MARTIN
CAPITAL MANAGEMENT, LLC
Registered Investment Advisor

QUARTERLY
CAPITAL MARKETS REVIEW

October 2011

'BLAISE-ING' A NEW PATH

Longtime readers of Frank Martin's books, essays, annual reports, fireside chats, and—yes—these QCMs are quite familiar with the author's penchant for quoting famous (and occasionally obscure) philosophers and thinkers. Among those is French mathematician/philosopher Blaise Pascal. Rather than reiterate the story of Pascal's Wager (a marvelous study of logic in risk aversion), it seems more appropriate to quote one of Pascal's lesser-known sayings: "I have made this letter longer than usual because I lack the time to make it shorter."

No wonder Frank and Blaise are on such good terms.

As global financial events unfolded in late September, we felt it would be more timely to send our clients Frank's QCM lead essay, "How Could We Have Been So Blind?", at that moment rather than wait until the normal October release date of the quarterly review. If you haven't read it, now would be a good time; the information in it is still quite compelling and relevant. And if, for some reason, you didn't receive or have misplaced the article, let me know and I'll send you a separate copy.

Meantime, since Frank's quarterly essay is already in your hands and we *do*, in fact, have the time to make this letter shorter … we will.

The Quarterly Capital Markets Review begins, appropriately, with the issue on most investors' minds these days: Am I okay? Quite simply, there is nothing more important to us than allowing you the peace of mind that comes from knowing that we are well-positioned to ride out the current market turbulence and well-positioned to grow when market conditions change.

MCM research director Adam Seessel leads off with the portfolio review and his commentary on how we're faring in the big picture. Adam also has an important update on income-generating strategies we're developing at Martin Capital Management. Analysts Aaron Kindig and Clint Leman conclude our quarterly message with brief descriptions of some new additions to your MCM equity holdings.

–Gary Sieber, Chief Marketing Officer
gary@mcmadvisors.com

Third Quarter 2011 Portfolio Review

What a difference a quarter makes. Three months ago, the S&P market index was up 6%, and because of our defensive posture we were trailing the rallying market by more than five percentage points. After a very nasty third quarter for equities, however, the situation has reversed itself. Buffeted by fresh concerns about the global financial system, specifically in Europe, the U.S. stock market retreated nearly 14%, while the average total MCM account pulled back only about one-fifth that amount. As a result, year to date through September 30, the average MCM account is down slightly more than 1%, while the S&P is down nearly 9%.

While one quarter does not a record make, we are proud that we have remained true to our core philosophy: Protect the downside first. Our overarching goal here at MCM is to compound your hard-earned capital over time, and that task begins with the cardinal rule of first *not losing* money. Only when we have that firmly in mind can we begin to make money on your behalf. As Frank has often written, we believe we are coming to an economic reckoning that follows a generation of financial recklessness, excessive borrowing, and a general sense of entitlement. In the short- and medium-term, this reckoning will be painful. Longer-term, it will set us up for a wonderful opportunity to buy high-quality businesses at bargain-basement prices.

This is what we are focused on now: Doing in-depth research on a sector-by-sector and company-specific basis so that our targets are clearly marked and squarely in our sights. Because we feel market prices are generally high, only a select few equities are currently on sale. Until the target environment becomes better stocked, MCM is largely keeping your powder dry. We are slightly more than 25% invested in stocks, with the bulk of your assets safely in U.S. Treasuries and ready to be put to use quickly when the time is right.

In all times, but especially in *these* times, patience is required. The famous words uttered at the Battle of Bunker Hill strike us as especially appropriate in today's market environment: "Don't fire until you see the whites of their eyes."

	3rd Quarter	YTD
MCM Equities *	-14.6%	-9.6%
MCM Total Account *	**-3.0%**	**-1.1%**
S&P 500	-13.9%	-8.7%

** approximate, net of fees*

(The MCM Equities Composite shows the performance of equity investments and equity-based options included in the accounts we manage at Fidelity. The equity percentage that each account holds at any given time may vary from 0% to 100% of the portfolio depending on each individual investment policy. Consequently, the returns shown do not necessarily reflect the returns any individual client actually obtained and are certainly not an indication of how your account will perform in the future. The MCM Total Account Composite shows the performance of all assets held in fully-discretionary fee-paying accounts that we manage at Fidelity, who have given us authority to invest 100% of the account in equities, and are managed per our model portfolio. Due to timing related to the QCM and MCM's desire to provide timely information to clients, a complete detailed calculation of returns is not done on a quarterly basis and both composites are therefore approximate. Both composites are net of all management fees and include the reinvestment of all income but do not reflect the effect of taxes.

The S&P 500 Total Return Index is 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.)

