MARTIN
CAPITAL MANAGEMENT, LLC
Registered Investment Advisor

"We have involved ourselves in a colossal muddle, having blundered in the control of a delicate machine, the working of which we do not understand."
— John Maynard Keynes

"Most people get interested in stocks when everyone else is. The time to get interested is when no one else is. You can't buy what is popular and do well."
— Warren Buffett

"Capitalism without bankruptcy is like Christianity without hell. You have to have atonement for the ridiculous levels of spending that both the U.S. and Europe have gone through… The spending idiocy of the world is going to catch up with itself and that's where we are today."
— Kyle Bass

2011
ANNUAL REPORT

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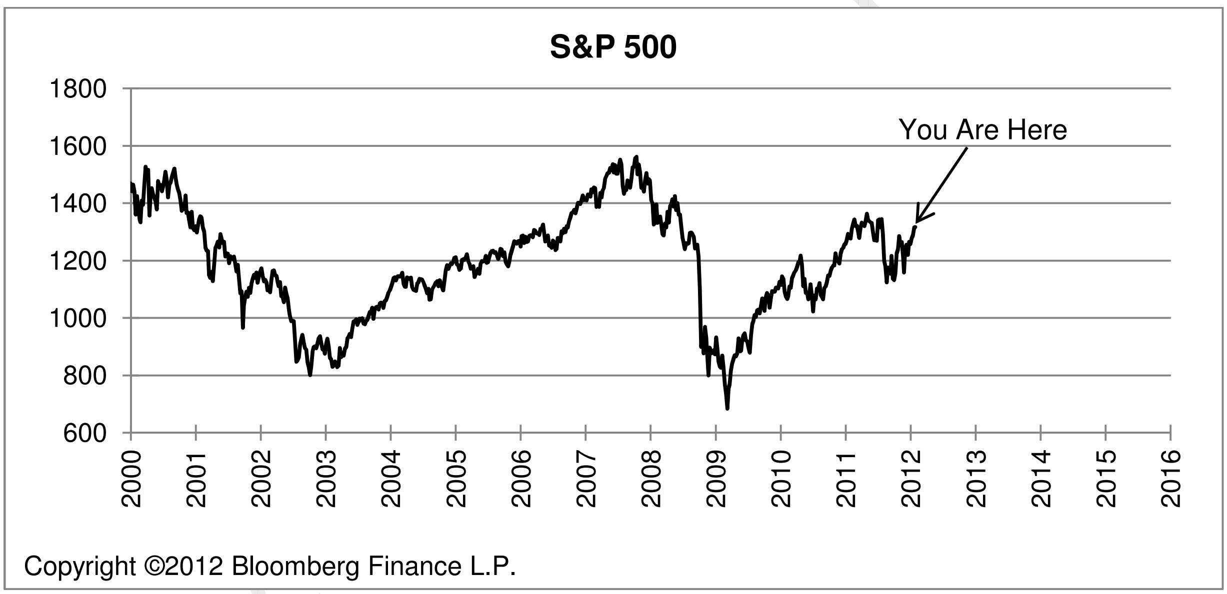
Dear Client,

Our hope each year in this report is not only to tell you how we have performed over the past 12 months, but also to transparently discuss our actions and place them in context both wide and narrow. It's an effort that serves two important purposes: First, it forces us to think critically about our philosophical and practical approaches to investing on your behalf. Second, it allows us an opportunity to express those thoughts in a way that, if done well, contributes to a deeper, more informed understanding on your part—our valued clients.

Physicists examine both the smallest sub-atomic particles and the largest galaxies, understanding that each perspective—micro and macro—offers important insight about the universal laws that connect them. We study wealth management and investment in similar fashion. It might be said that the universal perspective is where we do our worrying, but the sub-atomic perspective is where we do our investing. With that in mind, let's begin with a broad, time-encompassing picture of where we are … and where we've been. Consider the S&P 500 Index chart, dating back to 2000, below.

You Are Here



Pity the weary "market mountaineer" who has labored 12 long years through the jagged peaks and valleys of this snapshot. It has been a treacherous and emotionally taxing journey, with arduous climbs to euphoric heights in 2000 and 2007—and anguishing, humbling tumbles down canyon walls to the deep valley floors in 2002 and 2009.

On the other hand, if you have been one of our typical investors from the starting frame of this alpine landscape, your experience has been significantly different. You have not experienced the adrenaline rush of standing atop any individual pinnacle, but neither have you fallen to the bottom of any crevasse. Instead, you have walked a mountain path that has sloped upward more often than not; and you are presently standing at nearly twice the altitude of the mountaineer who has simply followed the overall contour of the equities markets. *As we write to you this year, more than four years since the market's last ascent to heights where the risks overwhelmed prospective returns, we have a feeling of déjà vu, a sense that we are once again in the danger zone, much closer to the peak than the valley. Consistent with our behavior prior to the two earlier episodes, however, the risks to which you are exposed today are minuscule compared to those that other mountaineers are taking. We have taken a safer and more deliberate route to higher ground—a route that* *makes it much less likely that you will be swept down the mountainside by an avalanche or that a loss of footing will be financially fatal.*

MCM Performance Summary

Period Ending December 31, 2011	MCM Equities *	MCM Total Account * (1)	S&P 500 (2)	Relative Performance (1)-(2)
Ten Years	5.8%	3.0%	2.9%	0.1%
Five Years	6.8%	3.3%	-0.2%	3.5%
Three Years	20.4%	7.3%	14.1%	-6.8%
One Year	-2.3%	0.1%	2.1%	-2.0%

* Compounded annually, MCM data are net of fees

** Disclosure: The MCM Equities Composite shows the performance of the equity investments in all discretionary fee-paying accounts managed by MCM. Historical returns include accounts that may no longer be under our management. The MCM Total Account Composite shows the performance of all assets held in fully discretionary fee-paying accounts of clients who have given us authority to invest 100% of the account in equities and are managed per our model portfolio. Because we began presenting the Total Account Composite in 2008, it contains only accounts that were actively managed on December 31, 2008, plus accounts that have since been added. MCM believes that because the fully discretionary accounts are, and historically have been, so similarly managed in terms of types and proportions of securities, survivor bias—if any—is not material. Both MCM composites are net of all management fees and include the reinvestment of all income but do not reflect the effect of taxes. The composites are compared with the S&P 500, an unmanaged market capitalization-weighted index of 500 common stocks chosen for market size, liquidity, and industry group representation to represent U.S. equity performance. S&P 500 returns do not include consideration for fees or taxes. Due to client nuances—including equity allocation constraints, start date, and cash-flow differentials (derivatives, constraints, tax issues, etc.)—an individual's account performance may differ materially from the composite.* ***Past performance is no guarantee of future results.***

	Annualized Growth Rate				
Year	MCM Equities *	MCM Total Account * (1)	S&P 500 (2)	Relative Performance (1)-(2)	MCM vs. S&P 500: Compounded Outperformance **
2000	29.3%	21.3%	-9.1%	30.4%	33.4%
2001	22.7%	17.1%	-11.9%	29.0%	77.3%
2002	-13.6%	-11.8%	-22.1%	10.3%	100.7%
2003	33.9%	25.5%	28.7%	-3.2%	95.7%
2004	4.7%	3.6%	10.9%	-7.3%	82.9%
2005	-0.2%	-0.8%	4.9%	-5.7%	73.0%
2006	5.0%	0.7%	15.8%	-15.1%	50.4%
2007	1.5%	3.1%	5.5%	-2.4%	47.0%
2008	-21.5%	-7.8%	-37.0%	29.2%	115.1%
2009	51.4%	21.6%	26.5%	-4.9%	106.8%
2010	17.9%	1.5%	15.1%	-13.6%	82.4%
2011	-2.3%	0.1%	2.1%	-2.0%	78.8%

* Net of fees
** Invested dollar with MCM relative to invested dollar in the S&P 500 since 12/31/99

We begin our annual discussion of MCM performance by first sorting out for you what we consider important … and not important. The two shaded columns above speak volumes about how we approach our jobs as stewards of your capital. You can see from the "Relative Performance" column in the table above that MCM has underperformed the S&P 500 Index in eight years out of the last 12. And yet, you can also see from the final figure in the "Compounded Outperformance" column that our typical clients finished that same 12-year period with 78.8% more money than a typical index investor. How is that possible? Bottom line: Because we choose when to put client capital at risk rather than being 100% invested all the time, we have given our clients market-beating returns without much correlation to the ups and downs in the overall equity markets. The "win by not losing" philosophy, in other words, has produced better-than-average returns with much less overall risk. It stands to reason, then, that we don't consider it important to match or beat the S&P on a yearly—and certainly not on a quarterly or monthly—basis. The vast majority of investment management firms focus their attention on the "relative" column and lose sight of how well they're actually compounding their clients' capital over the long run. More on this in a moment … but first a brief recap of 2011.

The year began on a promising note, with the S&P up nearly 10% from January 1 to its yearlong intra-day high of 1370 on May 2. From there it all went rather bonkers: The European sovereign crisis again loomed large in investors' minds and for the next five months extreme volatility reigned, reaching a fever pitch during the months of August, September, and October when yo-yo movements of 2% or more on the S&P 500 Index occurred on 72% of all trading days. By October 4 the S&P had officially reached bear-market territory, only to briskly recover during the fourth quarter. This was thanks largely to the new best friends of markets worldwide, the world's central bankers. To be fair, there was a whiff of economic recovery in the United States. However, it will not surprise longstanding clients to hear that to us, the market's late rally was a sign that hope had triumphed in the short term despite what we see as a rather grim, longer-term structural reality.

By the end of the year, the market had little to show for its turmoil, finishing 2011 up 2.1%. At MCM we also went largely sideways, but with much less volatility and with a much greater sense of purpose than the overall market. Reluctant to put client capital at risk in the face of widely underappreciated global deleveraging risks, including those of system complexity that are rarely talked about, we were on average 25–30% invested in equities during the year. As a result, our total return was only marginally positive—but without the gut-wrenching whipsaws that came for those managers under pressure to meet short-term performance mandates. Consider, for example, the plight of both Bruce Berkowitz and hedge fund manager John Paulson. Berkowitz was Morningstar's Mutual Fund Manager of the Decade for 2000–10, but he recklessly swung for the fences in the financial sector in 2011 and found his Fairholme fund down 32% for the year. Paulson, meantime, had pocketed billions in 2007–08 buying credit default swaps on mortgage pools and other exotica; but apparently overcome by a touch of hubris, Paulson thought he could replicate a once-in-a-lifetime gambit. Swing and a miss: Paulson's flagship fund was down 52% in 2011. With a decline of nearly 9% in the HFRX Global Hedge Fund Index in 2011, these masters of the universe did not cover themselves with glory this past year.

