

“An imbalance between rich and poor is the oldest and most fatal ailment of all republics.” —Plutarch

“How did you go bankrupt?” Bill asked. “Two ways,” Mike said. “Gradually and then suddenly.” —Ernest Hemingway, *The Sun Also Rises*

“The curious task of economics is to demonstrate to men how little they really know about what they imagine they can design.” —Friedrich August von Hayek

“By failing to prepare, you are preparing to fail.” —Benjamin Franklin

2015

ANNUAL REPORT

For further information, contact Client Relations
at ClientRelations@mcmadvisors.com

Total Account Composite Performance

In 2015, the annual return on MCM's total account composite was -5.8% after fees. Since we began documenting performance history at the end of 1999, coinciding with the peak of the greatest bull market in history, our compounded annual performance, net of fees, has been 4.3% compared with the S&P 500 Index's 4.1%.

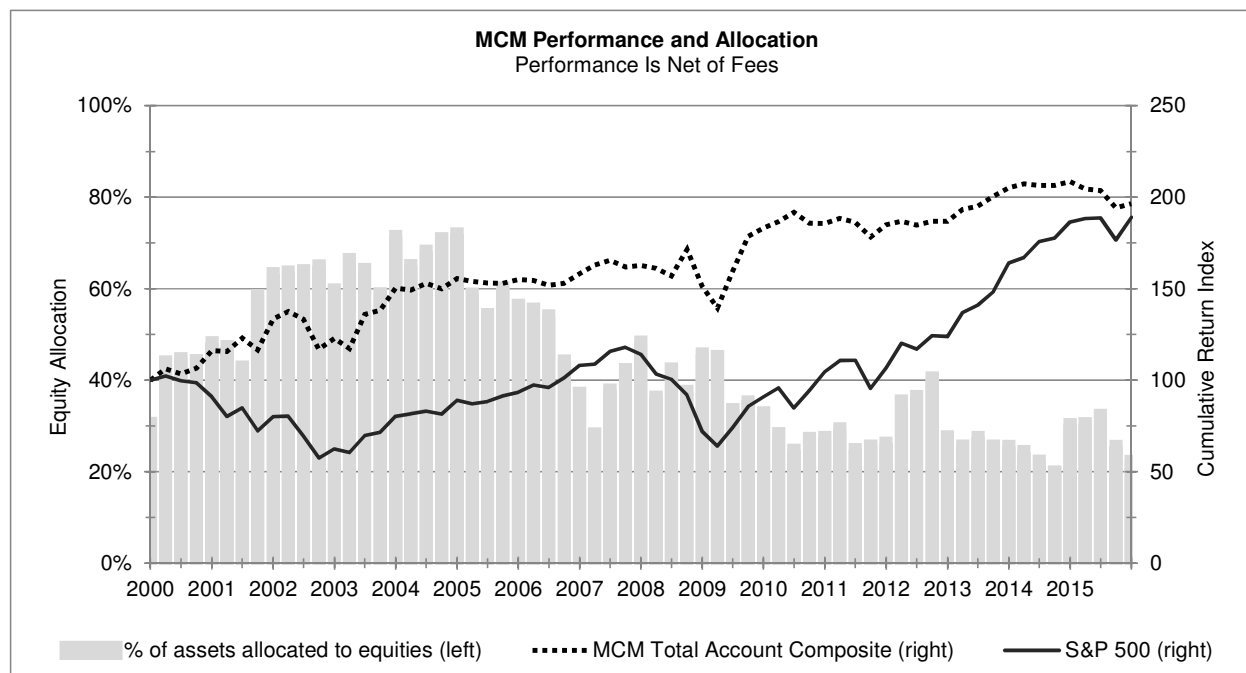
Year	Annualized Growth Rate			Relative Performance (1)-(2)	MCM vs S&P 500: Compounded Outperformance **
	MCM Equities *	MCM Total Account * (1)	S&P 500 (2)		
2000	30.4%	16.3%	(9.1%)	25.4%	27.9%
2001	22.5%	14.8%	(11.9%)	26.7%	66.7%
2002	(14.2%)	(8.0%)	(22.1%)	14.1%	96.9%
2003	33.4%	22.3%	28.7%	(6.4%)	87.2%
2004	4.3%	3.5%	10.9%	(7.4%)	74.7%
2005	(0.3%)	(0.3%)	4.9%	(5.2%)	66.1%
2006	4.8%	2.0%	15.8%	(13.8%)	46.3%
2007	1.5%	2.9%	5.5%	(2.6%)	42.7%
2008	(20.2%)	(7.0%)	(37.0%)	30.0%	110.7%
2009	57.6%	20.9%	26.5%	(5.6%)	101.4%
2010	18.1%	1.3%	15.1%	(13.7%)	77.4%
2011	(2.4%)	(0.3%)	2.1%	(2.4%)	73.3%
2012	15.9%	1.0%	16.0%	(15.0%)	50.8%
2013	46.7%	9.8%	32.4%	(22.6%)	25.1%
2014	20.4%	1.6%	13.7%	(12.1%)	11.8%
2015	(16.2%)	(5.8%)	1.4%	(7.2%)	3.9%

* Net of fees

** Invested dollar with MCM relative to invested dollar in the S&P 500 since 12/31/99

- *The MCM Total Account Composite consists of all portfolios (or consolidated portfolios) with assets greater than \$1 Million held in fully discretionary fee-paying accounts whose owners have given MCM the authority to invest up to 100% of the account in equities. MCM notes that one of the accounts in the composite has a large portion of assets invested in a non-earning asset. Due to the relatively low yields currently earned on U.S. Treasuries, this asset has a negligible impact on overall composite performance.*
- *The MCM Total Account Composite is managed in accordance with our Model Portfolio. The Model Portfolio is a representation of fully discretionary accounts positioned to conform to our ideal investment process. The primary investment objective for both the Total Account Composite and Model Portfolio is above average long-term growth in capital through a combination of capital appreciation and income, at below-average risk of permanent capital loss.*
- *Performance is shown Net-of-Fees. Assets are shown in US Dollars. **PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS.***
- *The MCM Total Account Composite performance is compared to the S&P 500 Index. The S&P 500 Index consists of 500 stocks chosen for market size, liquidity and industry group representation. It is a market value weighted index with each stock's weight in the index proportionate to its market value. The reported returns reflect a total return for each year inclusive of dividends but exclusive of taxes and management fees.*