MCM Income Strategies

Faced with few compelling individual investment opportunities and a genuine worldwide economic mess, we at Martin Capital Management have been working hard to find ways to not only protect your capital but also grow it. As Frank recently wrote, we are exploring various strategies using options on the S&P 500 index to profit from the renewed volatility in the U.S. stock market. We also have recently bought puts for clients with the appropriate level of options approval to protect our position in the common equity of Yahoo. We are making money on our purchase, and the stock is acting well as buyout rumors swirl about the company. Even so, we thought it in keeping with MCM's capital-preservation philosophy to protect against unforeseen catastrophic risk here. With our downside now protected, it also puts us in a position to buy more if we decide that's the right course of action.

Also of significant interest, our analytical team is burrowing into various projects with the goal of enhancing something that many MCM clients ask us about: current income, in the form of yield-producing vehicles. While the Fed's easy-money policy has made it difficult, I am pleased to report that we are beginning to find pockets of opportunity in the income-producing space. Rest assured, we are not going to join the easy-money crowd and stretch for yield. It has always struck us as foolish to purchase a security yielding 6%, then lose 25% or more on your principal because the underlying instrument was overvalued or just plain unworthy. "More money has been lost reaching for yield," Raymond DeVoe once famously wrote, "than at the point of a gun."

As we continue to poke and prod the markets for opportunities, however, some sensible choices are emerging. Ideas that are investable now are already being added to client portfolios. Other alternatives may or may not become investable, depending on which individual stocks we find attractive. And some ideas are not priced cheaply enough today but could fall to attractive levels should the macroeconomic picture continue to deteriorate. Here are three possible income-generating opportunities we're giving strong consideration:

- *Selling puts on stocks we want to own at lower prices*. Though the phrasing makes it sound complicated, this is a remarkably simple and elegant way to generate income. The idea was developed and advanced by Aaron Kindig, who analyzes the healthcare and energy sectors for MCM. His logic was this: In a generally overpriced stock market, there are businesses we would love to own—but at lower prices. While we wait, why not sell another investor the right to sell us the stock at the price we're looking for? This accomplishes two complementary goals. First, it gives us an entry point to a stock we like at favorable prices. Second, and most important for purposes of this discussion, our counterparty must pay us a premium for the right to sell us the stock at lower prices. That money goes straight into your pocket.

Our first such trade may help illustrate and clarify the process. We have followed Hewlett-Packard for years. While the company has been about as mismanaged as they come over the last decade, it still has a number of very valuable businesses: servers, storage, consulting, and—the crown jewel—the consumer-printing business. This latter business, with ink cartridges that are the steady-earning economic equivalent of Gillette's razor blade cartridges, is enormously valuable. Because the company has been so mismanaged, however, the stock is becoming seriously mispriced.

Not yet ready to buy HP's common stock at current prices, we instead sold puts on Hewlett-Packard stock for clients with the appropriate level of options approval. These puts obligate us to buy a roughly 1.5% portfolio position in HP common stock if the price drops below $19/share over the next four months. In return, we collect a premium of more than $1.50/share, which would reduce our actual cost to less than $18 for HP stock — a giveaway price we'd be happy to pay. The premium alone represents a pretax yield in excess of 8% on the common stock price, a decent yield while we weigh how to proceed with the underlying equity. While it's not a lot in dollar terms, the HP trade is representative of what we hope to do more of: identify attractive common stocks, wait for a fat-pitch price, and generate some income in the meantime. [Update: Now ten days into the 4th quarter, we have also purchased a small quantity of HP stock, apart from the obligations of our put-option program, as the price fell.]

- *Oil and gas royalty trusts*. I cut my teeth as a junior analyst on oil and gas companies 15 years ago, and I understand the industry fairly well. Aaron Kindig also has considerable experience here, and this summer we put a team together to study income-producing vehicles in the energy field.

Most oil and gas companies are dynamic, operating entities; they explore for and produce energy in an attempt to grow and expand their assets. Over the course of its normal life cycle, an energy company will have developed a certain oil and gas basin that has become mature. While it's not dying anytime soon, it certainly is not growing and is best placed in a passive, income-producing vehicle. This is the idea behind royalty trusts. They do not explore for hydrocarbons, they merely collect the profits from the interests of oil and gas wells in which they own an interest. In this way they are similar to a real estate investment trust—or REIT.

Many of these royalty trusts are not worth investing in because they have short lives. Unlike real estate, oil and gas wells are depleting assets. If you pick the wrong properties, they get used up very quickly and are done in 10 years. This would fit very much into the mold of reaching for yield but having nothing to show for it in the end. The royalty trusts we have identified do not belong in this category. Because of their geological characteristics, oil and gas rise to the surface very slowly, and much of what is extracted is replaced by additional hydrocarbons seeping up into the basin from deeper in the earth that were previously not counted as extractable. While these geological characteristics slow down the cash flow, they also make the resource last longer. These are the ones we like. We look for trusts that have been around since the early 1980s and yet still own a vast amount of underlying energy reserves.