MCM's total return was on average a positive 0.1%. As you'll read in the remainder of this report, we didn't think the odds justified taking homerun cuts (a la Paulson and Berkowitz) at pitches in the dirt. At MCM, our fee structure strongly encourages us to rationally balance risk taking with risk aversion. For those unfamiliar with it, our fee structure is not only simple but purposeful: We charge either an annual maintenance fee (75 basis points) ***or*** 10% of the gains in excess of a client's all-time portfolio high-water mark value. This incentive structure strongly motivates us to take prudent risk in pursuit of gain—but never if it puts the collective "us" (we're in this together in every sense of the phrase) in danger of falling far from the peak. The fees are essentially a governor against taking bets where the returns don't justify the risks assumed; they keep us out of what might be called "the Paulson hole." After all, the math is relentlessly cruel: When you lose 50% of someone's money, you must make 100% just to get back even. It will be years, filled with recriminations and other unpleasantness, during which Paulson's clients make the agonizing uphill climb simply to get back to where they started.

How far have the mighty fallen! We see nothing redeeming about inflicting such unnecessary misery upon you, for what we do unto you we do unto ourselves. At times holding large portions of the MCM portfolio in cash may not appeal to the short-term performance crowd—but like the "three yards and a cloud of dust" running game perfected by Ohio State football legend Woody Hayes, it wins over the long haul. This table illustrates the point beautifully.

MCM Account Value vs. S&P

Year	MCM Total Account *	S&P 500
1999	$ 5,000,000**	$ 5,000,000**
2000	$ 6,064,500	$ 4,545,000
2001	$ 7,099,674	$ 4,004,145
2002	$ 6,259,759	$ 3,119,229
2003	$ 7,856,270	$ 4,014,448
2004	$ 8,140,634	$ 4,452,022
2005	$ 8,078,695	$ 4,670,172
2006	$ 8,134,303	$ 5,408,059
2007	$ 8,386,380	$ 5,705,502
2008	$ 7,732,243	$ 3,594,466
2009	$ 9,402,407	$ 4,547,000
2010	$ 9,543,443	$ 5,231,778
2011	$ 9,552,987	$ 5,342,168

* Net of fees
** Assumes initial investment of $5 million on 12/31/99

Simply put, if you invested $5 million with us at the beginning of the millennium you'd have nearly $10 million now, after fees. If you put that same $5 million in an S&P index fund, you'd have about the same $5 million. What the chart doesn't tell you is that on average, we had only 50% of your capital actually employed in the markets at any given time; so it's as if we put 50 cents to work at the beginning of 2000 and got back $2, while by indexing you had to put a full dollar in—and all you got back was that same dollar.

A glance at the following table gives you an indication of how we did at the margin on our equity book over the course of the year. We added five new businesses to the portfolio in 2011—Amerigon, Amgen, Hewlett-Packard, Walmart, and Yahoo—and bought more of an existing name, Berkshire Hathaway. Five of these six produced nice gains in a generally flat market, especially when the gains are annualized.

Company	Date Acq'd	Avg. Cost	12/30 Close	Gain/(Loss)	Annualized Rate of Return	Position Size as of 12/30/11
Yahoo	6/24-12/1	$14.28	$16.13	13%	36%	4.2%
Berkshire	6/24/2011	$75.08	$76.30	2%	3%	3.0%
Walmart	6/24/2011	$52.49	$59.76	14%	28%	2.3%
Amgen	8/3/2011	$53.15	$64.21	21%	59%	2.3%
Amerigon	8/5- 8/8	$14.62	$14.26	-2%	-6%	0.9%
Hewlett-Packard	10/4/2011	$21.98	$25.76	17%	95%	0.7%

**It should not be assumed that the recommendations made in the future will be profitable or will equal the performance of the securities noted.*

As for sales, we disposed of three former portfolio companies in 2011: Brown & Brown, Gannett, and Garmin. We felt that none of them had a sufficient margin of safety in their prices to warrant holding them through the future environment we envision. Two of them continued to go up after we sold them—but the third, Brown & Brown, dropped sharply after we sold it based on concerns about significant changes in management. As mentioned earlier, our fee structure gives us powerful incentives to not only try to *make money* but also to *avoid losing it*. For a complete list of 2011 equity-related MCM buys and sells, please see Appendix A.

As 2012 begins, we are finding bargains similar to the ones listed in the table above. Stay tuned for some new portfolio names as the year unfolds. Meanwhile, rest assured that we are not out shopping for the latest hot idea (Facebook's much ballyhooed IPO is not an opportunity, it's a worrisome symptom), nor are we chasing the latest macro theme from CNBC (it was Japan in the 1980s, now it's China). Instead, through detailed research infused with a healthy dose of patience and skepticism, we are searching for mispriced securities that will do well regardless of the larger market environment. We're looking for fish, so to speak, that will make headway whether they are running with or against the current.

Synthesizing good, individual stock selection with a thoughtful overall allocation policy based on independent assessment of macro risks is at the heart of what we do at MCM. It's how we built our long-term record in the first place and how we intend to continue building it.

A Bird in the Hand

Human beings (and most other living species for that matter) have lived under conditions of scarcity throughout virtually all of history and therefore are simply not hard-wired for abundance, real or imagined. Today's neuroscientists say primal neural instincts take over that compel creatures to consume far more than they rationally know they should when presented with the opportunity. They overlook long-term consequences in favor of short-term rewards.

In essence, that's what we see today in many parts of American life. The richest society in history grew rich by devising ever better ways to meet the demand for every resource and commodity previously considered scarce—houses, cars, sex, food, and electronic gadgets, to name just a few. But abundance has backfired. The madding crowd, in its gold rush for material things, has trampled self-regulatory common sense. Today, a third of Americans are obese, drug and alcohol addiction is widespread, and personal indebtedness is oceans deep. Short-term speculation has displaced long-term investment, and legalized gambling is everywhere—both with instant jackpots in mind.[1]

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[1] Manifestations of what Keynes called "casino capitalism" are everywhere. According to the Bank for International Settlements, the total notional amount of largely unregulated derivatives (aka financial WMDs) outstanding was $708 trillion as of June 2011; high-frequency algorithm-driven trading constitutes 70% of U.S. market volume; hedge funds and exchange-traded funds (ETFs) have proliferated; and (perhaps among the more telling of anecdotes) until a

Institutional oversight is not immune either. From governments to corporations, a revolving door of politicians and institutional investors all leave their successors the problem of how to pay for today's excesses. The end result will be a dwindling supply of producing Americans saddled with burgeoning public and private debt that already totals $41.6 trillion, along with legacy commitments like Medicare and Social Security that add another $34 trillion.

UCLA neuroscientist Dr. Peter Whybrow, author of the book *American Mania*, thinks the United States is by and large a victim of its own success because people are simply ill-equipped to handle the abundance of modern times, as opposed to the scarcity our ancestors endured. He says it's not that Americans are any weaker psychologically than other people. In fact, you'll find the same emerging behaviors in other cultures where food and money are in rapidly growing supply. Dr. Whybrow says animals—even birds(!)—exhibit the same conduct in the face of abundance.

Pheasant Under (Magnifying) Glass

Consider "Henry the Pheasant." In England last year, on the grounds of Blenheim Palace, the Churchill family estate, a harsh winter and the efficiency of local hunters took a nasty toll on the pheasant population. As Dr. Whybrow tells this true story, only a single bird survived—and the locals affectionately named him Henry. Having made it through the scarcity of food and safe cover the previous winter, Henry had the entire field (literally) to himself when spring arrived. He made the most of it. Without competition for food in the freshly seeded tract, he ate almost constantly. Before long, Henry was enormous, and he used his gargantuan stature to frighten other birds away and consume even more food. Eventually, he got so obese that the locals noted he could no longer fly. Henry was indeed living the high life … until suddenly one day he disappeared. A fox ate him.

A Micro View: Seeing the Significant in the Trivial

When our research team scrutinizes the investment landscape through the physicist's electron microscope on a discrete, company-by-company basis, we see a lot of individual "Henrys"—fat, undisciplined companies that have done everything they can to ensure their own demise. This is especially true in the financial sector, where a generation of gorging on cheap and easy financing, constrained neither by external regulatory oversight nor internal common sense, has bloated and distorted the balance sheets of many "too big to fail" American financial institutions. Whether intended simply for bragging rights or for elusive economies of scale, these distortions are so great that, in our opinion, they are beyond a simple fix. Were it not for obliging gamekeepers—the U.S. government and the Federal Reserve—many of these fat pheasants would already be dead.

We are not alone in thinking that failure has been subsidized far too long. The best way to control systemic financial risk is to seal off the failed part and not let the contagion spread. Consider this illustrative parallel: If watertight bulkheads had been properly sealed, the Titanic would still be afloat. The hole from the iceberg would have caused the ship to list, but water would not have spread throughout the hull and sunk the entire vessel. At $2.7 trillion in total assets, Bank of America is like the Titanic built without watertight bulkheads that could compartmentalize and contain damage. Because of the design, even a seemingly minor incident can become a crisis. The smallest puncture or the biggest iceberg would cause similarly catastrophic results.

November CBS "60 Minutes" exposé, members of Congress—the very people we elected to write and enforce our laws and regulations—were openly engaging in an activity for which they are sending others to jail: insider trading. Space precludes completing this list of evidence, which could go on for pages.

At the same time, there are several financial institutions that throughout the last generation have remained relatively lean and disciplined—institutions that never forgot that their long-term business success depends precisely on staying alert, focused, and risk-averse. The American public understandably tends to lump all banks into one giant, monolithic category. From a distance they can all look the same, but our microscope reveals crucial differences. Upon closer inspection, some are so different from the rest that they can't even be considered members of the same species.

On the one hand, you have the "I never met a loan I couldn't justify if the incentive fees are high enough" financial institutions always in the forefront of the latest "innovative and creative" loan scheme. In similar fashion, their copious and ill-conceived use of derivatives, both as buyer and seller, to insure bad assets against default boggles the mind. Companies like Bank of America are now paying the piper for having danced to such exotic tunes: One in four of BOA's home-mortgage loans originated between 2004 and 2008 and sold outside government channels are now either in default or severely delinquent. In contrast, companies like Wells Fargo intentionally avoided such "financial engineering." Wells never really needed the government bailout of 2008–09, and the company justifiably disparaged those who did. "It is interesting," Wells CEO John Stump has said, "that the industry has invented new ways to lose money when the old ways seemed to work just fine."

We consider it our job to know about Bank of America, Wells Fargo, and the various other good and bad actors in today's financial landscape. How we look at these institutions says a lot about the bottom-up research process at MCM—and a lot about why we have not yet put much capital to work in this or other sectors of the U.S. stock market. So let's dig deeper.