S&P 500 Index and MCM Asset Allocation/Performance



Letter to MCM Clients

Performance Commentary: The Year 2015 in Review

To the Clients of Martin Capital Management:

Like 2011, the last year when the S&P was essentially flat, 2015 came in like a lamb and went out like a lion, at least in terms of its roar. The S&P 500 fell nearly 10% from its July peak by early September, but it ended the year on positive note, making back all its lost ground and ending 1.4% higher, including dividends. The MCM composite portfolio declined 5.8% on the year. Quite unlike 2011, had it not been for the shares of a handful of new-economy companies, and a few old ones, the S&P would've had a really downbeat year. The list includes the FANGs (Facebook, Apple, Netflix, and Google), as well as Microsoft, Berkshire Hathaway, Exxon Mobil, Johnson & Johnson, GE, and Wells Fargo. The shares of the 10 largest companies were up 21% in 2015, whereas the other 490 were down 4%, the largest spread since the late 1990s and reminiscent of the "Nifty 50" bifurcation in the early 1970s.

Compounding this return disparity between the largest 2% and the bottom 98% is the underperformance of traditional value stocks – our forte – as a strategy. According to Evercore, an investment banking advisory and investment research firm, in 2015 the single worst performing stock strategy among 14 different strategies was traditional value, with losses greater than 20%. Conversely, price momentum stocks, defined as shares with the largest price gains in the past 6-12 months, showed the largest returns in 2015 with gains exceeding 30%. Past instances of price momentum as the winning strategy have often occurred closer to the end of bull markets, rather than the beginning.

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While the volatility resulted in negative performance for the year, it did enable us to initiate a position in IBM, as well as add to our position in Walmart. We also took advantage of prices in July and November to sell long-standing positions in AbbVie, Amgen, and Travelers. We sold these positions in consideration of their fundamentals and valuation.

Except for Berkshire Hathaway, client portfolios do not contain shares in any of the 10 largest companies mentioned above. And, like most companies in the S&P 500, the equities in MCM portfolios were not immune to the volatility. The largest detractors to our performance the past year were associated with our investments in energy-related companies, predominantly those that are suppliers to exploration and production (E&P) companies. Few assets were more volatile last year than oil and gas.

The oil markets have been in a state of distress for one and half years, making this one of longest lasting down cycles since 1975. Among the many supply-side forces that have weighed on energy prices, including well-chronicled improvements in drilling technology, easy and low-cost financing bankrolled many a marginal player along the continuum from upstream to downstream. Additionally, OPEC has acted contrary to recent history, seeking to maximize production rather than to maximize price. The culmination of these factors, as well as suspect economic growth, has many wondering, "How low can you [oil prices] go?"

At this time last year, West Texas Intermediate (WTI) crude had fallen to the mid-\$50s from over \$100 a barrel in June 2014. While we recognized the possibility of oil prices falling further, our decision to expend 8% of your capital in four energy-related companies at the end of 2014 hurt our performance in 2015. Oil rallied to over \$60 during the second quarter but slumped over 40% by year end to \$34 a barrel. The prices of the energy-related companies we purchased fell in a magnitude similar to the price of oil.

When we took positions in energy-related companies in late 2014, we felt, at the very least, that there would be a trading opportunity as some degree of levelheadedness returned to the markets. We also were aware that some risk was involved in owning companies that either provided long-lived capital goods or services to E&P companies. When demand slows, prices fall and expensive assets are idled.

It is almost always the case that one buys more of a good idea whenever its price falls noticeably. While not a universal rule, it applies the majority of the time. With the fall of oil prices, however, it became apparent that Civeo, which provides room and hospitality services for oil and gas producers, was not a prudent "double-down opportunity." Civeo's debt, quite manageable under normalized conditions, simply loomed too large. Civeo's ability to service its debt hinged on the question, "Will oil prices return to near prior levels by the middle of 2016?" We can't answer that question, and instead of hoping for a return of higher prices, we decided the rational action was to cut our losses and focus our attention on other companies that have the financial wherewithal to prevail even at today's low prices.

The other energy-related investment we sold was Noble Energy, an international E&P company. We didn't buy shares in Noble outright but received them upon its acquisition of Rosetta Resources, a U.S.-based E&P company. The acquisition was completed in July 2015. We spent time learning about Noble Energy, but as the oil environment has evolved, we believe that the best way to play an eventual recovery in oil prices is through owning service providers rather than E&P companies. As a result, we sold Noble during the fourth quarter.

Post year end, benchmark WTI crude dropped into the high \$20s. As noted elsewhere in this report, the pundits began to worry about \$20 oil. When despair is rampant, value investors step to the fore. As is

invariably the case, nobody fretted when oil was reaching for the sky at \$150 in 2008 or \$110 in 2014. The (drilling) “rig count” is the lowest in decades and we think holding well-capitalized Helmerich & Payne and Baker Hughes (and adding to the latter in January) makes common value investor sense. They both continue to generate cash and maintain strong balance sheets. As we continue to study companies up and down the oil food chain, if we find additional opportunities, we expect to add to positions of only those capable of weathering a long storm.

