than will those to whom stalks (or "stocks") of wheat all look alike. The seeds that Buffett planted in the dark days of the take-no-prisoners bear market of 1973-74 later grew to heights unimaginable as the sun, as it always does, overcame the darkness — about the time the clouds of despair became so pervasive that nobody cared anymore. For those already beaten and bloody, the dog days of the fall of 1974 conjured up many images, none of which looked like opportunity. Is Buffett perhaps finding cause to prepare for what might lie ahead?

Once to every generation
comes the moment to decide;
in the clash of truth with falsehood,
all must choose and all must side.[2]

Who knows whether one of those defining moments awaits just beyond a bend in the road … It appears Buffett, ever rational and seemingly devoid of greed and avarice, has, at least for the moment, concluded that the risk of loss is greater than the opportunities forgone. That isn't a forecast — rather a nonspecific, tacit reference to the stage of the tide as he sees it. Unlike a forecast, there is no time dimension. Earlier in this section he used the same logic in explaining his bet against the dollar: "I have no idea what currencies are going to do next week or next month or even next year. [But] *I think I know over time*." Money, as Buffett proves time and again, seems to find its way to the pockets of those who are its worthy masters. Either you rule your money or it rules you; there is precious little middle ground. If you're not sure, you already know the answer. A wag wiser than I once proclaimed: "Money is a good servant and a poor master."

Buffett's for*bear*ance is not new. He had not been seduced by the rally that followed his exit in May of 1969. From 1969 through 1973-74, while the bear played with investors' hopes as a grizzly toys with a landed salmon, Buffett hibernated, passing on the one-decision-growth-stock "Nifty Fifty" craze. In a radical turnabout in his long-standing policy of "holding forever," in an October 27, 2003, *Barron's* interview he publicly lamented not selling Coke and Gillette at 50 plus times earnings in the late 1990s, when (I presume) they had become so expensive that they could no longer be considered "one decision" growth stocks, even though they were charter members of his sacrosanct "Sainted Seven." Whether Buffett also thought that both companies had lost some of their long-term luster is a question for another time. As a "value" investor,[3] committed to buying low and selling high, "Buffett understood that everything depends on the price you pay when you get in" [and apparently now at extremes, when you get out]. Loosely paraphrasing Maggie Mahar, author of *Bull! A History of the Boom, 1982-1999*, a value investor stops buying at the end of the cycle, when prices are the highest. Flashing back, in Buffett's view prices were still exorbitant in the early '70s, six years after the broad market began its long and jerky 180-degree barrel roll. Again quoting *Barron's*, "While most investors are motivated by a desire to make money, Buffett focuses first on not losing money."

An Investor's Unheralded Virtue

Let us now respectfully pause to consider an uncommon trait that is common among many great achievers: patience. In *Patience: How We Wait Upon the World*, author David Baily Harned attempts to resurrect this lost virtue, one that has served Buffett so well. Harned laments the popular disregard for waiting. Most of us do not consider cooling our heels as occupying a place "at the core and center of human life." In the world as many of us would want it to be, there should really be no "time wasted" at all (my words, but think of the irony of the phrase in this context). Gratification should be instant. Images of cell phones, Palm Pilots with Internet access, and the aggravation of long lines in airports following 9/11 raced through my consciousness. Moreover, we are unable to equate waiting with "doing anything." Harned observes that what now counts in life is "activity, agency, getting things done." As an antidote, Harned defines four dimensions of patience,

[2] Lyrics from Richard Bewes' hymn "Once to Every Generation."

[3] Buffett refuses to be pigeonholed by the dogma of the day that insists that growth and value are separate and distinct investment styles. He believes that growth is a component in determining the value of an asset. Watch for Peter Bernstein's comments on the subject toward the end of this section.

upon which one might reflect in a report such as this, taking a few seconds to customize the message as it might be applied by an investor, so as to grasp for one's own benefit its everlasting and practical relevance: "endurance (suffering without discontent), forbearance (bearing with the faults of others), expectancy (a willingness to wait), and perseverance (constancy)." We can understand the virtue better by reflecting on its four polar opposites: "Impatience and apathy (the extremes of which patience is the mean), boredom, and displacement (loss of touch with one's purpose in life)." A meaty mouthful, best consumed in small bites …

While the following has been aired before, I can't resist repeating the cryptic quotation from 17th-century mathematician and philosopher Blaise Pascal: "I have discovered that all human evil comes from this, man's being unable to sit still in a room." One of my mentors offers sage advice when he admonishes to "measure twice, cut once." The ratio of thought to action seems way out of balance. An investment veteran is one who remembers the long-forgotten tagline, "Investigate before you invest."

The Interdependence of Patience and Pitches

In a quick transition to allow your overheated cerebral cortex to cool down, we will take another quick trip to the ballpark. No serious conversation about baseball would be complete without reference to the two most prodigious sluggers of all times, Babe Ruth, whose record of 714 home runs stood for 39 years until broken by Hank Aaron in 1974, and Ted Williams, whose career began shortly after the "Babe" retired, earned a lifetime batting average of .344 and hit a total of 521 home runs, despite time away from baseball defending his country in two wars. Nicknamed the "Splendid Splinter," Williams was one of the greatest natural hitters of all time. Buffett, who frequently uses Williams' "sweet spot" analogy in explaining how he decides when to swing his golden bat, has drawn upon the techniques of the great ballplayers, as well as the great executives. Michael Lewis in *Moneyball* describes the atypical way Billy Beane, general manager of the Oakland A's, acquires players, along with the results his approach has produced in recent years. The A's have sported the second-best record in the Major Leagues the past four years (just one win behind the Seattle Mariners), with salaries a mere one-third of what George Steinbrenner, an obvious proponent of "financial determinism," has been paying the New York Yankees. Beane learned the secret of why so many rich men cannot buy success in baseball: "In professional baseball it still matters less how much money you have than how you spend it." In Buffett's league, having too much money actually reduces the likelihood of outsized success. (Beane is Buffett in baseball cap and spikes.) That Buffett takes the mound to throw out the first pitch at Omaha's Rosenblatt Stadium, home of the AAA Omaha Royals, before each year's Berkshire annual meeting is perhaps more symbolic than it appears on first blush.

In any event, Buffett was selected as the leadoff hitter, because he is the investor's equivalent of Babe Ruth and Ted Williams, rolled into one. (It also doesn't hurt that he, Walter Scott, and the Union Pacific Railroad own the team!) Taking what appears to be a reasonable swing at an old adage, if you really want to learn how to hit a baseball, don't start by asking a rookie. In fact, avoid a rookie even if you have no alternative. Bad advice is worse than no advice at all. On the practical side, unlike any others to follow, Buffett doesn't sell advice but rather takes his own, for which he is in every sense accountable. His batting average is measured with the same precision as Williams'. He is the spirit and soul of Berkshire Hathaway — the storied history of the name even implying that in the right hands a silk purse can come from a sow's ear ("He that hath a will *hath a way*") — a holding company with some $150 billion in assets, second only to General Electric in that metric. Since the mid-'60s he has allocated an ever-growing capital base with unparalleled skill and unequaled results. His 31% stake in Berkshire, approximately 99% of his net worth, is invested at absolute parity with outsiders, such as you and me.

Buffet's salary, so paltry as to make him unworthy of an invitation for membership to any CEOs club, is $100,000. Perhaps even more off-putting to members of the club is that he would be, to inject a Buffett aphorism, as out of place as a belch in the boardroom. Having never received a bonus or a stock option, what possibly could he contribute to the boardroom blather? Buffett exudes integrity in a business world where duplicity, incrementally but insidiously, has become the *de facto* standard. From my perspective, what makes him so unique is his willingness to share his wisdom with all who will listen, his sagacity so valuable that were he not incredibly charitable with his most valuable asset, people would pay a king's ransom to sit at his feet. Figuratively, we do. Each year a growing throng of us, a standing-room-only

19,500 or so last May, make the pilgrimage to Omaha to soak up the folksy, common-sense wisdom that is so deeply ingrained in the mental framework of Buffett and his sidekick, Charlie Munger, that it flows effortlessly and consistently as they subtly use six hours of questions from shareholders as a springboard to expound on their philosophy. It's like a Little Leaguer having Ted Williams as a coach. He is, no fizz intended, the "Real Thing."

What About Other Major-League Iconoclasts?

While admittedly stepping down a rung on the credibility ladder, I have chosen not to neglect the facts, and opinions, of several admittedly self-selected independent thinkers whom I respect, but whose batting averages are not as well known as I continue to zero in on the controversial issue raised by the title of this section: "Financial Cycles or Random Events?" An erudite maverick, Marc Faber, whose contrarian philosophy I largely embrace, warns investors when worldwide investment themes have become widely accepted and are, therefore, highly priced and risky.[4] He, meanwhile, continuously and assiduously searches for opportunities in unloved and depressed markets. While most of us are just waking up to the sleeping giant, Hong Kong-based Faber is way ahead of us on the curve: He has been managing money for wealthy Chinese investors for years.

Faber, like Buffett, finds secular cycle significance in the 80-year chart on the next page depicting the relationship between GDP and the market value of all publicly traded securities. Applied to an individual company, it would equate to the market-price-to-sales-per-share ratio, a rough and ragged secondary valuation technique. If you return to our Website, you'll find the same chart on page 23 in the 2001 annual report, which first appeared in a November 22, 1999, *Fortune* article penned by Buffett. He offers the graphic as a "simple quantitative antidote that investors can administer to neutralize their often emotional 'availability bias' assessment of the future."

By adding a second and complementary chart, along with using the same denominator, GDP, Faber compares total debt outstanding to the economy's capacity to service it. Using both tools, he points out the fundamental difference between what he describes as a "real economy" in 1982 and what he sees as the "financial economy" of today. In a real economy, the debt and equity markets as a percentage of GDP are small and their principal function is to serve as the conduit through which savings flow into investments. In a financial or easy-money economy (often encouraged by both low-cost equity and debt capital), the total market value of the equity market is far larger than GDP — and not only channels financial resources into economic investments, but the massive overflow gives rise to colossal speculative bubbles. Faber observes that malinvestments do occasionally occur in a real economy, but they are infrequent and their impact relatively insignificant. Certainly in 1982 the cost of both debt and equity capital was so high as to make most projects funded thereby appear conspicuously imprudent. Incidentally, given Federal Reserve Board Chairman Paul Volker's willful intent to crush inflation, the high-probability bet was that interest rates would eventually come crashing down. As those for whom I worked at the time will recall, it was the bet I then made with virtually all of my investment capital, and rates did fall. The pitch was clearly in my "happy zone." And the results were proportional.

Please examine these charts carefully. A picture may be worth, who knows, billions of dollars for Buffett? In 1981, domestic stock market capitalization as a percentage of GDP was less than 40%, and total domestic credit market debt as a percentage of GDP was 130%. By contrast, at present the stock market capitalization and total credit market debt have risen to more than 135% and 275% of GDP, respectively.[5]

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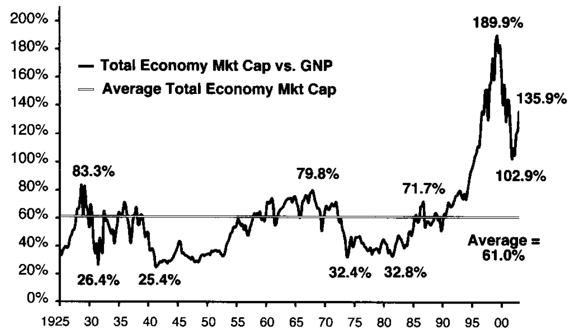
[4] Generally, I am most comfortable with investors where our shared fundamental beliefs include the positive correlation between price and risk, as well as the negative correlation between risk and return. "One of the many unique and advantageous aspects of value investing is that the larger the discount from intrinsic value, the greater the margin of safety and the greater potential return when the stock price moves back to intrinsic value. Contrary to the view of modern portfolio theorists that increased returns can only be achieved by taking greater levels of risk, value investing is predicated on the notion that increased returns are associated with a greater margin of safety, i.e., lower risk." Thus saith the partners of Tweedy Browne, who grew up in Graham-and-Doddsville.

