MARTIN
CAPITAL MANAGEMENT, LLC
Registered Investment Advisor

"No very deep knowledge of economics is usually needed for grasping the immediate effects of a measure; but the task of economics is to foretell the remoter effects, and so to allow us to avoid such acts as attempt to remedy a present ill by sowing the seeds of a much greater ill for the future."
—*Ludwig von Mises*

"In the short run, it will be said to be an attack, motivated by either deficient understanding or uncontrolled envy, on the wonderful process of enrichment. More durably, it will be thought to demonstrate a lack of faith in the inherent wisdom of the market itself."
—*John Kenneth Galbraith*

"Monetary policy is a serious issue. We should discuss this in secret, in the Eurogroup ... I'm ready to be insulted as being insufficiently democratic, but I want to be serious ... I am for secret, dark debates."… When denying that he attended meetings on restructuring Greek sovereignty in 2011 that others swore he was present for, he responded: "Look, when it becomes serious, you have to lie."
—*Jean-Claude Juncker*
(Pragmatic and brilliant Prime Minister of Luxembourg since 1995, head of the Eurogroup since 2005)

"I think the idea that everyone can have wonderful results from stocks is inherently crazy. Nobody expects everyone to succeed at poker."
—*Charlie Munger*

2012
ANNUAL REPORT

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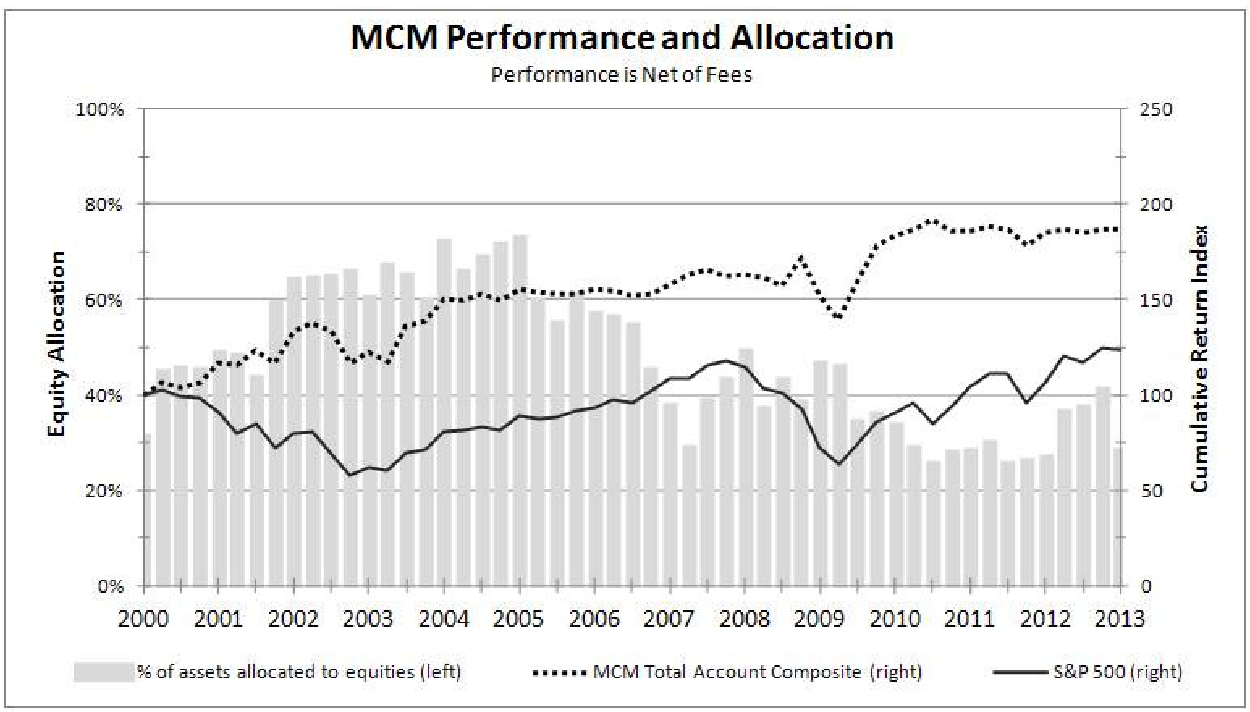
Dear MCM Client,

All things considered, 2012 was a frustrating year, evoking memories of similar experiences in 2005 and 2006. It was one of those years when we had far more cash than attractive investment ideas, mostly because of prices that were unsuitably high for a long-term investor's quest for value. The inventory of companies we'd like to own is growing and, like good wine, aging nicely as well. But purchase price is the only variable over which we have control, and it is our core discipline to wait patiently for prices to come to us rather than for us to chase after them. Maintaining that discipline is admittedly as agonizing and temporarily unfulfilling as it is essential. We have yet to understand the logic of overpaying for any long-lived asset (e.g., a house, a common stock, a bond) and thus locking in a sub-par, long-term return just because it's a popular idea—especially if its popularity hangs on the belief that the prices of those assets will defy all of history and remain elevated indefinitely.

With the Fed following the European Central Bank's Mario Draghi's lead "to do whatever it takes," another round of quantitative easing (QE) and other measures implemented in the third quarter have led the markets to increasingly believe that the safety net of the "Bernanke Put" has been institutionalized. Buyers, reassured by the Fed's actions and desperate to eke out some return in an environment we would characterize as "return-free risk," left few stones unturned. Sellers saw no need to part with their holdings, secure that the Fed had their back as well. Even *reasonably* priced investments were scarce. The managed market conjured the value investor's nemesis: low trading volume and negligible price volatility. Unlike the prevailing market conditions during the financial crisis, there were no notable occasions of widespread, fear-induced and panicky selling.



Disclosures: The MCM Total Account composite includes consolidated portfolios greater than $1 million where MCM has been given full investment authority. The strategy seeks long-term growth through a combination of capital appreciation and income. The reported return includes interest and dividends but does not factor in taxes. Returns are net of fees. The S&P 500 is a market value weighted index consisting of 500 stocks chosen for market size, liquidity and industry group representation. The *reported return is inclusive of dividends but exclusive of taxes and management fees.* ***PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS.***

As the summary graph above indicates, our goal is to earn absolute returns that eclipse those of the S&P 500 Index over the long term. Accomplishing that goal in the intermediate term, however, is exceedingly difficult in a year when short-duration, fixed-income securities yield zero. Because we have always focused on the management of risks when we believe they are high, often at the same time others are preoccupied with chasing short-term performance, both our absolute and relative returns were dampened by our defensive posture in 2012. Our overall record shows that we have indeed produced highly competitive absolute and relative long-term results, but we must also acknowledge that the long-term and short-term worlds were in conflict in 2012, as well as the first month of 2013, with the short-term forces having the upper hand for most investors.

