MARTIN
CAPITAL MANAGEMENT, LLC
Registered Investment Advisor

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Banking on Another 'Hit'

"Addict" is a powerful word. It suggests an insatiable desire for a substance or practice for which no cost is too high. It is an existence in which immediate pleasure always trumps any future consequences. An addict is, in fact, psychologically and/or physically enslaved. It is also linguistically appropriate that the word "addict" starts with "add." The cruel reality of feeding an addiction is that it requires larger and larger doses to achieve the same sense of euphoria. At a certain critical point, an increase in what was once viewed as life-sustaining … becomes injurious or even fatal.

Investors in U.S. equities and debt have thus far escaped facing the consequences of their addiction to easy money. If anything, they're still on a binge. QE3 (a third round of quantitative easing) could be announced as early as the Fed's September 12–13 meeting: a predictable outcome of unnerving deterioration in the developed world's economies and, to a lesser extent, that of China. The unfortunate reality of needing a larger hit to reach the same high has a name in economics: It is known as the Law of Diminishing Returns.

First, some well-known history regarding our addiction: Fed Chairman Ben Bernanke induced a market adrenaline rush with his speech in Jackson Hole, Wyoming, in August 2010. His proclamation gave birth to the $600 million second round of quantitative easing known as QE2. The markets jumped in the months that followed, shot-up with the stimulant of easy money. But without a proportionate response in the real economy, the dose wore off. The markets came back down again, regurgitating all their QE2 gains by the early summer of 2011.

By September of 2011, with stocks once again in the doldrums, an increasingly desperate Fed introduced the $400 billion "Operation Twist," selling shorter term Treasuries in its portfolio to buy longer term assets and thus drive their yields down. With global economic pressures abating to some extent, the markets rallied through March of 2012. By June, however, the financial and economic maelstrom in Europe was back in the headlines and U.S. markets were slipping on weaker economic news just as Operation Twist was about to expire. On June 20 the Fed extended the program through the end of this year and increased the amount spent by $267 billion. This time, the markets merely yawned. With the yield on the 10-year Treasury note at a near record-low 1.54% following the release of the abysmal June employment data on July 6, it seems reasonable to question whether the next "hit" might be utterly ineffective—or even an overdose.[1] To be sure, we won't get a rational answer from a junkie.

[1] Fed research itself shows that QE2 only lowered the corporate cost of capital by 13 basis points compared with the nearly 100 basis point of relief with QE1. That is because QE1 helped address a market failure in the MBS universe but QE2 was purely a panic response to "double dip" fears at the time. If $600 million of Fed balance sheet expansion can only trigger 13 basis point decline in corporate borrowing costs, then the Law of Diminishing Returns must be on our minds.

Who is the enabler here? Where is the addiction coming from? The bottom line is this: The conditions that led to the crisis of 2008 have yet to be addressed. After a decade of "medication," the addiction to cheap and easy money is deeply ingrained in the psyche of both investors and the central bank. Willful blindness is pervasive. The quick fix has become so expected—so readily available—that the time and collective determination necessary to address the addiction's pernicious, long-term consequences have been drugged into submission.

What happens when an individual or a group loses its ability to self-regulate—and insists on sacrificing its long-term self-interest for short-term rewards? How does the story end? The addict either spirals downward into hopelessness or, in a slightly better scenario, hits bottom. "If we refuse to regulate ourselves, the only regulators are our environment," says neuroscientist Dr. Peter Whybrow, "and the way that environment deprives us."[2] If meaningful change is to occur, it will be the environment that painfully administers the behavior-changing detoxification.

Watching Europe struggling to regulate itself brings to mind Robert Louis Stevenson's split-personality characters, Dr. Jekyll and Mr. Hyde. The fiscal rectitude among the northern nations (Jekyll) may be no match for the economic and financial chaos of those in the South (Hyde). The world is literally holding its breath, hanging on the hope that truth in this instance will be kinder than fiction.

One of the great perversities in investing is that when financial markets rise substantially and fears subside, logic would suggest that skepticism should rise also. After all, risks rise as prices advance ahead of fundamentals, particularly when induced by market price-distorting, interest-rate policies. The reward for risk taking thus decreases accordingly. And yet, investors desperate for return do not see—or *choose* not to see—that these policies will not end well. They certainly didn't in 2008. Instead, what many investors see immediately ahead is increasingly large doses of government intervention, which they interpret as the "high" sign that the coast is clear for more speculation.