Tied as it is to oil and gas prices, the yield on these trusts is somewhat volatile. On the other hand, it is quite tax-advantaged. Because of depletion allowances, most income is treated as a return of capital, and taxes are deferred until the units are sold. We calculate that a high-single-digit yield for these securities would be a good entry price. While prices are not quite there yet, they could well get there as the year winds to a close.

- *Municipal bonds*. As we described in MCM's 2010 annual report, U.S. state and local governments face serious financial challenges in the years ahead. That fact could make the usually placid world of municipal finance a very interesting place indeed. If and when that happens, Martin Capital will be ready to put capital to work on your behalf at advantageous prices in what we think is a very promising arena.

  Specifically, our financial sector analyst Zack Clark and I have identified a number of municipal bonds that are insured by Berkshire Hathaway Assurance Company (BHAC), a subsidiary of Warren Buffett's fabled Berkshire Hathaway. Buffett found it profitable to insure muni bonds for a short time during the latest fiscal crisis when nearly all the other less well-capitalized insurers fled the market. Over a period of two years, he insured, by our count, at least $20 billion in face value of these bonds. The bond insurance is irrevocable and provides that the Berkshire subsidiary make all interest and principal payments in full when due should the issuing municipality be unable to do so.

  Well-capitalized and backed by Berkshire's larger subsidiaries, BHAC's insurance wrapper provides us, we believe, with a large margin of safety if the underlying bonds go on sale. There's a fairly good chance they will do so. In the months and years ahead there may well be several large and well-publicized problems in the world of state and local finance. Many local governments have been so careless with their coffers that somewhere in the United States there are going to be problems: A city will have trouble making its interest payments, a state (as California did recently) will have to issue IOUs instead of paying its bills, and there may even be some outright defaults as state and local governments cry "uncle" under the heavy debt burdens they've incurred over the last generation.

  When that happens, the normally staid world of muni bond trading will become chaotic. And if history is any guide, investors will not discriminate between money-good, BHAC-insured bonds and flimsier credits. Zack has identified these BHAC-backed bonds, and through our broker network we are ready to buy them—when, as always, the prices are right.

As I mentioned at the outset, the Fed's easy-money policy has pushed investors and speculators alike into anything that produces current income, thereby driving down yields and driving up prices to a point where the risk/reward is not in our favor. It is difficult indeed to find compelling income opportunities as a result. However, that is what you pay us for—to dig and scratch our way to producing good returns on your money over the long haul *without significant risk of principal loss*. On this last matter we will not compromise. Permanent loss of principal is toxic to long-term compounding and harmful to your financial well-being. Thus, we seek only ideas that are consistent with MCM's longstanding dual tenets: preservation of capital first and prudent growth when the odds are stacked in our favor.

–Adam Seessel, Director of Research
adam@mcmadvisors.com

Third-Quarter 2011 Portfolio Activity

August 2011: Bought Amerigon

It was a long, hot summer across most of the country. With the mercury and heat-index values soaring frequently above 100 degrees, just walking out to the parking lot became a chore. But the worst part may have been actually getting into the car and having your back sautéed against the seat.

Guess what? Come January, you'll have the opposite problem: car seats that feel like giant ice cubes. It sends shivers up your spine just thinking about it.

As you probably know, the auto industry rescued cold-weather drivers several years ago with the introduction of heated seats. On the other hand, cooled seats have not been on the auto industry's front burner (so to speak) until recently. A company called Amerigon has emerged as the creator and inventor of Climate Control Seat® (CCS), which can heat *or* cool.

There are two factors that make Amerigon an intriguing investment opportunity. The most obvious is market potential. Today, only about 20–25% of new vehicles sold worldwide are equipped with heated seats, primarily in cold climates as one would expect. The CCS, by comparison, currently has only about one-tenth of that market penetration and can be sold in both hot and cold climates. Taking ownership of the heated-seat market alone would translate into double-digit revenue growth on average, and recent sales trends for Amerigon show the CCS gaining traction in the marketplace. Initially available only in luxury automobiles, such manufacturers as Ford, Chevy, Kia, and Hyundai all offer the CCS today in increasingly lower-priced models—and for good reason. Perceived luxuries like climate-controlled seats are often sold as part of style or "trim" upgrade packages, so consumers aren't aware of the price markup for any individual feature. Amerigon can manufacture CCS components at fairly low cost and sell them to a seat assembly supplier for a reasonable price. Because of the public's willingness to pay for comfort seating (generally less than 2% of the total cost of a new car), auto companies can sell them to customers at a sizable markup to their cost. Amerigon's CCS units are thus attractive as profit-generating "extras," which creates the potential for a strong growth environment. Indeed, consumers purchased more CCS units in 2010 than in the first six years of their availability combined.

