

April 2013

The Skunk at the Garden Party

Iconoclastic economist John Kenneth Galbraith assumed the role of historian when he penned *A Short History of Financial Euphoria* in 1990. As such, he was more consumed with the past than the present—but his words echoed well into the future. As Galbraith's cautionary book hit the presses, the S&P 500 Index had doubled in value over the preceding five years and was poised for another meteoric ascent of more than 350% in the decade that followed. But even as investors savored the sweet fragrance of growing fortunes, Galbraith drew attention to the foul stench of an unwanted visitor wafting into the garden. Viewed with 20-20 hindsight from 2013, his words become eerily prophetic. Investors who took them to heart were undoubtedly spared the agony of watching their gains evaporate in the bursting bubbles of 2000 and 2008. Galbraith wrote his book to educate readers about the dangers of periodic episodes of euphoric speculation, getting right to the point in Chapter One:

There is protection only in a clear perception of the characteristics common to these flights into what must conservatively be described as mass insanity. Only then is the investor warned and saved.

There are, however, few matters on

which such a warning is less welcomed. 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 ...

History may not repeat itself, but some of its lessons are inescapable. One is that in the world of high and confident finance little is ever really new. The controlling fact is not the tendency to brilliant innovation; the controlling fact is the shortness of the public memory, especially when it contends with a euphoric desire to forget.¹

Galbraith admonished investors to resist two compelling forces in order to avoid becoming the unwitting victims of their own often subconscious avarice: "One, the powerful personal interest that develops in the euphoric belief, and the other, the pressure of the public in seemingly superior financial opinion that is brought to bear on behalf of such belief."

¹Galbraith, John Kenneth (1990). *A Short History of Financial Euphoria*. Penguin Books.

Little about today's disconnect between market prices and their underlying value smacks of a speculative mania. The current detachment is more subtle than the episodes Galbraith described. Quiet desperation by the long-maligned and yield-starved "Forgotten Man"² has none of the telltale signs that accompany more common euphoric bubbles, but the eventual consequences are quite similar.

The Big Bank Stress Tests: a Ruse?

Although the popular equity indices have finally clawed their way—with more than a gentle nudge from the Fed—out of the abyss into which they blindly fell exactly four years ago, the unresolved risks in the financial intermediation system remain a threat to both financial and economic stability. The 2012 Federal Reserve and Dodd-Frank Act (DFA) big bank stress tests were recently administered, and the headlines that J. P. Morgan Chase and Goldman Sachs failed to garner a clean bill of health drew attention away from the real issues: Do the stress tests simply measure what is measurable rather than what is meaningful? Are they little more than a ruse?

First, it's unlikely that many people know just how detached from reality the stress tests actually are. They included, for example, this hypothetical question for the big banks: How well are you capitalized should equity prices fall 50% and the unemployment rate rise to 12%? Given the experience in 2008, certain rosy assumptions were made that seem more than questionable. For starters, the stress tests assume that under any of the financial-shock scenarios, short-term creditors will not run. In an instinctively logical analogy, one would have to assume that theatergoers would stay put when someone screams, "Fire!" History suggests they won't.

Upon the failure of Lehman, for example, big banks ceased lending to each other, and institutional investors ran on the prime money-market funds that fund these banks, leaving the Treasury Department and the Fed a Hobson's choice.³ Because of the continued fragility of certain underexposed activities within the banking system, including the use of arcane derivatives, the threat may have become more ominous just as the government's capacity to shore things up has become weaker. If banks are forced to sell assets at fire-sale prices, the equity cushion is so small that most would be rendered immediately insolvent. Should there be a "next time," the problem will likely have grown beyond the capacity of governments and their agencies to contain it.

A second assumption, that the shock scenario will not result in banks reducing credit availability, is equally absurd. The shock will reduce the value of bank assets, and banks will, in predictable knee-jerk fashion, reduce credit, not extend it. This can create a vicious cycle. It isn't just the unwillingness of large banks to lend to other large banks that threatens financial stability. Rather than coming to the aid of their falling or fallen brethren for the greater good of systemic stability, banks tend to turn against their wounded competitors, thus exacerbating the crisis. The accounts of behind-the-scenes maneuvering when the weaknesses at Bear Stearns and Lehman hit the rumor mill stand out as shocking examples of this self-absorbed "kill or be killed" mindset.

² http://www.mcmadvisors.com/downloads/Frank_Martin_Forgotten_Man.pdf

³ Defined as the choice of taking either that which is offered or nothing; the absence of a real alternative. The term is named after 17th-century British livery stable owner Thomas Hobson. To rotate the use of his horses, Hobson offered customers the choice of either taking the horse in the stall nearest the door... or none at all.

