MARTIN
CAPITAL MANAGEMENT, LLC
Registered Investment Advisor

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'Don't Blink'

Talk about how quickly ideas become dated in the digital world …

Blink: The Power of Thinking without Thinking by serial success Malcolm Gladwell was already technologically extinct even as it was skyrocketing to the top of the bestseller lists in 2007. While Gladwell was blinking (an involuntary physical activity that takes 200–400 *milli*seconds), high-frequency traders were just getting a toehold in gaming the markets, thanks to a speed advantage measured in *nano*seconds. A millisecond, by the way, is 1/1,000th of a second. Molasses by today's standards. A nanosecond equals *one one-billionth* of a second. To put that in visual terms, light travels 1 foot (11.8 inches to be precise) in a nanosecond—just enough time/distance to give high-frequency traders an edge over everyone else.

Electronic exchanges were authorized by the SEC in the depths of regulatory sloth in 1999, but it took years to build out the fiber-optic and microwave transmission systems infrastructure and the servers that are now located inside the exchanges. Those were the vital elements for the scheme to really gain practical traction. Today, high-frequency trading (HFT) shops represent only 2% of the approximately 20,000 trading firms in the United States, but they control 73% of all the day-in, day-out trading!

Bestselling author Michael Lewis has brought all this to the forefront in the last couple of weeks in his newly released book, *Flash Boys: A Wall Street Revolt*. Similar in style to his previous financial industry exposés, including *Liar's Poker* and *The Big Short: Inside the Doomsday Machine*, the narrative of *Flash Boys* is, at root, a continuing examination of Wall Street's dysfunctional relationship with larger society. Lewis this time shines a light on the exchanges themselves and the major investment firms that, he says, act as co-conspirators in an attempt to indiscriminately exploit their customers big and small.

What Lewis left unattended were the systemic risks associated with HFT, of which the Flash Crash of May 6, 2010, was merely the tip of the iceberg.

At this point, many of you may be asking, "Why are you telling me this? It all sounds vaguely familiar …"

The short answer is that we strive for continuity of thought over time in our communications with you. On page 19 (and endnote 49) of the 2013 annual report that you received on February 12, we broached the possibility of admittedly remote, hypothetical, and potentially catastrophic consequences of another flash crash—but this one at the worst possible moment of any given trading day: the closing bell.

Our motive is anything but alarmist. If anything, it's opportunistic. We constantly monitor and evaluate the secular movements of security prices and the behavioral forces that we surmise to be the impetus behind the sometimes seemingly irrational impulses of buyers and sellers in the marketplace. Consequently, we have quite intentionally positioned ourselves to trade our liquidity for equity—if and when businesses we favor trade at prices that offer well-above-average expected returns. The opportunity to buy bargains can originate from endogenous (company-specific) or exogenous (external, like bear markets) shocks. And for long-term value investors like us, either of those eventualities also means correspondingly lower risks of permanent capital loss. As for the exogenous risks and concomitant opportunities, we're fairly confident about the "if" but far less confident about the "when." But the more we can learn about HFT—black holes, frontrunning, misaligned incentives, and all the other pieces of this fascinating (and occasionally disturbing) puzzle—the more confident we will be in seizing any opportunity, from wherever it emanates, when many others are panicking because they were blindsided. HFT is simply one example of an opportunity inherent in an exogenous shock, noteworthy primarily because few people have even given it a thought.

There is a bigger, more ominous and pervasive issue, however, to which Michael Lewis alludes: the ever-growing social-conscience gap between Wall Street and the rest of society, along with the apparent absence of any meaningful expression of contrition or remorse, let alone repentance. Acknowledging that the term "institutional morality" sounds oxymoronic to many, one would've thought that onerous regulations, however impotent, would have been imposed long before now to bridge the gap.