For your convenience, this year we have expanded our performance graph to include vertical bars that indicate the percentage of MCM "total account composite" portfolios committed to equities. Our current low percentage of common stock holdings is comparable with late 1999 and the summer of 2007. As was the case in each of those earlier periods, this is neither a tactical asset-allocation decision nor a market forecast. Rather, it is a direct reflection of the number of good opportunities available. In other words, as market prices collectively rise, the number of companies available at acceptable risk-adjusted prices shrinks.

> *Over the years, we have warned—typically prematurely but often quite accurately—of excesses that were brewing in the markets and the economy. The Internet stock mania, housing-market madness, and the excesses in newfangled financial products derived through financial engineering readily come to mind. Sometimes years went by before our concerns were borne out; sometimes bubbles inflated further before they burst. Today's absurdly low government bond yields for countries considered "safe" is another such bubble. If inflation were rising, or if the U.S. fiscal position were weighing on investors' minds, normally you might see these problems expressed in higher yields and falling bond prices. But because of QE, the usual market signals are masked and, consequently, are leading to growing imbalances …*

No, although they might appear so, the words in the paragraph above are not mine but rather those of Seth Klarman (quarterback of the $27 billion Baupost Group). On a risk-adjusted basis, Klarman's 30-year record may well be without equal. The inclusion of his thoughts in this missive is intended as neither a statement of "misery loves company" nor "great minds think alike." It is merely a tangible demonstration that most highly disciplined value investors are grappling with the challenges of a managed market environment.

Notes Concerning This Year's Annual Report

In an effort to promote transparency and encourage the exchange of ideas among like-minded value investors, MCM began making previous annual reports publicly available in the Library section of our website. This is not unprecedented, of course. The whole purpose of *Speculative Contagion* and *A Decade of Delusions,* for example, was to accomplish the same goal in published book format. As outside interest in these commentaries has increased, we have actually written two separate annual reports each of the last few years—one public and one private. The public version contained no reference to specific holdings or portfolio activity, while the private version (specifically for MCM clients) did include that important information. Beginning this year, to improve efficiency and reduce the amount of time we spend writing, we are distributing and posting the same public version to everyone. Summaries of our current holdings, along with purchases and sales made during the year, are posted to the password-protected, clients-only section of our website under the Recent Portfolio Activity tab. For clients who prefer to receive this information in hardcopy by regular mail, please contact Kristen Smith-Meyers at 574-293-2077 or via email at kristen@mcmadvisors.com.

We also recognize that some readers may have less interest in reading our detailed market commentary and would prefer succinct, summarized responses to the questions we have most frequently received over the last 12 months. Therefore, we are introducing in this year's report the FAQs (frequently asked questions) section immediately below as a preamble to the more traditional commentary.

FAQs—2012

Why did MCM purchase put options in 2010 and 2011?

The short answer is that just as we insure our homes, cars, and health against catastrophic loss, I felt that the equities within our portfolios should likewise be insured against such risk. The market, in my view, was selling well above what it was worth, and I bought protection should the pendulum swing to the other extreme. However, I misjudged how long the Fed would pursue its dangerously reactionary policies, doubling down in a financial cycle for which it had no models built upon historical precedent. I did not believe our central bank would "bet the ranch" on a long-shot, long-duration experimental strategy that, if it fails, will almost guarantee future adverse consequences that would dwarf whatever benefits are realized in the short run. Regardless of the underlying cause, stock prices have thus far continued to rise—and the insurance protecting your portfolio hasn't been needed up to this point. For those clients who have been fully insured, the premiums have reduced portfolio returns by 2.5% per year for 2.75 years.

Why does the market keep rising?

Each day, more and more investors are attracted to what they perceive as a virtuous circle in which the allure of rising prices, quite detached from value, is the catalyst for action. With 70% of U. S. equities nominally owned by institutions and with far more than 70% of the trading volume attributable to them, they have become the thundering herd. Fearful of falling behind in the short term and inviting investor antipathy, institutions must pay to play, and the rising prices that result beget further rising prices—until the momentum unexpectedly changes direction. The precipitating causes can range from the simple physics of markets collapsing of their own overvaluation weight (1973–74 and 2000–02) and/or from an exogenous shock like the financial crisis of 2007–08.

More subtly, a moral hazard is created when someone is apparently willing to pay for any negative consequences of another person's risky behavior. In the first decade of this century, bankers made questionable subprime loans largely because they understood that someone else lower on the food chain would be left holding the bag when the unexpected happened. In similar fashion, the Fed has now essentially promised to do whatever is necessary to protect asset prices from falling, inducing investors in marketable securities to ride the ocean swell. Tens of trillions of dollars are being swept along in that wave, and investors will likely be flushed out to sea when the Fed is no longer able or willing to fulfill its promise. Caveat emptor: "What the wise man does in the beginning, the fool does in the end."

Why are we holding cash in a rising market?

The capital markets seem momentarily unperturbed, rising in the face of a growing debt and deficit problem and a stealth Federal Reserve policy that I continue to believe will eventually end in tears. Additionally, the markets appear to have disregarded the risk of "predictable surprises."

These largely invisible threats to tranquility have three characteristics: (1) At least some people are aware of the problem (everyone I talk with *knows* there is a problem), (2) the problem gets worse over time (though no one can predict how long), and (3) the problem eventually explodes into a crisis that catches most investors unaware (remember 2008?). It is the nature of predictable surprises that while there is great certainty that a disaster awaits, there is equal or more *un*certainty surrounding the details of the impending disaster. As our track record shows through two full cycles of market euphoria and misery, cash is a robust, if not optimal, hedge against such perils.

Aren't there any alternative investments you can be making in this environment?

The investment universe has grown very large and is still expanding rapidly. There are many places to put your money, but we believe, in the fiduciary role we take quite seriously, that all such investments must be weighed against the risks they also carry. In many cases, those risks are undisclosed. We are aware, for example, of packages of securities ("securitizations") whose advocates propose they offer returns that are far above the negligible total returns we expect from conventional investments in a diversified portfolio of stocks and bonds at current prices. The longer term risks to capital, however, are often understated. Financial alchemy is more often embraced in good times than in bad.

Shouldn't value investors look only at individual businesses and ignore the bigger economic picture? Isn't your approach, in effect, "market timing"?

Systemic (or "macro") concerns are a major input into our company-specific (or "micro") analysis. Nearly all other value investment firms essentially ignore the larger economic picture and look only at individual businesses and prices. We cast a bigger net—and take a broader view. And this is an important reason why we've outperformed the S&P 500 over the long haul.