A related flawed assumption is that the value of troubled assets is knowable during a crisis. The Troubled Asset Relief Program (TARP) was not implemented as originally planned precisely because there was no way of knowing the actual value of subprime-mortgage-backed securities and collateralized debt obligations. The huge derivatives books at some of the largest banks are even more opaque and simply cannot be “unwound” in the midst of a crisis. Plainly stated, the system would freeze up, and governments would likely stand by helplessly until the system cleared on its own. Warren Buffett has written extensively about his own experience with closing down complex derivatives books. The Federal Reserve stress tests have no way of accounting for this uncertainty.

Belittling Big Banking

It wasn't just press coverage of the big bank stress tests that piqued my interest last week. Tucked away in a March 14, 2013, commentary by *New York Times* chief financial correspondent Floyd Norris (reprinted in its entirety at the end of this QCM) is a link to data provided by recently retired and outspoken Fed board member, and now vice chairman of the FDIC, Thomas Hoenig. Here's the link: <http://www.fdic.gov/about/learn/board/hoenig/capitalizationratios.pdf>

Based on mid-year 2012 numbers, Hoenig's data suggest that banks are a lot riskier than they appear. At Bank of America, which had a Tier 1 capital ratio of 13.8%, he calculated a ratio of tangible equity to tangible assets, including derivatives, and got a figure of 3.4%. That's a razor-thin margin of safety for too-big-to-fail banks, especially in light of the issues described above. The data that Hoenig provided should raise serious doubts about the efficacy of the rather more optimistic stress tests.

As is often the case, it's easier to predict behavior if one understands incentives. The traditional Main Street banking business of making and managing loans is anything but glamorous—and currently not very profitable. Demand for new loans is subdued for a number of reasons. Investment spending by households or businesses and financed with money borrowed from financial institutions remains relatively lethargic four years into the so-called recovery from the Great Recession. “Average” household net worth has recovered nicely. If median data were available, however, it would surely show that most of the recovery has benefited wealthier families. The majority of Americans do not feel better off, whether measured by disposable income or net worth. Much of the country still remains in the grip of the thrift paradox. This depresses both household investment and consumption spending, despite herculean efforts in Washington to promote both, regardless of cost or consequence.

On the credit supply side, banks still appear to be laboring under a heavy load of legacy credit problems. Given the relief granted in mark-to-market accounting, “extend and pretend” loan reclassifications, and manifold other measures (including the hotly debated interest-rate subsidy discussed in the reprinted Norris article), the fact that banks are not pushing credit into the economy is perhaps symptomatic of a deeper malaise of which they, but not the public at large, are aware. Zero-bound interest rates, the rarely discussed part of the bank-bailout package, appear to be a sword with a second cutting edge: In this Fed-induced, low-interest environment, net interest margins, the lifeblood of the traditional side of banking, have been stanching with a Bernanke tourniquet.

The plight in which banks find themselves is likely traceable to the fact that many loans that should have been written off during the financial crisis remain on the books. (One need look only at the record of

community banks that were deemed too small to save to see how bad things have really been.) Regarding the megabanks, think of Bank of America's seemingly endless mortgage loan nightmare and the razor-thin equity margin that stands between it and insolvency.⁴ The stress tests will certainly not fully reveal at-risk loans, and the banking regulators are loath to highlight them during the ongoing damage-control saga. After all, Bank of America passed. That's the sunny side of big banking most of us see.

As Norris details in his commentary, the incentives are in place for bankers to go to extreme lengths to compensate for underperformance in the traditional banking side of their businesses. Of particular concern is the "off balance sheet" portion, much of it derivatives-related and shrouded in obfuscation, made almost impenetrable by its complexity, even for those capable of wading through the morass that few of the bankers themselves understand (Jamie Dimon likely being one). To gain a deeper appreciation, study Hoenig's data closely. The derivatives books, admittedly largely made up of interest-rate swaps, are huge and generally quite profitable except during crises. Neither the "Volcker Rule" nor the Dodd-Frank Act has the regulatory muscle to effectively restrain such behavior. The power of the incentives and the lobbying efforts driven by them are simply no match for flat-footed legislators or regulators trying to stand in their way. As noted in the essay on complexity theory I wrote in 2012⁵, the use of "value at risk" (VaR) and bell curve (or normal) frequency distribution to quantify risk exposure within and among banks borders on fraudulent misrepresentation.