Bank of America: BOA or DOA?

Despite a massive bailout and recovering stock prices in the wake of the financial crisis, we wrote in last year's annual report that Bank of America was "far from being out of the woods." That proved to be true, as the company's stock plunged more than 50% in 2011 and took more than one noted value investor down with it. As it stands today in early 2012, we continue to be pessimistic about both BOA's prospects and by extension much of the U.S. banking system.

Indeed, in the great Hall of Shame that has been created by the excesses over the last generation, Bank of America stands in the Ring of Honor. Its catalog of excesses, oversights, missteps, obfuscations, and general bone-headedness almost defies comprehension. Rather than write about them in narrative form, perhaps it's best just to list a few of the lowlights.

- As of its most recent SEC filing, more than 20% of BOA's home-loan portfolio is with borrowers who scored below 620 on their FICO credit reports. Such scores are below even what's considered subprime, and bankers have a term for such borrowers: "credit lepers." Amazingly, this statistic has in the last year been trending upward, not downward, for BOA.
- BOA itself can in some ways be considered a credit leper in that it has made so many misguided, value-destroying acquisitions that it now closely resembles Henry the Pheasant—too fat to fly out of harm's way. Whether it was Security Pacific in the 1990s or Countrywide and Merrill Lynch in the latest crisis, BOA is like the Gang that Couldn't Shoot Straight. (The most absurd of all BOA transactions, the sale to NationsBank in 1998, is addressed separately below.) A simple statistic reveals everything: From 1998 to the end of 2011, BOA spent nearly $150 billion on acquisitions—and yet its market capitalization today is only roughly half that amount.
- Because it has made itself so complex via acquisition and in pursuit of the latest financial innovations, the bank must now regularly retain an army of lawyers, consultants, and

accountants. In the most recent quarter, for example, BOA spent *$937 million* on professional fees alone. Again, this is a *quarterly* figure. It's a staggering, almost unbelievable amount—but there it is on page 16 of the latest quarterly SEC filing. This amount is nearly double BOA's quarterly marketing expenses and almost as much as its quarterly occupancy expense—and, for comparative purposes, nearly as much as Caterpillar earned last quarter. BOA is thus aptly described as the poster child for diseconomies of scale.

- The bank's efficiency ratio, a standard measure of how well a bank is run, reflects how bloated and un-streamlined BOA has become. For a bank, the efficiency ratio measures how much it spends (excluding interest expense) versus how much it makes. Thus, as in golf, the lower the number (stated in this case as a percentage) the better. BOA was at nearly 90% in late 2011, fully a third worse than the industry average—a triple bogey, one might say.
- In perhaps its signature mistake of recent memory, BOA publicly approached the Fed—and was very publicly rejected—in its request for a "modest" dividend increase this past March. The fact that BOA requested a dividend increase without being certain that it would be approved gives the impression that its executives didn't fully appreciate the gravity of their predicament until *after* the Fed explained it to them. Through much of 2010, CEO Brian Moynihan had declared his confidence that a dividend would soon be increased. And after it was rejected, BOA was forced to disclose that both its Chief Financial Officer and Chief Accounting Officer did not know that the company was going to disclose the rejection to the public via an SEC filing—until after the filing was made.

So while it is true that Bank of America's stock trades at well below its stated tangible book value, it is easy to see why we don't trust the stated tangible book value in the slightest. In fact, when one does a careful parsing of the company's financials, that tangible book becomes very squishy indeed. To return to the credit-leper issue for a moment, BOA has nearly $60 billion of home loans that fall into this category. In addition, it has more than $20 billion of credit-card receivables in the same classification. While the company has reserves for potential losses, the $80 billion of "credit leper" exposure is rather frightening when one considers that the company has only $125 billion of tangible Tier 1 equity. It doesn't take many more bad assets, in other words, to tip BOA into the "requiring more capital" camp. We simply can't offer an informed opinion as to whether BOA's derivatives book is a moneymaker or a Black Swan catastrophe, but the information gap is not for lack of effort on our part. Impenetrable complexity makes it impossible for us and, we suspect, BOA senior management to analyze. No wonder the Fed acted as a "BOA constrictor" and denied the bank's request for a modest dividend increase.

All of this is a shame: BOA is one of this country's historically great financial institutions, once a venerable bank with California roots and a long, storied history. Of the top four U.S. banks in terms of deposits, only one—Wells Fargo—has not, in our opinion, become a fat, bloated, flightless pheasant.

Wells Fargo Waggin'

San Francisco-based Wells Fargo stands in stark contrast to BOA and many other U.S. financial institutions. While others used the last couple of decades to fly off the rails, Wells stayed more or less right on track. It puts much less emphasis on trading, has far less derivatives exposure, and in general has stuck to the unexciting but generally profitable business of taking in low-cost deposits and lending them out at a higher rate. Indeed, because of its laser-like focus on the "boring" business of banking, Wells has a durable competitive advantage. It obsesses over getting as many accounts as possible per client and has on average more than six. Because of this, it has America's stickiest client base and pays the lowest cost for deposits of any major bank in the United States.

When a bank pays less than anyone else for the raw material from which it makes its core product—loans—it can make less risky loans and still be as profitable as those with higher-cost deposits. And Wells' advantages don't stop there. Its edge is quantifiable, and *cultural* as well. To be precise, its culture drives the numbers we see in the bank's financial statements. Consider:

- Wells is not only the lowest-cost bank because of its strong, sticky core deposits, it is also the most stable of any major American bank because of them. Specifically, Wells' loan book is supported by a greater percentage of deposits than any bank in the country: Nearly 80% of its funding comes from deposits, not from selling debt as is the more common practice. With federal deposit insurance firmly backing the vast majority of its liabilities, Wells has built a bank quite different from its large domestic competitors and those in Europe. The bank need not fear a loss of funding caused by weak counterparties.
- Unlike BOA, Citigroup, and JP Morgan, Wells Fargo never made major forays into the exotic and toxic world of derivatives and proprietary trading. As a result, even today—after most bad actors have sworn they have "changed their ways"—Wells has one-third of the trading assets of Bank of America, one-fifth of Citi's, and one-eighth of JP Morgan's. As for derivatives, which Warren Buffett called "financial weapons of mass destruction," the record is even better: Wells has only 5–10% of the derivative book per dollar of equity capital compared with the other Big Three. No wonder Wells' CEO likes to say, "The more boring banking is, the better we like it."[2]
- As a result of its conservatism, Wells was well capitalized throughout the financial crisis—it took federal money only under duress—and remains ahead of the pack in terms of a capital cushion. Unlike most major banks, Wells is already quantifying its capital-adequacy ratios under the strict new Basel III rules, which aren't supposed to take effect until 2018.
- Because of this focus on stability and strength, Wells was able to play offense through the crisis while others were hemorrhaging capital. In the depths of the crisis Wells bought Wachovia, which mirrored on the East Coast its superb low-cost customer deposit franchise on the West Coast. The acquisition *doubled* Wells Fargo's retail deposit base, thereby extending not only its low-cost producer status but also adding strength and stability to an already stable foundation.

The following charts make the above state of affairs crystal clear. With a quick glance, you will see why we can say with confidence, "All banks are not created equal."

Bank	12/31/2007 Book Value/Share	12/31/2011 Book Value/Share	% Change
Wells Fargo	$14.45	$24.64	71%
Bank of America	$32.09	$20.09	-37%
Citigroup	$227.40	$60.78	-73%

[2] One might ask how we reconcile the fact that Warren Buffett has invested $11 billion at market in Wells Fargo and $5 billion at cost in Bank of America. The answer is in the fine print. If we could have purchased Bank of America under the same terms that Buffett did—including, importantly, the "anti-dilution provision"—we would've done so. And, yes, we still would've written this piece!

Bank	12/31/2007 Deposits/Share	12/31/2011 Deposits/Share	% Change
Wells Fargo	$92.65	$165.72	79%
Bank of America	$178.40	$98.32	-45%
Citigroup	$187.73	$27.26	-85%

The Investment Framework: Pulling BOA and Wells Fargo Together

Given the preceding data, it is clear to us that Wells Fargo has a much more valuable franchise than most other major financial institutions in the United States. But to any good investor, this is only half the equation. The other half is equally vital: How much is the market asking us to pay for it?

The answer is not great news to a potential investor like MCM. Unfortunately, banks like Wells and a handful of its slightly smaller, more regional brethren are now being properly valued by the marketplace for their conservatism, financial husbandry, and generally well-run franchises. In the depths of the 2008–09 crisis, we bought banks like Wells, US Bancorp, and M&T Bank—but we bought them when investors were panicking and their stock prices did not reflect their durable franchise value. Now that the stock market has recovered, these shares are no longer available at bargain prices. So while we continue to admire their *business,* we will not be buyers until we admire the *price* as well.

It should be noted that our current microscopic probe of Bank of America is merely the latest chapter in a saga we have followed for many years. We wrote warily about BOA in the 2006 annual report when the company's stock price peaked at $53.87. A little more than two years later, it cratered at $3.95. During the long slide, many once prominent investors mistakenly saw BOA as a "value play." Despite the relentless temptation to follow the crowd, we said "no thanks" as we often do when we really have no idea what something is worth. Thus far, Bank of America has been snaring the unwary as a "value trap," not a value play. We still think it's every bit as difficult to value the business today and, without the kind of dilution protection that Warren Buffett was wise enough to insist upon as a condition of his investment from a desperate Brian Moynihan, it's difficult for us to make a compelling argument that it is truly a bargain. For the sake of the financial system, however, we hope we are wrong.[3]

As chronicled on page 300 of *A Decade of Delusions,* Hugh McColl masterminded the 1998 merger of BankAmerica and NationsBank (renamed Bank of America). It represented the biggest catch in a serial acquisition binge dating back to when McColl took control in 1982. There is also great irony in the colossal egoism that has driven BOA in recent years, given the institution's humble, client-oriented past. Amadeo Giannini, son of Italian immigrants, founded the modern-day Bank of America in San Francisco and became a renowned figure after the 1906 earthquake by

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[3] Charles Perrow, professor emeritus of sociology at Yale and author of *Normal Accidents,* contends that financial innovation in the banking system (remember Hyman Minsky) "exceeds the complexity of any nuclear plant I ever studied."

providing loans to those who wished to rebuild. At the time, he loaned fire-damaged money recovered from the bank's vault by setting up a "desk" that amounted to a wooden plank stretched across a couple of barrels on the sidewalk. Loan agreements were made on a handshake, and Giannini proudly reported years later that all those loans had been repaid. Not a single default.