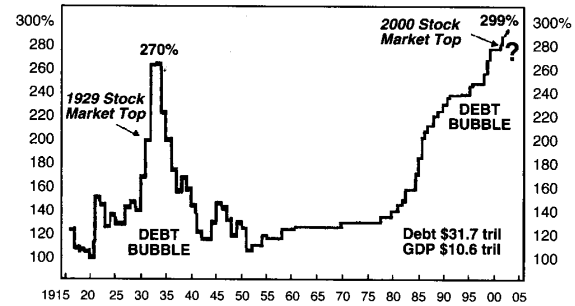
[5] Careful examination of recent Federal Reserve data indicates total U.S. debt outstanding of $31.7 trillion (households, $10.3 trillion; non-financial companies, $13.8 trillion; federal government, $7.6 trillion). In order to avoid double

Market Cap vs. GNP 12/31/24 – 12/31/03
Consensus Forecast for 12/31/2003



Source: Blue Chip Econometric Detail Consensus Forecast, NYSE, NASDAQ, AMEX, BEA

Total Credit Market Debt
(All Sectors) as % of U.S. GDP



"When we are living on this much borrowed money, we are also living on borrowed time." — Paul Volcker, Federal Reserve Chairman, 1979-1986

Source: St. Louis Federal Reserve, FRED II, BEA

Source: Outstanding Investors Digest, April 30, 2004

We believe that the link between the two charts makes their message even more ominous. Nonetheless, as persuasive as these charts appear to be, in our profession every snippet of evidence must be viewed skeptically. The practical genius of Benjamin Franklin is apparent in the following cryptic remark: "'Tis easy to see, hard to foresee." With that caveat firmly implanted in your mind, I will proceed. Net debt outstanding has risen dramatically in recent years. While an extreme example, Fannie Mae, the $950 billion mortgage lending giant that finances more than a quarter of U.S. residential mortgage debt, reported enthusiastically on its 2003 results, the "greatest year for housing in America's history. Housing sales were at all-time highs. Mortgage interest rates dropped to their lowest level since the late 1960s. Mortgage originations were up more than 40 percent from just the year before, coming in at a remarkable $3.7 trillion, as consumers bought homes or refinanced their existing mortgage." Hold your horses! This is in an $11.5 trillion U.S. economy and compared with an increase in total mortgage borrowing of just over $1 trillion between 1990 and 1996, the binge in borrowing in 2003 certainly seems unpropitious if not preposterous! Frank Raines, CEO, was unreservedly optimistic. (Prone to hyperbole, Raines neglected to point out that *net* mortgages outstanding increased by a much smaller $735 billion during the year. The net figure is the result of adjustments for refinancings, mortgage principal payments, and defaults.) Following the strongest year in the history of the U.S. housing market, Raines pours it on: "The American people are unsurprisingly bullish on housing and homeownership. Two-thirds of Americans believe now is a good time to buy a home compared with only 47 percent of Americans who are optimistic about the economy as a whole." (See the "Run for the Roses" section later in this report for insights on how investors chase the "last best thing.") As a sorry postscript, a year later, on the heels of Freddie Mac's "managed" accounting scandal (see 2003 annual report), Mae got her Fannie "spanked."[6]

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counting, financial companies are not included, which is 275% of the $11.5 trillion GDP. The Dow Jones Wilshire 5000, perhaps the most representative index of all publicly traded, domestically based U.S. corporations, tallied an approximate market capitalization of $15.6 trillion in late December, 136% of GDP.

[6] On December 22, 2004, the *Wall Street Journal* reported the forced departure of Frank Raines, CEO, 56, who took the blame for a shortfall in capital because of accounting changes imposed by the SEC and OFHEO (Office of Federal Housing Enterprise Oversight) that will require Fannie to recognize $9.18 billion in losses on derivative contracts, which were used for hedging interest-rate risks. A key issue for any new auditor will be whether the company's hundreds of billions of derivative financial instruments are valued properly on the company's balance sheet, given the wide latitude that companies are given in estimating the fair-market values of such instruments. Companies have been known to use the valuation of derivatives to manage earnings. Alan Greenspan is a fan of derivatives and refuses to

We have no idea how much debt the economy can service. Flashing back to 1982 … If, for whatever reasons, interest rates rise sharply henceforth, certain borrowers (like some households overloaded with consumer credit card, other installment, and/or mortgage debt) are likely to be stretched pretty thin. What we do know is that the purveyors of financial service products, including those financial institutions that deal in the black-box world of derivative products whose notional totals[7] don't appear in the above figures, have seen their earnings skyrocket, along with the debt outstanding. To be sure, money greases the skids of commerce, and easy money lubricates the engine of excess. In simple terms, financial bubbles, driven as they are by human folly, are often the result of too much money chasing too few worthy ideas, leading to overinvestment and excess supply. According to Martin Feldstein, CEO of the private National Bureau of Economic Research (and among several leading candidates to step into the shoes of Alan Greenspan in 2006), "Business spent $4.7 trillion on equipment and software from 1995 to 2000, 37% more than the prior six-year period. Now [2003] utilization rates of this beefed-up capacity are the lowest in 20 years." Add telecommunications and certain regional housing markets (try to reconcile the aforementioned explosion in Fannie Mae originations above with underlying household formation growth), and you begin to get the picture.

Lest we become too enamored with money — and the grand profits that can be earned by its changers — it's helpful to remember that it is also the ultimate commodity. There is very little room for differentiation in the long run. As for commercial banks in general, their history is resplendent with the uncanny capacity to play "follow the loser," mindlessly jumping from one folly to the next. After years of miscues, have they finally seen the light? I wouldn't take that bet if the odds were 10 to 1!

If debt as a percentage of GDP should eventually shrink — which we think is probable, though we wouldn't begin to speculate about when — financial sector earnings are almost certain to decline as a percentage of S&P 500 earnings as well. And here's the connection. With stock prices currently at a ratio of 136% of GDP, they might become obscenely expensive without the support of unsustainable earnings from the financial sector, *ceteris paribus*. It would appear that a sharp decline in either of these GDP ratios (debt or equity) could have a communicable and sympathetic effect on the other.

Notes another seasoned observer: "There have only been three times in the last 80 years where all elements of the stock market, the economy and debt structure have come together like they have today." Others are not so circumspect. Frederick J. Sheehan, in his bold and brash "An Investor's Manifesto," pointedly presents the nightmare scenario. "We are living at the long end — if 'end' it is — of gross financial imbalances. Most people don't understand this, or won't acknowledge it. This fog of extremity and perplexity is a financial maelstrom that has been building for a generation." We don't attempt to forecast the

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regulate them, arguing that they reduce risk, whereas Warren Buffett warned at the 2003 annual meeting that "derivatives are advertised as shedding risk for the system, but they have long crossed the point of decreasing risk and now increase risk. As with every company transferring risk to very few players, they are all hugely interdependent. Central banks are exposed to weaknesses." Let's hope Greenspan is right, for his successor may have a tiger by the tail.

[7] According to FDIC data, of the $71 trillion in derivatives outstanding early last year, 86% were interest-rate contracts. The remaining 14% of the derivatives in the mentioned FDIC study are foreign-exchange contracts and equity, commodity, and other contracts. Approximately 96% of derivative contracts are transacted through commercial banks. The dealer, J.P. Morgan Chase Bank, is by far the biggest player, representing more than half the market. There are three main areas of derivative activity: hedging, dealing, and speculating. For example, hedging is done by businesses to limit their risk exposure to interest-rate changes. Dealing is the market making by banks to earn fees on derivative contracts and provide the market for businesses to hedge or speculate. Speculation is the entry into a derivative contract without some or all of the offsetting components that are in hedging contracts. Derivatives are basically big bets made with heretofore unattainable leverage — and in amounts that are simply astounding, even to financially savvy mindsets. They expose not only the holders of the derivatives contracts to the risk, but the dealer banks as well if the holders default (counter-party risk). The LTCM (Long-Term Capital Management) crisis resulted from the unexpected defaults of Russia, and the holders of the derivatives related to those defaults experienced cascading losses, resulting in defaults and counter-party defaults. Life, however, is too serious to be taken seriously, so let's end with a smile. Bob Rubin, former Wall Street banker who served as Secretary of the Treasury under Bill Clinton, assumed the Clintonesque vernacular with ease as he explained the difficulty in protecting oneself against the unexpected. "Condoms aren't completely safe," he said. "A friend of mine was wearing one and got hit by a bus."

unknowable, nor should we discount it offhandedly as though it were not a possibility, however remote. Will we look back 10 years from now and call this the "perfect storm"?

The force behind secular cycles that can last for years seems always to be the same: human nature. Secular bull and bear cycles begin slowly because there is always a disposition in people's minds to think the existing conditions will be permanent. With this paragraph we segue into John Kenneth Galbraith's theory on cycles that is based more on the emerging science of "behavioral economics."

A Short History of Financial Euphoria

Galbraith's satirical wit makes this Canadian-born economist enjoyable to read. T*he Great Crash, 1929*, considered the definitive work in some circles on the economic devastation of 75 years ago (and never out of print, thanks to new speculative episodes that would bring it back to the public's attention), has been helpful, along with other books, including *Security Analysis* (photographic reprint of the 1934 edition) and the *Memoirs of Benjamin Graham*, both quoted extensively in earlier annual reports. Graham penned his remarkable tome while in the thick of battle, when the lingering pain from the slings and arrows were the measure of his defeat — and when absolution was nowhere to be found. His intellectual detachment, his ability to rationally assess the damage and identify its proximate causes (all the while almost mortally wounded financially and deeply distraught emotionally) demonstrated extraordinary will and self-control.

Galbraith, less a warrior and more a historian, waited 20-plus years until the dust had settled. By then the public, roundly chastised, finally wanted answers. He wrote *The Great Crash* in the 1950s, whereas his *A Short History of Financial Euphoria*, published in 1990 (with a second edition in 1994), used the extravagant '80s as a chance to revisit the inevitability of recurring episodes of financial euphoria. Prime malefactors to whom Galbraith referred — complete with accounts of their ignominious falls from grace — were junk-bond king Michael Milken; Donald Trump, gambling's Tower of Babel (whose greatest virtue is chutzpah and greatest vice, bad hair); and Canadian real estate moguls Robert Campeau and the Reichman brothers, not to be confused with Rock 'n' Roll Hall of Famers the Righteous Brothers, whose "You've Lost That Lovin' Feeling" holds the distinction of being the most-played song in the history of radio. Wisdom is often found in the strangest places. Investors would be well-advised to listen to the simple, six-note opening line "You never close your eyes …" Though written for the '80s, Galbraith's observations were inadvertently prophetic and poignant for the decade to follow.

More inclined toward pragmatism than prophecy, Galbraith was leery of the image that a seer rubbing a crystal ball conveyed. "There are, however, few matters on which such a warning is less welcomed," he wrote. "In the short run, it will be said to be an attack, motivated by either deficient understanding or uncontrolled envy, on the wonderful process of enrichment. More durably, it will be thought to demonstrate a lack of faith in the inherent wisdom of the market itself." Galbraith recounted how Paul Warburg, a founder of the Federal Reserve System, and investment author Roger Babson were vehemently criticized in the 1920s; the reactions from the investment public were bitter, even vicious, regarding Warburg and Babson's warnings of ultimate collapse and depression if the speculation continued unabated in the late '20s.

Galbraith warned that investors must resist two compelling forces if they are to avoid speculative manias, of which the late 1990s surely qualifies: "One, the powerful personal interest that develops in the euphoric belief, and the other, the pressure of public and seemingly superior financial opinion that is brought to bear on behalf of such belief." Both stand as proof of the great 18th-century German literary figure Johann Christoph Friedrich von Schiller's famous dictum that the "crowd converts the individual from reasonably good sense to the stupidity against which," as he also said, "the very Gods Themselves contend in vain." As has been repeated time and again throughout these reports — and to which Galbraith lends his two cents' worth: "History may not repeat itself, but some of its lessons are inescapable. One is that in the world of high and confident finance little is ever really new. The controlling fact is not the tendency to brilliant invention; the controlling fact is the shortness of the public memory, especially when it contends with a euphoric desire to forget.

"The rule is that financial operations do not lend themselves to innovation. What is currently so described and celebrated is, without exception, a small variation on an established design, one that owes its distinctive character to the aforementioned brevity of the financial memory [assumed to be around 20 years]. The world of finance hails the invention of the wheel over and over again, often a slightly more unstable version. All financial innovation involves, in one form or another, the creation of debt secured in greater or lesser adequacy by real assets."

This sameness, seldom recognized at the time as such, lends itself well to cyclical yearnings, with the rhythm rooted deeply in the human psyche. Buffett points to the facts and Galbraith to the mind; both reach the same conclusion.

Riding the Train: When to Get On, When to Get Off

As the equity market gradually got its legs after being pummeled for the years leading up to 1982, the road from despair to eventual irrational exuberance had so many detours, switchbacks, and sideshows that only a steely eye on the compass could keep one on course. Having entered the industry as a neophyte in 1966 at the age of 24, I furthered my education in the school of reality, participating fully in both cycles to which Buffett has referred. By 1982, at the age of 40, the undersigned had logged 15 years of experience in the industry. No longer a novice, I lived history in the making, every day. The market gradually picked up speed at the pace of a tired locomotive pulling a full load, huffing and puffing as it snaked its way up the mountain. Later, as the grade leveled out a bit, it traveled at an ever-increasing pace as "financial news TV" and eventually the Internet invaded our homes and offices to the point where it was nearly impossible to resist jumping aboard the train to sure riches. Unfortunately, when the rolling stock reached the crest of the mountain few realized it was time to detrain. When you don't know where you're going, it's hard to know where to get off. They don't blow the whistle for that. Once the train picks up momentum on the other side of the mountain, most everyone looks back up at the mountaintop from whence they came — and not to where they're going. By the time the passengers realize their mistake, it's too late; they've already punched their ticket at a high price. The locomotive is careening around curves, out of control, ironically down toward the valley of *opportunity* below.

As the economy evolved from real to financial from 1982 to 2000, many what now appear to have been minor bubbles occurred: IPOs in the early '80s, Michael Milken's junk bonds, the leveraged-buyout craze in the second half of the '80s, and the so-called (and largely forgotten) "Crash of '87" were but a few of the more obvious examples. Undeterred, the longest peacetime expansion on record chugged along, seemingly impervious to interference from the various and sundry financial episodes, with the salubrious, long-run, threefold effect of generally falling interest rates, stable commodity prices, and generally rising stock prices serving as a tailwind. According to Marc Faber, when bubbles burst in the real economy, the collateral damage tends to be limited. In a late-stage financial economy, on the other hand, investment manias and stock market bubbles often grow to be so large that, when they come apart at the seams, considerable economic fallout follows. It should be noted that in the almost four years following the bubble of the late 1990s, the main front of economic distress that was expected to follow has yet to pass through. It appears that Greenspan may have engineered another perfectly soft landing … or, as mentioned earlier, has he simply "robbed Peter to pay Paul"?! If memory serves me correctly, Buffett took to the high ground in 1969, five years before the recession of 1974-75, the sharpest economic setback since the Great Depression.