Big banking remains both symptom and a symbol of an incredibly complex man-made system that, having never been cleansed of years of accumulated excesses and having never been forced to mend its ways, quickly reverts to its old bad habits. The big banks no doubt never had any intention of being other than perfunctorily contrite—and certainly had no incentive to genuinely repent and change their ways. Cutting to the chase, how many miscreants have gone to jail for their starring roles in one of the most outrageous and egregious social and economic crimes of modern times? As one must infer from the ongoing behaviors and unmitigated misaligned incentives (in part confirmed by the ratios that Thomas Hoenig provides), the financial behemoths appear far more fragile than they, the Fed, and all other authorities who lose sleep over such things would like to admit. Leverage, both on and off the balance sheet, reveals a system that, as Norris's op-ed piece suggests, remains in a "critical state." The gargantuan U.S. and global shadow banking system, with which there is some overlap, is a subject for another day.

The depth and breadth of distortions caused by interference with the natural pricing processes of money and credit—and the assets that are priced based on the cost of money—boggle the mind. Thus far we've seen only the upside of the distortions (excluding disenfranchised savers, of course). Floyd Norris, meantime, provides a glimpse (beginning on page 14) at what the true downside might look like.

⁴ That's what makes the anti-dilution clause so essential to Buffett's Bank of America investment. It protects Berkshire's proportionate ownership in the event that additional equity capital must be raised.

⁵ For a more detailed study of complexity theory vs. VaR as a risk-assessment model, see http://www.mcmadvisors.com/downloads/i_cannot_leave_the_truth_unknown.pdf

First-Quarter 2013 Portfolio Review

Martin Capital Management's Total Account Composite returned 3.48% in the first quarter of 2013, trailing the S&P 500 Index by 7.13%. The equities in our portfolio meanwhile continued to rise faster than the index, gaining 16.34% compared with the broader equities market advance of 10.61% in the first quarter.

A significant cash position dampened MCM total returns for the quarter. As noted in many previous commentaries, however, those cash holdings reflect our commitment to maintaining a long-term perspective in a world increasingly dominated by short-term thinking. We are cognizant of what we feel are serious undisclosed or unrecognized risks ("tail risks"), and we simply don't understand the logic of investing just to be invested—blindly following the crowd to the middle of the bell curve. Reaching for return usually means overpaying, accepting excessive risk, and compressing one's time horizon. Those common behaviors often lead to lower rather than higher returns in the long run. As noted in the 2012 MCM Annual Report (published in February 2013), we've sensed the possibility of tail risks before. Avoiding exposure to potentially catastrophic losses actually works better for long-term compounding than submitting to the short-sighted and counterproductive pressure to keep up with the Joneses.

In truth, the popular averages have only recently regained the ground they lost in the 2008–09 financial crisis. Investors have spent the last four agonizing years clawing up the side of the hole in search of the light. We wouldn't wish that on anyone—a competitor or the clients thereof. The MCM Total Account Composite, spared much of the agony of the bear market, were already making new highs by the end of the third quarter of 2009—and by June 30, 2010, they had risen still farther to 18.5% above the October 2007 peak. By comparison, the S&P 500 was still deep in negative territory, 26.9% below the previous top.

By that time the S&P had surged more than 50% from its 2009 lows, standard fare for bear market rallies. In the spring of 2010 we began to position ourselves for what we thought could be the final phase of the bear market, which usually is when acute risk aversion displaces risk-indifferent return seeking and becomes deeply embedded in the investor psyche.

The real economy (GDP, personal income, and employment) was struggling, largely unresponsive to huge doses of fiscal and monetary stimulus. We did not believe that the Fed, which had stepped in to provide liquidity during the crisis, would continue its aggressively accommodative monetary policy indefinitely in trying to ameliorate what emerged as a more intransigent solvency problem. We were shocked when Ben Bernanke opened Pandora's box at Jackson Hole in August 2010, declaring without shame his intention to effectively force the prices of risk assets higher. From the opening bell, we couldn't understand the wealth-effect spending logic. Over 90% of common stocks are owned by the wealthiest 10% of the population, and we doubted that, no matter how much of their financial market wealth had been recovered, they would spend us out of the recession. Moreover, we were stunned that Bernanke was knowingly sacrificing the interest income to savers in order to balance the scales.

Make no mistake, while we would certainly like to have had a larger share of the market's 25% gain since the spring of 2010, we feel that those gains have been "earned" by assuming risks that are mounting with each dose of monetary adrenaline. For a host of reasons, we're in no position to attempt to emulate Japan's latest desperate experiment. Most investors remain fully exposed to the dangers discussed elsewhere in this report

and will not “cash out” before—or even soon after—such risks might manifest themselves. As committed value investors, we feel that MCM clients will continue to be on the right side of history.