By contrast, following the 1998 merger, the behind-the-scenes persuasive powers of McColl drove the relocation of the bank's San Francisco headquarters across the continent to Charlotte, North Carolina. The landmark edifice constructed there, known sardonically as the "Taj Ma-Coll," is but one of many ritzy concessions to the gratification of towering egos and reckless new extremes of brashness. The nickname is even more fitting when one considers that its namesake, India's Taj Mahal, is essentially a fancy tomb.

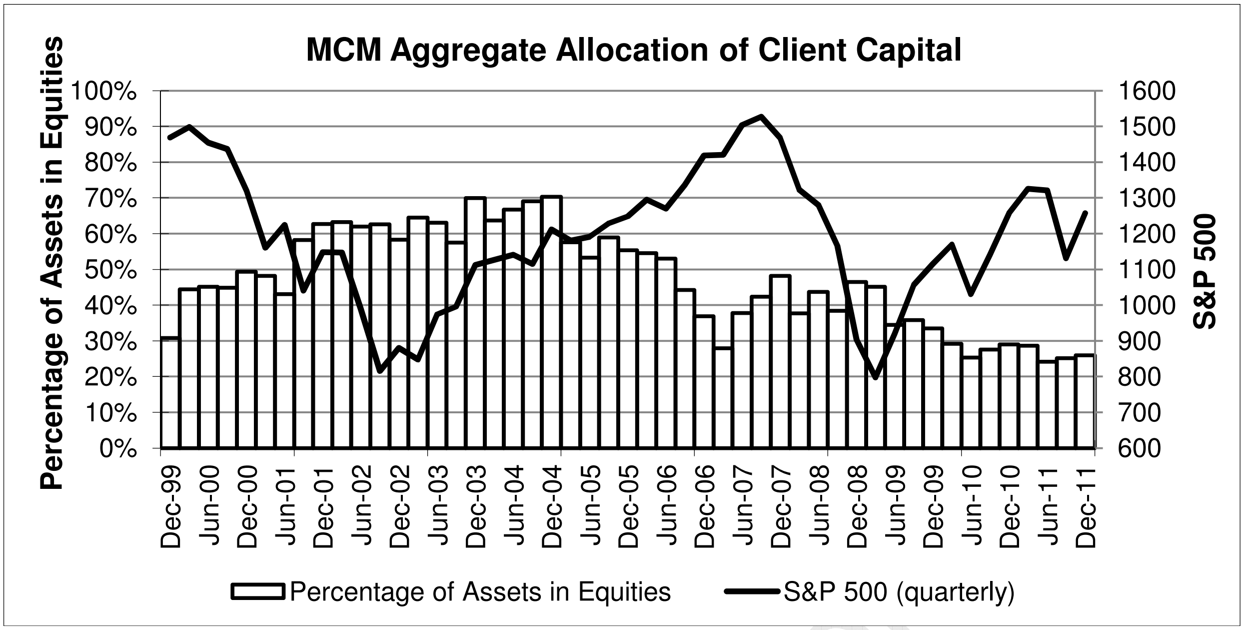
As we quickly pull back from the microscopic lens and view the financial industry against the broad backdrop of the economic universe, it's clear why we find ourselves largely holding cash on our clients' behalf. Most of the good franchises, in banking and many other industries, are currently properly valued or even overvalued. The second-tier franchises like Bank of America are seemingly cheap until you look under the hood. To be sure, we are finding isolated bargains in manufacturing, technology, apparel, and healthcare, but these are few and far between. Until franchises like Wells Fargo and other great "A+" businesses go on sale, our preference will be to protect your capital and patiently wait for the right opportunity as a disciplined value investor should.

Risk-Free Return vs. Return-Free Risk

Our goal for clients, simply stated, is long-term growth of capital that well exceeds average market returns while exposing portfolios to well below market risk. We believe that being fully invested at all times and in all circumstances is fundamentally incompatible with value investing. Only in deeply depressed markets is one likely to find enough individual companies selling at prices with compelling margins of safety to fill an entire portfolio. Moreover, experience has taught us that fear-inducing paper losses place an unnecessary emotional burden on the client that can be counterproductive to achieving the goal described above. H. Jackson Brown Jr., author of the '90s bestseller *Life's Little Instruction Book*, urged readers, "Don't be afraid to go out on a limb. That's where the fruit is." Sage advice except during natural disasters like forest fires, tornadoes, and earthquakes. Jim Collins, author of *Good to Great,* takes a different tack in his latest book*, Great by Choice*. Armed with a mountain of statistical evidence, Collins says great leaders in turbulent times are not daredevils, contrary to popular mythology. They are, in fact, risk-averse to the point of appearing paranoid.

As our own record makes abundantly clear,[4] we've held to that belief since the late '90s. At the end of this current cycle (see "17-Year Cycles: Of Locusts, Bulls, and Bears" later in this report), the era is likely to be remembered as a time of great temptation and even greater disappointment that, when all is said and done, might be best summarized by the ignominious characterization "return-free risk" as opposed to risk-free return. We trust that our actions speak louder than our words. Look carefully at the solid line on the following aggregate allocation chart; it represents the quarterly closing prices of the S&P 500 with the index numbers provided along the right margin:

[4] See *A Decade of Delusions* (2011).

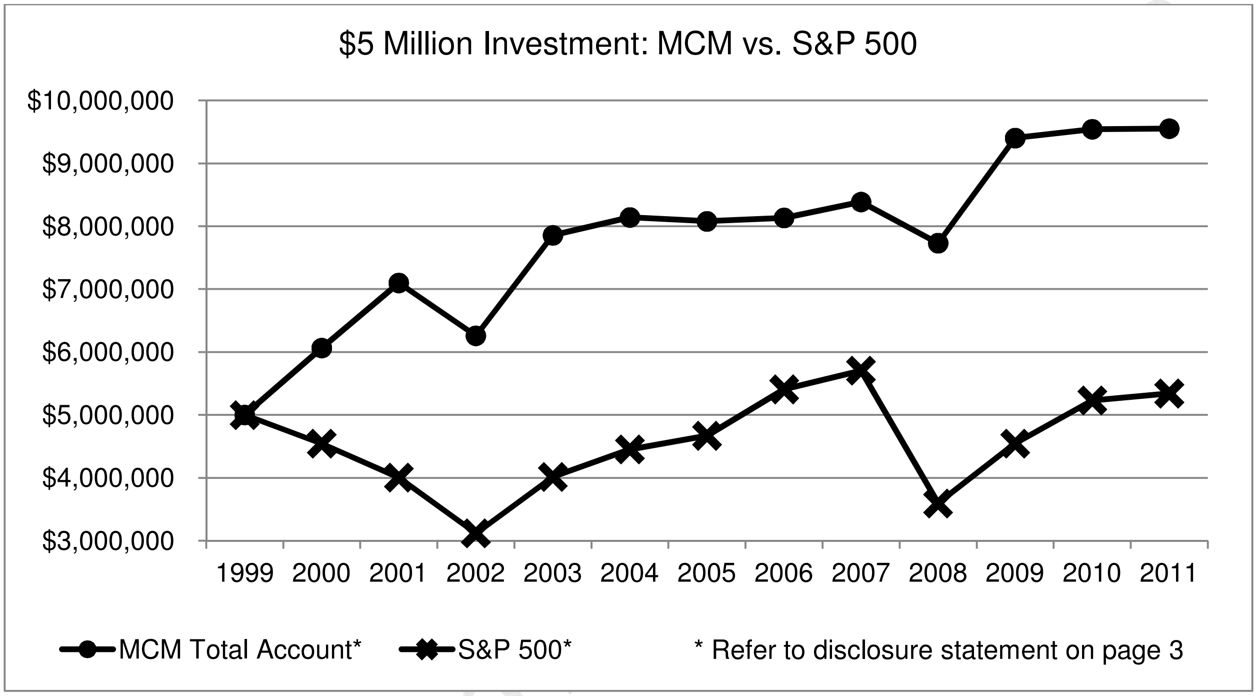


Two things are conspicuous about it: (1) At the beginning of the decade it stood at 1500, while 12 years later it is less than 1300, and (2) during that time span, it experienced declines of roughly 50% on two occasions. Dividends, yielding on average 2% (merely half the long-term average), helped to bring the total return into the black. That said, no other decade since the 1930s was as chaotic and unproductive as this one. Risk, which we define as the potential for permanent capital loss, was so high as to require us, true to our principles, to carry unusually large amounts of cash as a hedge against adversity throughout much of the 12-year span. The vertical bars on the same chart leave no doubt that we did exactly that.

Looking in greater detail, the last 12 years can be divided into three contiguous periods. Anticipating that the technology bubble in the late '90s would eventually burst, we owned no technology stocks and had 70% of client assets in cash just before the bubble did indeed pop in early 2000. The market was radically bifurcated at that time: Investors couldn't get enough of any technology-related stocks, nor could they disgorge quickly enough anything in their portfolios that might be considered "Main Street mundane." As a result, we found many values among the unloved. Because of the combination of committed capital and appreciation in the prices of the companies we had acquired, equities rose to 60–70% of our portfolios from 2001 through 2004.

By then, given the combination of the emerging housing bubble, the reckless explosion in leverage in virtually all public and private sectors of the economy, and the rise in the S&P 500 to levels likely to be fundamentally unsupportable under the scenario we envisioned, we found ourselves again holding more and more cash. On the eve of the financial crisis, equities represented less than 30% of the assets we managed. From the perspective of the individual companies we owned, investors had bid their prices to levels that implied an under-appreciation of the growing risks. During the depth of the financial crisis in late 2008 through early 2009, we made the deliberate choice to be opportunistic with nearly half of your capital. We acquired positions in companies tainted by leverage but in our judgment not at risk of failing, and we bought the highest-quality bank stocks we could find (like Wells Fargo, as noted earlier).

As the markets rebounded, we concluded that the foundation for the overnight reversal in fortunes was as fragile as the "easy money fools' rally" of 2004–07. As is obvious from this annual report, we think the risks of significant loss are once again unacceptably high, made all the more so because cash is yielding virtually nothing. Investors desperate for a return on their money have driven up the prices of risk assets, including common stocks and junk bonds. They are now at levels that have reduced their expected returns and margins of safety to below our minimum thresholds. We feel that investors are paying far too much for assets simply not available at a reasonable price during times when Fed policy has left interest rates zero-bound. Ben Franklin was right: "Necessity never made a good bargain."