Naturally, with such enormous market potential, competition is inevitable, which brings us to the second factor that we feel will make Amerigon's future bright: Any new entrants into the climate-controlled seat market would face significant barriers. Currently, Amerigon boasts a 90% market share of the heated-and-cooled seat market. Moreover, Amerigon recently acquired its only other competitor in the field, a German company named W.E.T. The acquisition solved two issues for Amerigon. First, it ended ongoing patent litigation between the two competitors. And more importantly, it allowed Amerigon to no longer rely on foreign manufacturers for its production needs. With the acquisition of vertically integrated resources at W.E.T., Amerigon can control and protect the production process in its own manufacturing facilities.

In addition, the science underlying the CCS is much more complicated than it might seem to the outsider. It's called thermoelectrics. Simply put, Amerigon—led by its founder, a CalTech scientist—has developed the capability of applying an electrical current in opposite directions to either heat or cool the seat through a specially designed plate system. The process itself requires no moving parts, fans, or gas compression.

Amerigon expects the company can earn roughly $1.25/share on current sales levels by capturing additional margin in controlling the manufacturing process and consolidation of redundant offices. So far, Amerigon is a 1% position with an average cost of roughly $14.61. We've paid what we feel is a fair price of less than 12 times earnings for a company that appears to have demonstrable advantages in a market destined to grow.

–Clint Leman, Research Analyst
clint@mcmadvisors.com

August 2011: Bought Amgen

Another recent addition to the MCM portfolio is a new name and a new business sector for many of our clients. At first glance, Amgen might appear to be just another pharmaceutical company. There are, however, some important characteristics that land it squarely in the value-based investing framework we utilize at MCM.

Amgen is one of the oldest and most profitable U.S. biotechnology companies, a leader in developing products that stimulate the production of red and white blood cells. These products are most useful in treating cancer and chronic kidney disease (CKD). Amgen also makes products to relieve the symptoms of inflammation for rheumatology and dermatology patients.

Pharmaceutical companies were, in their heyday, the darlings of Wall Street. With chemically produced medicines aimed at large markets and shielded from competition by patents, products often became blockbusters, and earnings could grow rapidly for years. But all pharmaceuticals faced the inevitable negative impact of patent expiration. Without that protection, competing pharmaceutical companies can make exact or nearly exact copies, so-called generics, of another producer's drugs. The generics are about 80% cheaper than the brand-name drug, and research has shown that the original producer of a chemical drug will lose virtually all sales of the brand-name prescription within two years.

In stark contrast, *bio*pharmaceutical technology involves the production of proteins, antibodies, and other complex biological medicinal substances. They are essentially *grown* rather than *manufactured*. Enbrel, for example, Amgen's product for the treatment of inflammation, will lose its patent protection in 2012 but there is not one single competitor even in Phase II testing. Why the drastic difference from oft-copied chemical pharmaceuticals? Look at it this way: An aspirin molecule has just 21 atoms, while a protein or antibody molecule could have thousands or tens of thousands. Put that in three-dimensional space, and the level of complexity and interaction within the body becomes staggering. An exact copy, or generic, of a biotech product simply cannot be made in the same way and with the same precision that a typical chemical pharma product can. Others may get close (thus the term "biosimilar"), but it is not the same product. Since a biosimilar is not an exact duplicate, it may not only produce an unanticipated adverse physical reaction, it also could render the original biotech product ineffective.

Europe has had a biosimilar protocol in place since 2006, but Amgen products have nonetheless maintained their market share. Amgen thus has the profitability of old-school pharma—without the drawback of revenue falling off a patent cliff. The business of biotechnology is therefore arguably a better model than the traditional pharma business. But importantly to value investors, Amgen is hardly priced to reflect that reality.

Amgen expects to earn about $5.10/share this year, has $5-plus net cash, and plans to return about 60% of income to shareholders through dividends (about 2% current yield) and buybacks. Management believes that earnings can increase at least 50% over the next four years, and industry publication *R&D Directions* rated Amgen the "Best Biotechnology Pipeline." As always, the final decision for us rests with the price we're being asked to pay. In this case, we think it's quite reasonable. At about 10 times earnings, combined with the product and economic stability described above, Amgen seems too cheap to pass up. Expect additional purchases if even lower prices occur because of market volatility.

–Aaron Kindig, CFA, Research Analyst
aaron@mcmadvisors.com

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MARTIN
CAPITAL MANAGEMENT, LLC
Registered Investment Advisor

300 NIBCO Parkway, Suite 301 ■ Elkhart, IN 46516 ■ Phone 574.293.2077 ■ Fax 574.293.2153 ■ www.mcmadvisors.com