MARTIN CAPITAL MANAGEMENT, LLP

FIRESIDE CHAT

Chat No. 8
Skepticism Suspended

April 22, 2010

"*This Time Is Different: Eight Centuries of Financial Folly* is a prodigious effort with a tongue-in-cheek title that concludes with the obvious: Human beings have learned little from past mistakes. More worrisome and germane, researchers Rogoff and Reinhart (introduced in MCM's 2008 Annual Report) discovered that governments (including, most poignantly, Washington) are no more inclined to reveal their true financial condition today than in the past. The lack of transparency—and the strategic incompetence it allows to metastasize undetected to often counterproductive extremes—contributes to the human suffering that ensues in crisis after crisis.

In another irony, transparent only to those whose skepticism has not been suspended, is that today's crisis management may be nearly as ineffective at stemming the tide as the various and sundry, and often experimental, myriad interventions during the Great Depression. That statement is not made ill-advisedly. The very laws and regulations written in the 1930s to prevent another upheaval and to protect citizens from having to suffer the consequences should it recur ("security" laws and regulations, bank deposit and unemployment insurance, and over 100 more of the same intent) have had a most perverse and unintended side effect. By providing relief for the many from the burdens of failure—at the cost of penalizing the success of the few—incentives that inadvertently promoted antisocial behavior were unknowingly put in place.

Thus the seeds that grew into the current crisis were contained in the interventions taken to prevent a repeat of the Great Depression. Given the safeguards present at the onset of the current crisis, the destabilizing forces that have once again risen to threaten our financial and economic system must have been mighty indeed. That such extraordinary excesses can be contained with so little comparative consequence boggles the mind. Whatever their motives, the fact that governments, Oz-like, are likely playing Russian roulette behind the curtain should be ample cause for us to match such recklessness with an equal measure of skepticism.

The Insidious Disappearance of Accountability

The very safeguards mentioned above are mirrored in the glacial abrogation of personal responsibility across broad swaths of America. In what is known as a "moral hazard," those who don't directly bear the consequences of their behaviors tend to act differently than those who do. Think of the Welfare State boomerang.

In business, the slow deterioration of the common-law practice that defines the nature and extent of the relationship between a principal and his agent (employer/employee, owner/manager, beneficial owner/institutional shareholder), namely the "agency dilemma," has become more problematic as the chasm between agent and principal widened.

Regarding the ownership of American business and industry, institutions came to dominate (from 10% in the 1950s to 70% currently). In an era Hyman Minsky dubbed "managerial capitalism," the investment time horizons of institutions have shrunk to the point where Keynes, were he alive, would charge them with casino capitalism. Once long-term investors, common stock mutual funds, which nominally control 26% of American industry, now turn their portfolios over 100% each year. Rather than acting as advocates for their beneficial owners, or standing tall as the last bastion of capitalism, institutional investors are more likely to take flight than fight when trouble appears. The demanding and thankless work of policing recalcitrant CEOs and their minions is left to others who follow in the revolving door of institutional shareholders. The buck often gets passed until the music stops. As of March 2007, as the game of musical chairs was about to end, the institutional ownership of AIG, Fannie Mae, Freddie Mac, Bear Stearns, and General Motors was 64.3%, 92.2%, 78.8%, 66.6%, 87.4%, respectively.

Prior to the early '80s, Wall Street investment banks were organized as partnerships (including Cleveland-based McDonald & Co., where the undersigned, as a general partner with unlimited liability, worried more about his net worth than his net income!). Once investment banks transform themselves into publicly traded corporations, personal liability ceased to be the constraint of aberrant behavior that it once was. The mischief this subtle change enabled was instrumental in the collapse what had become a financial house of cards by 2007. Because of the complexity and interconnectedness of the financial services industry and the financial "weapons of mass destruction" it created, institutions became so intertwined that when the crisis hit a pervasive fear instantaneously coursed through Washington: Failure of one or more of a largest could trigger a systemic meltdown. Thus was born the "too big to fail" doctrine.