This second chart examines the investment results from our strategy of managing assets to avoid risk of permanent capital loss. Our investment in the wallflowers early in the decade was both low-risk and wonderfully productive, both in absolute terms and relative to the S&P 500. In 2002, the last year of the three-year bear market, our portfolio was more correlated with the market, and we gave up ground temporarily, only to leapfrog ahead in 2003. From 2004 to 2007, our increasingly defensive strategy resulted in a grating period of flattish performance while the S&P, which outdistanced us most notably in 2006 by 15.1%, closed the gap in relative performance … until the financial crisis took everyone—well, almost everyone—by surprise. Not only were we able to "win by not losing" in 2008 to early 2009, even the huge, artificially induced rally off the March lows was kind to us in 2009. In April 2010, we ("I," as MCM's chief investment officer, is the appropriate pronoun) made a 3% commitment to hedges against a market decline, which added almost 10 percentage points to portfolio performance until pre-empted by the 20% rally following Ben Bernanke's infamous Jackson Hole, Wyoming, speech on August 27. Had I lifted the hedges we would've come close to matching the performance of the S&P in 2010 by playing, of all things, defense. But I didn't, and we didn't. Tomorrow's opportunities are limitless and, as Bill Belichick and the New England Patriots painfully discovered with 57 seconds remaining, defense wins Super Bowls.

This past year was full of crosscurrents and contradictions, marked by sharp swings in sentiment with little forward progress. Early consensus bets were on a rising market, if for no more substantive reason than 2011 was the third year of the presidential election cycle, understandably the time for those who pull the levers in government to dress up the economy for the grand ball in November. This was no trivial matter. Since 1939, the market had never fallen during the third year of the presidential election cycle. On the contrary, on average it had risen 17%. Tempted, yes, but we didn't swing at that pitch.

Something more troubling, more ominous, was bothering us. We made our reservations—and disappointment—known in the "Forgotten Man" essay of July 2011. The Fed, while unsuccessful at keeping the rally going, did effectively raise the strike price on the Bernanke put. The implicit message was taken at face value by investors: *There isn't now, and will not be for the foreseeable future, any return in all the traditional safe places to put money. Uncle Sam, however, will protect your backside.* In a disturbing case of "willful blindness," the Fed threw a sucker pitch at which most investors felt they had no choice but to take a cut. There was and is a massive migration out the risk curve into uncharted waters in search of return, with most investors unaware that, despite the Fed's implicit assurances, it is helpless to make good on its pledge except under the most benign of future circumstances.

Sometimes anecdotes make a point most emphatically. We recently examined a portfolio appraisal from one of the largest (almost $700 billion under management) blueblood wealth management trust companies. Under the line item "Governments and Corporates," the report indicated the current yield[5] to be 7.4%. In order to achieve that level of yield, the underlying notes and bonds would likely have an average rating of Ba/BB or less (better known to most investors as "junk status") and average years-to-maturity of around 17. Likewise, the line item "municipal bonds" indicated a current yield of 4.41%, suggesting an average rating of A+ or less and average years-to-maturity of around 14.

In other words, to get more income, bond investors are forced to accept lower quality debt and/or lock their money up for a longer period of time. It's quite apparent that few investors are fully aware of the extent of the risk they're taking. Consider, for example, buying a five-year Treasury note today that yields 0.5%. Not very enticing, right? By "stretching for yield," one must purchase an A+-rated corporate bond due 20 years down the road—2032—to get a 4% annual return. But here's the danger: If market yields should rise 3 percentage points on that bond because inflation takes hold, or if the bond quality deteriorates because of further economic contraction, the market price would decline by more than 30%. That would effectively offset eight years worth of interest income, making the dull, half-percent Treasury note the more enlightened choice. Unwitting investors have poured hundreds of billions of dollars into lower-quality, longer-dated bonds in their search for higher yields. Many will unfortunately discover that, to paraphrase Will Rogers, return *of* principal is a bigger concern than return *on* principal.

Nevertheless, institutions once considered upstanding are selling/drinking the Kool-Aid. They are giving clients what they're asking for: more yield. If they don't, they reason, someone else will—and clients will leave to find them. To be sure, the customer has a place in their pecking order—but sadly, not at the top. You can't be righteous and pay the bills; besides, if the Fed doesn't worry about long-term consequences, why should they? Speculation was rampant, even reckless in the last half of the 1990s, but today it's desperate. With interest rates driven to zero in 2008 and expected to remain nonexistent until at least 2014, the epitaph will surely be written by

[5] As an example of what Charlie Munger would call "moral drift," many investment managers report to their clients "current yield" rather than "yield to maturity," or even better, "yield to worst" ("yield to call" or "yield to maturity," whichever is lower)." Not surprisingly, in times of low market yields, current yield overstates the true return if the bond is held to maturity. A little sleight of hand here and a little there …

analyst/economist Raymond DeVoe, Jr.: "*More money has been lost reaching for yield than at the point of a gun.*"

Apart from avoiding those same beguiling sucker pitches, throughout 2011 we regularly asked ourselves, "Are we fully utilizing our edge?" We constantly remind ourselves that if we parrot the actions of others, we cannot be anything but average. We know that as value investors, we must flexibly and opportunistically purchase mispriced assets of any type (equity and debt instruments of all stripes and of all sizes), which requires patience; discipline; a fundamentals-driven, bottom-up focus; the inclination to be contrary; and a long time horizon.

Needless to say, the ranks of value investors are not crowded (lonely might well be the operative word) because most investors lack the gumption and conviction to stand apart from the herd and tolerate short-term underperformance, along with the criticism that usually accompanies it, in order to achieve long-term rewards. Second, we must not turn a deaf ear to our competition but respectfully evaluate consensus thinking; we must know what those in the herd are doing. We focus on their processes, not their results. It's easy to fall into the trap of short-term "performance envy," which leads many investment managers into a perpetual cycle of underachievement. We're also painfully aware that an unhealthy number of practitioners in our industry are consumed with asset gathering. Sustained underperformance is disastrous for achieving that goal, but mediocre performance is not. Most firms accept trend-following mediocrity. The only way to significantly outperform is to periodically stand far apart from the crowd, something few are willing or able to do.

The blink-and-you-missed-it financial crisis of 2008–09—compressed as it was into less than six chaotic months—was a short-term victory of pragmatics over principle. On the side of pragmatism, Ben Bernanke's tenure as Fed chairman may be identified with his signature utterance in the midst of the crisis: "There are no atheists in foxholes or ideologues in a financial crisis." Offering ostensibly a counter view, Rahm Emanuel, incoming President Obama's Chief of Staff, was quoted in *The New York Times* in January 2009: "You don't ever want a crisis to go to waste," he said then. "It's an opportunity to do important things that you would otherwise avoid." In the end, the fear of the patient bleeding to death on the operating table took precedence over any other considerations, including economic or political principles.

The Lesson of 2008: 'Once Bitten, Twice Shy?' or 'Damn the Torpedoes and Full Speed Ahead?'

MCM viewed that fleeting moment and its potential long-term, wealth-threatening consequences not as a fortuitous reprieve, but as a call to arms from a bullet narrowly dodged from a gun with more rounds still in the clip. As stewards of your wealth, we believe that no duty of care is greater than avoiding large and permanent impairment of capital. As our performance-based fee schedule makes abundantly clear, we are intent on earning solid returns, but the overarching imperative to carefully control risk requires that we be patient when others can be impulsive, that we remain focused when others can be careless, and that we occupy ourselves with the long-term consequences of any action we contemplate while others chase short-term performance. We think of your money as though it were our own. In an existential way it is, because our funds are invested alongside yours, and our outcomes will be similar. We are thus known as conservative, but we do not see that as a negative characterization.

Our contrarian streak arises out of our belief that our primary loyalty is not to the party on the other side of the trade, but to you, our clients. We don't hobnob with those searching for a finite number of ideas in a quiet conspiracy against you. It is the arm's-length nature of the secondary market in which we buy and sell securities that the winners gain at the expense of the losers. In this context, it is largely a zero-sum transaction among anonymous parties. Not only do we have no obligation to tell a counterparty that we think they are wrong but, in fact, if we didn't hold that belief we would not be entering into the transaction in the first place. And, indeed, sellers may, unbeknownst to us, have little choice in their actions. For example, most institutions that held the unsecured debt of Enron when it declared bankruptcy in December 2001 were statutorily mandated to sell it, irrespective of the fact that it was trading for pennies on the dollar. In 2004 the liquidation plan estimated recoveries at 17% of face value. So far, buyers have actually collected 53% of face value. At the risk of sounding crude, "One man's trash is another man's treasure."

Although capitalism may come under increasing criticism in the years ahead, we believe that unfettered product and capital markets are the fairest and most efficient means of allocating society's scarce resources. Others will argue that socialism delivers greater equality of outcome regardless of inequality of input, but surely they must concede that the cost is a much smaller pie. Besides, as former British Prime Minister Margaret Thatcher once said, "Socialist governments do traditionally make a financial mess. They always run out of other people's money."

Market prices are the arbiter of value under our system. When they are distorted by extra-market intervention—when the Fed, for example, engineered destabilizing, below-market interest rates through the first seven years of the new millennium and zero-bound interest rates, presumptively, for the next seven—the resulting skewed prices of assets of all stripes can lead to malinvestment by those unaware of its effects. If we correctly understand the mispricings that have resulted, we consider it rational to hold cash when others acquire what we believe to be "return-free risks." Under our system of economic enterprise, we also believe that prudence and risk aversion are usually best taught by the school of hard knocks where the grade of "F" signifies financial loss. Although governmental intervention has postponed the day of dealing with the harsh reality of an unfathomable burden of excessive debt, it will not magically disappear simply because we wish it so. As brilliant hedge fund manager Kyle Bass has eloquently (if bluntly) said, "You can't hate the mirror because you're ugly."

Returning to the story of Enron, for us it's not the headline-grabbing $68 billion lost by the teeming throngs of credulous growth investors who bought the story that Ken Lay and Jeff Skilling spun before declaring bankruptcy. The real unheralded story is the billions *earned* by eclectic value investors who sorted through the debris and bought the defaulted debt of Enron for a tiny fraction of its eventual worth. Far from the mainstream, these value investors shunned being identified with those willing, unintentionally as it may have been, to sacrifice their clients' assets on the altar of conventionalism. All of this brings to mind the blood-and-guts wisdom of U.S. General George Patton: "It's an honor to die for your country, but make sure the other guy gets the honor."

If Ever There Were a Time for Robust Risk Models …

Chances are, if an investor didn't realize the markets were in the grip of the dot-com bubble in the late 1990s, or the real estate and financial bubbles leading up to 2008's crisis, or perhaps the most wealth-threatening bubble of them all currently under way, his understanding of risk and any so-called risk models he might employ are likely inadequate.

Little mention has been made of the Euro crisis thus far in this report. It's been on-again, off-again headline news since the Greek tragedy took center stage in May 2010. We are adding nothing to the general body of knowledge by suggesting that much of the Euro zone is massively overleveraged and is heading into an austerity-driven recession. In that respect, and as noted later in this report, it may well serve as a prelude to what could lie ahead for us in the U.S. Where we at MCM might be able to add value is in suggesting that there is a catastrophic risk potential in the subterranean world of opaque financial innovations within the global financial system. Because of outdated risk models currently being used, systemic risk is actually greatly accentuated, not lessened.