2005: Mirror Image of 1982?

Another prognosticator for whom I have high regard weighs in below. Octogenarian and brilliant thinker Peter Bernstein, author of our 1996 Christmas Book, *Against the Gods*, observed in the spring of 2003 that the old rules no longer apply. Bernstein is a realist. "For now, equities aren't the best place to be for the long run," he wrote. "The long run here is not necessarily going to bail you out, or even if it does, the margin by which equities will outperform could be too small to compensate for the volatility. … The hard truth is that the market cannot grow that much faster than GDP." Using the same data that brought Buffett and Faber to their feet, Bernstein echoed: "In March 2000, stocks were valued at 181% of GDP, up from 60% just over 10 years earlier [and 40% in 1982]. Of course, an investor could gamble that dividends would climb higher or that investors would push price-earnings ratios back to stratospheric heights, boosting capital gains. But that's not a risk I would want to take under any circumstances," making it clear that he was opining exclusively on the long run. "Yet," Bernstein acknowledged, "it would be extremely difficult for most investors to realize that 'the world has changed' — that we had entered a new era of investing: boom and bust." Finally, Bernstein cautioned against assuming that tomorrow will be pretty much like today.

What Have We Learned?

I hope you have learned from the evidence and arguments presented in this section that long-term "secular" cycles, like the tides, do exist. Although I don't think the timing of these cycles can be predicted, it does seem to be much easier to recognize the top of a boom or the bottom of a bust than it is the great expanse in between. When those heady or harrowing occasions arise, there's little else you need for making rational investment decisions than to "get physical" by swinging back to the first paragraph of this section a dozen or so pages ago. Fixate on the motion and the message of the simple playground swing. The waves are relatively random and benign, unless taken for more than they are. The behavioral impetus in which cycles are deeply rooted is discussed in a later section, "*Run for the Roses.*"

As for where we are in the long-term cycle, I turn to Benjamin Graham to frame the perspective: "If you see that a man is very fat, it makes little difference that you are able to precisely calculate his exact weight to enhance your conclusion." Synthesizing all that I have read, no other conclusion could logically follow than that the markets are likewise "very fat." How fat? We attempt next to put the S&P 500 earnings on a justly and fairly calibrated scale.

FULLY DELUDED EARNINGS

Penance(?) in the Cuff-Links Cooler

The phrase "Fully Deluded Earnings" was coined by Jim Grant, editor of "Grant's Interest Rate Observer." We venture into this misty landscape at the risk being deemed delusional ourselves. Grant, with whom I have corresponded on occasion, is a "permabear" who, in the '90s, willingly shouldered the brunt of the abuse from those who took delight in ridiculing bearishness, like the haughty patrician Louis Rukeyser, before he was bear-clawed and summarily fired as 31-year host of the most popular financial news program ("Wall $treet *Weak*," in the opinion of this wonk, was always the more fitting name). "Bear" with me, but guess who got the last laugh? Michael Lewis, who wrote the Wall Street best-sellers *Liar's Poker* and *Moneyball* (the latter got a nod several pages ago), calls Grant "one of the most interesting market analysts alive."

Lewis says there's a tendency to exaggerate the importance of bullish sentiment, even if proffered by a dimwit (not Dim*net*; see opening quotation!), and denigrate those (some of whom are first-rate thinkers) who speak to the contrary; see the similar opinions of John Kenneth Galbraith toward the close of the preceding section, "Financial Cycles or Random Events?" Why this phenomenon of human nature, you ask? To update Willie Sutton's alleged dictum ("Why did you rob banks?" "Because that's where the money was"), most of the money is on the bullish side of the street. Likewise, fabricated earnings became the wellspring of greenbacks galore for those for whom crossing over the ethical line was a baby step. Sutton, who actually stole the title for his book *Where the Money Was* from a reporter, was thereby handcuffed to a lie for eternity. Sutton was romanticized for his Robin Hood-like flippancy, whereas today's turnabout "robbin' hood," who deftly picks the pockets of his (relatively poor and, thanks to his actions, getting even poorer) family of shareholders to line his *own* pockets, does short, and certainly not fatal, penance in the cuff-links cooler.

It doesn't take a Harry Houdini to escape the chains of FASB (Financial Accounting Standards Board). But FASB ain't no Houdini. It can't hold a candle to the great magician when it comes to escaping the clutches of Congress, after it reaches that fork in the road when it must choose between the deafening, palm-greasing, clamor of lobbyists and the squeaky but clear voice of reason. Accordingly, the game of deluding — first earnings and then those who relied upon them — became well-nigh-ubiquitous. In this short section, and with the help of those with whom we spoke at Standard & Poor's, along with the vast amount of data available on their Website and the periodical the "Accounting Observer," we'll try to make some sense of how we think earnings should be determined and presented to shareholders.

The Benchmark S&P 500 Index

The S&P 500 Index is the generic benchmark against which most U.S. equity performance is measured. It represents 70% of all U.S. publicly traded companies. Lest you think the S&P 500 is flawless, please refer to the 1998 annual report section titled "The Friendly Brute with No Brains."

Is the Market Cheap or Dear?

In the normal course of our reading it's not uncommon to come across substantial, sometimes shocking, variations among market commentators on the richness or cheapness of the market in general. We thought it might be useful to delve more deeply into the numbers in search of what may approximate the truth of the matter. According to Standard & Poor's, the average P/E ratio from 1935 on a *trailing four quarters, as reported*, *basis* is 15.63. Some market commentators have argued that with the S&P 500 at approximately the 1200 level, and since *operating earnings estimates for 2005* are close to $73, the market is valued at just over 16 times earnings, only marginally above the long-term average and thus not overly expensive.

There are two problems with this line of reasoning that makes it a comparison of apples and oranges. First, while operating earnings is an important metric that can speak to the profitability of the core business, this approach essentially treats income and expenses not directly tied to the day-to-day functioning of the business as forever irrelevant to the calculation of earnings. The most important expenses excluded from this calculation would be interest, adjusted for tax effect, and "extraordinary" charges or credits. The definition of "extraordinary" has been vitiated. That's the first example of the apples-and-oranges confusion. Second, the P/E ratio of 15-16 is frequently compared with one using "forward" and not "trailing" earnings. We've always believed "a bird in the hand is worth two in the Bush." The (desired?) effect is generally to understate the P/E ratio.

S&P's estimate for 2004 *reported earnings* is currently $58.63. The S&P 500 Index closed 2004 at 1,212, which puts the estimated trailing *as reported* P/E at 20.7. Using these metrics the S&P 500 PE ratio is 32% higher than the aforementioned mean. Stated another way, if the S&P 500 would have closed the year at the long-term mean P/E (based on the estimate of trailing as reported earnings) it would have been 916, or 24% below the actual year-end close. Granted, we have no compelling argument that the S&P 500 should, forthwith or even anytime soon, regress to its long-term average P/E of 15.63, particularly with the discount rate (of which prevailing bond yields are a component) as low as it is historically. Yielding to our obligation as wealth managers to muse about future opportunity sets that may be dramatically different from today's, the possibility of both rising interest rates and equity-risk premiums, to say nothing of deteriorating assumptions regarding future earnings prospects, could put us in the most uncomfortable position of looking *up* wistfully at the "mean" P/E.

The reader may not need to be reminded that while the numerator of the P/E is calculated with exactitude every few seconds by S&P, the denominator — the earnings variable — is as malleable as the imaginations of those who concoct it. Going beyond the apples-and-oranges issues cited above, let's spend a few moments trying to further demystify earnings.

S&P 500 'Core' Earnings

In an attempt to cut through the clutter of the various (and often confusing) numbers presented as "earnings," Standard & Poor's has developed a "core" earnings figure for the S&P 500. The basic goal is to adjust *reported earnings* to get to a number that better reflects the core profitability of the 500 businesses, which in the aggregate represent the index. Here's the overview. S&P:

- Starts with the as-reported number.
- Reduces that number for the approximately 75% of stock option issuance that does not appear as an expense on the income statements.
- Subtracts various pension-related expenses that have in good times often been treated like "cookie jar reserves."

- Adds any goodwill impairment charges.[8]
- Adjusts for gains and losses.
- Adds settlement and litigation expenses to get to a core earnings number.

As can be seen from the chart below, over the relatively short time period supplied by S&P where these adjustments were made, the core earnings number has always been less than the *as reported* number. (Reconstructing earnings prior to the 2002 FASB 142 ruling on the treatment of goodwill is a task too daunting even for S&P.)

S&P 500 Core Earnings Adjustments

	1996	1997	1998	1999	2000	2001	2002	2003	2004 Est.	2005 Est.
Operating EPS	40.63	44.01	44.27	51.68	56.13	38.85	46.04	54.69	67.21	73.66
As Reported EPS	38.73	39.72	37.71	48.17	50.00	24.69	27.59	48.74	58.63	65.00
Option Exp PS	(0.49)	(1.12)	(1.56)	(2.50)	(3.82)	(5.31)	(5.31)	(3.92)	(3.40)	
Pension Int Adj.	(0.12)	(0.05)	(0.33)	(0.14)	(2.68)	(5.07)	(5.01)	(0.29)	(3.98)	
Other Net Pension Adj.	(0.90)	(1.11)	(1.42)	(2.28)	(2.69)	(2.26)	(1.99)	(1.71)	(1.42)	
Goodwill	0.03	0.18	0.24	0.16	0.83	2.47	6.91	1.77	1.34	
Gains & Losses PS	(1.36)	(2.50)	(4.45)	(4.24)	(3.28)	1.58	1.19	0.45	(0.08)	
OPEB PS	0.03	0.05	0.07	0.13	(0.34)	(0.39)	(0.35)	(0.32)	(0.70)	
Sett & Litigation PS	(0.01)	0.16	0.47	0.76	0.90	0.40	0.83	0.91	1.73	
Reversals PS	(0.01)	(0.03)	(0.11)	(0.14)	(0.06)	(0.10)	(0.19)	(0.08)	(0.06)	
Core EPS	35.90	35.30	30.62	39.92	38.86	16.01	23.67	45.55	52.04	

As for more details, the first adjustment (and probably the one with which most people are familiar) is option expense. Reported earnings are reduced by the estimated amount of options expense that companies choose not to include in their reported earnings.[9] The next modifications to consider would be the pension expense adjustments, which are not so black or white. The several pension adjustments, while important, are too complex to discuss here. We believe we understand the issues and recognize there are legitimate arguments on both sides. What is not supposition, however, is the extent to which pension funds, in the aggregate, are under-funded. That number, as of the end of 2003, was $165 billion. As of August 2004, S&P estimated that "funding should improve but at the end of the year S&P companies will still be under-funded by $112 billion." Returning to the subjective, in our judgment pension actuarial asset return assumptions are generally on the high side and, accordingly, pension expense is likely to be a drag on earnings for some time. As for the potential snake-pit promise of post-retirement health care benefits, we'll save that discussion for another time.

Goodwill impairment is the next adjustment to consider. While it's true that the actual goodwill impairment is a non-cash charge, it is at least debatable whether this means it should therefore be added to the reported earnings and, all other things being equal, increase the core earnings number. Thought of in its entirety, an impairment charge means that there have been real economic losses. Value (cash and/or company stock) has been exchanged for an asset that is deemed now to be worth less than the original price paid. To be sure, to allocate the entire charge to any one quarter seems arbitrary when the decisions that culminated in the recognition of the loss were often years in the making. More on goodwill later …

[8] In 2002 FASB ceased requiring corporations to amortize goodwill over (typically) a 40-year period, a change with which we were in general agreement. Instead, it is the responsibility of the company and its accountants to determine when goodwill is permanently impaired. It is then immediately written down to its post-impairment value. Since the goodwill impairment charge is a non-cash and presumably non-recurring expense, S&P adds it back to arrive at core earnings. More commentary on the subject in the text later in this section …

[9] Currently about 25% of S&P 500 companies expense the issuance of options, typically using the Black-Scholes pricing model. A recent FASB ruling, which could be overturned by Congress, will require that all companies whose fiscal year ends after June 15, 2004, must expense options issued. Within five years, I believe that options will be no more than a shadow of their former self in terms of their importance as a component of executive compensation.

Apart from the core earnings adjustments, there are other considerations in determining the sustainability of after-tax earnings, of which the following is but one. According to the Bureau of Economic Analysis, the third quarter's seasonally adjusted corporate profits as a percentage of GDP were 6.8%. Were it not for the combined affects of the 2002 and 2003 Tax Acts — amounting to corporate tax savings of $123 billion for the annualized, seasonally adjusted data as of the third fiscal quarter of 2004 — the after-tax profit margin would've been a much smaller 5.7%. With the budgetary constraints that Congress will ultimately have to address, it may be irresponsible for an analyst to presume that the tax breaks are permanent. You do not have to take our word for this. The General Accounting Office said as much in a December 14, 2004, letter to the President, the President of the Senate, and the Speaker of the House of Representatives.[10]

Let's return briefly to the subject of "goodwill" so as not to slight the importance of historical perspective. The widely accepted definition of the value of a business is the discounted present value of all the cash you can take out of it over time. Cash expended to purchase businesses in excess of tangible assets (the bulk of the purchase price for most companies these days) is recorded on the balance sheet as purchased goodwill. If, for whatever reasons, the goodwill is later deemed to be impaired, the cash expended earlier becomes money poured down the rathole. The present value of that malinvestment of cash should logically reduce the current value of business. Likewise, cash expended to repurchase shares in the market — to offset options issued or to manage earnings — at prices that are to the advantage of the departing shareholder (and therefore to the detriment of the one who stays the course) also should effectively reduce the current value of the business. Not so, according to contemporary Wall Street reasoning, where earnings, however measured, are the final arbiter of value. (Forget the cash? Not so fast. Doesn't everything ultimately get reduced to cash? Isn't it the lowest common denominator?) Sacrificing a chunk of often hard-earned shareholders' equity for past sins is deemed to give a bracing boost to profitability. Getting rid of the drag on earnings from the impaired assets with the stroke of an auditor's pen gives a lift to earnings. Similarly, the downsized shareholders' equity causes return on equity to rise. No wonder stocks rise on such public admissions of past errors. This nonsense is nothing new. See Benjamin Graham's comments on "Stock Watering Reversed" extracted from the 1934 edition of *Security Analysis* on page 61 in the Appendix to the 2000 MCM annual report. As for the earlier iteration, here follows his summary of the same practice more than 70 years ago: "The idea that such sleight-of-hand could actually add to the value of a security is nothing short of preposterous. Yet Wall Street solemnly accepts this topsy-turvy reasoning; and corporate managements are naturally not disinclined to improve their showing by so simple a maneuver."