Preparing for the Inevitable

We should note at the outset that if one is prepared, bear markets are to be welcomed, not feared. Moreover, the farther markets fall below our measure of aggregate intrinsic worth, the more likely it is that the list of companies selling at ridiculously low prices will grow to the point where the number of opportunities gradually outstrips the money we have available. During calendar year 2008, the share prices of 100 companies plunged more than 60%, another 100 slumped more than 45% and another 100 declined more than 33%. As one might expect, many sold at compelling price-to-value relationships. The market prices of only 25 companies—a mere 5% of the S&P—were up for the year.

But what about the rest of the time when the market is not so broadly compelling to the buyer? During those long stretches, we also believe it is more constructive to think of the stock market as a market of stocks. Like Santa’s elves, we work feverishly all year building our inventory of ideas, although for us individual Christmases can come unexpectedly as individual stocks can and do fall in and out of favor, irrespective of the market. For example, while the S&P as a whole was essentially flat for 2015, it masked turbulence behind the seemingly benign averages noted earlier. Listed as follows are industries (within broader sectors) where the average price change was greater than 20%.

Industry	Average 2015 Price Change
Diversified Metals & Mining	-70.8%
Casinos and Gambling	-53.5%
Aluminum	-37.5%
Department Stores	-36.6%
Oil & Gas Exploration & Production	-35.5%
Oil & Gas Drilling	-32.2%
Railroads	-31.5%
Trucking	-24.7%
Household Appliances	-24.2%
Consumer Finance	-21.2%
Oil & Gas Equipment & Services	-20.4%
Managed Healthcare	20.4%
Home Improvements Retail	21.0%
Restaurants	22.1%
Oil & Gas Refining & Marketing	24.6%
Brewers	26.0%

Source: S&P GIPS Scorecard

As it is today, unless one defies all that history teaches, the bull market that began in March 2009 will be followed by a bear market. When it will happen, how severe it will become, and how long it will linger, no one can be sure. Though ignorance may be a convenient excuse, it does not relieve stewards of someone else's wealth from the burden of responsibility to contemplate and prepare for such a risk.

It is reasoned that the ambivalence about the next bear market springs from nothing more substantive than the shortness of financial memory, rather than from a well-grounded and firm conviction that it won't ever happen. The irony is that, even as warning signs accumulate, it is the very *lapse of time* since the last period of reckoning that *fosters complacency* and *may well be the added condition making the next event more, not less, likely*.

We have long had a fascination with financial and economic history. After all, "What's past is prelude [of what's to come]," wrote Shakespeare in *The Tempest*. We don't understand why it is necessary to learn firsthand from our own mistakes when we can take the shortcut of observing the foibles of our predecessors. Some lessons *can* be learned vicariously. We have been alert to the aforementioned warning signs earlier than most in the past. Of equal if not greater importance is developing the skill of assimilating signals from a host of independent inputs to gain some sense of the cohesive whole.

One would never have been capable of preparing for the financial crisis bear market without being able to at least vaguely comprehend the impending collision of various disparate elements. Among the many that were *quantifiable* were the emerging residential real estate bubble, abetted by reckless financial innovation (concurrent with a once-in-a-lifetime debt supercycle), and the continuation of an overly accommodative experimental monetary policy. The combination had the characteristics of a complex system in a critical state.

The post-2009 bull market has been perplexing from a quantitative standpoint. First, the S&P has tripled as corporate profits grew over 60% on the strength of record-high profit margins (until recently). And yet, since the end of the so-called "Great Recession," GDP has recovered at only a 2.2% annual rate, half of the average following previous post-World War II recessions. The aftershocks of the accompanying financial crisis, including the near-record amounts of debt that remain on the books of governments, households, and corporations, is like the sword of Damocles hanging over the economy and financial system.

Even the outward good news that the unemployment rate has been halved from 10% to 5% is suspect because the labor force participation rate is the lowest since the 1970s. Growth in real total wages has been a paltry 2%. A continuation of the accommodative monetary policy that preceded the last bear market, eight years of ultra-low interest rates, both nominal and real, stabilized the last crisis, but their continued application seems to have destabilized everything else since. Interest rates are used to price risk. In the current environment, the risk-pricing mechanism is broken. The S&P valuation levels foretell longer term future returns that are likely to be *de minimis*. The link between the market and the quantifiable elements of the economy and the financial system is not often this tenuous.

But focusing on the quantitative is never enough. One must also have been able to integrate the soft sciences of individual and social psychology: the *qualitative*. Simply measuring what is measurable is not enough to form a holistic picture. The research of behavioral economists like Dan Ariely (*Predictably Irrational*) and Robert Shiller (*Irrational Exuberance*) may be the added ingredient to give some cohesiveness and symmetry to the maze of confusing and sometimes contradictory economic and financial data. The irrationality of humans would seem only to stir the pot of uncertainty were it not for a *certain* predictability and repetition in the patterns of human unreasonableness. The irony is that in the short and intermediate term, the *qualitative* soft-science elements may have greater input value than the quantitative in determining what moves the prices of securities and, therefore, markets.

The Ebbs and Flows of Crowd Psychology

Common sense suggests that it might appear convenient for the wealth of nations if markets and economies were to cleave closely to the Industrial Revolution's upward-sloping trend line (the first such period of per capita growth in the history of humanity), just as the world would be much safer if disputes between political and other factions could be resolved through diplomacy, rather than by the devastations of conflict and war. But markets, like all political and social organizational wheels of which humans are the hub, are no more collectively unselfish, tranquil, and rational than the individuals comprising them. Knowledge is cumulative; wisdom is not. Moreover, "Men, it has been well said, think in herds; it will be seen that they go mad in herds, while they only recover their senses slowly, one by one."¹ The more we learn about the repetitious proclivities of humankind, collectively or individually, the more we can turn that considerable force in our favor.