While our record speaks for itself, equity analysis can admittedly be subjective, despite frequent claims to the contrary. Individual stocks, for example, can appear reasonably valued, depending on the rosiness of the inputs one uses. Using more conservative inputs that capture the nature of our macro concerns, stocks are generally expensive today. There is enough truth to the adage "A rising tide lifts all boats"—albeit some more than others—that margins of safety generally decline. Another old saying we rarely hear is "Beware of bargains in bull markets." There are compelling exceptions to these adages that were never intended to be universal in their application. However, it takes exceptional talent and self-discipline to build a portfolio that defies the force of the tide.

We believe it is prudent to sell stocks when their prices rise to the point where expected future returns no longer make economic sense. We fully expect that leaving the party early will result in us trailing in rising markets—but *prepared to buy* in falling ones. We are often asked why we don't jump on the bandwagon, at least for a short ride, while the market continues its rise. That *would* be market timing, and it generally doesn't work well. If we had the foreknowledge to know the *day before* the "real" rush for the exit begins, we'd all be rich. Because there are so many false starts, the beginning of *the* rush is never known until it's too late to do anything about it. That is the nature of markets. Thus we wait (im)patiently until a better set of investment opportunities (i.e., lower risk and better odds of sustainable long-term positive returns) comes along.

Why should we pay you fees to hold cash?

If holding cash is the equivalent of the ostrich burying its head in the sand, no value is created and no fees should be paid. If, on the other hand, the manager's inaction is enlightened and purposeful, if it reflects strategic thinking and self-discipline in the game of investment chess in which not everyone is a winner, it may well be of value. To the forward-thinking investor, cash is not the end, but the means. At its most rudimentary level, it is a well-reasoned and disciplined form of deferred gratification. Inundated with the latest news, much of which is simply noise, investors find themselves anchored in the present. It's difficult for all of us to see beyond the here and now. Thinking about and preparing for possible future opportunities that are outside our normal field of vision give lowly cash a dignity that will in time be revealed.

It may be instructive to redirect the question in this way: Why should anyone pay fees to managers who are substantially (or fully) invested today, possibly putting investors' capital in harm's way to earn well below average future returns? What if these managers are not disclosing risks like those that kept rising from 2004 through 2007, until all the illusory gains and more were given back in 2008? Is there more value in a manager helping you to find the best deck chairs on the Titanic or in one who warns you about icebergs before boarding?

The question then evolves to who is best equipped to eventually put cash back to work in a timely and opportunistic manner. For those who have the demonstrated capacity to trade their liquidity with boldness and risk-modulated conviction in a short-duration crisis or a drawn-out and seemingly endless slump, the answer is obvious: There is no need to pay us or anyone else for what you can do on your own. For the other 99%, we will serve as the courage of your convictions as we have demonstrated on multiple occasions in the past when fear gripped the markets and bargains became numerous.

Finally, there is the matter of the fees themselves. MCM is one of very few firms in the industry whose fees are variable. When our absolute performance is less than an annual rate of 5%, our fees are far below industry averages. The only incentive under which we make portfolio decisions on your behalf that's greater than earning high rates of return is the one that says "In order to win, first, you must not lose." In direct contravention with the mathematics of compounding, the prevailing fee structures in our industry are not designed to encourage protection of capital as one of the key tenets of long-term compounding. Rather, as may be the case presently, the fee structures may actually encourage excessive risk taking.

Is cash the best hedge against consumer price inflation?

Cash gives investors flexibility to adapt to changes in inflation, stated (CPI—Consumer Price Index) or unstated, and to act according to how financial assets respond at the time a change occurs. Although our central bank's policies are intentionally inflationary as one means of stimulating consumer spending *now* through fear of higher prices *later,* it will have a difficult time containing rising interest-rate pressures if it is successful.

Longer term, the decade of the 1970s may provide a very crude directional comparison for thinking about possible future inflation scenarios: The CPI doubled, as did the market yields on 10-year Treasury bonds. An investment of $100 in cash, bonds, or equities at the beginning of the decade was worth $92, $87, and $94, respectively, at the end—*after adjustment for inflation.* Thus, whether in the short term or in the intermediate term, cash has a record of being at least a robust hedge against inflation.

Consumer price inflation does not appear to be an imminent risk. More importantly, fluctuations in the CPI are of less immediate concern to most of our clients than to those for whom such goods and services represent a significant portion of their income/wealth.

What is the best portfolio protection against possible deflation in financial assets?

Without a doubt, the more urgent and pertinent question is how to protect one's portfolio against the possible downside of what will ultimately be unsustainable financial-asset price inflation dating back to 2009. While starting below trendline levels, the compounded annual total return for the S&P 500 over the last four years has been 24.5%. The prices of financial assets—stocks and bonds—are trading at a significant premium to their intrinsic worth based on "normalized" interest rates and earnings, some at levels that likely constitute a bubble.

The answer is as obvious as it is unappealing: cash. For the first time in generations, the nominal (sticker price) yield on cash is effectively zero. Adjusted for inflation, it's modestly negative. Investors are understandably unhappy and disoriented. Having limited familiarity with investment history, they tend to extrapolate the present into the future. In their desperate urge to earn something—anything—on their money, they are unintentionally putting their principal at risk.

The amount of cash a committed value investor holds as a percentage of his or her portfolio is proportional to the number of favored individual businesses selling at market prices that offer the complementary virtues of: (1) a generous margin of safety and (2) a holding-period total return that is economically compelling. It should be noted that the amount of your capital we have at risk is not influenced by what others are doing.

What assurances can you give me that better opportunities will appear as I continue to hold zero-return cash?

This is one of the most frequently asked questions I receive. First, my belief that more productive and less risky investment choices lie ahead does not require faith, as in the spiritual realm, or wishful thinking in the secular one. Faith is belief without proof. Because of the repetitive and cyclical nature of things financial, proof is abundant for the observant. One need only grasp the significance of the force of gravity as evidenced in the movement of a pendulum. While highly asymmetrical, there is a rhythm to the emotional forces that move herding institutions, which, in turn, move the markets. In some crude and unpredictable way, they endlessly cycle from absurd euphoric highs to irrationally desperate lows, while the underlying values on which those prices are based tend to trend slowly and steadily upward over time. The certainty that a more attractive investment opportunity lies ahead is no less predictable than that a pendulum, having swung far to one side, will in time reverse its course. One of the irrefutable certainties of investment in marketable securities is that (1) their prices will fluctuate, sometimes to extremes. Another companion, and confounding, yet equally irrefutable certainty is that (2) when those extremes occur, nearly everyone forgets (1).

What do you mean when you say that today is not the new normal?