Where does that leave us? The preceding discussion was simply a subjective look at some of the adjustments the S&P folks make to arrive at their core earnings figure, which is their attempt to demystify earnings. There are arguments for increasing or decreasing the adjustments for several line items. For 2004 specifically some of these arguments seem to counteract each other, and we would (netting them out) arrive at a figure very close to S&P's core earnings of $52. Putting this back into the context of valuations, the core earnings above would result in a market multiple of just over 23 times. You may scold us here for committing the same sin we accused others of committing earlier — of comparing apples to oranges — in that we are contrasting core earnings with reported earnings. Despite the difficulty in reconstructing core

[10] "… The federal government's gross debt as of September 2004 was about $7.4 trillion, or about $25,000 for every man, woman, and child in the country. But that number excludes such items as the gap between promised and funded Social Security and Medicare benefits, veterans' health care, and a range of other unfunded commitments and contingencies that the federal government has pledged to support. If these items are factored in, the current dollar burden for every American rises to about $145,000 per person, or about $350,000 per full-time worker. GAO's fiscal policy simulations illustrate that the fiscal policies in place today — absent substantive entitlement reform or unprecedented changes in tax and/or spending policies — will result in large, escalating, and persistent deficits that are economically unsustainable over the long term. Without reform, known demographic trends, rising health care costs, and projected growth in federal spending for Social Security, Medicare, and Medicaid will result in massive fiscal pressures that, if not effectively addressed, could cripple the economy, threaten our national security, and adversely affect the quality of life of Americans in the future." This is a direct quote, folks, from the General Accounting Office. I'm not making it up.

earnings well into the past, we don't believe the variance would be extreme. In our judgment, by any reasonable measure, the market is not cheap. You might recall Warren Buffett's statement: "We would rather be generally right than precisely wrong." As for us, if we are to err, let it be an error of excessive conservatism. You don't lose real money by forgoing opportunity. Remember also, as the dairy farmer put it, "To err is human, to forgive bovine."

Venturing a look into the future, we'll conclude this section by offering a comment or two about profit margins and earnings growth. First, after careful study, we see nothing structural that will impede the gradual regression of net margins toward their long-term mean of around 5%. The mean itself seems to reflect some long-held tacit acceptance of the sharing of the GDP pie among capital, labor, and government. Second, we are equally unimpressed with arguments that GDP growth will accelerate to rates heretofore unseen. Accordingly, despite all the earnings management nonsense of the 1990s, we think the historical trendline growth in earnings is the most optimistic metric to use for extrapolating into the future.

As for how we cope, in our opinion, with an overvalued market and the difficulty many financially leveraged companies will have in "goosing" dividend payout ratios — particularly in light of the most favorable taxes on dividends, at least for another four years — up to the levels that support arguments of a 10% return from common stocks, please refer to other sections of the report.

RUN FOR THE ROSES

Of Pawns, Guinea Pigs … and 'Retail Investors'

"Each age has its particular folly, some scheme, project or phantasy into which it is plunged, spurred on either by the love of gain, the necessity of excitement, or the mere force of imitation. … Money has often been a cause of the delusion of multitudes. Sober nations have all at once become desperate gamblers and risked almost their existence upon the turn of a piece of paper. … Men, it has been well said, think in herds; it will be seen that they go mad in herds, while they only recover their senses slowly and one by one." This passage is from another Christmas book, Charles MacKay's *Extraordinary Popular Delusions and the Madness of Crowds.*

Returning once again to our baseball metaphor, a "changeup" may keep you, the batter, from dozing off at the plate. Getting right into the swing of things, let's begin with the end in mind. Picking up where the 2003 annual report left off, let's take a look at the denouement of (for lack of a better description) the *average* retail investor as described in the next paragraph. Throughout this section we infer that the adjective "average" modifies the stereotypical characterization "retail investor," respectfully realizing that an individual outcome may fall anywhere on the Bell curve, on either side of the mean, which distribution no doubt has a large standard deviation. The final resolution of the sequence of events, almost as though following a well-worn script that calls for generous improvisation, could be stated more politely, but not with more succinctness.

It might be noted that the subject appears two years running as testimony first to the writer's belief that everyone in the know should come to the aid of the least informed, like the crowd that on occasion pursues the purse snatcher. Second, though the pieces of a chessboard include the stately Kings, Queens, Bishops, Knights, and Rooks, of which there are 16 in all, there are an equal number of pawns who, metaphorically, represent the "retail investor." The pawn is the chess piece of lowest value and, as chess players know, every pawn move creates a weakness beside it or behind it. The parallels abound. Rooks (also called Castles — what fun we could have with that if only we had the time!), another word for swindler outside the game of chess, are (so much for chivalry) more valued than Knights. Not all is hopeless, however. While the pawn is the first line of defense to be sacrificed to protect the King, if he survives to reach the eighth rank, he can be promoted to any piece other than a King, including the all-powerful Queen. Can you feel Darwin's presence in this ancient game that predates him by centuries?

One is at a loss to stereotype the so-called "retail investor" in terms of cause, but perhaps less so in effect. Those who ended up empty-handed or nearly so, who had little to show but regrets for whatever effort and savings they expended during the great "Run for the Roses," may fit the characterization of the effect.

(Dan Fogelberg's 1981 song, a favorite with some Derby fans, is rich with irony, beginning with the album title, "The Age of Innocence." The lyrics in the first stanza in the chorus tell it all:

And it's run for the roses as fast as you can.
Your fate is delivered. Your moment's at hand.
It's the chance of a lifetime in a lifetime of chance.
And it's high time you joined in the dance.
It's high time you joined in the dance.)

As for cause, some retail investors were artless, venturing without either plan or purpose; others exhibited a credulity that impedes effective functioning in a practical world; still others were congenitally uncritical; while many were found lacking in worldly wisdom. The crafty were "too smart for their own good by half." A share was surely greedy or slothful, failing to realize that a person cannot consume more than he has produced. Wealth, many learned the hard way, is the product of an individual's capacity to think. Most regrettably, a not insignificant number of these investors were pawns in a social/economic construct where, increasingly, corruption is rewarded and honesty becomes self-sacrifice. As for "retail investors" taken as a whole, Thomas Carlyle sardonically observed: "I do not believe in the collective wisdom of individual ignorance."

The retail investor in this drama about financial cycles is not a bit player, though in the posthumous analysis of a mania that reached bubble proportions (before its ultimate demise), he went largely unnoticed, especially in the early acts. By a series of unintended consequences — following the introduction of the self-directed 401(k) plan in 1981 and the coincidental rebirth of the mutual fund industry — he found himself standing center stage, with a look of astonishment on his face, holding the proverbial bag when the curtain began to fall.

For purposes of this study, mutual fund investors, as a group, are the best guinea pigs to be found. (It is not our intent to demean any participant or group of participants in the capital markets. One definition of "guinea pig" is "a person who is used as a subject for research," and that's how it is used here. In the rough-and-tumble world of investment where disciplined rationality may be the most important trait that keeps an investor and his money from being separated, the more we can surmise about the behaviors of the person on the other side of the trade, the better our chances of surviving or even prospering. For the truly patient, it is not a zero-sum game. In the short run, though, it can be brutal.) Not only are "retail investors" deemed to be among the least experienced participants in the financial markets, there is a plethora of data available on their behavior, thanks to the Investment Company Institute's (ICI) Statistical and Research work in quantitatively supporting the mutual fund industry's "asset gathering" (remember the pawns?) marketing efforts. By carefully examining the data and thus gaining an awareness of this process that seems to forever migrate toward the denouement of the retail investor, we will acquire another shred of evidence about the nature of financial cycles and, more importantly, gain a better understanding of whether we're closer to the beginning or the end of the run. For the retail investors who read this rather disheartening saga, may they gain wisdom as a result so that when history repeats itself they will promote themselves to the eighth rank and become imbued with a new sense of power.

While the drama begins in 1982, a prologue is necessary to set the scene. From the vantage point of today, anyone with a yen for the practical lessons history can teach will look back to that year and see it as one of the most opportune times to commit one's savings to marketable securities during the last 100 years; it was the equivalent of fishing in a stocked pond. More importantly, the rational (not to be confused with retail) investor would have reached the same conclusion — contemporaneously in 1982 when he could and sometimes did seize the moment. Stocks and bonds were so stunningly cheap that an abiding conviction about a rather understandable universal principle is all that would have been necessary to induce the wise man to throw in his lot: the natural tendency of price and value to converge (think again of the child-on-the-swing analogy). Price-value convergence? Mathematicians call it regression to the mean, and physicists, when describing the pendular moment of stock prices (thanks to Newton), note their inclination to gravitate toward the albeit vague notion of "intrinsic value," the point of the arc where they would come to rest without external agitation. Unfortunately, the retail investor was anything but rational when the opportunity arrived. He had lived through the torturous 17 years before, a long span of history, memorable for its violent shorter-term waves. While the tide, the Dow Jones Industrial Average, ended literally within a pathetic 5 points from where it began, the typical retail investor had been regularly whipsawed, often completely consumed in trying to stay afloat in turbulent seas.

Exhausted and disoriented, he eventually succumbed to despair, in his desperation thinking he had been rescued by the life raft of high, short-term nominal interest rates. Unfortunately, the raft had a slow leak. Three years into the bull market, individuals remained guarded, accounting for only 11-15% of the daily volume on the NYSE, compared with more than 40% in 1975, just 10 years earlier. As for household assets, according to the Federal Reserve, in 1968, when under the mattress would've been a better place, 35% were invested in common stocks, directly or indirectly. In 1989, by contrast, well into the next secular bull market, skittish investors had committed just 13% of their assets to equities. Always chasing yesterday's winner in stocks or the highest current yield in fixed-income securities, most Americans throughout the 1980s found safety initially in money market funds and CDs, then later in bond funds. Fortunes would have been made had they simply reversed the order. Later to become ubiquitous in the 1990s, mutual funds (profiled extensively in the MCM 2003 annual report) — after years in a torpid state following the abuses of Bernie Cornfeld and his gang of scalawags in the "go-go" 1960s — cycled back into favor. To be sure, mutual fund ownership grew fivefold during the '80s, albeit from a small base but, as noted above, for the majority of investors, mutual funds were not yet synonymous with equities.

Pension Funds, Managed for Mediocrity

Pension funds, lest you be led astray by concluding that in *all* cases money and brains are positively correlated, after throwing an average 55% of new money at equities during the 20 years leading up to 1982, finally chastened, collectively they timidly parceled a relatively paltry 24% of fresh money into common stocks when they were as cheap as they had ever been. Pension fund managers are the institutional equivalent of the retail investor. As discussed in earlier reports, investment committees invariably oversee pension funds. Committees are small crowds and, according to the oft-quoted late-'90s Christmas book *The Crowd* by Gustave LeBon, when smart men and women combine their intellects to presumably optimize a solution, the result tends to be surprisingly counterproductive. Rather than being boosted by brilliance, groupthink has a perversely dilatory effect on collective reasoning. When a group is unable to foster an atmosphere of independence and diversity of opinion, which includes free-flowing exchanges of ideas, it often falls victim to the plague of the lowest common denominator. Henry David Thoreau turns the common into the eloquent: "The mass never comes up to the standard of its best member, but on the contrary degrades itself to a level with the lowest." We may be coining a new word, *un*synergism, wherein the whole is *less* than the sum of its parts, but this is not a new idea (see 2001 annual report, bottom of page 37). Mark Mobius, author of *Passport to Profits*, punches the clock: "A committee is a group of people who keep minutes and waste hours." Read on and you'll discover how corporations have responded to this dilemma.

'Willful Ignorance'

As examined in last year's annual report, under the title "The Great Abdication of Fiduciary Responsibility," the 401(k) plan was conceived and marketed ostensibly to give the individual investor more flexibility and control over his financial destiny, which admittedly it did in spades. Prominent on the hidden agenda, though, was the mad scramble to pass the "hot potato" of the risk and responsibility for managing the assets from the employer to the employee. American sociologist Robert K. Merton's first and most complete analysis (1936) of the concept of unintended consequences helps to explain what happened. As will be apparent below, Merton would likely describe the corporate desire to cede responsibility for managing retirement assets (as noted above, the abysmal performance of the defined benefit pension plan was increasingly becoming an albatross around its corporate neck) as "imperious immediacy of interest." By that he was referring to instances in which an organization wants the intended consequence of an action so much that it purposely chooses to ignore unintended effects. (That type of willful ignorance, a root cause of unintended consequences, is very different from true ignorance, which would more appropriately characterize the plight of the worker into whose unskilled hands the proverbial hot potato is summarily dropped. Where the battle-weary sponsors saw risk, the newcomers envisioned the American dream. One man's garbage may be another man's [fool's?] gold …) Please understand that such behavior is not deemed by the writer as malicious, only shirking from responsibility — "passing the buck," if you will. In the name of expediency, responsibility should be delegated as far down the food chain as appropriate but no farther. As to "how far," I suppose the question could be asked: Is the person to whom the duty is conferred able to make rational decisions on his or her own and therefore wholly answerable for his or her behavior? "Everything should be made as simple as possible, but not simpler," Albert Einstein once sagely observed.