The topic is, not surprisingly, controversial. Warren Buffett, during a March 14 interview on CNBC, predicted there will be another financial crisis and stocks will fall 50%—but not for a long time. By way of analogy, Buffett said that a patient just released from the emergency room is less likely to engage in the very behaviors that sent him there in the first place. Sounds logical. Seth Klarman, who as head of the Baupost Group is in my estimation the greatest risk-adjusted investor extant, took the counterpoint in his January 2014 letter to limited partners:

> Six years ago, many investors were way out over their skis. Giant financial institutions were brought to their knees when untested structured products that were too-clever-by-half turned toxic and collapsed. Financial institutions and institutional investors suffered grievous losses. The survivors pledged to themselves that they would forever be more careful, less greedy, less short-term oriented.
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> But here we are again, mired in a euphoric environment in which some securities have risen in price beyond all reason, where leverage is returning to many markets and asset classes, and where caution seems radical and risk-taking the prudent course. Not surprisingly, lessons learned in 2008 were only learned temporarily. These are the inevitable cycles of greed and fear, of peaks and troughs. Can we say *when* it will end? No. Can we say *that* it will end? Yes. And when it ends and the trend reverses, here is what we can say for sure. Few will be ready. Few will be prepared.

We at MCM faced the same conundrum in 2007. Fortunately, our writings and actions at that time paralleled those of Klarman. His actions were no doubt more decisive and deliberate than ours, but we found ourselves on the right side of history. We feel similarly positioned and in general agreement with him again today.

Returning to the importance of continuity from one communiqué to the next, we introduced in our recent annual report the concept of a "barbell" portfolio strategy designed for the market conditions described above. You'll find it on page 22 of the annual report in the section titled "Decision Making Without Forecasts and the Role of Optionality."

In the intervening months, our research team has been working on the more specific question of *how to turn that idea into action*. So … rather than offer a lengthy, big-picture essay in this quarterly letter, you are receiving (as a separate attachment) a very pragmatic and timely research report prepared by our analysts: "The ABCs of MLPs."

Like high-frequency trading, master limited partnerships (MLPs) have mushroomed in popularity since the financial crisis. Had the Wall Street distribution machine been crippled by the crisis or had investors become more discerning (rather than desperate), we are convinced MLPs would've failed to thrive. We strongly believe that more than a few of these partnerships are selling at prices far above what they are intrinsically worth, and we are exploring several avenues we might take to exploit that discontinuity. Unlike owning index puts, a widespread market sell-off is not absolutely necessary for one to profit handsomely from the knowledge we have acquired about the inner workings of MLPs.

Stay tuned for more on this topic…

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First-Quarter 2014 Portfolio Review

	MCM Total Account Composite (net of fees)	S&P 500
1st Qtr 2014	1.0%	1.8%
Since Inception *	5.3%	3.7%

* Annualized
Inception Date 1/1/2000

Martin Capital Management's Total Account Composite returned 1.0% in the first quarter of 2014, trailing the S&P 500 Index by 0.8%. The equities in our portfolio once again outperformed the S&P, gaining 4.2% in the first quarter, compared with the broader equities market advance of 1.8%.

Company	Model+ Position Size	Q1 Price Change++
Berkshire Hathaway Inc	4.5%	5%
Gentex Corp	4.1%	-4%
Travelers Cos Inc/The	2.6%	-6%
Wal-Mart Stores Inc	2.6%	-3%
Stryker Corp	2.4%	8%
Amgen Inc	2.0%	8%
Abbott Laboratories	1.9%	0%
Garmin Ltd	1.4%	20%
AbbVie Inc	1.2%	-3%
Gentherm Inc	1.2%	30%
Colfax Corp	1.1%	12%

+ The model is a representation of fully-discretionary accounts positioned in conformity with our investment process. Differences among individual accounts and the model may exist for account-specific and/or client-specific reasons.
++Price Change reflects only the market price difference from the beginning of the quarter to quarter end. It does not include dividends and interest.

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.

"In the short run the market is a voting machine. In the long term it is a weighing machine."

–Benjamin Graham

All of our companies reported positive 2013 year-end results in the first quarter, and the market rewarded some of those businesses much more than others. As a whole, our companies, and especially our largest positions, are reasonably valued. On average, they trade at 16 times current earnings. A few holdings, however, have seen their valuations grow and stock prices increase significantly in a very short period of time.

Benjamin Graham's words (above) highlight two common approaches in the marketplace: momentum investing and value investing.

Momentum investing is predicated on the analysis of various technical measures of recent price movement. Price movement in a stock is presumably an indication of how the stock will perform in the not-too-distant future.