Perhaps the most frequent question we get is about catalysts, about what precisely will trigger a reversal of fortunes. Because of the nature of the beast, sometimes the answer, as vague as it is real, can spring forth from the pages of great literature, like George Eliot’s *Silas Marner*:

The sense of security more frequently springs from habit than from conviction, and for this reason it often subsists after such a change in the conditions as might have been expected to suggest alarm. The lapse of time during which a given event has not happened is, in this logic of habit, constantly alleged as the reason why the event should never happen, even when the lapse of time is precisely the added condition which makes the event imminent.

Remember that cash functions essentially as a call option without a strike price and without an expiration date. In our view, investing it all now would mean, at best, earning low to mediocre long-term returns or, at worst, exposing your capital to significant risks about which most investors are not particularly well-informed. Waiting and investing at a more opportune time will, we believe, reap much greater returns over time.⁶

For reasons explained in greater detail in the Recent Portfolio Activity section later in this report, during the first quarter of 2013 we sold our positions in Walgreens and Hewlett-Packard, as well as a portion of our Stryker holdings. Meantime, the 10 remaining stocks in our concentrated portfolio continue to rise in price collectively at a more robust rate than the market in general.

| Company | Current Position Size* | Q1 Price Change |
|---------------------------|------------------------|-----------------|
| Abbott Laboratories** | 1.9% | +10% |
| Abbvie, Inc.** | 2.2% | +16% |
| Amenigon (Gentherm, Inc.) | 1.4% | +23% |
| Amgen | 3.6% | +19% |
| Berkshire Hathaway–B | 4.0% | +16% |
| Colfax | 0.7% | +15% |
| Gentex | 4.7% | +6% |
| Stryker | 2.0% | +19% |
| Travelers | 2.8% | +17% |
| Walmart | 2.7% | +10% |

* As reflected in MCM’s model portfolio tracking transactions without individual account adjustments such as deposits, withdrawals, or opening account date, all of which may affect individual accounts.

** Price adjusted for stock split and spinoff of Abbvie, Inc. from Abbott Laboratories on January 2, 2013

⁶ For a more thorough discussion of the long-term benefits of having the option to hold cash in an investment portfolio, see: <http://www.martinfocusedvaluefund.com/commentaries/why-would-an-enterprising-investor-hold-cash-today/#more-490>

The final portfolio component, the S&P 500 Index puts (12/21/13 @ 1,000), continued to decline in value as the market advanced in the first quarter and as the options moved closer to expiration. They now represent only a three-tenths of 1% position size within the portfolio. The index hedges have 256 days before expiration at the time of this writing. At this point, their sole value is as insurance against catastrophic risk. Theoretically, if the market were to fall 35% in the next six months and the VIX were to rise accordingly—an outcome that not many people expect—the hedges would increase in price roughly 20-fold. At current prices, such an increase in value would add only 6 percentage points to aggregate portfolio performance. If the scenario described above were to occur and the equities in your portfolio correlated directly to the S&P, your total portfolio would be down roughly 3% and cash, as an option to buy anything of compelling value at the time, would represent 70% to 75% of your assets. Please note: These approximations apply only to accounts that had acquired a full option position.

| | MCM Total Account Composite (net of fees) | S & P 500 |
|--------------------------|--|----------------------|
| 1st Qtr 2013 | 3.5% | 10.6% |
| Since Inception * | 5.1% | 2.4% |

* Annualized

Inception Date 1/1/2000

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 and are managed per our model portfolio. Returns are calculated in U.S. 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.

Past performance is no guarantee of future results.

First-Quarter 2013 Portfolio Activity

January 2013: Sold Hewlett-Packard

“Beware of bargains in a bull market.” That old aphorism was among the warnings contained in the 2012 MCM Annual Report. Bargains appear in many varieties and guises; not all of them actually turn out to be bargains in the final analysis. The “value trap” is one of the more common pitfalls of bargain shoppers like us. A company looks cheap based on current earnings, but the trap is sprung when the company finally discloses risks and subsequent losses that result in current earnings being overstated.

Hewlett-Packard traded at about \$80/share during the dot-com bubble before collapsing during the bust. It then rallied to almost \$60/share in early 2010. This once great company with its “razor blade” printer business (i.e., profitably selling printer cartridges in much the same way Gillette largely built its business selling blade cartridges unique to their razors) has struggled to cope with an industry where Shumpeter’s “creative destruction” is the norm. HP’s board—and thus its management—have constantly been behind the innovation curve.