Although an anachronism in the codes of conduct for far too many corporate managers today, perhaps the following will serve as an admonition to the recalcitrant … Not one to duck the duties that came with the Oval Office, Harry Truman stood stoutly behind the famous sign on his desk "The Buck Stops Here." Of course, feisty Harry liked the hot seat! He also purportedly said, "If you can't stand the heat, stay out of the kitchen." Are any members of corporate boards listening?

Mutual Funds: There's Gold in Them Thar Hills!

The vehicle *du jour* to serve as middleman between the newly "empowered" worker and the capital markets where anyone can become a millionaire was the ubiquitous croupier, the mutual fund, offering more flavors than Baskin-Robbins, a smorgasbord of confusing choices cleverly promoted under the intuitively appealing banner of broad diversification. The "manifest destiny" of the individual was in sight. At last the common man would rule the markets — and until the spring of 2000, he felt as if he did. By 1998 approximately three of every four new dollars invested in corporate retirement plans were going into 401(k)'s, indicating a successful passing of the "buck" ("burden" later proving to be a better word). Having come from the "sell" side of the street, it was clear to me that the "packaged product," where commissions and fees in the early years were larcenous, saved the retail brokerage industry and gave birth to yet another middleman, the financial planner, after stock commissions were deregulated in 1975.

In 1990 and 1991, money that flowed into the funds that invest in stocks averaged barely $25 billion; by 2001 inflows exceeded $260 billion, equal to almost half of the total mutual fund assets invested in equities in 1990. At the end of the decade, two-thirds of all active workers covered by a retirement plan were responsible for directing their own investments. (Obviously, the vast majority who invested in mutual funds directly had the final say about where their savings were invested.) With interest rates low and stock prices levitating, particularly as the 1990s passed the midpoint, they jumped evermore enthusiastically aboard the stock bandwagon. By the end of the millennium, 401(k) investors had stashed 75% of their assets in equities. (*The Great 401(k) Hoax* by William Wolman and Anne Colamosca does a yeoman's job of painting the backdrop.) Blind inertia was at full throttle as fund investors embraced, as never before, the greatest stock market boom of the 20th century, even as the tech-driven Nasdaq peaked at 5000 and began its harrowing free fall in March 2000, with 80% of its illusory value disappearing into the thin air from which it had come like a thief in the night, all within two years. Apparently unaware that prices are ultimately tethered to something (is it not so in all other value-for-value transactions in which the reader engages?), however long the rope and therefore oblivious to what lay ahead, retail investors poured $260 billion into U.S. equity funds throughout 2000, fully half of which went into "Aggressive Growth" equity funds, according to the ICI. Saving the most for last, their final splurge in 2000 exceeded the $150 billion that ratcheted its way up the risk chain into equity funds in 1998, followed by $176 billion in 1999. The unfortunate and unintended consequence — widespread financial disaster for millions of retail investors — was born of true ignorance.

From 1980 to 2000, the percentage of U.S. households that owned mutual funds increased almost *ten*fold, from 5.7% to 49.6%, the ICI noted, with a discernible sense of pride. By year-end 2003 the penetration rate had dropped a mere 1.8 percentage points. Stated differently for the writer's emphasis: Household mutual fund assets were largely committed to fixed-income securities in the earlier years when interest rates were relatively high. Individual investors gradually migrated toward equities in the 1990s as stock prices rose while interest rates were going the other direction. To put things in a broader perspective, in 2003 mutual funds owned 28% ($3.9 trillion) of the $14 billion in market value of all publicly traded U.S.

equities. That's a *18*-fold increase from $216 billion in 1999. About $2 trillion in mutual funds were owned directly by individuals, with the remaining $1.7 billion held by institutions, approximately half of which on behalf of individuals through such company-sponsored retirement plans as 401(k)'s. As noted above, 75% of 401(k) plan assets were committed to common stocks at the peak. A complementary statistic, the percentage of long-term mutual fund assets committed to common stocks, rose from 38% in 1990 to 70% in 2003.

The vast majority of the $7.4 trillion invested in mutual funds of all types, including $2 trillion in money market funds and $1.5 trillion in bond funds, is controlled by individuals. Likewise, a large proportion of the cash flows going into different classes of mutual funds are largely at the discretion of the individual decision maker, frequently aided by financial planners whose models are little more than linear extrapolators. Referring to the oft-quoted metaphor from Benjamin Graham, the mutual fund investor may indeed be "Mr. Market." For those of you not familiar with this gregarious but naïve fellow, a short paraphrase from the classic *Intelligent Investor* may help.

Imagine that Mr. Market is your partner in a business where you have invested $1,000. Every day he tells you what he thinks your interest is worth and offers to buy your share or sell you more at that price. Some days his offer seems reasonable based on the future prospects of the business, while other days his enthusiasm or fear may cause his offer to seem a bit silly. If you are a sensible businessperson, will you let Mr. Market's daily communication determine your view of the value of a $1,000 interest in the business? You may be interested in his valuation when he offers to buy at a ridiculously high price or sell at a low price, but otherwise you would be better off to value your interest based on the operational and financial reports of the business. With this metaphor in mind, what does Mr. Market look like today? According to demographic information provided by ICI, his or her median age is 48 years; household income, $68,700; household financial assets, $125,000, excluding primary residence but including assets in employer-sponsored retirement plans; household mutual fund assets, $48,000; number of mutual funds owned, 4. Half the decisions are made jointly, the remainder evenly divided between men and women. The average 401(k) account balance, excluding plan loans, was $39,885 at year-end 2002, with approximately 23% of the average household's financial assets, including mutual funds, owned outright. Workers in their 60s with at least 30 years of job tenure at their current employer had an average 401(k) account balance of $146,211.

What about the $37,000 of average household assets that were invested directly — and not through a mutual fund? Exhibiting the "credulity that impedes effective functioning" in the increasingly ethically challenged world of finance, the easily deceived were sitting-duck prey for the disingenuous. Longtime skeptic David Tice, in testimony before Congress in the spring of 2001, illustrated the point by noting that individual investors ended up owning a shocking 75% of all Internet stocks. In order to add some balance to this otherwise discouraging scenario, it seems appropriate to indulge in a little moral reflection and muse for a moment about ultimate consequences.

No Crime Goes Unpunished

Willful ignorance was defined earlier as the desire for an intended consequence of an action that is so strong and overarching that one purposely chooses to ignore any unintended effects … to put it charitably, to reap what one has not sown. Of this ethical if not legal transgression, many were conflicted but few convicted. Men and women of power and responsibility — including CEOs and their boards (the order here implying the convoluted power hierarchy), investment bankers and their research affiliates, and mutual fund companies and their managers — willingly sold their integrity (souls?) for a disproportionate share of the spoils. (The following remarks are not directed at 401(k) plan sponsors who, for the most part, were going with the times. Several independent-minded sponsors with whom I've spoken simply felt they had no other choice.) As for those who, with willful maliciousness, have pillaged with self-enriching stock option programs and other sleight-of-hand techniques under the guise of the doctrine of (un)just incentives and rewards, "stealth compensation" hardly characterizes the practice with the moniker of injustice that it so richly deserves. We don't quibble with "stealth," as this term befits the conduct, but "compensation" (the return for services rendered) leaves us incredulous at its audacity. In any other venue of misconduct, it would be called larceny — and on the grandest and most socially grotesque scale.

We should not envy the moochers and parasites, nor should we conclude, regardless of the outward appearance of apparent indifference, that they are without conscience. Despite this massive redistribution of wealth, the love of money serves up its own justice for those who come by it dishonorably. Ayn Rand, in *Atlas Shrugged*, points out the true "cost" of ill-gotten gain: "Money is your means of survival. The verdict you pronounce upon the source of your livelihood is the verdict you pronounce upon your life. If the source is corrupt, you have damned your own existence. Did you get your money by fraud? By pandering to men's vices or men's stupidity? By catering to fools, in the hope of getting more than your ability deserves? By lowering your standards? By doing work you despise for purchasers you scorn? If so, then your money will not give you a moment's or a penny's worth of joy. Then all the things you buy will become, not a tribute to you, but a reproach; not an achievement, but a reminder of shame. Then you'll scream that money is evil. Evil, because it would not pinch-hit for your self-respect? Evil, because it would not let you enjoy your depravity?" What goes around comes around …

Inertia for the Long Term?

Despite warnings to the contrary, bloodied but not broken (yet) mutual fund investors have not lost faith in common stocks. Due to the combination of 401(k) plan cash flow momentum and seemingly unattractive alternatives, savings continue to flow toward equity funds. Mirroring the market, they fell to a still positive $54 billion in 2001, then turned modestly negative to the tune of $25 billion in 2002, just before the spirited rally that began in the spring of 2003. Based on the latest information provided by ICI, October 2004 year-to-date net new cash flows into stock mutual funds totaled $146 billion, up from $123 billion from the same period in 2003. Tellingly, $1 billion was withdrawn from taxable bond funds by October 2004, compared with a net inflow of $41 billion in a more cautious 2003. No doubt partly motivated by lower tax rates, the pace of net liquidations from tax-free mutual funds quadrupled to $12 billion. Economist Herb Stein's Law, "If something can't go on forever, it will end," originally appeared in the press in the 1980s as a warning about the ever-growing balance-of-payments deficits. He was careful not to say when! As for the mutual fund mania, I will hide behind Herb to avoid the time trap!

In terms of fund balances, the latest information available is for year-end 2003. One subset, mutual fund assets invested in 401(k) plans, grew to $1.9 trillion, with an estimated 42 million workers in the United States participating. Equity securities represented 67% of 401(k) plan assets at year-end 2003, up from 62% in 2002, generally reflecting the strong performance of the equity markets relative to fixed-income securities. Equity securities included equity funds, the equity portion of balanced funds, and 16% in company stock. (Steve Leuthold, in the December 2001 issue of *Investment Insights*, reported that the average 401(k) plan had 39% of its investments in company stock, another frequently overlooked item on the hidden agenda.) Equity fund managers, indicating either their optimism about the markets or their willingness to put investors' money fully at risk to avoid their own professional peril (career risk), maintained a low 4.4% of assets in cash.

Portentous or Poppycock?

Based on the study of mutual fund data going back to 1980, a couple of conclusions seem to be driven by the facts. First, apart from the growth in popularity of mutual funds as part of a household's portfolio assets, which as warned in last year's report is subject to the law of regression to the mean, fund flows tend to follow the hottest game in town. One can logically draw certain inferences about the finality of a secular financial cycle when mutual fund investors embrace it *en masse*. To put it bluntly, the behavior of the retail investor today is the mirror image of what we would logically expect of a seasoned, rational investor at the bottom of a secular bear market. Nobody knows how or when (the "if" is not so chancy) we will migrate from a fully priced, widely embraced, retail-driven investment environment that the wise approach with vigilance and restraint to one where the margin of safety is so great that, ironically, nobody cares. Well, almost nobody. The risk-averse investor who, by virtue of the boundless bargains, would be justified in throwing his customary caution to the winds. Buffett's comment elsewhere that "the hangover may prove to be proportional to the binge" is all we can bank on — and never with absolute certainty, only with high probability.

Second, the automatic cash flow programs like 401(k) plans, as noted above, do not represent a commanding portion of mutual fund cash flows into equities. Like the Baby Boomer cash cow myth (a favorite half-truth flaunted by financial advisors in the late, great "Run for the Roses," the fallaciousness of which was laid bare in the 2000 annual report, page 32), potent were it not for the fact that demand often begets its own supply, the oft-used argument that the cash flows into equities from 401(k) plans will shore up equity prices seems to be a late-in-the-game, seventh-inning credulity stretch. It also is unlikely that hoards of discretionary cash from retail investors will drive the markets upward during the next decade as they did in the 1990s. To the contrary, unless rising prices magically reappear to stimulate their instinct to play "follow the momentum," disaffection may result. Instead of providing incremental demand, they could become the proverbial wet blanket. Who will step up to the plate? Perhaps, as I suspect Buffett fears, foreign investors, loaded with dollars, will eventually assuage their currency losses by buying yet more of American business on the cheap? Congress will surely meddle, smiting those who will be characterized as "infidels" with a new iteration of Smoot-Hawley. After that, "Katie bar the door …" But now I'm off on a rant!

Apparently it did not occur to most market strategists to compare the losses of 2000 with the mauling of 1970 — in what turned out to be the first cyclical bear market of several during the aforementioned 1966-82 period when, start to finish, the Dow made as much forward progress as a jogger on a treadmill. Following the crash in 1970, the "Nifty Fifty" of the '70s still stood tall. Those blue chips would not be decimated for another three years. Quoting San Antonio sportswriter Dan Cook (1976), former NBA basketball coach Dick Motta (1978), and countless others since, "The opera ain't over 'til the fat lady sings."