'Don't Just Do Something … Sit There!'

We at MCM will not be seduced into making investments based on such unsound short-term thinking, despite its pervasiveness. We remain focused on the relationship between price and value and will forgo rallies that are based largely on government actions or money flows. The risks of such speculative activities are simply too great.

Jesse Livermore, the speculator who amassed fortunes during the Panic of 1907 and the Crash of 1929, *only to lose them*, nonetheless had great instincts and the ability to learn from his mistakes. More than 100 years ago, he shrewdly observed: "The game does not change and neither does human nature."[3] He credited his successes to the ability to "sit tight," to avoid becoming impatient or doubtful "when the market takes its time doing as he figured it must do."

[2] Lewis, Michael (2011-09-28). *Boomerang: Travels in the New Third World.* W. W. Norton & Company, p. 206.

[3] One of Livermore's favorite books was *Extraordinary Popular Delusions and the Madness of Crowds*.

Noted hedge fund manager Seth Klarman of Baupost Capital expanded on Livermore's observations in the following message to his investors. Please read it carefully in light of what's happening today. Klarman is, in my opinion, second only to Warren Buffett in terms of performance over the past three decades *after properly adjusting for the risks incurred*. He gave me his permission to use this copyrighted excerpt in our quarterly report following a recent exchange of personal e-mails:

> It wouldn't be overstating the case to say that investors face a crisis of low returns: less than they want or expect, and less than many of them need. Investors must choose between two alternatives. One is to hold stocks and bonds at the historically high prices that prevail in today's markets, locking in what would traditionally have been sub-par returns. If prices never drop, causing returns to revert to more normal levels, this will have been the right decision. However, if prices decline, raising prospective returns on securities, investors will experience potentially substantial mark-to-market losses, thereby faring considerably worse than if they had been more patient.
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> The alternative is to remain liquid, defy the steady drumbeat of performance pressures, and wait for the prices of at least some securities to drop. (One doesn't need the entire market to become inexpensive to put significant money to work, just a limited number of securities.) This path also involves risk in that there is no certainty whether or when this will occur; indeed, securities prices could rise further from today's lofty levels, making the decision to hold cash even more painful. Meanwhile, holding out for better returns involves a (potentially lengthy) period of very low (albeit certain) positive returns available from today's short-term U.S. Treasury instruments.
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> While we have strong suspicions, it cannot be said with certainty which path will prove wisest. What is clear is that just about everyone will choose the former one. Those in the investment business compete on the basis of short-term, relative (not absolute) investment performance, and prefer to follow the herd (at the price of assured mediocrity) rather than stand apart (risking severe underperformance). From a business perspective, how much better to be actively deploying capital, even if the investments are mediocre, than to be stalled in neutral; the employees keep busy, while the clients confuse decisions with diligence, activity with insight, and a fully invested posture with a worthwhile portfolio.
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> Most investors would make the same choice. Human beings are … endowed with [only] so much patience, after all. Few are able to look past near-term returns, and today anything appears to offer better returns than cash. Also, given their relative-performance-oriented, competitive nature, investors loathe the possibility of underperformance that comes from sitting on the sidelines; they find it better to be in the game (unless, of course, the market drops). Most significantly, they remain highly skewed toward the greed end (how much can you make?) and away from the fear end (how much can you lose?) of the spectrum of investor emotions. In short, investors remain the consummate yield gluttons, seeking high return without regard for the likelihood of actually achieving it or for the risk incurred in the process.
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> Betting that the markets never revert to historical norms, that we are in a new era of higher securities prices and lower returns, involves the risk of significant capital impairment. Betting that prices will fall at some point involves opportunity cost of uncertain amount. By holding expensive securities with low prospective returns, people choose to risk actual loss. We prefer the risk of lost opportunity to that of lost capital, and agree wholeheartedly with