The ubiquitous bell curve, for instance, is still mistakenly believed to be the best gauge of the distribution of risk in the current environment. Similarly, the Value at Risk model (VaR) is widely used in finance for risk management, financial control, and financial reporting, as well as for computing regulatory capital. Despite its mathematical elegance, VaR failed miserably during the crisis of 2008 and is even more ill-suited for today's greater-complexity-related risks. The model persists in no small measure because the activities it rationalizes are so lucrative. Banks and other financial entities use VaR to show that risky but competing positions in credit default swaps and other arcane derivatives essentially offset each other. (Recall our earlier reference to Bank of America's derivatives book.) I insure you, you insure me … and it's a wash, right? In fact, such risk models allow much greater leverage scale and, thus, the extra riches that ballooning balance sheets make possible.

The game increasingly has become a one-sided bet: Heads I win, tails you lose. The purveyors, focusing on their own risk management, are likely less than fully cognizant of the burgeoning systemic risks of which each is a small but crucial part. With the Central Bank's implicit put in place, why should they worry about it? If this sounds like pre-Lehman 2008, it should. When Goldman Sachs hedged its AIG positions by purchasing insurance from Lehman, the critical weakness in VaR was exposed to the light of day. VaR arrived in a tattered academic suitcase packed alongside MPT (modern portfolio theory), the same flawed intellectual baggage in which price fluctuations are said to be random and risk is proclaimed to be independent of price (i.e., the efficient market hypothesis).

Complexity theory, effective in explaining events in the physical world, may be the most robust methodology for explaining the behavior of infinitely interdependent man-made systems like financial markets. Nature occasionally provides instructive examples as well. The September 2011 wildfires that destroyed nearly 4 million acres and 4,000 homes in Texas were the worst in state history. Importantly, the extent of the disaster did not hinge on what touched it off, but on the "critical state" of the dry Texas landscape. Lush vegetation (read: fuel) from years of uncontrolled growth was equally susceptible to ignition from something as powerful as a lightning bolt, or as insignificant as a carelessly discarded cigarette. Rather than call wildfires and financial crises "extreme events," it's more accurate to call them extreme results from normal events. Complex systems, according to *Currency Wars* author Jim Rickards, "arise spontaneously, behave unpredictably, exhaust resources and collapse catastrophically." Thus "fat tail" events, rare in normal (bell curve) frequency distributions, are prone to occur more often in such systems, and the scale of the damage is limited only by the scale of the system itself. Power-law distributions are far better at capturing risk exposure.

Derivatives exposure between U.S. financial institutions and those in Europe, as well as those among European financial institutions themselves, is the black hole of finance. When their use becomes global in scope and incomprehensibly interwoven, *gross* exposure may be the operative metric, not *net* exposure as measured by VaR. If the Euro problem becomes a nightmare, this misjudgment of complexity and scale is where it will probably begin. A more thorough discussion of this crucial but often overlooked subject will soon be posted to our website.

Investment Strategy in Uncertain Times

It is a common practice in our profession, particularly for those who are fully invested all the time, to find ways to cope with cognitive dissonance—those moments when one's beliefs and actions are in conflict. Popularized terms to describe coping mechanisms are given various names, including willful blindness, disaster myopia, and financial amnesia.[6] But by staring the tiger in the eye, we dismiss the need for such mental gymnastics.

Given the pervasiveness of what we believe to be the illusion that the economy and the capital markets can resume a growth trajectory while dragging the ball and chain of mountains of debt, we see opportunity for capital growth "being long the short side."[7] Regression to the mean (and often well beyond), is ultimately an irresistible force and supports our strategy because: (1) common stocks in general offer more risk than return, a condition that, in the near term, only lower prices will correct, and (2) blind-siding tail risk is dangerously elevated as discussed above. Cash is a good passive hedge against market risk—and a respectable hedge against the twin maladies, inflation or deflation—when one is uncertain about which will occur and when.[8] Hedging or even going a bit farther in being "net short" by using long-term equity index put options is more assertive and more unconventional.

Just as we believe that risk is not a constant but rather a function of the price one pays for an asset (think about Enron stock when it was a highflyer and the Enron bonds when they were in the Dumpster), we think options should be viewed no differently. What they give us is synthetic leverage with a known downside risk. Currently they are neither cheap nor insanely expensive, and index options, because they are treated by the IRS like futures contracts, are taxed at approximately 23% whether you hold them for a week or a year. That gives us the tax-efficient opportunity to actively manage them to reduce cost to carry (in lay terms, effectively reducing our annual insurance premiums).

Although the microscope has helped us avoid what could be value traps like Bank of America, it has also brought into sharper focus the needles in the haystacks. As the confirmation receipts you've received in the mail this year and on into 2012 would attest, we've found a few bargain-priced stocks we like.

17-Year Cycles: Of Locusts, Bulls, and Bears

In 1999 Warren Buffett was so disturbed by the pervasiveness of what he believed to be wildly unrealistic investor expectations about future returns from the stock market, he removed his normal veil of silence on the subject. *Fortune* magazine Editor Carol Loomis synthesized the four talks he gave that year in a November 1999 article, "Mister Buffett on the Stock Market." Since the simple logic of Buffett's arguments resonated with my own more intuitive views, I dissected his work with intensity to close the intellectual gap and discussed my observations in the 1999 MCM Annual Report.[9] I revisit them here, in 2012, to give you what radio commentator Paul Harvey used to call "… the rest of the story."

Most investors in marketable securities, to say nothing of the greater universe of non-investors, view the future through the only lens they find familiar and comfortable—a lens that

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[6] A thorough discussion of these topics may be found in the first-quarter MCM Quarterly Capital Markets Review, viewable on our website at http://www.mcmadvisors.com/downloads/mcm_2011_q1_qcm.pdf

[7] Michael Burry, featured in Michael Lewis's *The Big Short*, coined the phrase. Burry, like John Paulson, purchased credit default swaps (CDS) on various subprime, mortgage-backed security pools. Based on his fastidious research, Burry believed that the financial markets were overcome by a mass collective delusion. Buying CDS allowed him to profit if prices of the mortgage pools fell. Selling the pools short would have exposed Burry to a maximum 100% gain on the upside and unlimited loss on the downside—but owning a derivative (CDS) did just the opposite. Being "long the short side" limited his losses to the amount invested while allowing potential gains that were hugely asymmetrical.

[8] See James Montier's superb essay, "A Value Investor's Perspective on Tail Risk Protection: An Ode to the Joy of Cash," viewable on our website at: http://www.mcmadvisors.com/downloads/ode_to_the_joy_of_cash.pdf

[9] See *A Decade of Delusions*, pages 58-61.

extrapolates the recent past. We often refer to such behavior as "rearview-mirror investing." And it works, except at inflection points—at secular peaks and troughs when long-term trends, much to the surprise of the multitudes, are about to reverse. When Buffett spoke out in 1999, it was in the 17th year of a remarkable period during which the S&P 500 had increased tenfold. In investment management parlance, that's a compounded annual rate of return, including dividends, of 19%, nearly double the 10% average recorded by the authoritative Ibbotson research dating back to 1926. According to a Gallup poll in mid-1999, investors looking back in time to see the future, saw nothing but more of the same. Those with less than five years of experience expected the S&P to appreciate at 22.6% annually over the next 10 years. The expectations of those with more than 20 years of experience were a more subdued but nonetheless backward-looking 12.9%.

Taking poetic license, Buffett applied the biblical symmetry of the 17-year "cycle of the locusts" to lay an allegorically correlative foundation from which he viewed the future in 1999. The first cycle, from 1965 through 1981, Buffett dubbed "the lean years," and the second, from 1982 through 1998, he called "the fat years," as the paragraph above quantitatively attests. From there, he hypothesized how stocks might actually perform in the *next* 17-year period, from 2000 through 2016. Buffett understood, as do we, that history doesn't repeat itself in neat and tidy 17-year cycles. The odds of the first two cycles precisely repeating themselves are at best remote. Fortunately, we live in a world where long-term success goes to those who really understand compound interest and apply it deftly. If you are contrary and generally right, you can put miles between yourself and the thundering herd.

Buffett methodically analyzed the principal variables upon which common stock prices are based: the underlying growth in GDP, after-tax corporate profit as a percentage of GDP, inflation, interest rates, and price/earnings ratios. In the table below, the original data are modified for consistency throughout the three cycles and, importantly, Bob Shiller's 10-year moving-average, inflation-adjusted earnings have been substituted for reported earnings.[10]

	1965–81	1982–98	1999–2011
Nominal GDP Growth	9.5%	6.3%	4.3%
Real GDP Growth	2.8%	2.9%	1.8%
After-Tax Corp. Profits as a Percentage of GDP	6% to 3.5%	3.5% to 5.2%	5.2% to 7.3%
Annual Inflation Rate	1% to 9%	9% to 1.6%	1.6% to 3.4%
Long-Term Interest Rate	4% to 14%	14% to 5%	5% to 3%
Shiller Real Earnings Growth	2%	0.6%	2.8%
Shiller P/E	23x to 8x	8x to 39x	39x to 21x
S&P 500 Total Return	7%	17%	2%

During the lean years (1965-81), the S&P 500 index was essentially flat with comparatively generous dividends (representing two thirds of the total) bringing the compounded annual return up to 7%.

[10] Ben Graham, whose work inspired Shiller, would be pleased that our focus is not on short-term, quarter-to-quarter earnings guidance and comparisons—is that really the way to run a business?—but on actual good news where things were improving month to month, not the asinine stories we see today where bad numbers are interpreted as good because they were "better than expected," and declining numbers are called good because the rate of decline is slowing down. (Likewise, Graham's protégé Warren Buffett would likely have used Shiller's numbers if they had been available in 1999. The long-term perspective is particularly *apropos* today because the reliability of both bottom-up and top-down earnings forecasts, when we need them the most, prior to recessions, is abysmally bad. Fresh in our memories, trailing 12-month operating earnings the S&P turned decidedly south coincident with the beginning of the Great Recession in December 2007, whereas consensus earnings forecasts, both bottom-up and top-down, finally followed with a vengeance in the summer of 2009, 18 months later, just when the recession was officially ending. Moreover, the dampening effect of the great deleveraging underway and the likely temporary boost profit margins are enjoying because of low labor and interest costs, have likely given profit margins, and thus reported earnings, an unsustainable boost.)