The Invisible and Irresistible Forces

Perhaps there is something lurking behind the curtain that dwarfs even the backstage machinations of governments … Could it be that forces in the physical world, though largely invisible in finance and economics, are at work? Is it possible that Newton's third law of motion—that for every action there is an equal and opposite reaction—may lead one to logically conclude that the forces that caused the apple of near universal excess to overcome gravity and rise to such dizzying heights are likely to be counteracted by equal and opposite forces?

Nearly 200 years later philosopher and essayist Ralph Waldo Emerson appealed to the laws of physics to explain the nature of man in a similar action and reaction duality. He called it the law of compensation. Within every cause, Emerson reasoned, grew the seed of its own effect. In other words, actions have consequences—and those consequences, though likely quite different from the actions themselves, are more or less proportional.

The capital markets and those who opine with similar vigor on (or attempt to manage) the economy act as though both laws have been suspended … or are irrelevant.

Could it be that skepticism and disbelief are what has been suspended? As you'll read immediately below, it wouldn't be the first time.

History from the Inside Out

Thanks to electronic media, over last year the undersigned has figuratively traveled back in time, each day reading 30–40 vignettes from the *Wall Street Journal* on dates that correspond to today's, only circa 1930–31. The perspective from virtually viewing history from the inside out, one day at a time, all the while knowing the ending, is instructively different from the way most people view it. By April 1930 the Dow had regained half the ground lost since the Crash of 1929 and most of the pundits and commentators believed that the worst was behind them. A year later, on April 15, 1931, the Dow Jones average closed at 168.41.The reaction to the worsening news on that day was not unlike that of so many days before: denial coupled with optimism. The *Wall Street Journal* on April 15: "[The] banking situation doesn't show any real business revival yet. Loans at Fed member banks alone are down $852M since start of the year, while investments held by banks continue to grow; 'there seems to be almost no demand for credit, at least of a type that banks are willing to extend, and so long as this condition continues money will rule extremely easy and banks will be forced to seek employment for their funds in the investment market.'" A broker, obviously unaware of the dampening effect of contracting credit, struck this note of optimism: "After this period, [the] technical position will be unusually favorable for a sustained advance, based on business improvement that should by then be apparent."

The experience of reading today's political, social, and economic developments and opinions alongside those of the same date eight decades ago is, in a certain sense, unnerving. A day rarely goes by without me wondering whether the "passions of man" constitute the only constant in history. "History does not repeat itself, but it does rhyme," observed Mark Twain, perhaps with that in mind … Even Rogoff and Reinhart, despite their scholarly exposition—or perhaps because of it—are guilty of overlooking the very warning implicit in their book's title. Like Congress, the White House, and every other author who has written about the crisis, they couldn't resist the folly of proposing solutions to a problem that is intransigent: the irrepressible proclivities of humanity.

Because people today, much as those almost 80 years ago, were on the inside of the economy looking out and because human beings are an integral part of the very system they're trying to analyze, those who believe that governments are in control of economies may be the victim of their own prejudice. Read on.

The Intersection of the Philosophical and the Pragmatic

As the keynote paragraph made clear, Washington isn't philosophical, it's pragmatic. And in times of crisis it is often spontaneously reactionary and doggedly deceptive. Decision making is compressed into short-term ad hoc measures. Consequences are tomorrow's problem. Analytic philosopher Bertrand Russell saw a certain transcendent utility in anecdotal wisdom, especially during times of upheaval. Acquiring the kind of knowledge that gives order and unification to complex social systems like economics—which does so by critically examining the grounds of our convictions, prejudices, and beliefs—allows one to frame issues in a broader, although admittedly inexact, context. (When explicit answers for questions can be found, the field of inquiry leaves the realm of philosophy and becomes science!) Like Newton and Emerson before him, Russell sought understanding in the midst of confusion and sometimes chaos. And so it is for us. If, by leaning toward the philosophical, by thinking longer-term while critically evaluating prevailing "convictions, prejudices, and beliefs," we just might be able to see through the smoke to the fire.

The pragmatic solution to economic unpleasantness throughout the last decade has been to repeatedly inject the economy with the adrenaline of cheap and easy money. The philosopher shudders in disbelief. The ongoing attempt to put off the consequences of years of cumulative excesses by jacking up the prices of assets to levels above their intrinsic worth through the alchemy of financial engineering (the latest increasingly desperate iteration of which is pushing interest rates down to near zero) is itself not without potentially dire consequences. The Fed action is having the effect of driving people out of the safer assets into the riskier ones, of sacrificing the prudent to save the foolish. Societies have crumbled for lesser transgressions.