The amalgamation of investors that we call markets have their seasons of recklessness—whether because of excitement over the latest innovation or, as of late, years of cumulative, yield-starved desperation—when they carelessly disregard risk in pursuit of return. When millions of investors obsess over some mass delusion, reinforcing each other's convictions contagiously, amplified by feedback loops, market prices become disassociated from underlying values.

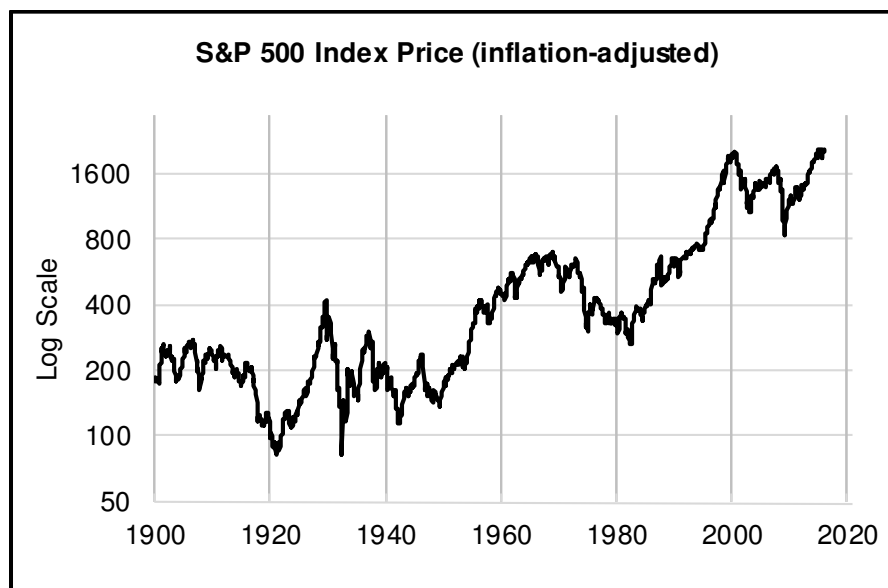
In our humanistic striving for internal consistency, if we have to choose between what the market tells us and what the underlying fundamentals *should* be telling us, we generally default to the former. The ability to remain rational when holding two conflicting ideas in mind at the same time is rare—and surely the sign of a first-rate investor. The choice we all face is difficult: Either we think for ourselves, or others will think for us. The path of least resistance, requiring the least amount of thought and stress, is to go with the majority. In euphoric times investors are generally inclined to see the glass of opportunity as half-full, while in bear markets they flip-flop. Sinking into despair, they stand remorsefully as their glass drains from full to half-empty, as the bubbly froth they thought was real dissipates. More troubling, in their darkest moments, they instinctively develop an inexplicable certainty that all will be lost.

As explained in last year's MCM annual report,² the one variable that most closely correlated with the occurrence of the seven great market flood and ebb tides since 1900 was the change in valuation.³ Contrary to popular belief, it wasn't fluctuations in GDP, earnings, or interest rates. Accordingly, we believe we have a huge advantage when competing with those who declare themselves top-down agnostics. When qualifying companies for inclusion in our portfolio, there is considerable advantage in having some awareness of whether we might be navigating against the tide or with it.

¹ Mackay, Charles (1841). *Extraordinary Popular Delusions and the Madness of Crowds*. Richard Bentley.

² 2014 MCM annual report

³ Valuation measured by the average price-earnings ratio, also known as the cyclically adjusted P/E or CAPE. By using a 10-year moving average of real S&P reported earnings in the denominator of the P/E ratio, much of the cyclical volatility inherent in last twelve months (LTM) reported earnings is removed. The CAPE is consequently a stable measure of whether the markets are generally expensive or cheap.



Time Span	Shiller P/E		Annualized Rate of Change in		S&P 500 Real Annualized Return		
	Beginning	End	Shiller P/E	Shiller EPS	Capital Appreciation	Dividend Return	Total Return
1900-1921	18.5	6.1	(4.9%)	2.4%	(2.6%)	5.3%	2.6%
1922-1929	6.1	32.6	24.1%	(2.8%)	20.6%	6.2%	26.9%
1930-1949	22.0	10.5	(3.6%)	0.8%	(2.8%)	5.6%	2.7%
1950-1965	10.5	23.7	5.2%	3.8%	9.2%	4.7%	13.9%
1966-1981	23.7	7.8	(6.7%)	2.0%	(4.8%)	3.8%	(1.0%)
1982-1999	7.8	44.2	10.1%	0.7%	10.9%	3.5%	14.4%
2000-2015	44.2	25.9	(3.3%)	3.5%	0.1%	1.9%	2.0%

Regardless of whether one uses reported or 10-year moving average earnings, the message conveyed by the chart above is that, with the exception of the late 1990s, the market has rarely been this expensive. There's no forecast implicit in that statement, but there is a warning buried in the data: The market as a whole is anything but cheap. All the noise notwithstanding, the tides favor the prepared and the opportunistic.

So devastating, in fact, was the 90% decline in the Dow Jones Industrial Average from October 1929 to June 1932 and the Depression that followed, that chastised investors saw the glass of opportunity as half-empty well into the 1950s. When the tide had reached its low point in 1932, and again in April 1942, the depression mindset paralyzed rational thought. Looking in the rearview mirror, it was fear that people saw, not opportunity, staring them straight in the face!

Quite unlike the 1930s, the "technology innovation" bubble's 50% decline in the S&P from March 2000 through July 2002 had only a muted impact on investor sentiment. The damage was not universal, being confined largely to the information technology sector representing 30% of the S&P's value at the peak (and 13% at the bottom). The accompanying "growth recession" was comparatively mild as the Fed again intervened, driving short-term rates down from 6.5% in October 2000 to 1% by November 2003. Because the damage was not ubiquitous, most investors quickly shed any remnants of the fleeting glass-is-half-

empty fears and embraced the “financial innovation” bull market in housing and stocks. The “easy money fool’s rally” ensued, ending four years later in 2007. There was no dead low-tide moment.