At the time we purchased shares in HP, the company was selling at a value equal to our estimate of the printer business alone, a value derived by decaying the value of that business over a relatively short period of time as the trend toward a paperless society continues. The trap became evident with the disclosure that Hewlett-Packard, in its haste to get ahead of what it believed to be the curve, bought a pig in a poke with its \$10 billion acquisition of Autonomy. Many smart value investors were shocked by the revelation; the company, incredibly, said it was shocked too.

An Australian analyst, John Hempton, with whom I spent time while in New York City late last October, made a compelling case that the Autonomy acquisition was likely to come a cropper. He was right—and for the right reasons. Leery, we applied the “cockroach theory” (there’s never just one cockroach in the cupboard) in analyzing Hewlett-Packard’s pension liabilities. Overstating expected returns—particularly given my reserved macro outlook—is rampant. By my estimate, Hewlett-Packard’s unfunded liability is in excess of \$5 billion. One too many cockroaches ...

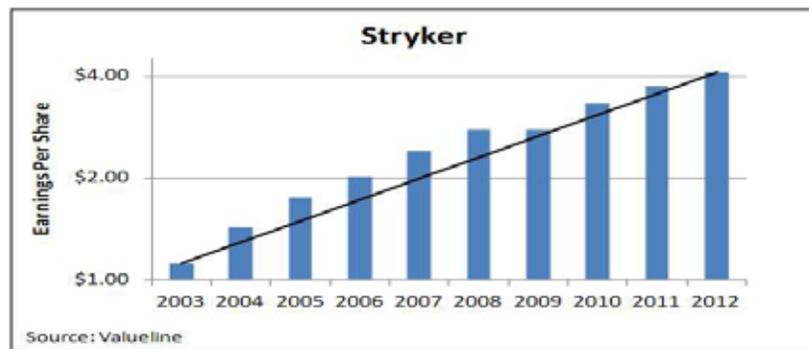
As is our protocol, we had purchased the company when it was decidedly out of favor and under selling pressure, at an average price of \$19.42/share. In the quarters following, Meg Whitman worked diligently to help the company find its niche, knowing that the highly profitable printer operation had a finite life expectancy. Additionally, a business with 360,000 employees is not an easy turnaround. In the panicky selling following the Autonomy disclosure, HP traded as low as \$11.35 on November 20. Such emotion-charged selling is usually followed by a “dead cat bounce.” That’s just the way markets work. We exited our position over the month, averaging \$14.83.

Our rule of thumb is to build such a large margin of safety into the purchase price of a security that if we find ourselves in a value trap we can exit with minimal damage. In the case of HP, our losses were mitigated by a respectable but not robust margin of safety at the time of purchase, along with a disciplined approach to selling the stock once the decision was made to remove it from our portfolios. While the damage sustained by many others we know was far more substantial (and in some cases is ongoing), that’s not the

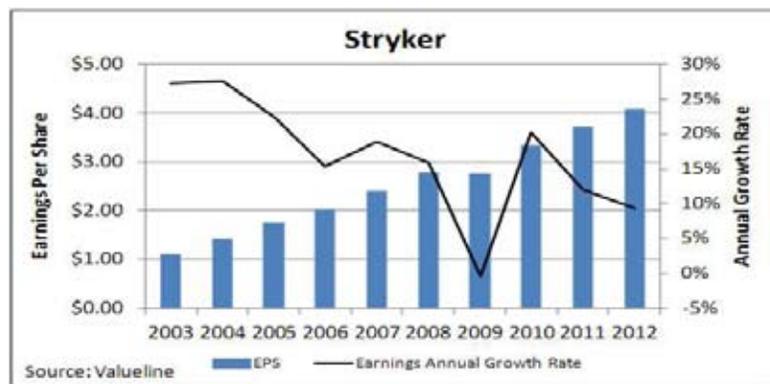
standard by which we judge ourselves. Our experience with HP illustrates the difficulty of researching an admittedly complex company in a very competitive and fast-changing industry.