Is Risk Management Passé?

Preoccupation with risk was all the rage a year ago. The yield differential between U.S. Treasury bonds and low-quality corporate "junk" bonds is a logical proxy for the extent to which investors in all asset classes are willing to accept risk (of default, in the case of bonds) in the pursuit of return. In March 2009 the *spread* between Treasury bonds and the lowest-quality corporate bonds not in default proceedings, the S&P CCC-rated "extremely speculative" category, peaked at roughly 35%. Fear quickly morphed into greed and, by the end of 2009, a new record for the issuance of junk bonds was set. In a reversal of epic proportions, yield-desperate investors drove the spread down to 9%. Junk bonds were the 1980s brainchild of Michael Milken, who exploited, in the pejorative meaning of the word, a legitimate premise. That the word *junk* would assume unquestioned legitimacy in the investor's vernacular was surely an early symptom of the growing indifference to risk. It's a baby step from there to CDOs (collateralized debt obligation), especially with unregulated derivatives exploding on the scene in the late '90s.

Aside: When risk management is passé for the majority, it is "anything but" for this minority!

Index Put Options as a Means of Capitalizing on the Preoccupation with Return

Whether in the debt or equity markets, investors are reaching for return without grasping the full import of its mirror image. Full of ironies, investors are being nudged farther and farther out on the risk limb by a monetary policy determined to reflate risky assets. If the attempt to forestall deflation by this most questionable means fails, investors will be the sacrificial lambs. And if the markets for risky assets surprise everyone and head south, the economy will no doubt be right behind. "As Nero fiddles …" Congress debates financial reform to protect the investor and the taxpayer against an enemy of its own legislative creation, moral hazard.

When risk premiums plummet, particularly when the unintended byproduct of monetary stimulus runs amok, things are not likely to end well. Markets that undervalue risk are anathema to a value investor. Dollars selling for $.50 are as scarce as hen's teeth. Instead of value, we are more likely to find 50-cent pieces selling for a dollar. If and when the risk pricing anomaly is remedied—the latter being the biggest uncertainty—put options may be the means by which to capitalize on the adjustment. If the undersigned is wrong on both counts, the options will have the same value as flight insurance once you are safely back on the tarmac!

Under the best of outcomes (because market volatility tends to rise in some proportion to how dramatically market prices fall), option premiums often rise asymmetrically. If the S&P 500 were to fall 25% to 900 within six months it's quite possible the options could triple in price, even though the "strike" price, 700, is still 200 points away. Do market fluctuations of that magnitude occur in that short a period of time? The two sharpest uninterrupted declines in the preceding bear market, each about 30%, took less than two months from top to bottom. The next two, approximately 16% each, were less than three months. The biggest interrupted swoon, 46%, occurred during the peak of the crisis between September 2008 and March 2009.

But that's history, and it may be bear market-biased. Thinking in the future, as we are inclined to do, and also being inclined to believe that the spectacular market rise currently being celebrated has underpinnings similar to the cheap money "fools rally" from 2003 to 2007—all within the context of a secular bear market and an economic contraction that may not have seen its darkest days—the only development that would leave us scratching our heads would be further dramatic moves to the upside. We cannot forecast if, when, or how far the pendulum might swing but, like the "Perfect Storm" essays in the 2005 and 2006 Annual Reports, occasionally we seem to be slightly ahead of the crowd in sniffing out trouble.

Portfolio Management and Reconciling the Top-Down and Bottom-Up Perspectives

As a bottom-up, value-oriented investment firm, we're often asked how we reconcile what we're commissioned to do and what appears to be a preoccupation with assessing top-down risks. Please review the charts below. Note the five annotations on the first chart. The first and second mark historical inflection points when, from a top-down perspective, the markets were valued at "back up the truck" levels. The last three, all recent, offer a different perspective.

The second group of bar charts, a bottom-up look, show the percentage of companies in the S&P 500 index that were cheap based on four common valuation metrics for the five annotated dates on the first chart.