I'm aware of only a few times in history when the current and prospective return for an investor in marketable securities has been so minuscule *compared with the return on labor*. The median household income, mostly salaries and wages, for 2011 was almost exactly \$50,000 (\$27,000 more than the poverty level of income for a family of four). Amazingly, a conventionally balanced investment portfolio[1] today would require an initial investment of \$3.2 million to generate the same amount (\$50,000) of interest and dividend income.

Moreover, if interest and dividend yields would mean-revert and rise to their historical averages (the "old normal") of 5% and 4%, respectively, the market value of the so-called

[1] 25% invested in five-year U.S. Treasury notes; 25%, 10-year U.S. Treasury notes; and 50%, S&P 500 index fund.

conservative portfolio could decline almost 38% (down $1.2 million).[2] This effectively locks investors into low returns *and* severely limits future choices because most investors are loath to realize paper losses on their principal.

Can you give me tangible assurances that my patience will be rewarded?

Let's also assume that rather than investing at today's low historical returns you choose to consume a portion of your principal instead, spending $50,000 a year, while anxiously watching your zero-earning portfolio shrink slightly to roughly $3.1 million. If in two years you then invest the slightly lesser remaining amount at the higher rates indicated above, your annual income would increase more than 2½ times, from $50,000 to $135,000—a gain of $85,000 a year. The reward of patience: $850,000 more in income over the next 10 years. Worth waiting for?

Of course, if market interest rates or dividend yields were to rise still further—which will almost certainly be the prevailing fear at that time—paper losses will again be in store. There is some consolation in knowing how different things will be then from what they are today. Mean reversion will become your friend, if not immediately, then eventually (remember the pendulum), because market prices will rise when yields fall toward the mean—precisely the opposite of what would occur today.

Admittedly, this is a scenario designed to shock you, to cause you to step back and observe how disconnected from historical reality relative values have become. As counterintuitive and paradoxical as this may appear, when cash pays nothing, and seemingly everyone is going to great lengths to avoid holding it, it may be the safest and eventually the most opportunistic place for your money.

Inaction … Is an Action

The year 2012 will go down as one of the most intellectually stimulating and challenging in my memory. As one who takes the weighty fiduciary mantle seriously, I found great discomfort in the actions of actual buyers and sellers in the capital markets as they voted prices higher. These actions ran counter to my carefully reasoned and meticulously documented convictions. Because of such divergence between my views and those at the point of convergence where supply and demand result in a trade, I felt it my duty to dig deep and go beyond the obvious and the superficial. Plumbing the depths of original and often complex source material, I intentionally eschewed the opinions of others. The markets, in my view, had much the same drama as a Sotheby's auction where the bidding becomes more about the bidders than the object being bid for. In the markets for intangible assets, when the incentives are often badly misaligned, the fake is often made to look real.

This report is largely focused on those whose once earnest search for return has become desperate as prices seemingly head for the moon. Thankfully, most MCM clients have remained impressively rational throughout this ordeal. For those who need a little encouragement, however, duty and understanding compel those of us who have seen this movie before to make every effort to "talk them off the ledge." During times of great temptation—in the late 1990s, in the mid-2000s, and during the last several years—our efforts were redoubled in an attempt to separate the

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[2] The longer it takes for mean-reversion to occur, the less the losses will be in the 50% of the portfolio invested in U.S. Treasury securities as they approach maturity. Since the S&P 500 is effectively of infinite duration, it is as vulnerable today as it would be in five years, without adjusting for dividend increases.

counterfeit from the genuine. Validation was slow in coming in those earlier episodes and appears to be in no hurry again this time.

Fortunately or unfortunately, pain is not easily remembered. By somehow managing to protect our clients from the ravages of the two most traumatic reversals of fortune in modern times, two dangerous outcomes could have resulted. First, we may have unintentionally made it appear easier to avoid trouble than it actually was. You may have assumed that because you didn't have sleepless nights during the financial crisis, we didn't either. (I've *never* tossed and turned about my own portfolios, but I would be less than candid if I didn't say that I worry about clients who may focus more on the movement of market prices than on the less conspicuous and more important microeconomic underpinnings to which those prices are ultimately linked.) Thus, we could have fostered a false and dangerous sense of invincibility. Second, and certainly most disconcerting to me personally, it's possible that I may suffer from overconfidence fed by the illusory certainty of hindsight. Past successes might actually mitigate the likelihood of future ones. While a minor consolation at this juncture, I have always relied on a back-up system of checks and balances. It's a final risk-management filter to which I have often referred: Pascal's wager."[3]

'Time to Start Thinking'[4]

All of us are motivated by forces, both conscious and subconscious, that are as unique as our fingerprints. I aspire to be a "thinker." Anticipating your reaction, my answer is yes, I'd rather be perceived more like the character depicted in Rodin's statue and less like Don Quixote. Some years ago I came across a tattered copy of French priest Ernest Dimnet's book, *The Art of Thinking,* published in 1928. It was on the best-seller lists in the U.S. in the 1930s alongside Dale Carnegie's self-help works, but it is mostly forgotten today. Beyond the intrinsic and timeless appeal that I found in the excerpt below, the revolving popularity and obscurity of the book—and subject—was itself prophetic. That it was not heralded as a breakthrough when first published is no more surprising than its rise to best-seller status only after havoc had been wreaked on Wall Street and in the broader economy. As Dimnet makes clear, the thinker's reward will never come from popularity among the masses but from the faint glow of inner satisfaction, of "seeing where others do not":

> What is it that characterizes the thinker? First of all, and obviously, vision … The thinker is pre-eminently a man who sees where others do not. The novelty of what he says, its character as sort of revelation, the charm he attaches to it, all come from the fact that he sees. He seems to be head and shoulders above the crowd, or to be walking on the ridge-way while others trudge at the bottom. Independence is the word which describes the moral aspect of this capacity for vision. Nothing is more striking than the absence of intellectual independence in most human beings: They can form an opinion, as they do in manners, and are perfectly content with repeating formulas. While they do so, the thinker calmly looks around, giving full play to his mental freedom. He may agree with the consensus known as public opinion, but it will not be because it is a universal opinion. Even the sacrosanct thing called plain common sense is not enough to intimidate him into conformity …

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[3] Nassim Taleb (Black Swan and Anti-Fragility) and I share an abiding belief in which there is no compromise, although he states Pascal's wager mathematically: "This idea that in order to make a decision you need to focus on the consequences (which you can know) rather than the probability (which you can't know) is the central idea of uncertainty. Much of my life is based on it."

[4] British journalist Edward Luce, used the quote in the epigraph of his provocative and forward-thinking book—and one that practically leapt onto my Kindle library—Time to Start Thinking: America in Descent. Not surprisingly, the book has not reached best-seller status. Shades of Ernest Dimnet, whom you are about to meet.