To conclude with a sober observation about the uninitiated, the behavioral propensity of financial cycles can be summed up succinctly: the accumulation by the wise when prices are low, followed by the distribution to the inexperienced when prices are high. The usually hapless *average* mutual fund investor adds another layer of evidence to reinforce the idea of financial cycles.

WHAT'S A HITTER TO DO WHEN THE PITCHER IS THROWING JUNK?

When 'Nothing' Is More Than Something

As an "active manager" with ostensibly unlimited strategic and tactical options before us, we must discuss an "institutional imperative" that narrows, rightly or (mostly) wrongly, the range of practicable options for many in our industry. When a firm is hired to "manage money," in our harried world it is most often judged against the standard of "activity, agency, getting things done." The fearsome S&P 500 benchmark or some other index stalks them like a relentless nightmare. When stocks are moved from prime shelf space to the bargain basement, there are frequently steals galore among the discarded — though not seen as such except in retrospect — for those few who have both the wherewithal and the mindset of a seasoned shopper on the first business day after Christmas. But what course of action do most "wealth managers" take when businesses are richly valued and opportunities scarce? They continue to swing, like the pinch-hitter in the bottom of the ninth a run down, because that's what they are hired to do. There must be a reason why most rarely let equities slip to less than 50% of their holdings, even if they fear the worst for their portfolios. At some point the shrinking percentage of equities (perceived as forgone opportunities) prompts the question that managers fear more than losing money for their clients: "Why do I need to pay you a fee when I can buy Treasury bills on my own?" Managers, whose fees are based on their ability to gather and retain assets (the standard construct, though not necessarily an indication of their capacity to preserve and enhance their clients' wealth) will do almost anything to avoid having to field that one-hop line drive.

Seth Klarman, president of the Baupost Group Inc., and author of the 1991 Christmas book, *Margin of Safety*, is anything but defensive on the subject of holding cash, regardless of the institutional imperative: "You are paying us to decide when to hold cash and when to invest it, to determine when the expected return from a prospective investment justifies the risk involved and when it does not."

We might present essentially the same idea with a different slant. Our long-standing contention is that cash, along with its short-term equivalents, is the default asset class. To the extent that we uncover enough ideas that conservatively promise five-year returns in excess of our 15% threshold rate, cash balances will shrink as cash flows out of safe-harbor, short-term investments toward the higher-return assets, just as water naturally seeks its own level. Conversely, when such ideas are in short supply, as they are today, cash will flow in the opposite direction, toward the default asset class. Portfolio allocation percentages are not set arbitrarily or by formula but rather by the availability of mouthwatering opportunities.

Klarman also addresses the psychological stress on the patient manager who holds cash: "Emotionally, doing nothing seems exactly like doing nothing: It feels uncomfortable, unproductive, unimaginative, uninspired, and (probably for a while at least), under-performing. One's internal strains can be compounded by external pressures from clients, brokers, and peers. If you want to know what it's like to truly stand alone, try holding a lot of cash. No one does it. No one knows anyone who does it. No one can readily comprehend why anyone would do it. Also, believing that better opportunities will arise in the future [the optimistic bias] than exist today does not ensure that they will. Waiting for bargains to emerge may seem like a better strategy than overpaying for securities today. However, tomorrow's valuations may be higher still."

Klarman's "between a rock and a hard place" (like our president, who's still between "Iraq and a hard place") dilemma is credible, though it comes close to diluting if not contradicting his first straightforward assertion. One can vaguely see the ghost of the imperative shadowing the nervous manager as he makes his every move. Cash is like a burr under our saddle, a constant reminder to redouble our research efforts in search of new ideas that make their way through our filters. We're never working harder than when we appear to be doing nothing. When asked how he discovered the Law of Gravity, Newton said, "I thought about it a lot." There is a great, and often overlooked, gulf between the genesis of an idea and its fruition. The grandeur of the results often make the enormous effort expended in between seem insignificant in comparison. Thomas Edison said that "genius is 2% inspiration and 98% perspiration." We're human, so we're also most comfortable being fully invested. But in that urge there is too often the tendency to anchor one's thinking in the limited opportunity set of today, forcing "opportunities" that don't really exist, like the parched man who mistakes a mirage for the water that will actually quench his thirst. To put it differently, the best golfers know that birdies come "as they will" as a result of good swings and good strokes; they aren't forced by obsessing about score.

The St. Petersburg Paradox and the Margin of Safety

MCM is a boutique manager catering almost exclusively to a relatively homogeneous group of well-to-do clients. We earnestly believe we have an atypical duty of care to the individuals who make up our client roster, as this aside bears witness. We are not simply one of several hired guns but rather see our relationship or role as more intimate, perhaps equivalent to that of a personal investment steward. Our generally 40-something and mostly much older (the oldest being 94 and going strong) clientele has certain investment proclivities in common, one of which is *not* Russian roulette, as shall become clear below.

Before it was renamed Leningrad, the port in northern Russia was called St. Petersburg. A parlor game ostensibly devised in that fair city en*tails* coin flipping and probability theory. Please bear with as we try to get you from Russia to the point! The "expected value" of the St. Petersburg game is the sum of the expected payoffs of all the consequences (which are potentially infinite in number) — an infinite number of dollars. A rational gambler would theoretically pay any price to enter the game since such price would always be less than the infinite expected value. And yet a respected theorist argues that "few of us would pay even $25 to enter such a game." If so, there must be something wrong with the standard decision-theory calculations of the expected value upon which the game depends. Daniel Bernoulli, an 18th-century Swiss mathematician, discovered the St. Petersburg paradox.

Beyond the obvious practical obstacles to flipping a coin billions of times, there are other explanations that are more reasonable in attempting to resolve the paradox. Bernoulli introduced the now-well-known concept of *decreasing marginal utility*. Stated in terms relevant to our use, if one possesses $1 million, one may risk some portion of it in order to double one's sum. On the other hand, if one already has a net worth of $10 million, another million, representing a much smaller (10%) increase, is not likely to have the same marginal usefulness to its owner as in the first example, and the second player would presumably (and rationally) be less inclined to bet as much as the first.

A companion explanation is *risk aversion*. Perhaps we can explain it by examining its opposite. The lottery player and those who gamble at pure games of chance in casinos are not risk-averse but may in fact enjoy risk taking. We would consider such behavior irrational because in these games the entry fee is greater than the expected utility.

Departing from pure games of chance, we believe there is another metric that reconciles decreasing marginal utility and risk aversion for the rational, well-heeled value investor that has a huge influence on the extent to which he's in the game. It's the concept of *margin of safety*. Assuming the market is inefficient on occasion — not a heroic assumption for us — the greater the margin of safety implicit in a deeply depressed market or stock, the less the risk and the greater the expected return. At prices low enough, the concept of decreasing marginal utility takes a backseat as part of the decision-making process.

The environment in which we find ourselves is one, in the aggregate, that appears to offer little margin of safety. It is much more appealing for the risk-prone than the risk-averse investor. As the margin of safety increases, perhaps as the result of falling prices, the dynamic changes dramatically in favor of the risk-averse investor. We believe that most of our clients share this mindset.

'Swing, You Bum!'

To be sure, our fee structure intentionally prods us to aggressively search for ideas when we have cash, with the high-water mark acting as a governor on our enthusiasm, to check our swing unless the pitch seems headed for that part of the strike zone where, for us, a hit is most likely. If we are to retain rationality as one of our chief virtues, we must sublimate our natural inclination to keep swinging to the much more demanding calling of remaining patient, of evaluating each pitch with the idea that it's far better to walk to first base than to strike out swinging for the fences. It is no coincidence that Babe Ruth and Ted Williams were third and fourth, respectively, in career bases-on-balls statistics. While the following is an oversimplification, it helps to make the point: Ted Williams' lifetime record of 541 home runs compares with 2,021 walks (8,084 pitches went by that were "called balls" — all the while Williams was poised, at the ready, but checked his urge to swing before the pitch crossed the plate). While I would prefer using his best-ever lifetime batting average of .344 to make the point, the analysis quickly gets too complex. Rather, I roughly estimate that for each home run he hit, Williams watched patiently at least 30 pitches he didn't like thumped into the catcher's glove. With steely-eyed determination at the plate, oblivious to an ever-lurking hostile press and tuning out his well-intentioned fans, in a most businesslike manner he let slide by every less than acceptable "pitch" that might keep him from achieving his objectives. He approached every at-bat with the end in mind. It was diligence, determination, and discipline — not destiny — that put Ted Williams in the Hall of Fame.

Many mainstream portfolio managers, judged as they are on short-term performance, feel they must be swinging all the time. They must focus on the present, on survival. If they don't meet the relentless present demands, they'll have no corner office from which to build a great long-term record. Individual investors — or the handful of advisors, such as MCM, who are granted substantial autonomy by their clients whose focus is on building wealth — who aspire to long-term success cannot afford the luxury of impatience (though they usually think the opposite is true). Rather, they must hold their ground in the batter's box until the fat pitch comes over the plate. As Buffett says, "The stock market is a no-called-strike game. You don't have to swing at everything; you can wait for your pitch. The problem when you're a money manager is that your fans keep yelling, 'Swing, you bum!'" Even Ted Williams (or Warren Buffett, for that matter) was not exempt from those cries. He simply ignored them, though not without considerable personal cost: Throughout much of his illustrious career, Williams was pilloried by the press.

The institutional imperative to "do something" does not apply to Buffett, since Berkshire Hathaway's shareholders, like those of a closed-end investment company, can neither cajole nor coerce him, they can only vote with their feet by selling their shares in the open market. In a sense, observing Buffett is an uncompromised "pure play" in rational thinking and acting. Make no mistake about it, Buffett is under a far more stringent, self-imposed imperative than the typical investment managers: to protect and enhance the value of Berkshire Hathaway on behalf of its shareholders, of which he is by far the largest at 32%. He is paid as a shareholder on performance, not promises. He knows as surely as night follows day that golden opportunities will appear with time, and he is content to stand, the bat on his shoulder indefinitely, until they appear. At Berkshire's annual meeting in 1998, he remarked, "We're not going to buy anything just to buy it. We will only buy something if we think we're getting something attractive. ... You don't get paid for activity. You get paid for being right." As noted above, we at MCM feel largely free of the institutional imperative, in part because we also are paid for being right and penalized for being wrong — both through our personal portfolios that look very similar to those of our clients (yes, we eat our own cooking!) and our performance-based fee arrangement — but also because our clients are savvy and understand the virtue of patience (of seeming to do nothing) and its positive, and seemingly counterintuitive, effect on long-term compounding.

As for hunkering down in Treasury bills … that may look to the casual observer in the stands like the equivalent of watching and waiting for the perfect pitch — while sitting on your *gluteus maximus* in the dugout! In reality, about the only thing you can do while standing at the plate, bat poised (if you expect to react quickly in order to take a cut at the ball that crosses the plate in your sweet spot), is be vigilant. Moreover, since the sweet-spot pitches are never telegraphed in advance (unlike batting practice), you must always be at the ready.

Returning to Ted Williams, Buffett metaphorically refers to the Splendid Splinter's swinging methodology to emphasize the importance of patience. "In his book *The Science of Hitting*, Ted explains that he carved the strike zone into 77 cells, each the size of a baseball. Swinging only at balls in his 'best' cell, he knew, would allow him to bat .400; reaching for balls in his 'worst' spot, the low outside corner of the strike zone, would reduce him to .230. In other words, waiting for the fat pitch would mean a trip to the Hall of Fame; swinging indiscriminately would mean a ticket to the minors."

The Mathematics of Patience

Having no interest in the minors, beyond throwing out the first pitch at the Omaha Royals home game during Berkshire's "Woodstock of capitalism" weekend, the most successful investor in the world suggests parking your money in cash equivalents and short-term bonds. He'd rather have historically low short-term returns than buy stocks or companies likely to return less than his threshold rate of return "because I'm going to be holding on to those forever ... [E]nough acquisitions like that and you end up with a very average business. So, in this low-interest environment, we have a lot of money in bonds right now."

In responding to a question at Berkshire's 2003 annual meeting about investment hurdle rates,[11] Buffett said, "10% is the figure we quit on. We don't want to buy equities when the real expected return is less than 10%, whether interest rates are 6% or 1%. It's arbitrary. Ten percent is not that great after tax." Charlie Munger further qualified his partner's response by adding: "We're guessing at our future opportunity cost. Warren is guessing that he'll have the opportunity to put capital out at high rates of return, so he's not willing to put it out at less than 10% now. But if we knew interest rates would stay at 1%, we'd change. Our hurdles reflect our estimate of future opportunity costs." Warren finished the exchange with a specific example: "We could take the $16 billion we have in cash earning 1.5% and invest it in 20-year bonds earning 5% and increase our current earnings a lot, but we're betting that we can find a good place to invest this cash and don't want to take the risk of principal loss on long-term bonds" [if interest rates rise, the value of 20-year bonds will decline]. The MCM hurdle rate, as noted previously, is 15%, a full 5 percentage points greater than Buffett's minimum. We think it's appropriate for two reasons — one a strength, the other a shortcoming: First, because the assets we manage are minuscule compared with Berkshire's, our universe of investment candidates is so much larger that we stand a better chance of finding pricing inefficiencies and other anomalies. Second, Buffett's finely honed investment prowess gives him a significant edge in qualifying future uncertainty in an investment. Recognizing our relative weakness in that regard, we must insist on a higher margin of safety implicit in a higher hurdle rate.

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[11] The quoted comments were not extracted from a transcript, as no recordings are permitted at the Berkshire shareholders' meeting. Relying on my own memory and the excellent notes taken by Whitney Tilson of Tilson Funds (he played court stenographer at the meeting), the quotations constitute our best approximation of what was actually said.