> the sentiment espoused by respected value investor Jean-Marie Eveillard, when he said, "I would rather lose half our shareholders … than lose half of our shareholders' money."
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> Some argue that holding significant cash is gambling, that being less than fully invested is akin to market timing. But isn't a yes or no decision the crucial one in investing? Where does it say that investing means always buying something, even the best of a bad lot? An investor who can't or won't say no forgoes perhaps the most valuable tool available to investors. Charlie Munger, Warren Buffett's long-time partner, has counseled investors, "Look for more value in terms of discounted future cash flow than you're paying for. Move only when you have an advantage. It's very basic. You have to understand the odds and have the discipline to bet only when the odds are in your favor."
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> Investors expect corporate managements to make carefully reasoned decisions, such as whether or not to commit their capital to build new factories, hire additional staff or acquire a competitor. A corporate management that invested capital at low expected returns just because they had the funds at their disposal and nothing immediately better to do would inevitably arouse investor ire. Why, then, should any investor (hedge fund, mutual fund, or individual) always deploy 100% of their capital into marketable securities, applying none of the analytical rigor or intellectual honesty they would demand of the underlying corporate managements? As we said last year, why should the immediate opportunity set be the only one considered, when tomorrow's may well be considerably more fertile than today's?

Compelling observations from Seth Klarman. Now for the surprise: The preceding passage was an excerpt from the Baupost Limited Partnerships' 2004 Year-End Letter, published in January 2005. The MCM Annual Report of 2005, which included "The Perfect Storm?" essay concerning the looming subprime mortgage crisis, conveyed much the same message. It would appear that Klarman, MCM, and a handful of other investment managers paid close attention to what contributed to Jesse Livermore's successes and, more importantly, his failures. Perhaps because of Livermore's propensity to give it all back, enlightened managers have a well-cultivated aversion to loss. I would further suggest that today's environment looks strikingly similar to the one that existed when Klarman and I urged patience in anticipation of a better opportunity set.

As we look forward to the second half of 2012 and beyond, the words of Jesse Livermore are ringing in my ears: "That's about all I have learned—to study general conditions, to take a position and stick to it. I can wait without a twinge of impatience, I can see a setback without being shaken, knowing that it is only temporary."[4]

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[4] The June retail sales report released on July 16 sadly confirms our concerns about the fragility of the so-called economic recovery. Down 0.5% for the month, retail sales have declined for three consecutive months. Each time that's happened in the past, save once, the economy was already in recession. And the one exception, October-December 2000, the recession began the very next quarter.

Second-Quarter 2012 Portfolio Review

Martin Capital Management modestly outperformed a sluggish second-quarter equities market: The S&P 500 Index was down 2.75% for the quarter, while the MCM Total Account Composite dropped 1.0%. While our equity performance was a little worse than average, our large cash balances and our hedges against a broad market downturn provided capital-preservation ballast. These latter two—cash and market hedges—were the reasons for our modest market outperformance.

In terms of portfolio strategy, the season of "treading water" at MCM continued during the second quarter, and it continues as we approach full summer. From our perspective, there are simply very few attractive individual value equity opportunities in the markets. Coupled with a grim macroeconomic backdrop, the equation adds up to not moving the needle much one way or another. That makes us somewhat uncomfortable, but not nearly as uncomfortable as the alternative: *giving in to the perceived need to do something* and thus greatly increasing the risk of permanent loss of capital.

Ever since the market lows of early 2009 and continuing with Ben Bernanke's fateful decision to pursue QE2 in late summer 2010, investor sentiment has been characterized by an almost desperate sense of chasing anything to provide quick-buck returns. So far, that particular game of musical chairs has not ended badly, and we congratulate those who have made money in these last 2½ years. From our side, though, we haven't been able to see how there's any *sustainable and risk-averse* way to keep the music playing. Given our overriding concerns expressed earlier, we are not prepared to put client capital at risk simply to keep up with the Joneses for a short period of time. It's the long term that counts, and it's the long term on which we remain steadfastly focused. With a recently completed external audit (formally called GIPS®—Global Investment Performance Standards) of our track record from 2000 to 2010, we can point to and are proud of our cumulative 85.52% return through that tumultuous 11-year period compared with the S&P 500's 4.6% cumulative return. That record of outperformance was earned and will continue to be earned by occasional periods of inactivity—of treading water, if you will. Long-term, steady compounding of capital remains our goal.

In topographic terms, we may one day call today's mundane results delivered by both MCM and the larger market "the Flatlands." However, we suspect that a deep valley lies at the end of these plains; and it may well be a valley that investors, as in 2008–09, will have a hard time climbing out of. We don't know *when* the road ahead will begin its descent, but our ability to read the economic terrain has been generally accurate in the past. We're usually early in our efforts to protect your capital, but better to be a year too early than a moment too late. Ultimately, the capital preserved today becomes the capital we can deploy in the future when other investors panic and sell stocks at bargain prices to patient investors like us.