Value investing is predicated on the analysis of business fundamentals—sales, earnings, growth prospects, and earnings sustainability defensible by means of competitive advantages, capital structure, and a number of other factors. Value investors believe that a stock's true worth is the present value of future cash flows the associated business will generate.

Graham also said, "An investment operation is one which, upon thorough analysis, promises safety of principal and an adequate return. Operations not meeting these requirements are speculative." We have little faith in chasing momentum, nor do we trust an individual's ability to consistently predict the emotional state of short-term investors (reflected in the allegorical character Graham aptly named "Mr. Market") in an effort to promise safety of principal and an adequate return. On an individual company basis, our discipline is to buy stocks when prices are cheap relative to fundamentals and sell them when they're not because, in the long run, the fundamentals drive a stock's value.

The dichotomy in investors' attitudes and philosophies can result in stock price movements that can't always be explained in the short run by fundamentals. As a result, prices driven by momentum can make value investors look very wrong at times and leave them second-guessing why they ever sold. Nonetheless, we believe that the discipline of utilizing a business perspective to analyze and value businesses is the most intellectually honest and repeatable approach. Accordingly, we are willing to look wrong in the short run for the sake of reducing risk and producing positive results in the long run.

Gentherm (THRM), a manufacturer of automotive heated and cooled seats, provides an example of this discipline. We sold half our position in the company in the first quarter of 2014 just shy of $33 per share. The share price has subsequently risen to as high as nearly $37, and it could go higher yet.

We first purchased the company's stock back in the summer of 2011 for an average price of roughly $14 per share. It has appreciated roughly 150% in the time we've owned it to nearly $35 a share at quarter end—a

40% annualized return. The question for value investors is whether the fundamentals support this impressive change in price. THRM earned $30 million in operating profits the year we bought it, adjusted for the acquisition it made. Last month, the company reported operating profits of $52 million for 2013, nearly a 70% increase since 2011. Earnings per share have grown 21% in this time.

We are happy with the performance of the business and the company's execution regarding the acquisition. It has given THRM in-house manufacturing capabilities as it seeks to further commercialize its proprietary thermoelectric technologies. We are also believers in the company's growth opportunities and competitive position as auto manufacturers continue to adopt THRM's heated and cooled seats even in mid-range and lower-end models. The automotive runway in front of Gentherm is long, and the company has opportunities based on its existing technologies in other markets as well.

We are concerned, however, that there is little margin of safety in today's price, which values the company above 30 times its 2013 earnings per share (EPS). When we bought THRM, we were paying 15 times earnings for a well-positioned company with secular growth prospects. At that price, one didn't have to assume 20% growth for the investment to work out favorably. We expected a total return on investment of roughly 15% on an annual basis, roughly congruent with our expectations for the performance of the underlying business. Today, to justify the current price, one must be willing to make some lofty assumptions with respect to company prospects, auto sales in general, and future price multiples. Past experience is not a guarantee of future results.

At this point, after trimming our position by half, we still hold a little more than a 1% position of THRM in our model portfolio. We like the *business* and its long-term prospects. Over the next 5 to 10 years, it seems quite likely that THRM's products will be found in far more vehicles than is the case today. We are much *less* fond of today's *price*, though, especially in light of the possibility that consumers may retrench. We don't have strong opinions about whether auto sales will continue upward in the meantime—or at least not at the high rates recently seen. Any hiccup economically would likely spill over into consumers' auto-purchasing decisions. Nevertheless, the current reality is that auto affordability is high because interest rates remain low, the used-car market is rather tight, manufacturers are beginning to increase buyer incentives, and the vehicle fleet is relatively old. All these circumstances have put some wind in the sails of auto sales. That, of course, is subject to change.

Contrary to many momentum investors, we (as value investors) view an investment to carry more risk, not less, as its price rises. THRM's price has not reached levels of absurdity (if economic headwinds remain subdued), but should it continue to outpace the fundamentals, we will sell more or even all of our THRM holding and patiently await a price that once again provides an adequate margin of safety. That's precisely what we did with Gentex (GNTX), currently our second largest holding, and it has worked out well for MCM clients on both occasions when we were able to find it available at a compellingly low price. One of the great advantages of publicly traded companies is that you can easily buy them – or sell them – as often as you like depending on the price being offered by "Mr. Market."

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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).
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