The six months of purgatory from September 2008 to March 2009 again did not crush the momentum of the speculative contagion that had been building over time. Within a year of the bear-market low in March 2009 and the recession’s end three months later, risk taking ramped up at an unexpected clip during what may be remembered as the now seven-year-long, wide-open-spigot, “monetary intervention” bull market. Once again, the inevitable was postponed.

Entering 2016: A Bizarre World Addicted to Easy Money

The reigning delusion has been the elixir of artificially low interest rates. Ever since the Crash of 1987, the Fed has injected speculators with an “upper” every time a market swoon threatened to spill over into the real economy, with each hit needing to be stronger than the last. Finally, paranoid over the possibility of a repeat of the 1930s, the Fed progressed from syringe to IV drip in 2008, drugging short-term interest rates to zero and strong-arming longer-term rates lower through multiple quantitative easing (QE) programs. Going from high to high, investors have never been subjected to the withdrawal pains, which are the human cost of detoxification. December’s baby step toward raising short-term rates, and the equivocation about the course of rates ahead, makes Dr. Yellen the monetary physician who is administering methadone at the inconsequential rate of 10 mg per day. If we are ever to have a sound basis for rational expectations and stability to return to the capital markets, the drug of artificially low-cost credit must be withheld and the addicts must hit rock bottom, “recover[ing] their senses slowly, one by one.” If weaning a large cadre of financial junkies is not the Fed’s greatest nightmare, it should be.

Those addicted are not only the investors in marketable debt and equity securities. Others who buy and sell marketable assets of all stripes and locales are no less immune. As a case in point, consider pricing in the contemporary art market. It has become, well ... surreal. Characteristic of any bubble, and the antithesis of the typical supply-demand paradigm, as the prices of contemporary works of art have risen, so has the supply. By stark contrast, the enduring appeal of classic art is that its supply is fixed in the short run. Contemporary art is predominately the playground of the top 1%. It goes largely unnoticed by most investors—like the extravagant fad of cigar bars of the ’90s or the high-stakes poker games among hedge fund luminaries prior to the financial crisis.

Another pricing anomaly traceable in part to global ultra-accommodative monetary policy, the commercial real estate markets in the major U.S. business and financial hubs have reached prices almost 25% above pre-crisis peaks. That’s in spite of the moribund economic recovery. The oft-referenced Green Street Commercial Property Index, having fallen from 100 in September 2007 to 61.2 in May 2009, has doubled since to 122.7 as of this past November. Picture swashbuckling Donald Trump musing about the market for trophy commercial real estate properties! According to Fitch Ratings, loan-to-value ratios have been over 100% for the last two years, reaching 110.3% in late 2015, nearly identical to the record 110.7% in 2007. It’s the no-margin-of-safety way the real estate tycoons do business, and why, with no skin in the game, many shamelessly and perfunctorily seek bankruptcy protection when things go south. The pertinent question is, “Who are their creditors?”

Though there are many new and questionable places where such debt finds a home in this risk-indifferent environment, we single out only one because of its consistency in being the bag holder: the commercial banks. As of mid-2015, these institutions had extended \$1.7 trillion in commercial real estate loans. Solely for the purpose of establishing the magnitude of this figure, total U.S. bank Tier 1 equity capital was \$1.5 trillion at the end of the third quarter of last year.

Those of us who thought that investors would have “learned their lesson” from the near miss in 2008 seriously underestimated that the Fed, like the European Union’s iconic central banker Mario Draghi, “would do whatever it takes.” It appears that a post-Depression-era mentality, characterized by unwavering conservatism and acute risk aversion, cannot be deeply embedded in the investor psyche without a precipitating event of proportionate magnitude. Returning to the addiction analogy, hitting rock bottom is the prerequisite for a sustainable recovery, in no small measure because the commitment to never-take-another-drink-again sobriety—analogue to going cold turkey as a speculator—is the only hope. There is a bright side for recovering addicts. Most addicts admit that their former “high” life was an unsustainable illusion—that it would someday come crashing down. Despite the humiliation and suffering that ensue when they do hit bottom, many say that life on the wagon has never been better.

‘Baited’ for Another Crisis: The Many Iterations of the Securitization Game

In the run-up to our most recent financial debacle, the securitization “bait” was sugarcoated with Aaa/AAA ratings from Moody’s and Standard & Poor’s, and institutions snapped it up. Various iterations of securitizations spawned and competition mounted. Standards fell while creative financial engineering flourished. The rating agencies were chastised and repentant—at least for a while. Consequently, risk was pushed farther downstream to where we find ourselves today, where there are enough “fish” unable to distinguish between the latest threat: the real worm and the synthetic one. Where there is a need, Wall Street will fill it, often with something that looks good but without nutritional value, eventually causing acute indigestion!

Actively managed funds have become marketers, not managers, with \$9.7 trillion in total assets. Unmanaged index funds (\$2.1 trillion) have grown mightily to fill the disillusionment void and, as noted elsewhere, at what could be precisely the wrong time. Exchange traded funds (ETFs), given new larcenous license in 2002 by providing for the instant gratification of intraday trading, have sprung up like spring dandelions, with assets ballooning to \$2.1 trillion. Master limited partnerships (MLPs) have already become the disaster that we wrote was inevitable 21 months ago.⁴ Real estate investment trusts (REITs), with a market value of \$939 billion, along with a host of other packaged products, have proliferated to cash in on the demand from less well-informed retail investors, those motivated in this episode by need rather than greed. Naïve or foolish retail investors became speculators in residential real estate during the first half of this past decade. Since 2010 they have become speculators in these latest instruments of securitization. It seems inevitable that the outcomes will be similar.