February 2013: Reduced Stryker Position

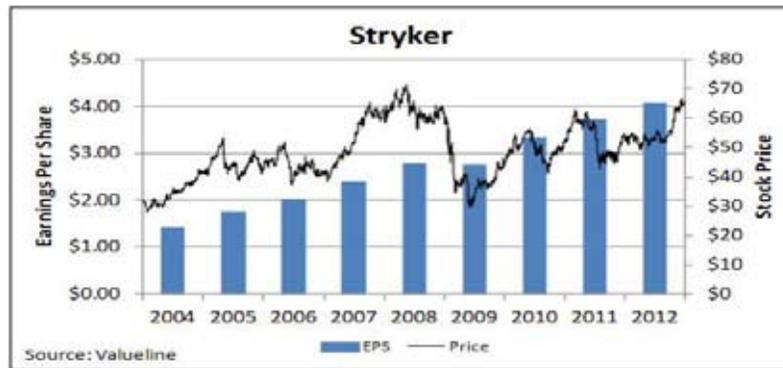
The decision to reduce our position in Stryker from 4% to 2% is much more an attempt to adapt our portfolio strategy to market realities than due to any fundamental apprehension about the company or its valuation. Research confirms what we have known intuitively for decades: Stock prices are much more volatile than the underlying fundamentals (earnings, dividends, and book value, among other metrics). This volatility is easily explained by first looking at the fundamental factors to which prices are ultimately tethered. The intrinsic value of a company like Stryker grows at a relatively stable rate over time. The end demand for its healthcare-related, durable-goods products has enjoyed a steady increase throughout the company’s history and, because of the nature of the business, its margins also have been comparatively stable. Because the company is well-capitalized, dramatic changes in the cost of money or its availability have little impact. As graphically portrayed below, earnings-per-share growth has averaged 15%/year, and the actual results have not varied much from the trend line over time.



Look closely, however, at the blue columns (earnings), compared with the trend line. Stryker was actually growing faster than the overall 15% rate from 2003 to 2008. The growth rate since then (2009–12) has been a bit slower. The next graph shows the change in Stryker’s annual earnings growth rate—down from more than 25% in 2003–04 to 10% last year, with a dip to near zero in 2009.



Finally, as you can see in the graph below, the decelerating growth rate has resulted in the company's stock price coming more in line with, rather than trading at a premium to, its earnings in recent years.



Price volatility is introduced into the equation because steady fundamentals do not translate directly to changes in the stock price, but rather through transactions in the marketplace between buyers and sellers—people like you and me. While modern portfolio theory portrays investors as equally informed and uncompromisingly rational, their behavior in the marketplace strongly suggests otherwise. For example, Stryker traded two years ago at \$65/share, then subsequently fell to \$45/share, and now once again it has returned to the \$65 level. Obviously, many forces beyond just the steadily rising earnings impacted the market price of Stryker during that two-year time period.

This is where an adaptable portfolio strategy comes into play. In a market that is increasingly at the whim of changes in central bank monetary policy, investor attention is understandably focused on the Fed's anticipated actions, and individual stocks become the means by which investors speculate on changes. A newly coined term for this kind of behavior is called "risk-on" or "risk-off" trading. As we have written extensively, we believe that Fed intervention in the markets distorts the natural pricing mechanism, with inevitably dire long-term consequences. More to the immediate point, it induces greater price volatility.

Because of this volatility, which we consider antithetical to prudent investment, opportunities of this sort occasionally appear for us. We will attempt to be somewhat more active in trading fundamentally stable core holdings like Stryker. When investors become overly exuberant because of the latest Fed pronouncement or geopolitical event, we'll trim back our position and harvest the gains; and when investors display the opposite mood at some future point, we'll repurchase the dollar amount sold and thus increase the number of shares we own. If handled reasonably well, we feel the average annual total return from the investment should increase.

Because we think Stryker is reasonably valued, we're quite comfortable retaining a 2% position. If the stock should move dramatically upward or downward from here, we'll take whatever action we deem appropriate at the time in the context of the strategy outlined above.

March 2013: Sold Walgreens

The retail pharmacy landscape has evolved considerably during the last 20 years, and Walgreens (WAG) is no longer the simple business maturation story it once was. In 1990, approximately 60% of prescriptions were paid by cash, 10% by Medicaid, and 25% by third-party payers. Today, cash payers account for less than 5%, while Medicaid accounts for 6%, and private third-party payers account for roughly 90% of Walgreens' pharmacy business. As the numbers show, pharmacies are no longer selling directly to millions of consumers, but rather they must negotiate the price of prescriptions directly with intermediaries. The intermediaries are better known as pharmacy benefit managers (PBMs), and they work on behalf of plan administrators to manage prescription benefits more efficiently, both from an operational and financial standpoint. Today the two largest PBMs fill 45% of all prescriptions, and the 10 largest PBMs fill 85% of U.S. prescriptions.

Additionally, the retail pharmacy market has become saturated with more than 60,000 pharmacies in the United States. In the past, Walgreens has been able to consistently grow by building new stores and expanding its footprint. Today, however, 75% of the U.S. population lives within five miles of a Walgreens pharmacy, so store growth no longer offers a clear runway for growth. WAG has more or less acknowledged this; store growth has been cut by roughly two-thirds.