There are several obvious conclusions that can be drawn from the bar charts: In 1974 and again in 1982 large percentages of companies were mouthwateringly inexpensive, although for different reasons. In March 2009 more companies fell into the cheap category than in October 2007, but they didn't come close to matching the percentage of close-out sale offerings in 1974 and 1982. Finally, the scarcity of bargains today matches a similar paucity at the peak of the upswing in October 2007.

Inside out or outside in, it's pretty much the same story.

To be sure, beyond doing whatever it takes to stay out of harm's way (as investors discovered to their great dismay during the 18 months leading up to March 2009, if you're sailing on the Titanic it's not the best deck chairs you should be looking for as a place to sit), the most time-consuming and analytically-demanding endeavor for a firm like MCM is discovering companies whose investment virtues are not widely known or appreciated. Unlike other managers who practice Modern Portfolio Theory (MPT), who are broadly diversified and therefore have no incentive to get up close and personal with the *stocks* in their portfolios, we think of the businesses in which we own fractional interests almost as family. "Stocks" is simply too impersonal a word for us.

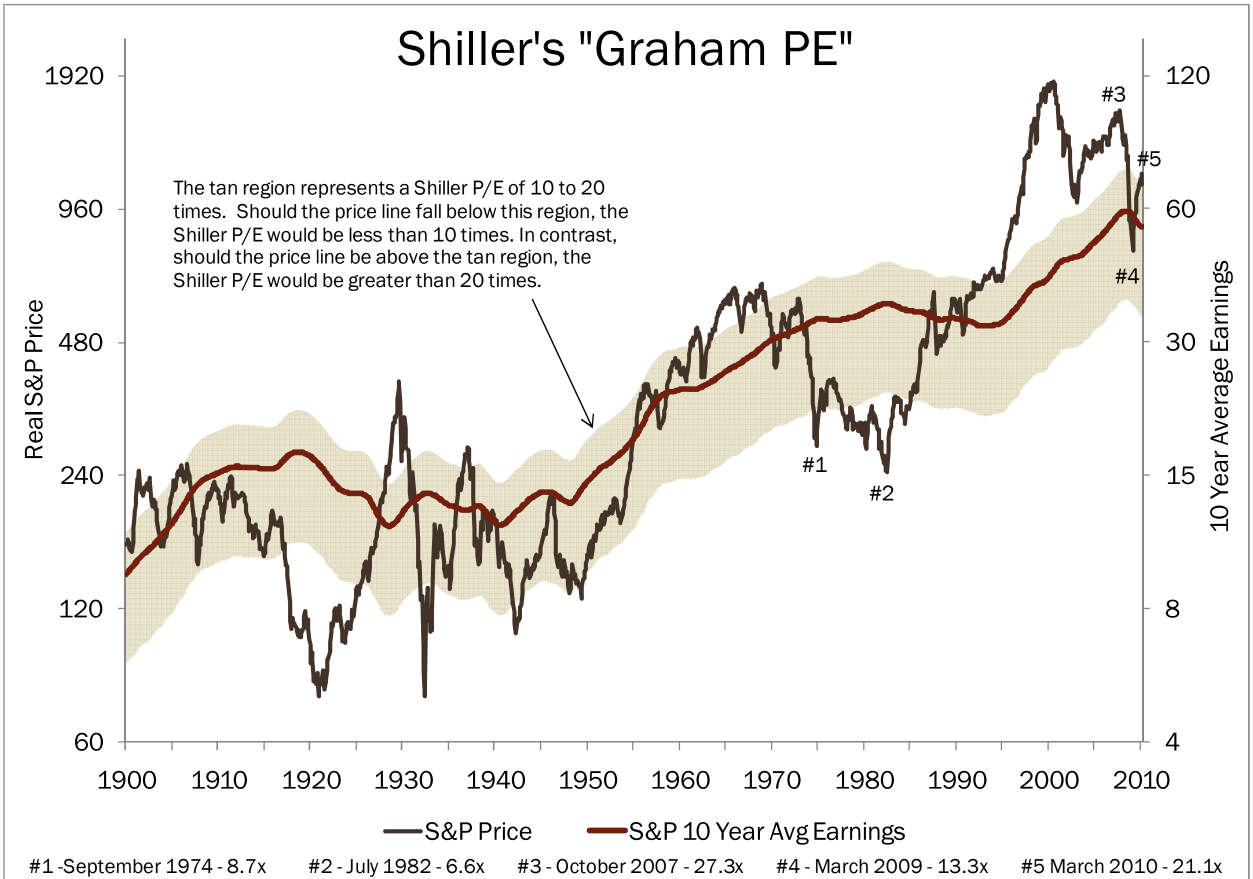
Think of it as looking for a bride using e-Harmony.com. We do all the rational analysis before we meet face-to-face, at which time emotions often take over! Reversing the order sometimes works in relationships but it rarely leads to happy endings for investors.