In theory, financial intermediaries are the small fish’s advocate. In practice, however, they become predators, falling squarely in the “Don’t ask, don’t tell” camp. For these croupiers in the money game, righteousness is the shortest and quickest road to ruin. For investors who aren’t intimately familiar with how this sausage is made, *caveat emptor*. For those who have seen the just-released movie based on Michael Lewis’ *The Big Short*, no warning is necessary.

Understanding the Enemy

The idiosyncratic nature of human beings is our enemy within, unless we understand our proclivities. Extensive studies by behavioral economists reveal that most investors seem to view the market as a force of nature unto itself. They seem oblivious to the reality that they, collectively, determine the level of the market. Moreover, they underestimate how similar their own thinking is to that of other investors who read the same news and watch the same talking heads on tout TV. And the final straw is that they default into

⁴ Martin Capital Management Research Team (2014-04-02). “Master Limited Partnerships.”

believing that prices are rational because they are set by the “smart money” sophisticated institutional investors who dominate the markets. While the institutional cowboys change horses on average once each year (ranging between 25% for the lowest quintile and an astonishing 230% for the highest, according to Jack Bogle), most are always in one saddle or another since all shares of stock outstanding must be owned by someone all the time. Arbitrage, in whatever form, may smooth out pricing inefficiencies between securities, but it has little to do with the rational pricing of the market as a whole. This sum-of-the-parts model is adequate for assessing relative value but is surely ill-equipped for determining absolute value. Security analysis has a difficult time handicapping risks that are not company-specific.

Delving deeper into the psyche of individual investors, these same students of human behavior have produced convincing evidence showing that some people are reluctant to speak out and risk looking different or foolish if their views vary from their peers. Others, when reacting to widely held beliefs or the opinions of highly regarded experts, simply conclude that the majority or the experts must be right. These various and sundry experiments have led to one simple conclusion: People—more pertinently here, investors—are ready to accede to the opinions of the majority or a recognized authority even when those views are clearly in conflict with their own commonsensical judgments.

A 100-Year Flood?

Natural disasters like the record-setting Mississippi River flood now under way (as of this writing), the Fukushima tsunami in 2011, and the Haiti earthquake in 2010 that killed over 100,000 are deemed so unlikely that they are called 100-year events. Each had a presumed 1% probability of occurring within any given year. Importantly, if any one of these tragedies had not occurred in 99 years, the probability in the 100th year would still be 1%.

Man-made destruction, however, is a different animal. The Great Depression nearly a century ago decimated America’s financial and economic income and wealth. The devastation lingered for 10 years. It might be reasonable to call a business calamity of that magnitude a 100-year event. Unlike most events in nature, however, depressions are no more random than the volcano that inches year by year toward the earth’s crust and finally erupts. The probability of both bursting on the scene *increases* over time.

Extremely rare human-centric events like depressions recur precisely because memories of the past fade, and vigilance gives way to apathy. The preconditions develop insidiously, gradually, and cumulatively, so as to be well-established before becoming apparent. Even the impact of regulatory reactions to prior events—to make sure they “never happen again”—erodes over time as their apparent success is confirmed. Yet, they are most important when they appear to be least needed. One of the more telling recent examples was the 1998 repeal of the 1933 Glass-Steagall Act, which had erected a wall of separation between commercial and investment banking. Dodd-Frank was born a toothless tiger, undeserving of even honorable mention.

When the U.S. plunged into financial crisis in 2008, it was like so many stacked dominoes toppling. The essential point here is that the dominoes had gradually and unceremoniously grown in number over time. The progressively more complex financial system had reached a critical state, like a dangerous accumulation of snow on a mountainside, or a forest that over the years had accumulated an ever-thicker floor of dry tinder. Any complex system can remain in a critical state for a long time. However large or small, all it needs is a catalyst to start the chain reaction. Allowing Lehman no option but to file for bankruptcy may have been the trigger that gave Depression-era scholar and then Fed Chairman Ben Bernanke, along with the U.S. Treasury and a host of other government agencies, license to respond with extreme measures “to prevent another depression like the 1930s.” How is it that these learned officials were

not aware that the financial system was in a critical state before it became necessary to weigh in with the D-word? If they weren't then, is it logical to assume that they will be when and if there is a next time?

The Depression of the 1930s was not a random 100-year flood. The gradual placing of the dominoes that resulted in the Great Depression began many years earlier. The small-*d* depression of 1921, the last unmitigated depression, was as steep as it was brief. Identical in length to the recent Great Recession, in a mere 18 months the destabilizing post-war inflation had been stopped in its tracks, and within three years GDP broke into new high ground. Confidence in the natural resilience of the economy surged, and the Roaring '20s blossomed into full flower.

By sharp contrast, massive governmental intervention stopped whatever unknowable calamity might've been in the wings during 2008's financial crisis. The still unanswered questions are:

- Did intervention permanently fix the problem or simply postpone the inevitable?
- Were the dominoes removed—or at least buffers placed between them?
- Was the probability of a 100-year flood effectively reduced to 1%?

Among the more ominous of the many parallels between today and the 1920s is the disparity in income and wealth between the haves and the have-nots.⁵ Today's gap is exacerbated by the slow growth in the economy, leading to virtual stagnation in low and median incomes. Since the recession ended in June 2009 through year-end 2014, 58% of the *gains* in income, including those on capital, have accrued to the wealthiest 1% of Americans. The top 1% earned more than 21.2% of household income in 2014, rivaling the 24% share the top 1% earned in 1928, and the wealthiest 10% captured a near-record 49.9% of annual household income.