The journey of a thinker is arduous, filled with traps and snares, and it is without end. It is not so much a goal as a way of life, not so much a destination as a journey. While I seek truth, nagging doubt is my constant companion. Is it really confirmation of my beliefs I am seeking? It would be the height of arrogance and ignorance to unequivocally deny the presence of the confirmation bias. Could I be tilting at windmills like Quixote?

The iconoclastic Bertrand Russell once made the following sweeping generalization: "The whole problem with the world is that fools and fanatics are always so certain of themselves, but wiser people so full of doubts." Apparently demonstrating his thesis, when asked if he was prepared to die for his beliefs, his answer was, "Of course not. After all, I may be wrong."

In previous writings I have referred to another obscure book, written by another Frenchman in 1895. *The Crowd,* by Gustave Le Bon, like *The Art of Thinking,* was not an out-of-the-box sensation. It was a half century later in 1954 that the authoritative *Handbook of Social Psychology* dubbed it "perhaps the most influential book ever written on social psychology." Le Bon's seminal achievement was in describing the rather remarkable behavioral and cognitive transformation that takes place when people surrender their individuality in becoming part of a crowd. He observed that individuals are likely to function at a lower level—intellectually, morally, and emotionally—as a result of submission to the will of a crowd. In the poetic phrasing of his time, Le Bon observed,

> Men the most unlike in the manner of their intelligence possess instincts, passions, and feelings that are all very similar. From the intellectual point of view an abyss may exist between a great mathematician and his boot maker, but from the point of view of character the difference is almost slight or nonexistent.

In other words, members of crowds begin to feel and express the emotions of a "primitive being." Machiavelli calls the root cause of the repetitious rhythm of so much behavior among humankind the "immutable passions of man."

Le Bon certainly never dreamed of the day of smartphones, the Internet, and the proliferation of social media. Our fascination with instant communication dates back to at least 1946 when Dick Tracy introduced the iconic "2-Way Wrist Radio," which was then upgraded to the "2-Way Wrist TV" in 1964. Flash back to mid-18th century continental America: A letter from Ben Franklin might take as long as 14 days to make the 109-mile trip between New York and Philadelphia. When he was in England, transatlantic mail delivery took months, and Franklin would often send multiple letters on different ships in hopes that at least one would arrive safely. Those who framed the Constitution not only had time to think, but some of their greatest works originated when they contemplated in solitude. While their sessions were often raucous, politicians and statesmen had ample time for thought and reflection. Is it any wonder that those in office today, who have sworn to uphold the Constitution, find critical thinking so difficult amid all the noise and the frenetic pace of contemporary life?

Today the world is connected electronically and instantaneously. Synthetic crowds can form at the click of a mouse. The Arab Spring is analogous to the French Revolution about which Le Bon wrote, except it's on communications steroids. In similar fashion, the world of finance transacts its business at the speed of light between and among Bloomberg terminals and supercomputers around the globe, 24/7/365. The process is depersonalizing and sometimes dehumanizing, rendering otherwise reasonable men and women captive to primal instincts. It should not be surprising then that many of them become impulsive and emotional, and momentum is difficult to derail. There's no time to contemplate—and mere nanoseconds to act. The facts have become increasingly irrelevant, and asset prices have become at least temporarily untethered from the fundamental factors on which their value ultimately rests.

I suspect that all of us wonder about the extent to which we have succumbed to the influence of the crowd. Here is a simple test: If you believe in the stress-test potency of the implicit guarantee of the Bernanke Put, you are, no doubt unwittingly, under the influence of the crowd. I restate that the purpose of this letter, where it applies, is to talk people back from the ledge of irresponsible and unintentionally self-destructive behavior to the safe ground of rational and independent thinking. Le Bon provides the encouragement. Once one understands the destructive tendencies of the crowd, one may be freed to believe that as an individual, one's chances for survival are greatly enhanced. A functional IQ of 120 will trump a crowd of geniuses hands down. Once one views the world through this lens, the absurdities of the consensus appear in sharp relief.

These musings may have intuitive appeal, but the question must arise: Does it work in practice? Does disassociating oneself from the crowd to engage in fiercely independent thinking work in investment management? Many years ago I concluded that if I did not put my time-stamped thoughts down in writing, they would carry little weight in the future. With them staring me forever in the face like an unforgiving mirror, I have no choice but to embrace the harsh reality of my mistakes or receive the encouragement from the occasional victories. If one is to be a lifelong learning machine, there is no substitute for the rigor and relentlessness (not to mention restlessness) of this process. Our memories tend to be selective, leading us to recall mainly our successes. The written word is not so malleable or accommodating.

This Looks Awfully Familiar …

History is a wonderful teacher. Not only does it help us understand the social, economic, and political admixture that precipitated events of the past, it also allows us to view the successes and failures that came in response to those events. Perhaps most importantly, it allows us to study these attributes detached in time from the passions of the moment and thus, it is to be fervently hoped, with a clearer head.

With that in mind, we offer in this year's annual report a brief review of MCM comments over the last 15 years, many of which seem to rhyme (historically speaking) with events unfolding today. As a firm, we have always been meticulous in documenting our thinking—and noting the precise time at which we thought it. *A Decade of Delusions* (2011) is, at its core, a ship captain's log: an accurate, detailed, permanent, written record that notes the conditions we encountered on each leg of our investment journey and explains why we steered the course we did at that unique moment in time. Each action taken—each turn of the ship's wheel, if you will—may not have been noticeable to those on deck but certainly had a bearing on where they ended up.

Moreover, the log entries help either verify or disprove whether the captain "sees what others don't see." While passengers and crew may be preoccupied with the visible yet temporal movement of passing waves, the captain must also gauge the unseen yet inexorable ebb and flow of the tides—and their strong currents by the shoals—with the goal of successfully navigating history's broad sweep. Perfection, perhaps, comes from surfing the waves while never losing awareness of the stage of the tides. But few seem to master both, and I long ago chose to learn and mind the tides because of their more powerful and potentially deadly pull. In this observer's clearly minority view, high tide in the equities markets was reached around 2000, and low tide still lies ahead. Prudent wealth management includes an abiding respect for the too often overlooked undertow of negative compounding: "Over time, markets will do extraordinary, even bizarre, things. A single, big mistake could wipe out a long string of successes."[5]