The most difficult companies to find, and potentially the most exciting and productive, we call the "haymakers." Typically early life-cycle businesses, the true keepers, the rare youngsters who have the maturity of an adult, are as difficult to find as needles in haystacks. One must dig deep into the mound, most often to come up empty-handed. The analyst who finds one or two of these gems a year, and the future bears full witness to his powers of discernment, will be anointed a genius.

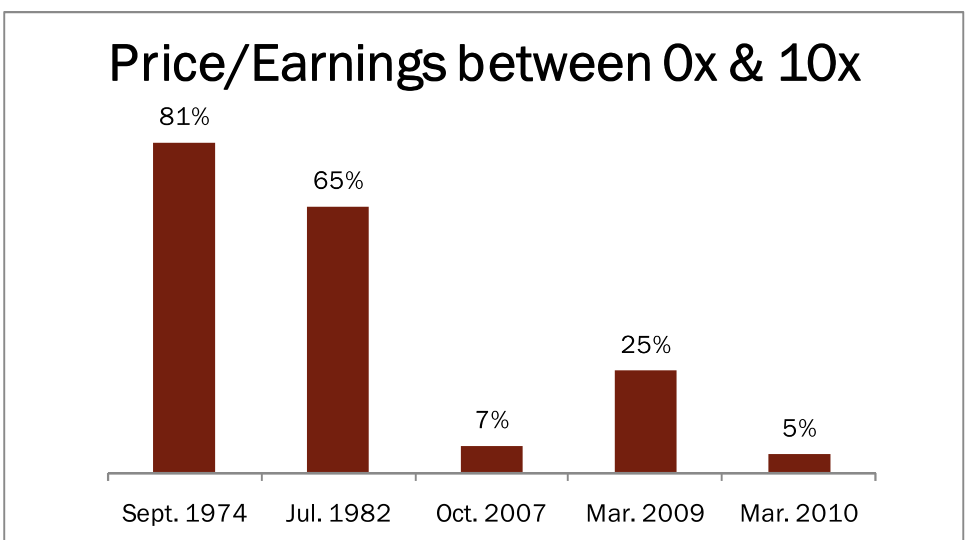
While requiring less effort, more mature later-stage companies that are well-known (where we have no obvious edge or informational advantage) are, during comparatively normal times, likely to be priced accordingly. When we can buy them smartly, they can become portfolio workhorses, producing relatively steady singles or doubles but rarely home runs: we might call them the "stalwarts." Those that have sustained blows sure to disturb others—but which we believe will be healed over time—may be priced at bargain levels. Analogously, these are the "wounded warriors." Our client portfolios are usually made up of a combination of these three different types.

Just as "a rising tide lifts all ships," the opposite is also true. If, as this essay suggests, today's high tide will likely follow the rhythms of nature, finding businesses of all three types becomes that much easier. They are most plentiful when the market is dominated by distressed sellers, many of whom are parting with heirlooms not because they want to but because they must raise cash. In Greenspan-speak, it's known as the "liquidity preference." In the real world, like in and among the financial titans post-August, 2007, the public denials of the need for liquidity are usually accompanied by acute private urgency. Those who travel south of the border might know it as "Montezuma's revenge." All three can also be found during periods of "catalyst myopia," when prices are deeply depressed but nobody can point to a specific reason to buy anything—you know, the reciprocal of today's environment. ☺