Although nominal GDP rose at an annual rate of 9.5% (real, inflation-adjusted, GDP was a much lower 2.8%), two negatives more than offset this economic growth: Corporate profit margins fell below average and 10-year moving-average P/E ratios dropped to secular lows. The P/E ratios bottomed out because of the competition equities encountered from double-digit interest rates on fixed-income securities, and because of investor "rearview mirror" despondency. Disaffection with the stock market was widespread at that time. Money invested primarily by retail investors in equity mutual funds declined from $45 billion in 1972 to $32 billion in 1978. The infamous cover story of the August 12, 1979, edition of *BusinessWeek* captured the *zeitgeist* of the bear market. As an indication of how little its writers understood capital markets, only two points need be made: First, equities, save for companies that go bankrupt or are acquired, exist in perpetuity–when one set of owners gives up the ghost, another is there to pick up the pieces and, second, to assume that double-digit inflation would be a permanent condition was beyond naïve.

In a cruel but predictable turn of fate, the best time to buy stocks is often the very moment when financial physicians have signed the death certificate; 1979 was no exception. Lean expectations gave rise to the fattest stock market performance episode in modern history. Although the rate of growth in GDP declined, profit margins increased, interest rates plummeted, and P/E ratios skyrocketed to the highest multiples in history, far eclipsing the records of 1929. Mutual fund investors flocked back to the markets in droves, particularly as the 1990s blossomed and the public embraced technology and the incipient Internet boom. Under 35% of U.S. households owned mutual funds at the beginning of the decade. A scant 10 years later, 50% of households (54 million) had jumped on the bandwagon.[11] But once again, the "rearview mirror" betrayed. Buffett argued that for investors' irrational exuberance to be realized, GDP would have to grow at an unprecedented 12%, corporate profit margins would have to remain elevated, and stratospheric P/E ratios would have to hold.

As for those Gallup Poll dreams of continued stock growth, the delusionary 22.6% annual expectations of greenhorn investors were simply laughable—and Buffett pointed out that even the 13% predictions of the "experienced" crowd would need all the above to go right. The only thing bankable in the 13% expectation was the record-low dividend yield of 1%. Insanity by another name. Not caught up in the madness of the moment, Buffett rationally concluded that euphoria would inevitably give way to reality, and investors would be lucky to achieve returns of only 6% for the next 17 years (a 4% return after inflation).

Well, here we are now 12 years into the current cycle, and as the preceding table reveals, Buffett has proved that history is a good teacher and that the majority rarely rules in investing. Thus

[11] That remarkable saga of blindly chasing the latest, greatest idea could've easily been second-last chapter in an updated edition of Charles McKay's 1841 classic, *Extraordinary Popular Delusions and the Madness of Crowds,* and was the genesis of *Speculative Contagion* (2006) by Frank K. Martin.

far, from 2000 to today, the total return from the S&P 500 has been a mere 2%, all of which came from the near bottom-scraping dividend yield. Nominal GDP has grown at 4.3% (real, inflation-adjusted GDP grew at the slowest rate for the three cycles at 1.8%), and inflation and Treasury bond yields were well below historical norms. Inflation-adjusted Shiller earnings outpaced GDP as after-tax corporate profit margins increased. Long-term interest rates, more the product of Fed monetary intervention than market forces, continued their downward trend that began in the early 1980s, falling farther, from 5.1% to 2.9%, as if inexorably heading to zero. But the real spoiler in terms of the failure of the S&P 500 to keep pace with the underlying fundamentals was once again P/E ratios, which fell from an all-time-record high of 42 to the still nosebleed level of 21, five points above the long-term average and triple the level commonly seen in secular bear market bottoms.

Martin and Buffett: Birds of a Feather?

Warren Buffett isn't making midcourse adjustments to his simple but not-*too*-simple 17-year prognosis. Our opinions, unlike Buffett's, do not move markets, and we are thus less inhibited about expressing the need for some modifications. For starters, let's begin with a confession. There was not a single reference made to private or public sector balance sheets in Buffett's 1999 outlook (or for that matter, in the prior two cycles). Generally healthy balance sheets were assumed, given the long post-World War II expansion and the frugality of a generation that remembered, if you'll recall our earlier parable of abundance, the excesses and demise of the Roaring '20s version of "Henry the Pheasant," and the resulting Great Depression. Neither Buffett nor I foresaw the explosion in the use of credit throughout the economy, both public and private sectors, aided and abetted by a cheap-and-easy-money Fed policy, that has thrown asset pricing and financial-risk calculations out of kilter ever since. Nor did we foresee that federal, state, and local government spending and transfer payments would surge to more than one out of every three dollars of GDP. The ratio in France, generally considered to be more socialist in culture than the U.S., is $1.68 of every $3.

From 1940 through 1985, total nonfinancial debt as a percentage of GDP stayed close to 150%. It jumped to 200% by the end of the 1980s, then flatlined through the 1990s. During the first 12 years of the current cycle, the ratio has skyrocketed to nearly *286%!* Since the Great Recession began in December 2007, federal debt as a percentage of GDP rose from 65% to 96%, made less conspicuous in terms of deficits in the short run only because the average interest rate is a mere 2.8%. While the numbers are "off balance sheet," the total potential commitment of public (ultimately taxpayer) resources in federal loans, guarantees, and bailouts during the 2008 financial crisis peaked at $23.7 trillion and the Fed's balance sheet (and the source of tomorrow's inflation) exploded by $1.9 trillion. Fortunately, most of those guarantees were not required in 2008–09. But given Uncle Sam's willingness to even make them available, it seems reasonable to imagine that similar forms of government intervention will be called upon if the solvency crisis of 2008–09 refuses to remain dormant. Underfunded future promises including Medicare, Medicaid, Social Security, and public pension liabilities add another head-turning $34 trillion, according to the GAO. These are promises likely to be compromised, if not broken, so we would caution against putting too much emphasis on the burden they will exact from future generations.

One perplexing but rarely mentioned aspect of the explosion in total debt is its ever decreasing marginal utility—the number of dollars of debt needed to increase GDP by one dollar. During the 1980s, nominal GDP grew by $2.9 trillion, while total debt outstanding grew by $7 trillion; in the '90s GDP grew $3.9 trillion, but the debt needed to fuel it increased by $8.5 trillion; the last decade (2000–09) is about "Henry" going from plump to morbidly obese, with GDP growing by a relatively paltry $4.6 trillion, while total debt ballooned by an astounding $20.7 trillion. (See table below.) Talk about less bang for the buck.

Decade	Nominal GDP Growth (trillions)	Domestic Nonfinancial Debt Growth (trillions)
1980–89	$2.9	$7.0
1990–99	$3.9	$8.5
2000–09	$4.6	$20.7

As we wrote last year, referring to the ongoing economic malaise as the first "balance sheet recession" since the 1930s, insufficient aggregate demand is a symptom of excessive indebtedness. Spend or print money as U.S. leaders will, the economy remains unresponsive to either Keynesian (federal government borrows and spends) or monetarist (the Fed increases the money supply) stimulus during the Great Deleveraging. The downside of excessive indebtedness is equally problematic, particularly when it reaches levels that greatly exceed the present value of future revenues necessary to pay it down to more manageable levels. Trying to surreptitiously shift the burden to savers through inflation and to our foreign creditors through currency devaluation—precisely what we believe to be the Fed's unspoken intent—brings it face to face with an intransigent paradox. On the income side of the ledger, the main (and unwanted) effect of quantitative easing in 2011[12] has been to reduce real income. On the expense side, interest costs are sure to rise with inflation. Together, the result is that as real incomes decline the interest cost on the debt surges, likely putting an end to any attempt at taking the inflationary way out.

In 1999 neither Buffett nor I foresaw that Henry the Pheasant would find credit so cheap and accessible that he could consume far beyond his means. Now that we know of Henry, I wonder (though Buffett is of a different view) if it was really a good thing that he narrowly missed being eaten by the fox in 2008.[13] Three years later he is still obese, although somewhat aware of his weight problem. But with nothing and no one forcing him to go on a diet, he hasn't shed a pound; and because he is older and heavier, his chances of flying are fading fast. Perhaps when Henry least expects it, Mr. Fox will get his due.

The demise of Henry is not the end of the story, but rather the beginning of a new chapter in the long book of the history of economic cycles. New pheasants will appear and, having witnessed or learned of Henry's mistakes, will swear never to repeat them … until their own memories fade. The cycles between lean and fat are part of the pheasant—and human—condition.

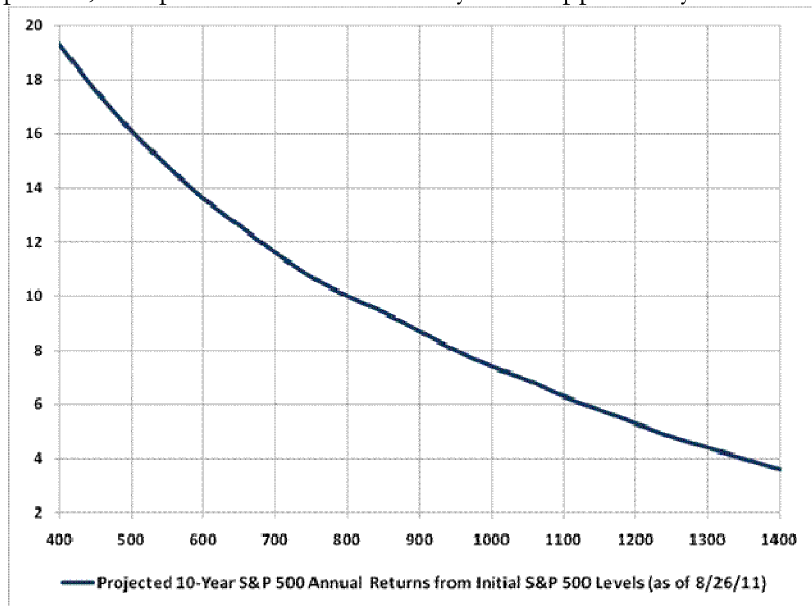
Sitting in the Fat Bird Seat

Make no mistake, the death of Henry will be traumatic—especially for Henry—and there are many Henrys who will sooner or later face the inevitable fox. New and healthy growth will come, just as a devastating forest fire cleans out the old to make room for the new.

The slow, one-at-a-time death of Henry, in our opinion, will not be final until the Shiller P/E swoons to signal a secular bear market low of 10 or less (we'll leave the math to you with regard to its effect on the S&P 500). That leaves us two choices: (1) Take a chance that Henry will make it a few more years. You won't make much money, but you will have the thrill of being chased by a

[12] As this report goes to press, is rumored that another trillion dollars is being readied if needed in 2012.
[13] In the preface of *A Decade of Delusions*, on page xxii (or location 310 in Kindle), that very issue is explored. Counterfactualists will be debating it 75 years from now, just like economic philosophers today are ruminating on the "what-ifs" as they attempt to synthetically reconstruct and learn from the Great Depression.

fox. And you won't be alone because Henry always attracts a crowd (misery loves company). Or: (2) Wait for the fox to finish dining, knowing that future prospects will improve for those few who bide their time and remain spry enough to fly from danger. We frequently remind ourselves, and you, our dear clients, that independence, not conformity, constitutes the surest road to investment success. When the next *BusinessWeek* cover proclaiming "The Death of Equities" appears, the patient, disciplined value investor's cycle of opportunity will be at hand.