The ascension of the top 1% has not been an overnight phenomenon: Their share of household income in 2000, 2007, and 2012 was 21.5%, 23.5%, and 22.8%, respectively. The only other time span in modern history when the top 1%'s share of household income exceeded 20% was from 1925 to 1929. In recent history the populist response is to tax the rich. According to the IRS, the top 2% of earners—those who had their marginal tax rates raised from 35% to 39.6% in 2013—already pay nearly 50% of all income taxes. Ayn Rand's *Atlas Shrugged* gives a preview of just how far that idea can be pushed.

There is another solution. While surely long forgotten, the extreme disparity in the 1920s was resolved to the point of becoming a nonissue for the next 40 years for two reasons—one economic, the other political. First, though the '20s were a boon to the top 1%, the '30s were a bust as the value of capital assets and the income they produced collapsed. Second, Franklin Roosevelt, in retribution, imposed taxes reaching 80% on those with the highest incomes. Doubtless outside of anybody's political or economic model, what if the growing wealth and income disparity since 1980 is remedied in a way that betters the lot of no one in absolute terms—the same way it was in the '30s?

In light of Warren Buffett's exhortations before and after his 2007⁶ qualification that:

Over time, markets will do extraordinary, even bizarre, things. A single, big mistake could wipe out a long string of successes. We therefore need someone genetically programmed to recognize and avoid serious risks, including those never before encountered ...

⁵ Martin, Frank (2015-08-23). "Deflation: Improbable But Not Impossible."

⁶ Berkshire Hathaway 2006 Annual Report.

... it is unlikely the dire outcomes alluded to above would've fallen within that presumably narrower mandate. We are alert to the possibility of a variety of "black swans" that could wreak havoc on wealth. We will do our best to balance our pledge to grow your wealth against the overarching commitment to protect it against catastrophic investment risks.

Eternal vigilance is our only option. We go to great lengths to avoid getting caught up in groupthink at the risk of slavishly falling into lockstep with the majority. The consensus view of things and events to come is little more than simple extrapolation from the present. Most of the time, such mindlessness is no threat to one's financial well-being. But at inflection points, the majority inevitably plunges into the abyss together, a fate we're committed to avoid. Recognizing our species' tendency toward irrationality, the study of the patterns of history helps us remain centered, rational, and, ideally, away from the shoals during the ebb tides that inevitably will come. This truth of human nature cannot be overstated: There are no new eras, only new errors.

The Emperor Has No Clothes

Hans Christian Andersen's well-known fable is about a mass social delusion. The emperor's vanity made him susceptible to the entreaties of impostors who sell him an imaginary suit of clothes that will be invisible to all but those who are "in the know." Since neither his minions nor, eventually, his subjects wanted to admit that they were not privy to the special or secret information that he possessed, the charade cascaded into public spectacle.

Centuries later social psychologists have given the phenomenon an educated name: pluralistic ignorance. Put simply, it is *where no one believes, but everyone believes that everyone else believes*. A classic example is in a classroom setting where, after having presented the students with difficult material, the teacher asks them whether they have any questions. Even though most students do not understand the material, they may remain silent. The students interpret the lack of questions as a sign that the other students understood the material and, to avoid being publicly exposed as the stupid one, are reticent to ask questions themselves. Each student is aware of his or her ignorance with respect to some facts—but believes that other students are not ignorant of those same facts.

Pluralistic ignorance understandably can lead to errors on a grand scale. It's a social phenomenon for people to make systematic errors in judging other people's private attitudes. Nowhere is this more apparent today than in the public's perception of the U.S. Federal Reserve System, a secretive and largely unaccountable monopoly, with an unprecedented experimental monetary policy of driving the price of credit to zero for the last eight years and counting. Even though we ordinary folk grasp the illusion of the proverbial "free lunch," the Fed's material is infinitely more imposing than that presented by the aforementioned teacher. We assume that others are privy to the special powers that the Fed possesses, and thus we suspend our disbelief. *No one believes, but everyone believes that everyone else believes*.

This herding process is abetted by the imperial power of the Fed over an individual's free thinking and reasoning. As we have already seen, most people are ready to believe expert opinion even when those opinions contradict their matter-of-fact judgment. To be sure, confidence in the power of the Fed is not without basis or precedent. The prevailing prescription of applying the monetary palliative to truncate episodic maladies big or small began with Alan Greenspan in 1987 and continues (unexposed) to this day.

Modern-day, coin-of-the-realm emperors Alan Greenspan and Ben Bernanke, and now cleanup appointee Janet Yellen, were sequentially anointed with monarchical powers to rule over the bankers' bank *nonpareil*. Their ascension is like none other in democratic republics. Bernanke catapulted from obscurity to the

preeminence of the second most powerful office in Washington with the stroke of George W. Bush's pen. Pretty heady stuff for man whose ambitions were not so lofty. Greenspan, by contrast, acquiesced to the title of "Maestro" without so much as perfunctory protest, not unlike Donald Trump's moth-like attraction to the limelight.

Ambition and hubris—perhaps even vanity—have led many to succumb to the sirens' song. I cite no less of an authority than the father of capitalism, Adam Smith, who warned us of the perils of both the office and those who seek it:

[The conveyance of near dictatorial powers on a person who] should attempt to direct private people in what manner they ought to employ their capitals, would not only load himself with a most unnecessary attention, but assume an authority which could safely be trusted, not only to no single person, but to no counsel or Senate whatever, and which would nowhere be so dangerous as in the hands of a man who had the folly and presumption enough to fancy himself fit to exercise it.⁷

Nearly 200 years later, Friedrich Hayek, in his 1974 Nobel Prize acceptance speech, "The Pretense of Knowledge," contemporized Smith's admonition:

If man is not to do more harm than good in his efforts to improve the social order, he will have to learn that in this, as in all other fields where essential complexity of an organized kind prevails [such as in the modern market economy], he cannot acquire the full knowledge which would make mastery of the events possible ...