Payer concentration and the saturated retail pharmacy market have left Walgreens in a weak negotiating position subject to pricing pressure—and without much growth opportunity from continued store development. To offset these issues, Walgreens needs new avenues of growth or the ability to pay less for the prescriptions and general merchandise it buys. These needs have prompted management to pursue acquisitions. Walgreens' current position requires some strategic response. Whether or not acquisitions are the right answer, the prices it has been willing to pay are questionable and highly contingent on realizing synergies. We believe that new operational and allocation risks exist at Walgreens so long as management continues to make acquisitions. Organic growth opportunities include health services, but it appears there will be strong competition to provide these services, given the market's anticipation of reduced profitability due to government involvement.

In the end, an argument could be made that Walgreens is cheap on future earnings based on anticipated synergies from acquired companies, but we believe that WAG's business carries more risk than in the past. Currently, Walgreens is trading at 15x current earnings and at best 10x 2016 earnings. The company will continue to provide much needed services as the Boomer generation ages. That alone, however, will not relieve the pressure on Walgreens' pharmacy profitability. This has become a more complicated company and industry run by a management team needing to make large, strategic moves. Given the increased risks and questionable prices management is willing to pay for large acquisitions, we feel that the current price does not compensate us well enough to continue holding the position.

First-Quarter 2013 Research Activity

In the current market environment, most of our research time and energy is spent building an inventory of investment ideas we can act upon quickly if and when the market prices of those specific companies fall to compelling levels. That said, our eyes aren't cast entirely upon the future. Given the amount of cash we're holding, we continue searching in earnest for businesses in which we can invest today.

It has been our policy not to discuss investment ideas currently being vetted. We're making an exception this quarter, however, in order to point out the challenges of finding bargains when the clearance rack has been picked over by countless other shoppers. In this instance, the market is reasonably efficient, and obvious bargains are rather rare. We often find ourselves looking for the equivalent of an article of apparel that has been quickly rejected by others because of a conspicuous stain or other disqualifying blemish. Our "edge" is our ability to examine the garment in question carefully to see if the flaw is superficial or permanent. Other shoppers are usually right to leave the item on the shelf—but not always.

Therefore, we're currently examining a number of "rejects," including DirecTV, Garmin, and Weight Watchers. It's easy to spot the stains on each of these enterprises, but will the spots come out in the wash? If we dig deeply enough to determine to our own satisfaction that "this stain" should not be viewed with "disdain" ... one or more of these companies might appear in your portfolio. But don't hold your breath! In time, we expect to be shopping in a store where even the finest Armani suits are on sale. Between now and then, however, we'll likely be doing a lot more looking than buying.

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Website Information

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- 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.

Hidden Numbers Make Banks Even Bigger

by Floyd Norris

New York Times, March 14, 2013

It sounds like a simple question. How big is that bank?

But it is not.

Under American accounting rules, banks that trade a lot of derivatives can keep literally trillions of dollars in assets and liabilities off their balance sheets. Since 2009, they have at least been required to make disclosures about how large those amounts are, but the disclosures leave out some things and—amazingly enough—in some cases do not seem to add up.

The international accounting rules are different. They also allow some assets to vanish, but not nearly as many. As a result, it is virtually impossible to confidently declare how a particular European bank compares in size with an American bank.

Much of that will change when first-quarter financial statements start coming off the printing presses in a few weeks. For the first time, European and American banks are supposed to have comparable disclosures regarding assets. Their balance sheets will still be radically different, but for those who care, the comparison will be possible.

This comes to mind because these days it seems that big banks do not much want to be thought of that way. A rather angry argument has broken out regarding whether “too big to fail” institutions get what amounts to a subsidy from investor confidence that no matter what else happens, they would not be allowed to fail. The banks deny it all. Subsidy? Penalty is more like it, they say.

We’ll get back to that argument in a moment. But first, there is some evidence that the big American banks may have scaled back their derivatives positions last year. At five of six major financial institutions, the amount of assets kept off the balance sheet appears to be lower at the end of 2012 than it was a year earlier.

Still, the numbers are big. JPMorgan Chase, the biggest American institution, had \$2.4 trillion in assets on its balance sheet at the end of 2012. But it has derivatives with a market value of an additional \$1.5 trillion that it does not show on its balance sheet, down from \$1.7 trillion a year earlier.

So is JPMorgan getting bigger? Measured by assets on the balance sheet, the answer is yes. That total was up \$93 billion from 2011. But after adjusting for the hidden assets, the bank appears to have shrunk by \$109 billion last year. If the bank used international accounting rules, it appears it would be getting smaller.

Not having those assets on the balance sheet makes the bank look less leveraged than it might otherwise appear to be. If you simply compare the book value of the bank with its assets, it appears it has \$11.56 in assets for every dollar in equity. Add in those derivatives, and the figure leaps to \$18.95.