All of this is not to say that we were entirely inactive during the quarter. We added to our core position in Gildan, which in the short term is working out well, and also to Hewlett-Packard, which hasn't yet borne fruit. In addition, we sold our longtime holding in Progressive based mainly on valuation and some macroeconomic concerns described in more detail in the Portfolio Activity section that follows. Finally, we both bought and sold shares in Old Republic, a property and casualty insurer. While it is generally not our style to jump in and out of a stock so quickly, we considered it appropriate in this case. As you'll read in the

Portfolio Activity section below, Old Republic serves as an example of how we feel we should handle the occasional mistake that occurs in stock selection.

–Adam Seessel, Research Director
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Beginning this quarter, Martin Capital Management is presenting its performance numbers in a new way. This is because, after more than a year's worth of painstaking and meticulous work, our performance record has been externally verified under a stringent protocol known as Global Investment Performance Standards, or GIPS®. The audit was performed by Cohen Fund Audit Services based in Westlake, Ohio, initially covering the period from 2000 through 2010. We picked January 1, 2000 as the starting date because that approximates the origin of MCM's current investment strategy focusing on value-based equities with the discretion to at times hold cash and employ active hedges. Our 2012 quarterly and YTD performance figures, though not part of the original audit, are nonetheless based on the same GIPS rules and account composites. We should note that MCM's performance numbers have always been calculated using industry guidelines and internally audited for accuracy. The externally-audited numbers are very close to those we have historically reported; small variations resulted from the GIPS rules defining the structure of the MCM Total Account Composite. For more information, or to obtain the complete 12-page GIPS audit report, please call Kristen at 574-293-2077 or make a request by email at kristen@mcmadvisors.com.

	MCM Total Account Composite (net of fees)	S&P 500
2nd Qtr 2012	-1.0%	-2.8%
YTD 2012	-0.1%	9.5%
Since Inception *	5.1%	1.3%

* Annualized

Martin Capital Management, LLC is an investment advisor registered with the Securities and Exchange Commission. MCM's primary investment objective is to achieve above-average long-term growth at below-average risk of permanent capital loss. The MCM Total Account Composite shows the performance of assets held in fully-discretionary fee-paying accounts that have given MCM authority to invest 100% of the account. Returns are calculated in US dollars. The composite is net of all management fees and includes the reinvestment of all income but does not reflect the effect of taxes. The inception date for the composite is January 1, 2000.

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.

MCM claims compliance with the Global Investment Performance Standards (GIPS®). A copy of MCM's most current GIPS audit report may be requested by contacting our office at (574) 293-2077 or by email at kristen@mcmadvisors.com.

Past performance is no guarantee of future results.

Second-Quarter 2012 Portfolio Activity

June 2012: Progressive Corporation

We sold our stake in Progressive Corp. (PGR) during the second quarter of 2012. It's an excellent business run by sound managers. However, its stock was priced accordingly. Furthermore, as explained below, we felt there were also some macroeconomic risks associated with holding the equity.

Clients of Martin Capital Management will recall that when it comes to individual stock selection, we filter all our data through three primary lenses: the quality of the business in question, the quality of the management running it, and the price the market is asking us to pay. Often, when discussing stocks internally, we shorten this business/management/price paradigm into its abbreviation, "BMP."

If we were to invest solely on the business and management portions of our BMP analysis, we would likely hold Progressive (PGR) shares indefinitely. As value investors, however, we must never ignore the price component. We strive to adhere to the old adage, "Price is what you pay, value is what you get," and we concluded that with PGR, price and value were very nearly the same. That means it has less upside potential than when we first bought it. We thus sold our stake in Progressive in June at an average price of about $20/share. That's more than twice PGR's book value, which is a bit expensive for our taste.

In addition, the history of the property and casualty industry demonstrates that it's very difficult for one company to achieve market-leading returns indefinitely. PGR's average return on equity over the past five years is 15%, a truly impressive figure that is almost twice the industry average. Travelers Insurance had an average ROE of 12% during the same period—slightly less than Progressive, but still noteworthy. By comparison, we bought Travelers in March of this year for less than half the price/book ratio at which we sold our Progressive shares in June.