Until we chat again,
Frank Martin, CFA
Senior Partner

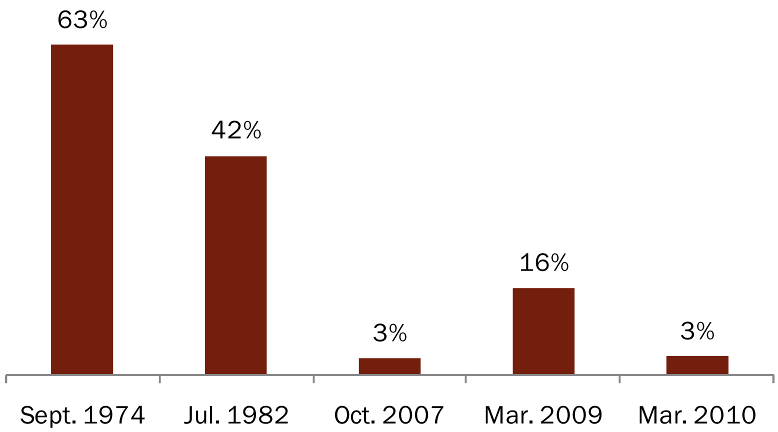


Data can be found on Robert Shiller's website: http://www.econ.yale.edu/~shiller/data.htm



Source: Standard & Poor's; Note: based on month end data

Price/Sales < 0.5x



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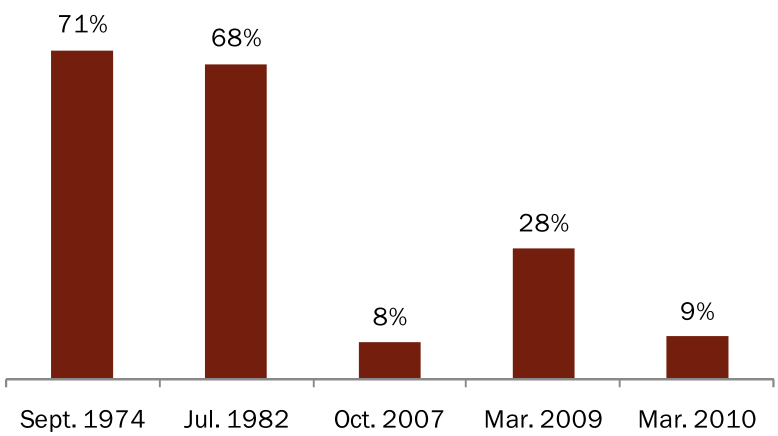
Price/Book < 0.75x



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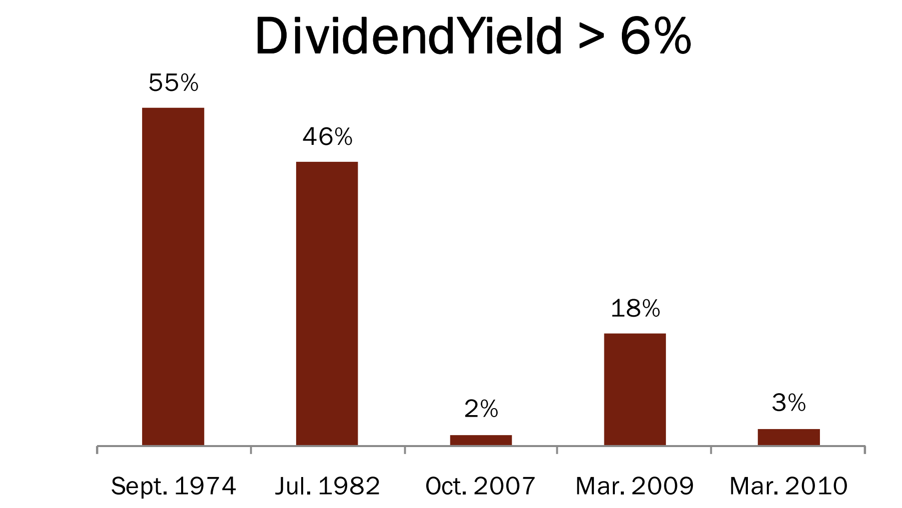

Source: Standard & Poor's; Note: based on month end data