It is not as if those assets are not real, or that they are perfectly offset by liabilities also kept off the balance

sheet. There is a similar amount of liabilities that are not shown, but there is no way to know just how they match up with the assets in terms of riskiness. The nature of derivatives makes it hard to assess aggregate totals.

If a bank has a \$1 million loan to someone, that is an asset that would go on the balance sheet at \$1 million. Presumably the worst that could happen is that the bank would lose the entire amount. But a large derivative position might currently have a market value of \$1 million, and thus would be shown as being worth the same amount, whether on or off the balance sheet. But if the market moves sharply, the profit or loss could be many multiples of that figure.

Under American accounting rules, banks that deal in derivatives can net out most of their exposure by offsetting the assets against the liabilities. They do this based not on the nature of the asset or liability, but on the identity of the institution on the other side of the trade—the counterparty, in market lingo.

The logic of this has to do with what would happen in a bankruptcy. What are called “netting agreements” allow only the net value to be claimed in case of a failure. So the bank shows the sum of those net positions with each party.

But those positions are not offsetting in terms of risk, or at least there is no way to know if they are. The figures shown in the financial statements and footnotes simply describe market values on the day of the balance sheet. If prices move the wrong way, an asset can turn into a liability, or a liability can become much larger. And both can happen at the same time. The asset might be an interest rate swap, while the liability is a wheat future. Obviously, they are not particularly likely to move in tandem.

To return to JPMorgan, on its balance sheet are derivative assets of \$75 billion, and derivative liabilities of \$71 billion. Neither number is very large relative to the size of the bank, and you might think that swings in values would be unlikely to be very large. But those numbers are \$1.5 trillion smaller than the actual totals. Obviously, the swings on a portfolio of that size could be much larger.

A few years ago, the accounting rule makers set out to get rid of the netting, and make balance sheets more accurate. But there were complaints from banks and others, and the American rule makers at the Financial Accounting Standards Board concluded that was not a good idea. So there is still netting in the United States. Some of it, involving repos and reverse repos, is not disclosed at all now, but will be when the new rules kick in.

The sort-of invisible derivative assets and liabilities are only part of the reason that it is so hard to really get a handle on just how risky any given bank is. Regulators look at banks’ “Tier 1 capital ratios,” in which they divide capital by “risk-weighted assets.” They get high numbers.

But Thomas Hoenig, the vice chairman of the Federal Deposit Insurance Corporation—which will be on the hook if a bank fails—sees problems with both parts of that ratio. He says that risk weightings can be misleading and that capital includes some intangible things—such as deferred tax assets—that would be of no use in a crisis.

He prepared a table, based on midyear numbers, that asserts that banks are a lot riskier than they appear. At

Bank of America, which had a Tier 1 capital ratio of 13.8 percent, he calculated a ratio of tangible equity to tangible assets, including the derivatives, and got a figure of 3.4 percent. “Banks,” he said in an interview, “are riskier than what the Tier 1 capital ratio would have you believe.” He added that after adjustments are made, it becomes clear that “smaller banks hold much higher capital.”

Smaller banks, in general, have little in the way of derivative positions. Wells Fargo is unusual in being big and not having a huge derivatives portfolio. (It also is unusual in that its disclosures do not make clear just how large the amounts are that are hidden, as do those of most other banks, although the numbers are clearly relatively small.)

That brings us back to the question of whether there are still “too big to fail” institutions, and what advantages they have. The Dodd-Frank law tried to make sure there would be no more such banks by requiring that systemically important financial institutions—now known as SIFIs—have plans to wind up their operations without requiring a bailout to protect the system. Opinions vary as to whether that would work in a new crisis.

Two senators who want to keep any bank from being too large—Sherrod Brown, a Democrat from Ohio, and David Vitter, a Republican from Louisiana—have asked the Government Accountability Office to study whether big banks get an effective subsidy because investors think they are too big to be allowed to fail, and therefore are willing to accept lower interest rates. Some research by economists has put that advantage as high as 80 basis points, while other research has come up with lower figures.

This week Wall Street fired back. A group of financial industry associations released a paper arguing the advantage was much smaller, and might not exist at all now that Dodd-Frank is the law.

“Just last week,” the paper said, “Standard & Poor’s issued a briefing that concludes that investors are now imposing a funding premium of 35 basis points on large banking companies.”

That was a bit misleading. The S&P video compared big banks to similarly rated large industrial companies, not to small banks, and suggested the difference might reflect fears of rating downgrades at the banks.

It is interesting that the big banks like to have financial statements that make them look smaller than they are, and vigorously dispute the idea there is a financial advantage to being big. Perhaps they protest too much.

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