Please take a look at this enlightening chart,[14] put together by Stanford economist and investment manager Dr. John Hussman, Ph.D. We include it in this report because (1) our approach to valuing equities is nearly identical to his, (2) it is deep in meaning and yet simple to read, and (3) you'll not likely see anything so seemingly preposterous elsewhere. As you study it, try to avoid the common mistake of allowing yourself to be anchored in the present with the S&P around 1300. Instead, imagine that the unexpected happens and the S&P should fall to 600, a number chosen to awaken the drowsy. The 10-year expected return would then rise to about 14%—far better than the 4% expectation from today's market levels.

While the chart displays expected returns from various levels of the S&P, it doesn't depict closely-related factors that are of equal importance. If the chart is in fact a reasonable approximation of the range of possible outcomes from this moment in time, the odds are great that a person who is fully invested now—unless he is that rare bird that can make headway in hurricane-force winds—will be miserable a good deal of time as he is blown hither, thither, and yon in the years ahead only to end up not far above where he started. More perniciously, persistent misery may give rise to destructive emotions, like despair and maybe even fear. At that point uncertainty leads to the one risk from which recovery is extremely difficult: permanent capital loss. Mind you, it's not because the businesses in which you own a fractional interest go bankrupt, but rather because the insufferable pain of relentless paper loss becomes too much to bear; it's your appetite for risk that goes bankrupt. When people capitulate to their fears—when they utter those words of submission, "GET ME OUT" (GMO)—they effectively seal their own fate.

So, if you consider the preceding arguments rational, they prompt the question: Why do the majority of investors run with the herd, blindly imitating others? The reasons are many but surely envy and autophobia, the fear of abandonment (of being left behind), are among them. One antidote is for the independently minded investor to think about Henry, and ask yourself whether you are able to rise above your primordial instincts and self-regulate, rather than let the environment determine your destiny. That's no mean feat even for the strongest among us. In other words,

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[14] As a rule of thumb, this curve shifts to the right at a rate of about 6% annually, which is the approximate growth rate of long-term, normalized fundamentals (earnings, dividends, book values, revenues, and even nominal GDP).

rational and realistic investors must determine how much is enough. Make no mistake, by being satisfied with what you have now, your "enough" is likely to grow exponentially in the future—*precisely because you had forgotten to think about it.*

If future events cause the greater-opportunity, lower-risk curve to move from the lower right to the upper left (see previous chart), the compelling economic simplicity of the value proposition will trigger action among investors like us. At that moment, all a value investor will know with certainty is that the time is ripe to sow. Think back to the Enron debt. The harvest, in the fullness of time and without anxious expectation, will likely be bountiful. Those aggressively and impatiently pursuing investment success for its own sake, without a sense of how much is enough, will stand the risk of expending exhausting amounts of energy and experiencing much angst, only to end up with little to show for their efforts in relation to the sacrifices made.

MCM Through the Looking Glass

What is it about microscopes and telescopes that fascinate people of all ages? Much of the answer lies in the thrill of seeing what others cannot see. Magnification on scales both small and large allows us to verify the reality that surrounds us all the time, but of which most people are largely unaware given the limitations of normal human vision.

Though we can't truly live in these "other worlds," they nonetheless define our reality, and they are eminently instructive as we exercise those distinctively human traits of trying to figure out how to *manage* and *improve* our reality. At MCM, we use both the micro and macro views to evaluate investment opportunities by seeing a reality that others may not see. We feel our edge comes from understanding the value of examining businesses both in fine detail, as well as in the context of the global economic landscape. German philosopher Arthur Schopenhauer once observed, "Talent hits a target no one else can hit; genius hits a target no one else can see." While we make no claim to the genius of our own work, Schopenhauer's "vision" is wonderfully aspirational—and inspirational—for all of us at MCM.

It's only fair then, to momentarily turn the lens on ourselves.

For most of our history, I (Frank) have played a central role in the investment management process. While I remain fully engaged in that process, leadership at MCM is increasingly a shared proposition. Adam Seessel has ably taken the reins of our investment team—structuring the research process, generating investment ideas, and organizing our analysts (Aaron Kindig, Clint Leman, and Zack Clark) in circles of competence that have quickly enriched their sector knowledge and sharpened their edge. The progress and quality of research under Adam's guidance are most encouraging and bode well indeed for the future of our firm. Gary Sieber, as will be obvious in 2012, is exhibiting similar leadership in marketing.

As should be evident from reading this report, MCM has become a cohesive, selfless team. Adam's fingerprints all over the commentary on equities, and, along with Zack's, on the Bank of America analysis; Clint's on all the data and graphics; and Gary's, well, everywhere. Aaron Kindig and Karman Eash, from content review to compliance, left their marks as well. You may find it cliché, but MCM is truly and increasingly synergistic, where the whole *is* greater than the sum of the parts. I see the future every day in the faces of our entire staff—including MCM's indispensable unsung heroes, our operations team led by Karman Eash, and including Karen Sherer, Sue Massey, Kristen Smith-Myers, Janet Willoughby, and Connie Williams—that future looks very bright indeed.

With the tireless and invaluable advice and counsel of our Board of Directors[15] during this year of transition, the firm has been reorganized as a meritocracy, with authority, responsibility, and

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15 See website for bios.

accountability closely linked. More than ever before, annual compensation of all line positions is directly tied to how well your portfolio performs in absolute terms. (Needless to say, we all sacrificed this year to keep you and your money out of harm's way.) Ownership stakes in the firm are being offered to those named in the preceding paragraph currently and annually thereafter so that they, instrumental in creating the value that you are receiving, will reap the long-term benefits of their labors as well. Of the many growth and development initiatives undertaken this year, one that will soon be conspicuous is the intended launch of a "product" for the market of investors who desire our unique brand of investment stewardship but at dollar amounts less than our stated minimums.

None of this would be possible, of course, without the continued support and patience of our clients. Day by day, year by year, and in some cases decade by decade, you live the words of Jean de LaFontaine: "Patience and time do more than strength or passion." Such wisdom liberates us to defer gratification on your behalf today, anticipating greater rewards in the future. Thanks for your loyalty during the lean years, which, though frustratingly long, have not yet gone the way of Henry. As Dr. Whybrow points out, nature has a way of administering pain when we refuse to regulate ourselves. With an exorbitant amount of global debt still hanging over our heads, austerity and subpar growth appear to be "nature's remedy"—at least in the near term. Beyond that threshold, however, lies the party for which we are preparing.

Thoughtful *New York Times* journalist and commentator David Brooks, speaking at the Wake Forest University commencement in 2007, observed that the ancient Greeks had coined the phrase, "We suffer ourselves to wisdom." Henry the Pheasant might have quipped more succinctly, "No pain, no gain." The dawn of the new age of "rational optimism" will follow a figurative night of gloom. At MCM, we'll do our best to reward your loyalty by helping you get from here to there and, together, to experience the thrill of sailing downwind with following seas for years to come.

Frank K. Martin, CFA

Appendix A

It should not be assumed that the recommendations made in the future will be profitable or will equal the performance of the securities noted.

Past Recommendations

Security	Date of Action	Action	Market Price on Activity Date	Target Price	12/30 Close
Emmis	1/14/2011	Sell	$ 1.26	MKT	$ 0.66
Emmis	1/21/2011	Sell	$ 1.13	MKT	$ 0.66
S&P 06/18/11 Puts @700	3/16/2011	Sell	$ 0.80	MKT	Expired
Brown & Brown	4/20/2011	Sell	$ 25.28	MKT	$ 22.63
Brown & Brown	4/21/2011	Sell	$ 25.23	MKT	$ 22.63
Brown & Brown	4/25/2011	Sell	$ 25.22	MKT	$ 22.63
Brown & Brown	4/26/2011	Sell	$ 25.00	MKT	$ 22.63
Brown & Brown	4/27/2011	Sell	$ 25.15	MKT	$ 22.63
Brown & Brown	4/28/2011	Sell	$ 25.47	MKT	$ 22.63
Berkshire Hathaway - B	6/24/2011	Buy	$ 75.22	MKT	$ 76.30
Wal Mart	6/24/2011	Buy	$ 52.89	MKT	$ 59.76
Yahoo	6/24/2011	Buy	$ 15.01	$ 15.00	$ 16.13
Yahoo	7/20/2011	Buy	$ 13.80	$ 14.00	$ 16.13
Yahoo	7/29/2011	Buy	$ 13.56	MKT	$ 16.13
Amgen	8/3/2011	Buy	$ 52.89	$ 54.25	$ 64.21
Amerigon	8/5/2011	Buy	$ 14.88	$ 14.80	$ 14.26
Yahoo	8/5/2011	Buy	$ 11.77	$ 11.75	$ 16.13
Amerigon	8/8/2011	Buy	$ 14.45	$ 14.50	$ 14.26
HPQ 1/21/12 Puts @19	9/23/2011	Short Sale	$ 1.46	$ 1.50	$ 0.03
HPQ 1/21/12 Puts @20	9/23/2011	Short Sale	$ 1.86	$ 1.86	$ 0.04
YHOO 1/21/12 Puts @$10	9/27/2011	Buy	$ 0.22	MKT	$ 0.01
Hewlett Packard	10/4/2011	Buy	$ 22.46	$ 22.00	$ 25.76
Gannett	10/7/2011	Sell	$ 10.39	$ 10.50	$ 13.37
Gannett	10/11/2011	Sell	$ 10.81	$ 10.95	$ 13.37
Gannett	10/20/2011	Sell	$ 10.47	$ 10.58	$ 13.37
Gannett	10/21/2011	Sell	$ 10.96	$ 11.00	$ 13.37
S&P 12/21/13 Puts @1000	10/27/2011	Buy	$ 97.50	$ 100.00	$ 95.80
S&P 12/21/13 Puts @1000	10/28/2011	Buy	$ 95.25	$ 95.00	$ 95.80
Garmin	11/1/2011	Sell	$ 33.91	MKT	$ 39.81
S&P 12/21/13 Puts @1000	11/28/2011	Sell	$ 129.00	$ 127.00	$ 95.80
Yahoo	12/1/2011	Buy	$ 16.28	MKT	$ 16.13
S&P 12/21/13 Puts @1000	12/9/2011	Buy	$ 107.75	$ 109.00	$ 95.80
S&P 12/21/13 Puts @1000	12/29/2011	Buy	$ 94.75	$ 101.00	$ 95.80