The mathematics of waiting for fat pitches is quite compelling. Since if you come this far you no doubt get the gist of the concept, it does not seem necessary to inundate you with the numbers we have crunched. Suffice it to say, you can earn a modestly positive return for quite some time while waiting for fat pitches — before your average compounded returns become lackluster. There is a counter argument for those who, apparently unfamiliar with financial cycles, challenge with shrill voices in their impatience, "What happens if those pitches never come your way?" Buffett doubtless feels no obligation to take the challenge, for to reply might dignify a question unworthy of a response (but could have the unintended consequence of sounding a lot like a forecast as well). A market — or an individual company's stock price — is, in most cases, not likely to go from prince to pauper without plenty of price pain. Buffett believes in the tendency of price and value to converge. Buffett's above scenario, namely, the modest return from Treasury bills, is not his worst-case scenario. The math of patience becomes overwhelming if you factor in the possibility of swinging indiscriminately and striking out before the fat pitches come, a risk Buffett has made clear he is unwilling to take. Like the flowers mentioned earlier, sometimes they come in bunches; other times they come one by one.

"We have $16 billion in cash, not because of any predictions [about a market decline]," he says, "but because we can't find anything that makes us want to part with that cash. We're not positioning ourselves. We just try to do smart things every day, and if there's nothing smart, then we sit on cash."

You will recall from the section on "Financial Cycles," Buffett's cash hoard as of September 30 totaled almost $40 billion and he has placed a $20 billion bet against the dollar. Based on what we can infer about the thinking at Berkshire since the annual meeting in May, it would appear that he is laying up stores, girding himself for eventual, but not necessarily imminent, action. Given Buffett's record of snatching victory from the jaws of someone else's defeat (e.g., 1974), his cash cache, seemingly head-in-the-sand benign, looks like enormous potential energy to me. Klarman articulates the logic behind Buffett's actions: "Never limit yourself to the opportunity set of today. Indeed, for almost any time horizon, the opportunity set of tomorrow is a legitimate competitor for today's investment dollars. It is hard, perhaps impossible, to accurately predict the volume and attractiveness of future opportunities, but it would be foolish to ignore them as if they will not exist." The following quotation is from the notes taken by a student who was among a group of University of Pennsylvania and the Wharton School of Business students who spent the morning with Buffett on November 12, 2004. When asked a question about the rich valuation of the market he responded: "We are near the high end of the valuation band, but not really at an extreme. … I suspect that stocks are too high now. Nothing is cheap, and I am not finding a lot now, but there will be a day when you will be shooting fish in a barrel. The important thing is to be prepared to play heavily when the time comes, and that means that you cannot play with everybody." [The above may not be a verbatim quote from Buffett, but it seems essentially consistent with the way he sees things as interpreted by the writer throughout this report.]

Flashing back to earlier statements, these words fit "hand in glove": "Should tomorrow's opportunity [set] prove superior to today's, when presumably fear will have swept the field, and that perfect pitch finally crosses home plate, swing for the fences." Munger continues: "The wise ones [investors] bet heavily when the world offers them that opportunity. They bet big when they have the odds. And the rest of the time, they don't. It's just that simple."

Likewise, Buffett explains one reason pitches move from the outside edge of the strike zone to what Ted Williams called the "happy zone": "Occasional outbreaks of those two super-contagious diseases, fear and greed, will *forever* [italics added] occur in the investment community." While unsure of the timing or extent of these "outbreaks," Buffett advises investors to "simply attempt to be fearful when others are greedy and to be greedy only when others are fearful. … Fear is the foe of the faddist but the friend of the fundamentalist."

Marathon Endurance

The message throughout this report, summarized here, is that we are nearer the beginning than the end of the long secular transition from greed to fear, from exhilaratingly high prices to despairingly low ones, from irrational exuberance to levelheaded rationality and perhaps (I say irrespective of how remote the possibility) from a financial economy to real economy. Accordingly, we have, out of necessity, a heightened sense of vigilance, a pervasive but hopefully constructive skepticism. As always, we will focus on individual companies, constantly comparing price and value. Because of the higher-risk environment in which I think we must operate, we will be extra conservative in our calculations of intrinsic value. If, in spite of a possible ebbing tide, our convictions about the value of a company we own are high and a stock gets cheaper, we will buy more. When we're buying something of value, we want the price to keep going down. If the price gets low enough, our average cost will be well below the intrinsic worth of the business. Low prices motivate the value investor, like the post-Christmas shopper, to reach for the wallet.

Having spent my entire business life in the world of marketable investments, I'm convinced that there are always pricing anomalies in the market. As mentioned in earlier reports, the spring of 2000 was a bonanza for us: We picked up the discards when the players drew from the stacked deck of Nasdaq favorites, which brings to mind the aphorism, "One man's trash is another man's treasure." The Graham-and-Doddsville investors mentioned earlier have made their mark by successfully exploiting gaps between price and value. As Buffett said in 1984, "When the price of a stock can be influenced by a 'herd' on Wall Street with prices set at the margin by the most emotional person, or the greediest person, or the most depressed person, it is hard to argue that the market always prices rationally. In fact, market prices are frequently nonsensical."

I would like to repeat from earlier reports one important factor about risk and reward as it relates to the kind of investing in which we engage. In most games of chance with which we're all familiar, risk and reward are positively correlated — that is, if you want higher returns, you must assume greater risks. The proliferation of casinos and lotteries has done wonders to embed this positive correlation in the minds of millions upon millions of Americans. So ubiquitous is this perception that to suggest otherwise often provokes an incredulous stare.

And yet there's an easy explanation why Buffett's net worth is $35 billion while the fellow at the lottery window continues to fork over the last few bucks from his paycheck to voluntarily pay the most pernicious and regressive tax of all — shamefully, a tax on ignorance imposed by elected "representatives." (The irony of the lottery system is that the typical state's rake is often "pledged" to support education, of all things. The same vicious circle of "Catch-22" reasoning is knowingly employed by Congress, permitting Philip Morris to continue selling cigarettes to a new and nescient generation of smokers to pay the billions in claims from earlier ones.) Buffett's billions seem to suggest that the exact opposite is true with value investing. "If you buy a dollar bill for 60 cents," he says, "it's riskier than if you buy a dollar bill for 40 cents, but the expectation of reward is greater in the latter case. The greater the potential for reward in the value portfolio, the less risk there is."

By contrast, the lotteries and the casinos control the odds and therefore decide who "bears" the brunt of the risk. Is it any surprise that the odds are naturally stacked in favor of the house? It doesn't take a mathematician to understand why casinos and lotteries don't go broke, but gamblers do (as do, some may be surprised to learn, most lottery winners, but for different reasons). On the other hand, the value investor, by his understanding of the relationship between risk and return and his willingness to act independently on that insight, he *becomes* the house. He also controls the odds and (by inference) the risks; if he is skillful and patient, he stacks them in his favor. The markets are open every business day, and the prices are always fluctuating (the only certainty in the marketplace of which I'm aware). The smart investor turns a deaf ear to the crowd and listens to value instead, cherry picking the best, purchasing them at *his* price. If he is capable of calmly awaiting his moment, unshackled from the ultimatum of the clock and unprovoked by the need to do something, time becomes his ally.

From our bottoms-up perspective, the long-term challenge for us as a small shop doing battle with the New York Yankees of the investment world is to use our minds (we don't have the financial muscle) to do what Billy Beane does so extraordinarily: to find value where no one else can find value. In this picked-over supermarket where every melon has been thumped countless times (you should see the Charmin!), it seems that if, to paraphrase Beane, a company doesn't have something wrong with it, it gets valued properly by the market, and we can't afford it anymore.

Seeing the Tides Through the Heavy Surf

Where some people see a dark cloud, others see a silver lining. Having cast my lot with the value camp almost 40 years ago — at the top of the last great secular cycle in 1966 — I'm still amazed by how many opportunities came and went, like the waves, undulating between exuberance and despair, as the tide continued to ebb, oh so gradually and imperceptibly, until it quietly began to reverse its flow beginning in 1982. To capitalize on the post-1966 environment, you could not simply buy and hold, you had to buy cheap so that you could in the not-too-distant future sell dear. The tide was the enemy of those who became enamored with the waves. In most instances, though certainly not all, you "dated" a stock during those days, but you didn't marry it.

The opposite was true after 1982. The ever-present waves continued during the great bull market that ensued, but because of the steadily rising tide, opportunities were more plentiful, of greater magnitude and lasting longer, but also the rising water level buoyed many a less-than-enlightened idea ("a rising tide lifts all ships"). However, the comeuppance comes in the expression "Genius is before the fall" or, less poetically, "When the tide goes out, you find out who has been swimming naked." (Sadly, for many investors the relentless waves and crashing surf obscured the view of the tide until it had reached the equivalent of a river's flood stage in the late 1990s.) You may want to review the section titled "Run for the Roses" for less-graphic details.

Beyond MCM's non-negotiable allegiance to the basic principles of rational investing as an independent and flexible firm that promotes diversity of thought, we have no other conflicting philosophical loyalties. Period. The man who often sends me a thoughtful note after he reads this report, Peter Bernstein, gave his definition of a new paradigm in a public interview in early 2003. Bernstein's clients, it should be noted, are predominantly institutional managers and pension funds. He said bluntly: "[T]he traditional institutional approach, 'I will structure my portfolio in this way and make variations on the theme,' won't work. So what I'm suggesting is, throw it away. You have to be much more unstructured, opportunistic and ad hoc than you have been in the past." Later in the interview, "… [I]n this looser, more opportunistic environment I foresee the abandonment of the dreadful, depressing, defaulting process of putting managers into cubbyholes — large-cap growth, small-cap value and such foolishness — along with the stifling, stupid obsession with tracking error instead of absolute returns and risks incurred." This kind of diversity of thought is complementary to our philosophical moorings.

From the major bottom (1974) through the end of the secular regression in 1982, the S&P 500 advanced at an annual rate of 8.19% and at 13.7% with dividends[12] reinvested, while the book value of Berkshire Hathaway grew at the stunning compounded rate of 29.12%. Of course, back then Berkshire was the equivalent of a runabout, not a battleship. "Jack be nimble, Jack be quick …" and don't forget about the candlestick, or you might get burned. In 1977, quoting from the oldest annual report available on Berkshire's Website, Buffett wrote about his investment principles and the opportunities that appeared then in marketable securities:

> We select our marketable equity securities in much the same way we would evaluate a business for acquisition in its entirety. We want the business to be (1) one that we can understand, (2) with favorable long-term prospects, (3) operated by honest and competent people, and (4) available at a very attractive price. We ordinarily make no attempt to buy equities for anticipated favorable stock price behavior in the short term. In fact, if their business experience continues to satisfy us, we welcome lower market prices of stocks we own as an opportunity to acquire even more of a good thing at a better price.
>
> Our experience has been that pro-rata portions of truly outstanding businesses sometimes sell in the securities markets at very large discounts from the prices they would command in negotiated transactions involving entire companies. Consequently, bargains in business ownership, which simply are not available directly through corporate acquisition, can be

[12] Dividend yields are rarely low at the bottom of bear markets. A word to the wise: The converse also is usually true.

> obtained indirectly through stock ownership. When prices are appropriate, we are willing to take very large positions in selected companies, not with any intention of taking control and not foreseeing sell-out or merger, but with the expectation that excellent business results by corporations will translate over the long term into correspondingly excellent market value and dividend results for owners, minority as well as majority.
>
> Some principles never change …

Please understand, we can neither forecast the future (Galbraith sums it up by saying, "We have two classes of forecasters: Those who don't know — and those who don't know they don't know") nor expect to be as adroit as Buffett in capitalizing on the "sweet spot" pitches that will sporadically come hurtling our way. Meanwhile, in the future, as in the past, we have a decided preference for learning vicariously rather than firsthand from the school of hard knocks. As U.S. Gen. George Patton used to say, "It's an honor to die for your country, but make sure the other guy gets the honor." Nonetheless, to quote the quixotic Don Quixote from the musical, "Man of La Mancha," from which comes the expression "tilting at windmills": "The fortunes of war [investment?] more than any other are liable to frequent fluctuations." More to our immediate need, the dreamer also is recognized for having said, "To be forewarned is to be forearmed." And because of the nature of the business of investing and our diminutive size, we may be able to achieve successful results even if we find ourselves facing a headwind.

Inundated as you are with baseballs and beaches, why not alter course briefly with a h(t?)ide-bound sailing metaphor?☺ Instead of easing the sheets, engaging the autopilot, and relaxing for a gin and tonic as we would with the wind at our back, working our way "to weather" is not for the fainthearted. It's mentally and physically exhausting, requiring strength, conviction, concentration, and discipline. We must regularly tack to make headway toward our predetermined destination, "coming about" as needed to gain ground if the winds shift even five or 10 degrees. A sailboat never realizes its maximum speed sailing to windward, but as the old adage goes, we have no control over the wind, but we can and do trim the sails for optimal results under the prevailing conditions. While our compass needle and ship's head, except during tacking, are pointed toward "true north," which we define in this metaphor as first protecting and then enhancing your capital, the winds are *forever clocking*. When they come around to amidships or farther abaft the beam, we'll have all of our canvas flying, and the bow wave will curl high on the prow.

Concluding with a final reference to Quixote (many might say rather appropriately for the undersigned), we humbly admit that we may be "tilting at windmills" as we survey the battlefield that spreads out before us. Whatever lies ahead, we'll always keep it simple (the verbiage of this report notwithstanding!), leaning on a few "Universal Lessons" from Seth Klarman, along with a few of our own (see Business Principles and Investment Principles at the beginning of the report), as we stride purposefully into an invariably foggy future.