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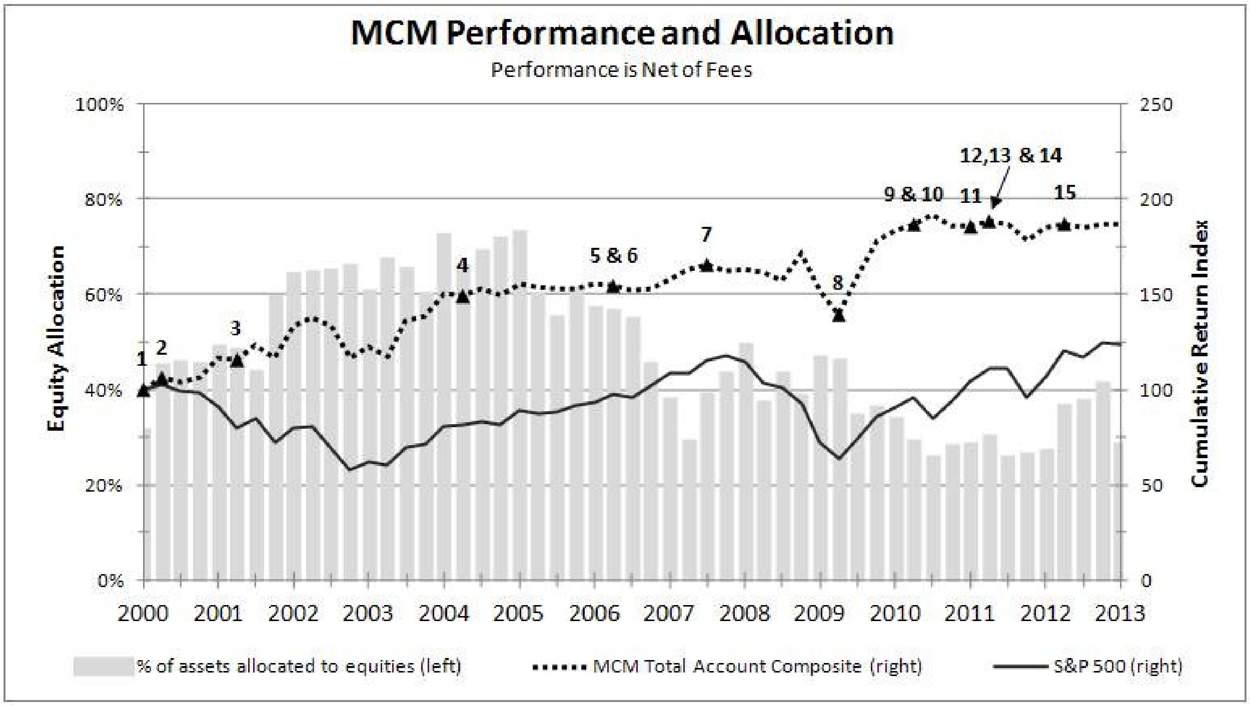
[5] Warren Buffett, Berkshire Hathaway 2006 annual report.

Below you will find the same graph presented earlier in this report with MCM and S&P 500 performance plotted alongside our total allocation to equities. Beneath the illustration, you'll be able to peruse a number of quotes from our annual reports (and thus from *A Decade of Delusions*) over the same period. A corresponding tag on the graphic timeline indicates when each quote was written. We leave it to you, the reader, to discern whether they offer any historical resonance or relevance (or rhyme). We believe they confirm that MCM does not think and operate solely in the present, but rather in the uncrowded, longer term mindset that allows hindsight and foresight to interact freely.



1. [February, 1999] We would be less than candid if we didn't admit to coveting the returns that the S&P 500 and Nasdaq 100 have earned during the past several years … The high-stakes game of musical chairs that Wall Street has been playing is neither one we understand nor one in which we have any demonstrated competence. In the final analysis, our respect for history's lessons … and our pledge to think and act rationally leave us no choice but to stay our carefully plotted wealth-preservation course. (*A Decade of Delusions*, chapter 1, pages 6 and 7)

2. [February, 2000] Now that the 1990s have drawn to a close, I wonder what history's verdict will be of these extraordinary times. Will it remember the last decade of the 20th century as the beginning of a new era with fresh rules and modernized standards, or will it expose yet another episode of investment metamorphosing … slowly but surely into rank and misguided speculation? Will the children of Generation X learn that their Boomer parents were like the rising sun at the dawning of New Age economics? Or, as Jim Grant has suggested, is knowledge in the field of finance cyclical and not cumulative? ... As memories of the lessons of the past fade over time, is each new and uninitiated herd of speculators little more than unsuspecting sheep being driven into the shearing barn to be periodically shorn? … Is the casino

capitalism of today, at rock(y) bottom, simply a new variation on an old theme? (*A Decade of Delusions*, chapter 2, page 70)

3. [February, 2001] The speculative pendulum is clearly swinging back toward sanity. How far and how long it swings remains the pertinent question. While the catharsis is under way, capital preservation must take precedence over capital enhancement … (Chapter 3, page 10) We will venture forth from that safe harbor, as we did last year, only when compelling opportunities appear in equity-type investments in which we can reasonably expect to earn considerably higher returns, consistent with our aversion to assuming anything more than moderate risk (*A Decade of Delusions*, Chapter 3, page 87) … A significant portion of whatever advantage we gained over mainstream thinking last year arose because we were able to buy the businesses we longed to own below their intrinsic value. That doesn't happen every year. (*A Decade of Delusions*, Chapter 3, page 92)

4. [February, 2004] Lest you throw up your hands in dismay, please be comforted in the knowledge that through the interaction of supply and demand, the free markets are a self-correcting mechanism, constantly adjusting to new realities … We are in agreement with Sir John Templeton who used to say he liked pessimism because of the prices it produced. (*A Decade of Delusions*, chapter 6, pages 195 and 196)

5. [February, 2006] The easy-money "financial" economy, rather than promoting consumer-price inflation, has, like squeezing a balloon, precipitated asset inflation instead. We've observed the malinvestment consequences as the technology stock market Bubble came to a costly end as the new millennium began. As for the epidemic of speculation that has metastasized to residential real estate and other asset classes—the fallout looms as a threat of unknown proportions. History leaves us no choice but to conclude that the "financial" and "real" economy consequences will almost certainly be anything but pleasant. (*A Decade of Delusions*, chapter 9, page 324)

6. [February, 2006] (Quoting Seth Klarman): "Focus on Risk before Focusing on Return." Cash is the ultimate risk aversion. The clients are uncomfortable. Why should people pay a money manager to hold cash? They are paying the manager to wait for the opportunity to invest. Think of the assets under management as if it is your own money. What other people think doesn't matter … Ignore questions like 'How does it look to our clients and peers?'"

   Peter Bernstein's and Seth Klarman's warnings about the hazards of disregarding, underestimating, or denying risks left me no choice but to revisit the subject nobody wants to talk about: a possibility that the confluence of different forces from different directions could, sometime, somehow, somewhere result in a financial and/or economic storm so unexpected and devastating as to be called by the unusual name "perfect." (*A Decade of Delusions*, chapter 9, page 328)

7. [July, 2007] Unconventional behavior can be quite conservative just as conventional behavior can be terribly risky. For example, one of the main reasons we are so underinvested in common stocks vis-à-vis other managers in this market is because, in my judgment, we are currently grossly underpaid for the risks we thereby assume. Our more conventional brethren are either impervious to the risk/return imbalance, see it as the price

they must pay to be in the game, or are in denial. (*A Decade of Delusions*, chapter 10, page 343) [Note: This excerpt is from a draft of a letter to MCM clients, advocating the purchase of put options on Goldman Sachs, Bear Stearns, Lehman Brothers and Merrill Lynch on the eve of the financial crisis.]

