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The Great Crash of 2008, Part II

November 20, 2008

Just over five weeks ago, on October 10, you received "The Great Crash of 2008," written the day before the 30-stock Dow Jones industrial average was as high as 9,500 and the Standard & Poor's 500, the investment industry standard benchmark, still reached 1,000. At the close yesterday the Dow finished below 8,000 and the S&P 500 just above 800, registering declines of 16% and 20%, respectively, over 29 trading days. Average daily price change in the S&P 500 over the last two months has exceeded 3%. In 2004 and 2005 there wasn't a single day with a price change exceeding 2%. Year-to-date the Dow has declined 40% and the S&P 45%. The major difference in the two indices for both periods can be traced largely to the greater weighting of financial companies in the S&P 500.

On Wednesday the 19th the third Fireside Chat was posted to our website in both audio and written formats. It was conceived in the wee hours of the morning on November 5, before most people awoke to learn that Barack Obama had been elected the 44th president of the United States. If this Fireside Chat is not hot in your hands or fresh in your minds, please Google our website "Martin Capital Management" for ready access.

Extraordinary times call for extraordinary measures. Anticipating that you're likely to be more than casually curious about what we're thinking and doing in the increasingly chaotic financial world, we have stepped up the frequency of our communiqués. (You have been and will continue to be inundated with a plethora of trade confirmations, which, without attendant explanation, could lead to confusion.) We will continue to keep you apprised as conditions warrant. A critical component of our commitment to you is to do everything within our power so that you sleep well at night, especially during tumultuous times. Like the president-elect, we are using the Internet to expedite the delivery of our message. While the risk of being second-guessed is always present, we think openness and candor take precedence. We hope you notice a consistency of thought throughout our writings. Accordingly, what follows is a brief summary of our continuing strategy.

First of all, consistent with the two above-referenced communiqués (as well as all that preceded them), for those clients who have given us authority to be fully invested in equities, we will likely keep approximately 50% of their assets in short-term U.S. Treasury securities until we enter what may be the terminal phase of this bear market—when volatility and volume slow markedly and abject despair sets in. Clients whose tolerance for volatility is less will carry higher levels of Treasuries. As an aside, we recently moved approximately 30% of our Treasury securities into two-year Treasury Inflation Protected Securities (TIPS). Priced in anticipation of deflation, they yielded approximately 4.5% at time of purchase.

Second, we're doing some very intentional restructuring of our equity holdings. The percentage of assets committed to equities won't change much, but the characteristics of the companies, along with the number of companies, will be more aligned with our perception of the risks and opportunities we foresee. For some days now we've been examining every one of our companies, focusing on what we believe are key factors in capitalizing on opportunities and minimizing risks presented by the current environment:

1. Companies with capital structures that give us reasonable assurance that they will endure under a severe-recession scenario or worse;
2. Managements that have demonstrated the competence and temperament to strengthen their companies' competitive positions in times of great adversity and uncertainty;
3. Companies whose near-term earnings visibility is clouded but whose long-term outlook is far more certain;
4. Market price declines that reflect the short-term nature of Wall Street thinking;
5. Companies, when aggregated in a portfolio, will produce as high a current dividend yield as possible consistent with the need of individual portfolio companies to retain earnings to finance growth; and
6. Companies whose market prices may advance sharply should "Mr. Market's" current bout of highly emotional selling prove to be an *over*reaction to an admittedly deteriorating economic environment.

With the benefit of 20/20 hindsight we would've carried more liquidity or held our put option hedges longer. In the extreme case of the unattainable but infinitely desirable state of perfect prescience, we would've been 100% in cash instead of only 50%. Of course, no one has the luxury of knowing the future at the time a decision has to be made. Even today we wonder what verdict hindsight will pronounce on the actions we're now taking. But what we do know—and this statement should be extremely important to you—is that we believe we possess (noted with a deep sense of humility) the temperament and emotional detachment to remain rational and focused no matter what is going on around us. Analogously, courage is not the absence of fear, but the mastery of it.

It can never be repeated enough: Our primary obligation is to protect your capital, a commitment on which we've delivered reasonably well, although never as well as what we would consider optimal. Once we feel we're on relatively safe ground in regard to our primary commitment, our secondary objective is to grow your wealth. In the midst of all this chaos, that is how we are positioning your portfolio. We were quite unpopular in some circles when we went against the grain of conventional wisdom and sold high. We expect to be no more popular buying low, particularly with almost absolute assurance that "low" will not mean "lowest." Those foolish enough to try to buy at the bottom often end up being very early and, ironically, can be found among those selling at the trough. At the other end of the continuum, those who have difficulty mustering the conviction to commit to anything usually go away empty-handed. We have a general idea of what the businesses we own (and anticipate owning) are intrinsically worth and, thus anchored, we're less likely to act foolishly—buying recklessly or not at all.

On a personal note, it's as though my entire 40 years of experience have prepared me for this time. An enduring fascination with history and human behavior, as well as the bear markets of 1973–74, 1987, and 2000–02, dress rehearsals all, have (I say not with hubris but with the scars from earlier battles fought) girded *us* for the conflict of wits and temperament now engaged. I use the plural pronoun intentionally, as our team has coalesced mightily as one in pursuing our singular mission. We cannot guarantee success. But in the vernacular of the young, if we "keep our cool," in the fullness of time we're almost certain to deliver on our commitment to both preserve and enhance your wealth.

Sleep well…

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