- "Buy low, sell high.
- What you pay matters.
- Trees don't grow to the sky.
- Things are neither as good nor as bad as the crowd thinks.
- It is better to hold cash than remain fully invested in overvalued securities."

'CAPITAL' INVESTMENTS TO CATCH UP WITH GROWTH

While the security markets lived up (or down) to their lethargic advance billing, which was deemed the most likely outcome in the Conclusion section of the 2003 annual report, MCM was busy making capital investments to rationalize its human resources, facilities, and systems so that we will be prepared to meet the needs of our clients over the foreseeable future, to say nothing of upping our capacity to keep pace with the growth already achieved.

The investment in human capital, our most critical internal commitment, took several forms this year. First, Andrew "Drew" Wilson graduated from top-rated Northwestern University's Executive Management Program (MBA) in May. Drew and his family — like Todd Martin, Dennis Blyly, and their wives and children before him — made the two-year sacrifice of committing approximately 20 hours a week to study and the seemingly endless days away from home, on top of working full time at the firm, to further his formal education. The management program curriculum at Northwestern and Notre Dame are particularly well-suited to enhance an ambitious fellow's competence and confidence as a business analyst and portfolio manager.

Recruiting at our firm has become a bit like Warren Buffett's acquisition strategy. He says he sits around and waits for the phone to ring. Although we certainly cannot lay claim to a reputation as universally known as his, nonetheless word about the unique way we practice the profession of investment management does seem to get around. In the spring of 2004 Tom Dugan, who like Aaron Kindig a year earlier, called me. That's a lazy man's dream come true! A remarkably focused young man, his credentials were impeccable. Having graduated from Rockhurst University, a Jesuit school in Kansas City, he worked at Sprint for two years as a financial analyst while completing the three-year academic portion of the CFA program. Indiana University's Kelley School of Management was his next objective. He ranked near the top of his class at both undergraduate and graduate schools; while at Kelley he was awarded the *Beta Gamma Sigma* designation. The precocious last of four children of a country lawyer, Paul Dugan, in Wichita, Tom was investing his odd-job savings at A.G. Edwards by the time he was 13. The clincher: Thinking his father's investment style needed a little more purpose and direction, Tom dragged his dad to the Berkshire Hathaway annual meeting on his own nickel the last three years running.

By strategic design, adding these two capable young men in the recent past has increased our research headcount by 50% … to six people. Of course, it will be some time before they reach the competence of a Dennis Blyly — or Todd Martin and Drew Wilson for that matter — but the environment in which they have found themselves is sure to foster rapid professional development. Aaron Kindig's learning curve has been especially steep, and his natural instinct to "think outside the box" has caused all of us to expand our field of vision. As for the three veterans named above, properly used and regularly calibrated, the knowledge and insights gained over time can be cumulative, with increased competency being the end result. The search for well-priced investment roses among the many thorns is the primary means by which we preserve and enhance the wealth of our clients. Staffing our firm with top-drawer achievers, rewarding them appropriately, and maintaining a collegial yet highly focused environment are some of the means by which we attempt to meet that vital obligation.

In terms of employing technology to its fullest, we made the decision to transfer custodial and trading functions to the Fidelity Registered Investment Advisor Group from Merrill Lynch. Our relationship with Merrill was excellent, but in the end our need for state-of-the-art "back office" and trading support, as well as our reluctance to use Merrill's or anyone else's research for which we nonetheless indirectly paid, carried the day. Although we regretted having to ask you to sign yet another set of documents, if it's of any consolation, the members of our support staff have been working their fingers to the bone for months to get the job done accurately and efficiently. For us, just a fine example of the synergies of teamwork.

As if that load were not heavy enough, the relatively isolated corporate skulduggery that gave rise to the scourge of the Sarbanes-Oxley Act of 2002, as well as the malfeasance among certain mutual fund management companies, prompted the SEC to issue a raft of new regulations for investment advisors. This onslaught of red tape and paperwork required extraordinary efforts by our support team to prepare a comprehensive, written Compliance Procedures Manual to meet the October 5, 2004, deadline. As so many discovered at unconscionable cost this past year or two, "When the paddy wagon backs up to the house of ill repute, it takes the good girls with the bad." For those inclined to send occasional off-color e-mails to our office, please refrain from doing so in the future — unless you are indifferent to an examiner from the SEC reading it someday! While this additional regulatory burden is a cost we all must bear (and to some extent benefit from) for the transgressions of a few bad apples in our industry, we doubt that it will do much to end the chicanery. That, by its nature, is more ethical dilemma than legal problem.

Nonetheless, Ann Frantz, our operations manager, has long organized her team to live by self-imposed standards that exceed those of the regulators in virtually all instances. With regard to operations, the transfer to Fidelity has been as close to seamless as is humanly possible, thanks to the selfless contributions from everyone on the support team. Kristin Antalavits, our chief trader and go-to person for a multitude of portfolio management matters, continues to exercise her duties with uncanny and ever-growing skill. The unflappable one, Karen Sherer, keeps taking on more responsibilities in the client account management area. We — or perhaps you — would be lost without her. June Bails wears a variety of hats — ranging from organizing the annual Omaha pilgrimage to assisting me with any number of writing endeavors to overseeing all the details that constitute the process of relocating as discussed below. Stephanie Malcom is our lovable girl Friday. She is one of those rare individuals who is enthusiastically capable of taking on any project you put before her. Our newest team member is Christine Broadbent, about whom you'll read in the bios to follow. In addition to providing executive support to three of us, she is, in medical parlance, a "floater." When something needs to be done quickly or someone needs help in meeting a deadline, you'll find Christine in the middle of it, her sleeves rolled up.

Finally, and with some reluctance from the parsimonious one (a.k.a. yours truly), we will be moving to new quarters in the spring of 2005. While a number of intangible benefits are presumed, the increase in our occupancy expense is a certainty! As will be apparent from your first visit to the new office — the third floor of the office building under construction at 300 Junior Achievement Drive on the "East Bank" of the Elkhart River — we have been able to contemporize our voice and digital communications capabilities, both internal and external. Moreover, designing a function-over-form work environment promotes collegiality where information is shared freely and easily, which is essential to arriving at the best ideas through active collaboration. Although we have been space-constrained at our Main Street location, we specifically sized our new space so as to limit our future expansion to one or possibly two junior professionals and two or three support staff. Our profession, in my judgment, is one that is not temperamentally amenable to economies of scale. To the contrary, it seems the law of diminishing returns becomes a deterrent to maximizing both output and overall job satisfaction when boutique firms get much larger than we are. There are other means by which we can grow our revenues without adding to the size of our team. Maintaining our low profile is also important: There will be no external signage.

FINAL THOUGHTS

…With many of my friends wintering in Florida, I'm often asked why I don't join the snowbird migration, particularly since they presume I can afford it! I'm surprised that no one has put two and two together and wondered why I am "four"-ever driving a 1995 vintage van. At this point I'm afraid to take it to the car wash for fear the paint will come off of the dirt! Actually, I do spend about 10 days each winter enjoying the company of those very same wonderful people. But at end of each day I always reach the same conclusion: There isn't anything I'd rather do than what I'm already doing. I don't want to put off 'til tomorrow what I most enjoy doing today. When I arise early in the morning here's what I have to look forward to: a few hours of writing before the rooster crows, followed by a day spent with the brightest, most energizing, and challenging group of (relatively) young people with whom I've ever had the pleasure of working, and serving a remarkable group of clients, many of whom have become friends, some the very best of friends. Interspersed among all the daily activities are many occasions to use my mind for its highest intended purpose (yes, thinking), as described in the first paragraph of this report. Albert Einstein's brilliance always sharpens my capacity to distinguish between what matters and what does not: "Perfection of means and confusion of ends seem to characterize our age." On many evenings, particularly in the winter, I lose myself among the pages of a great biography or other classic book. It's not that I don't like television, it's just that by the time I get through with everything that's important to me, there's precious little time left. And, to slightly recast the phrase, the time I have left is precious beyond measure.

I must confess to taking my day job with the utmost seriousness. The reality is that a not insignificant number of people have entrusted their assets to our care, both a heavy responsibility and a mandate to be the best we can be. Excellence is called for — and excellence is what we aspire to deliver. We frequently fall short, but it's not for lack of trying. Because most of our clients have given us the bulk of their financial assets, our first obligation is to allocate their capital intelligently and rationally. Most of them are well-to-do, and it is our job to make sure they stay that way. The central thesis of this report is testimony to how important I think that responsibility is. As for its length, my motto (if not mantra) is "Eschew obfuscation." Having said that, I can find no further justification for shooting from the lip — at least none that you would believe — so further rambling would not improve on saying nothing!

Doing my part to keep our team happy, cohesive, and focused is one of the most pleasurable aspects of my role as managing partner. With the incredible human capital with whom to work, I believe anything is possible if we remain disciplined, rational, and stay within our sphere of competence.

Finally, our firm is highly specialized. It is dedicated to serving a relatively small number of wealthy individuals and families. In this high-tech, increasingly depersonalized financial services industry, looking after clients like ours is a high-touch antidote for what causes most people to want to retire early. Each year I tip my hat to all of you who have invited me into your lives, who have opened your hearts and your homes, who have lifted me up as if on angels' wings.

Frank Martin, CFA

The Martin Capital Management Team

Frank K. Martin, CFA, Managing Partner

Frank has 37 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. He 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 Frank 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; Western Reserve Partners LLC, Ohio; and the Frank Martin Family Foundation. He is founder and chairman of the board of **DREAMSWORK,** a mentoring and scholarship program for inner-city children. Frank published a biography of his father, William F. Martin, in 2000 and presently has a 120,000-word manuscript in circulation that will be published in 2005 as a book titled *Speculative Contagion*. In 2005 he also plans to continue work on a proposed book, *In Temporary Trust.*

Dennis D. Blyly, CFA, Partner

Dennis has 19 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 (Iowa) College 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, Elkhart; and the Elkhart Chamber of Commerce.

Todd B. Martin, CFA, Partner

Todd has 16 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 CFA 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, where he remains affiliated as a guest lecturer at the graduate business school. Todd is currently a member of the boards of the Elkhart

County United Way and St. Joseph Capital Corporation and Bank (chairman of the Audit Committee), Mishawaka.

Andrew P. Wilson, CFA, Partner

Drew has more than nine years of investment industry experience. He was admitted to the partnership on January 1, 2004. Prior to joining Martin Capital in 1995, he was an employee benefits consultant with Watson Wyatt Worldwide, specializing in qualified retirement plans. He graduated *Magna Cum Laude,* with membership in *Beta Gamma Sigma*, from Loyola University, Chicago, where he majored in finance. Drew earned his CFA in 1998. He completed the top-ranked Executive MBA program at Northwestern University's Kellogg School of Management in the spring of 2004. He is a member of the Indiana University at South Bend School of Business and Economics Advisory Board and is vice chairman of a United Way allocation panel.

Aaron J. Kindig, CFA

Aaron joined MCM in December 2002 as a financial analyst. He earned a BA in accounting and business administration from Bluffton (Ohio) College in 1995. His honors include the Financial Executives Institute Award and Pi Delta Honor Society. He tutored accounting students for three years. After graduation he spent three years in the banking industry, followed by 4½ years in investment services. Aaron earned the CFA designation in 2003 and is a member of the Goshen Loan Committee for LaCasa of Goshen, Inc.

Thomas W. Dugan

Tom joined Martin Capital in July 2004 as a research analyst. Prior to that time, he spent two years with the Sprint Corporation as a financial analyst and was a summer associate in the research department of Waddell & Reed Mutual Funds during graduate school. He graduated *Summa Cum Laude* from Rockhurst (Missouri) University with a major in finance and economics. He earned an MBA, with membership in *Beta Gamma Sigma,* from Indiana University's Kelley School of Business in 2004. He has passed three levels of the CFA program and will be eligible for the CFA charter upon completion of the required work experience. Tom is a volunteer with Habitat for Humanity.

Charles R. Kirk

Charlie's contribution to our research effort is part-time. Given his impressive and varied background in business and his ability to cut to the core of an issue, it is much more valuable than the hours would suggest. He has 28 years of experience in plastics manufacturing. He was employed by Industrial Plastics Corporation for 18 years, the last 10 of which he served as president. The next four years he worked for operating units of Trinova Corp., IPCs acquirer, as general manager of the IPC division and as group vice president. From 1993 to 1995 he was president of Elkhart Plastics, Inc. Charlie received a BA in 1963 and an MA in 1964, both from the University of Akron, Ohio, and in 1968 his PhD from Temple University, Philadelphia.

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 A. 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. Before joining the firm, Kristin 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 was also 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.

June L. Bails

June joined MCM in August 2002 and has worked in the financial services industry since 1995. Most recently, she was employed as a case analyst by The Todd Organization, which specializes in executive benefits and non-qualified retirement plans. She was a registered representative and office manager at Compass Financial Advisors for five years. June is currently enrolled at Bethel College, Mishawaka, and will receive an associate's degree in professional writing in May 2005.

Stephanie A. 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 Elkhart-based Energy Management Systems.

Christine L. Broadbent

Christine is the newest addition to the Martin Capital team. She joined the firm in November 2004 as executive assistant to three of the four partners. She attended both Indiana University's Bloomington and South Bend campuses, studying anthropology and history. Prior to Martin Capital, she worked for the University of Notre Dame for a total of 12 years, beginning in the Undergraduate Admissions Office. Christine spent the last four years with the University's MBA program as admissions marketing coordinator, finishing the last three years as Assistant Director of MBA Student Services.