8. [February, 2009] At Martin Capital Management, our long-term wealth management record affirms the efficacy of the belief that if you can't find a dollar for 50 cents you should pass. As our written record reveals, we have a keener nose than some for both danger and opportunity. In earlier missives, we warned of impending peril when it was largely invisible. With this report we are alerting the rational investor to opportunity, without yet being able to see to the other end of the tunnel of despair. (*A Decade of Delusions*, chapter 11, page 383)

9. [February, 2010] In attempting to salvage the financial system and brace against the flood tide of unemployment, massive doses of Keynesian-style fiscal, as well as unprecedented monetary stimuli, were thrown willy-nilly at the crisis. Whether they will have the desired effect has not yet been determined but, regardless, the future burden of trillions of dollars of fiscal stimulus debt (and other bubbles fermenting because of zero interest rates engineered by the Fed) are all but guaranteed. (*A Decade of Delusions*, chapter 11, page 409)

10. [February, 2010 – Reflecting in 2010 about tensions present before the financial crisis hit] The year 2006 was one of discontent for some of our clients and, therefore, for us. The S&P 500 racked up its second-best year in what had been to that point a lackluster decade, rising 15.8 percent, and our total account performance was conspicuous by its anemic underperformance: a paltry 0.7 percent. Some of our clients were wondering if we were out of touch with a new reality … It was an agonizing year and a half before the financial storm of our lives hit. (*A Decade of Delusions*, chapter 11, page 412)

11. [November, 2010] I believe that the spectacular rise currently being celebrated has underpinnings similar to the cheap-money "fools' rally" from 2003 to 2007—and that we are in both a secular bear market and an economic contraction that may not have seen its darkest days. Thinking into the future as we are inclined to do, the only development that would leave us scratching our heads would be further dramatic moves to the upside. We cannot forecast if, when, or how far the pendulum might swing, but our record suggests that sometimes we seem to be slightly ahead of the crowd in sniffing out trouble. (*A Decade of Delusions*, Epilogue, page 434)

12. [February, 2011] … We had a competitive advantage that was in short supply when the crisis hit: the willpower and liquidity to purchase, in a constructively conservative manner, shares of companies being sold at attractive prices by anxious investors fearful of still greater losses … We added to our positions in many instances as prices fell, (though) on March 9 our equities were selling *50% below their cost.* Because the Great Recession was gaining momentum, and the impact on future earnings was anything but predictable, it was a little tenuous making the case that stocks were cheap on a valuation basis. What we did know is that fear and uncertainty had created a selling frenzy, with many investors willing to trade their stocks for cash at any price. In light of the circumstances, we think we made some prudent exchanges. That's the temperament value investors must have. Our equities rose more than 50% during 2009, doubling the return from the much more diverse S&P 500. As a result, compared with most of our peers who went deep underwater in the 2008 crash and

have had to assume greater risks in the struggle to resurface, our client portfolios were already reaching new all-time highs by the time the third quarter of 2009 had come to a close. (MCM 2010 Annual Report, page 5)

13. [February, 2011] [T]he greatest opportunity at the lowest risk comes from having lots of cash on hand precisely when others are consumed by fear. The unavoidable uncertainty as to *when* such opportunities will present themselves does not invalidate the idea; it simply affects the time and the amount of the ultimate payoff. (MCM 2010 Annual Report, page 5)

14. [February, 2011] One would've thought the near-death experience of many investors and institutions in 2008 and early 2009 would have humbled an entire generation. But shortly after the government focused its seemingly limitless resources on postponing the day of reckoning, the mood of the markets flip-flopped in the spring of 2009 from fear of loss to fear of falling behind. Government intervention essentially pre-empted the natural market-clearing process during which equities have typically plunged to back-up-the-truck valuations. Stocks were only fleetingly on the bargain counter, and we took advantage of the moment to selectively purchase mispriced companies. It's our belief, however, that stocks didn't stay cheap enough long enough to induce a permanent change in speculative behavior—the type of event that has normally been associated with the end stages of historically significant bear markets—and begin to build the solid foundation for what will eventually become the next secular bull market. (MCM 2010 Annual Report, page 6)

15. [February, 2012] 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 analyst/economist Raymond DeVoe Jr.: "More money has been lost reaching for yield than at the point of a gun." (MCM 2011 Annual Report, pages 15 and 16)

Back to the Present

In the first section of this report, I mentioned digging deeply into original source material in search of answers to explain the apparent disconnect between my views and the market's continuing antigravity act. For those interested in more detail, please email me, and a bibliography will be provided for the subject area in which you express an interest. Some that come to mind include financial versus economic cycles; possible unintended consequences of easy-money policies; theories and practical experiences with complex, man-made systems; and protecting one's capital in either inflationary or deflationary times.

For the most part in "digging deep," works were considered only if earlier published research corroborated the cogency of their thinking over a period of years. It seems everyone has an opinion about today, but the paper trail left by those whose opinions of yesterday may have been prescient is metaphorically equivalent to the "road less traveled." For example, Fed Chairman Ben Bernanke's speeches before and after taking office in 2006, transcripts from Federal Open Market

Committee meetings, writings, and other position statements sadly did not meet the test of enlightened insight (let alone foresight) and intellectual continuity over time.

On the other hand, please consider—as a single example to make a larger point—William White, a Canadian economist who used to do research at the Bank of England and the BIS (Bank for International Settlements) before taking over the Economic Development and Review Committee at the OECD (Organisation for Economic Co-operation and Development). He (along with his colleague Claudio Borio, whose work is also most compelling), presented in 2003 one of the earliest and most cogent warnings of the 2008 financial crisis. (Even as far back as 1996, White challenged Alan Greenspan's view that central banks can effectively slow the causes of asset bubbles.) In August 2003, White made his argument directly to Greenspan at the annual Jackson Hole conference, presenting a paper contending that the Fed should "raise interest rates when credit expands too fast." Greenspan was dismissive. In addition to scholarly writings in 2008 and 2010, in September 2012 White released "Ultra Easy Monetary Policy and the Law of Unintended Consequences," a 45-page paper that examined the possible unanticipated side effects of actions taken by the central banks since the crisis. The essay featured a very stimulating discussion of the intersections between monetary policy and the financial system since 2007. White's 2010 speech at Cambridge, "The Origins of the Next Crisis," correctly predicted the deflationary path that the Fed has spent trillions of dollars trying to avoid.