As mentioned at the outset, there also was an intangible macroeconomic element that bothered us about Progressive. Unlike Travelers, which invests the vast majority of its policyholders' premiums in ultra-safe U.S. government and municipal bonds, Progressive has a history of trying to increase its earnings by taking extra risk with its investment portfolio. Indeed, in 2008 the company actually lost money because of this. We were concerned that PGR's risk exposure again today could manifest itself in a decidedly negative fashion should the financial system experience another major shock. Our risk-averse approach to investing thus factored into our sale decision as well.

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June 2012: Old Republic International Corporation

Background

We began looking at Old Republic late in 2011 because it was priced at a considerable discount to its tangible book value. There is a lot to like about Old Republic, historically a highly reliable property and casualty insurer based in Chicago. Over the past 50 years, ORI has grown its book value at an average annual rate of

12.4% (16.2% including dividends), and it has increased its dividend annually for more than 30 years. *Slow* and *steady* have been Old Republic's watchwords for most of its history.

In late 2011, however, ORI was selling at about a 33% discount to book value, and it was paying a dividend of more than 7%. This was because, in the latest real-estate bubble, Old Republic had ventured into insuring mortgages, with disastrous consequences. It was unclear to investors when, or if, ORI would be able to fix the problem. After studying the company's segments in detail, we arrived at that same tenuous conclusion. So we put ORI aside and moved on to other projects.

Restructuring and Spinoff

In May of this year, however, ORI announced a restructuring plan in which its two problem subsidiaries (mortgage insurance, plus a similarly flawed consumer-credit insurer) would be combined into one new entity and then spun off to existing ORI shareholders in late June or early July. This spinoff announcement reignited our interest in ORI, and we revisited our earlier research. We decided that it was extremely likely—for several reasons—that the spinoff would be completed. First, ORI's president/COO and heir apparent to the current CEO stepped down from his position at ORI to lead the new subsidiary. Second, Old Republic had already sold 20% of the new company to the new management team. Finally, in our experience, the vast majority of announced spinoffs are completed as planned, simply because responsible members of management won't announce a spinoff unless they are quite confident that it will come to fruition.

We took a position in the company before the spinoff, believing we were buying into positive change from a solid management team that had built its reputation over the last 30 years. Needless to say, we felt blindsided when in late June (just two weeks after our purchase) ORI announced that it was withdrawing the spinoff plan. This meant that the current situation—a troubled mortgage and credit-insurance subsidiary potentially dragging down the otherwise healthy parent—would continue indefinitely. Of particular concern to us was this: Although the overall company would likely remain healthy going forward even without spinning off its troubled subsidiaries, certain technical events within the subsidiaries could cause Old Republic's $550 million of convertible debt to come due and be payable immediately. This in turn would cause ORI to raise new capital at potentially disadvantageous terms, including substantially diluting existing equity holders.

Re-Evaluating Our Thesis

After the spinoff was withdrawn, we quickly re-evaluated our thesis and decided to sell, taking a 15-20% loss on our 3.7% (at cost) portfolio position. Nobody likes losing money—especially risk-averse investors like ourselves. On the other hand, judgment errors are as inevitable in this business as in any other. Old Republic thus serves as a good object lesson for how we try to handle seemingly sound decisions that turn into mistakes.

We always strive to be intellectually honest—indeed, ruthlessly so. In this case, we had an investment thesis based on a specific set of facts, but the facts changed, and we had to accept the new reality. The Old Republic story had gone from a solid company liberating itself from a troubled subsidiary back to just a troubled company with an albatross around its neck. Furthermore, when we recognize a mistake, we seek to deal with it swiftly and decisively. In our experience, little good comes from hemming and hawing and hoping that the stock rebounds enough to get out at break-even. Given ORI's troubled mortgage subsidiary and the hugely complicating factor of its callable debt, it was best to acknowledge a small loss of capital and take our medicine upfront, rather than hoping for a cure that may never have come.

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- We recommend you change your password once you've accessed the client site. Passwords using combinations of upper-case and lower-case letters, as well as numbers, offer more security than simple names or numbers alone. Should you have any questions, or any suggestions as to how we can make the website more useful to you, please don't hesitate to contact us.
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- We'd love to hear your comments on this, or any other, communication from Martin Capital Management. Please call or email Gary Sieber (574-970-2926; gary@mcmadvisors.com).
- Please remember to contact Martin Capital Management if there are any changes to your address, in your financial or investment objectives, or if you wish to impose, add or modify any reasonable restrictions to our investment management services. A copy of our current written disclosure statement discussing our advisory services and fees remains available for your review upon request.

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