Excavating deeper still, White's central thesis in the 2012 paper is that central banks affect the financial system much more directly than they affect the real economy or even such nominal variables as the rate of personal consumption expenditures (PCE), inflation, or the level of nominal gross domestic product (NGDP). As a result, there are times when stepping on the monetary gas pedal does not produce the desired results. During a balance-sheet recession, the collapse in interest income hurts savers more than the decline in rates helps prospective borrowers. And the collapse of the yield curve threatens the viability of intermediaries and can actually constrain credit creation. The expansion of central bank balance sheets threatens the functioning of the shadow banking system by depriving it of safe collateral. Instead of helping to solve the immediate problem, it's possible that central bankers have actually been making it worse. And, of course, there's also the possibility that today's monetary policy is generating the conditions for another bubble.

The paper was commissioned by the Dallas Federal Reserve Bank, whose president is none other than former hedge fund manager Richard Fisher. Curiously, in reading the just-released transcripts of the 11 FOMC meetings conducted in 2007, it was Fisher whose unequivocal warnings of what was to come fell on the deaf ears of Chairman Bernanke.

While this is but one telling example among many, the fascination of trying to put the pieces of an ever changing puzzle together is quite captivating, particularly when you recall the words of Jean-Claude Juncker on the cover page of this report: "Look, when it becomes serious, you have to lie." I refuse to become cynical, but a skeptic I shall always remain.

In addition to what we'll provide on request, position papers will be regularly written and posted to our websites or sent to you by email attachment. Among those already available on our websites are:

- A detailed examination of complexity theory as a risk-management tool, "I Cannot Leave the Truth Unknown":
  http://www.mcmadvisors.com/downloads/i_cannot_leave_the_truth_unknown.pdf
- An explanation of why investment managers feel compelled to be fully invested all the time, despite the potential for negative consequences, "Running With the Pack: An Average Idea":

http://www.martinfocusedvaluefund.com/commentaries/running-with-the-pack-an-average-idea/#more-466

- A study of alternative (and prophetic) voices the Fed has ignored, "The Fed Chairman Is Not Always the Key Speaker at Jackson Hole": http://www.martinfocusedvaluefund.com/commentaries/the-fed-chairman-is-not-always-the-key-speaker-at-jackson-hole/#more-480
- An analysis of the optionality of cash, "Why Would an Enterprising Investor Hold Cash Today?": http://www.martinfocusedvaluefund.com/commentaries/why-would-an-enterprising-investor-hold-cash-today/#more-490

For the time-constrained, here are thumbnail sketches of six crucial points of divergence between our investment view and that of the thundering herd:

1. Perhaps the overarching difference can be traced to something as simple as time perspective. Substantial evidence points to a collective shortening of investment horizons, making it that much more difficult to articulate, let alone justify, the case for long-term investment.

2. "Short-termism" encourages almost everyone, from the Fed to investment managers, to conceal risks, the latter making it look as if they outperform peers given the risk they appear to be taking. Typically, the kinds of risks that can most easily be concealed, given the requirement of periodic reporting, are "tail" risks—that is, risks that have a small probability of occurring but are nonetheless capable of generating severely adverse consequences. In exchange, these risks offer generous, albeit ultimately unearned, compensation the rest of the time.

3. While others focus on the presumed short-term benefits of unprecedentedly accommodative monetary and fiscal policies, our attention is drawn to the longer-term unintended consequences of such policies. Those consequences could be grave, possibly resulting in both an unprecedented (at least in modern times) diminution and redistribution of wealth.

4. Although most economists are trained to exclusively analyze the nation's income statement and its component parts that aggregate to GDP, in our opinion the economic picture becomes much clearer when one looks as well at the nation's balance sheet.

5. Understandably, Wall Street is using and always has used reported earnings as the "E" in calculating the P/E ratio. (Imagine how thin the ranks of analysts would become if long-term investing actually came back into vogue.) For the investor who views the present as but one chapter in a very long book, we feel strongly that the CAPE (cyclically adjusted price-to-earnings) is the best long-term metric.

6. By simple extrapolation, the consensus view for 2013 is that yield-hungry investors will continue to throw caution to the wind as managed low-interest rates leave them little alternative—and that supply will not rise up to meet their demand. Such activity on their part almost precludes seizing opportunity on ours. The trend continues. In late January 2013, the S&P 500 hit a five-year high and is now the fifth-longest of the 33 bull markets since 1900. Junk bond yields fell below 6% for the first time in history. The downside scenario, of greatest concern to us, is the end of the "free lunch" of fiscal deficits, zero interest rates, and seemingly endless quantitative easing. That storyline

could take the form of a crisis— currency, sovereign debt, or economic—inciting panic throughout the financial markets.

Final Thoughts …

As I think back over the last several years, I am filled with an overwhelming sense of gratitude. First, it begins with you, our clients. You have allowed me to manage your portfolios just as I manage my own. You have believed as I do—although probably not with the same level of unwavering conviction that comes from spending most of my time inside the "sausage factory"—that despite its might, the "market" is neither omniscient nor omnipotent. At the great inflection-point highs in the past it has, in fact, been a beguiling temptress who morphs into a panic-stricken mob once the tables inevitably turn. But memories are short, and the drumbeat of rising prices drowns out the voices of those who speak of such things. Our pledge at MCM is to get you through largely unscathed.

High-risk yet seemingly benign episodes like the present put enormous pressure on those of us who work on the front lines every day. While experience provides us with some vague notion of *how* this will end, the *when* is much cloudier. We fully recognize that some market questions simply have no definite answers.

Time, whether used wisely or squandered, is, for each of us, finite. If I am indeed a thinker, I may be at the top of my game at the moment—and certainly hope to be for years to come. But that's a bet with longer odds five years from now than today. Accordingly, I am searching, with the help of a highly qualified third party, for a like-minded entity with whom to affiliate. The MCM Board of Directors, whose consistent vigilance and level-headedness over the years has been invaluable and greatly appreciated, will assist in this process.

Specifically, my overarching goal is to partner with an organization whose long-term, risk-adjusted investment record is as solid as (or ideally better than) our own. Of equal importance, it must be an organization whose forward-looking assessment of risks and returns is dependable enough that its long-term record will remain intact for years to come. When we find such a partner, the experience will be a seamless upgrade for you in terms of both present resources and future well-being. Any such affiliation will have my implicit guarantee that (1) all of my financial assets will remain invested alongside yours as they have always been and (2) I, along with the MCM staff you have come to know and trust, will remain fully engaged in serving you.

Frank K. Martin, CFA
February 2013