The recognition of the insuperable limits to his knowledge ought indeed to teach the student of society a lesson of humility which should guard him against becoming an accomplice in men's fatal striving to control society—a striving which makes him not only a tyrant over his fellows, but which may well make him the destroyer of a civilization which no brain has designed but which has grown from the free efforts of millions of individuals.

Hayek's central point is that too many in the one-step-removed world of ideas—or the lowly enterprise of politics—arrogantly believe they know enough to centrally plan or heavily regulate the diverse and ever-changing activities of everyone in a developed, complex, social system. Dr. Richard Ebeling, in his essay "Hayek's Warning: The Social Engineer's Pretense of Knowledge," argues that, in Hayek's view, no matter how intelligent, one cannot master all of these "multi-layered and interconnected different types of knowledge that only reside as dispersed and decentralized bits of information in the minds of the individual members of society."

In an era of increasing U.S. governmental intervention, free markets are morphing toward managed markets at the same time as China, in a most confusing on-and-off manner, is grudgingly freeing up some of its markets. As both countries are discovering, a mixed market may be the most problematic and destabilizing of all. Janet Yellen frequently comments that future Fed actions will be "data dependent." In such an incredibly complex system, what is measured is what is measurable, not necessarily what is meaningful. The Fed, in particular, relies on statistical averages and aggregates such as the general price and wage "levels" for the economy as a whole, then turns to postulating the absurd: the existence of empirical relationships between them. The real factors are those below this statistical, macroeconomic surface: those

⁷ Smith, Adam (2002-06-01). *An Inquiry into the Nature and Causes of the Wealth of Nations* (p. 313). Public Domain Books.

that determine the kinds and quantities of goods produced in the market, as well as the types and numbers of jobs available in different sectors. At the micro scale, it comes down to all the individual decisions by all the participants in the market system, each using his or her own unique combination of knowledge and judgment.

What connects and coordinates all of these multitudes of individual decisions and actions is the competitive *market price system*. It's that magical system that combines and integrates all the knowledge of all the people participating in the world of exchange. It is people's willingness and interest in borrowing to buy as consumers, along with their willingness and ability as suppliers to borrow and produce goods and services that comprise society's production and employment opportunities.

It doesn't take an economist to see what's happening. In a country addicted to credit, the "imperial" Fed has muscled its price down to zero, ostensibly for the initial purpose of reducing unemployment. And yet, in doing so, it has thrown the self-evolving price system out of its precious balance. When the cost of credit is held to levels well below what might be determined by a free, competitive exchange between creditor and debtor, traditionally prudent saving is discouraged and too often replaced with speculative endeavors in an attempt to make up the shortfall. On the other side of the ledger, reckless borrowing is encouraged. The litmus test for the efficacy of Fed policy involves answering the following questions: How would a 3%–5% increase in the nominal cost of credit affect the financial condition and behaviors of households, businesses, and governments? Conversely, if interest rates were to remain in the zero-bound range, naturally or by design, what could one infer about the financial and economic status of those same households, businesses, and governments?

Hayek prophetically cautioned in 1944 what became reality in 2008 when, in fear, we turned sharply to the left: "The danger is the greater because we may choose the wrong way, not by deliberation and concerted decision, but because we seem to be blundering into it."⁸

Andersen's emperor (for better or worse, he was in power for life or until deposed) had no choice but to march in stately procession before his subjects, parading in his underwear, his vanity exposed but with no place to hide. By contrast, today's monetary royalty has felt no obligation to hang around in office for eventual humiliation. Greenspan passed the baton to Bernanke just as the subprime crisis was erupting, and less than two years before the Great Recession. Bernanke, in revolving-door fashion, dished the hot potato crown to ambitious Janet Yellen in early 2014, just as the great unwinding of the process of monetary extremism was set to begin, its unintended effects still ahead.

Both Greenspan and Bernanke followed an all-too-familiar exit protocol, writing their own stories into the historical narrative. Greenspan's memoirs, *The Age of Turbulence: Adventures in a New World*, was an immediate sensation, topping Amazon's bestseller list on its second day, September 18, three weeks before the S&P peaked on October 11, 2007. Bernanke's *The Courage to Act: A Memoir of a Crisis and Its Aftermath* hit bookstores in September 2015, to almost no acclaim, immediately after cracks in the long-running bull market began to appear.

Having long been fascinated with the works of a number of great economic philosophers (and a few who seem to do it all like John Maynard Keynes), I attempt to read as much as possible of what is written by Federal Reserve Board chairmen—before, during and after their tenures. It is not an encouraging comparison.

⁸ Hayek, F. A. (2009-05-15). *The Road to Serfdom: Text and Documents—The Definitive Edition (The Collected Works of F. A. Hayek, Vol. 2)* (p. 29). University of Chicago Press. Kindle Edition.

Citing one example from Bernanke's memoirs, neither he nor Treasury secretaries Paulson (*On the Brink*) and Geithner (*Stress Test*), in their own memoirs, could come up with a credible explanation of why those who were calling the shots at the Fed and Treasury bailed out Bear Stearns in March 2008, only to let Lehman Brothers collapse into the biggest bankruptcy in U.S. history six months later, then the very next day rescue American International Group (AIG). (Counterfactual thinking has its limits, leaving us wanting, but rarely finding, the truth. We'll never know, had the Fed and Treasury refused to backstop the Bear Stearns takeover, if the onset of crisis would've been accelerated, yet, in the end, moderated.)

All accounts of those chillingly chaotic moments in American financial history, and the ad hoc reactionary macro policies that resulted, cause one to reflect once again on the words of Hayek (1944): "The danger is the greater because we may choose the wrong way, not by deliberation and concerted decision, but because we seem to be blundering into it."

Finally, unlike the disgraced emperor of fabledom, and like so many others from Washington, each one has found life abundant in the private sector after civil servanthood. Greenspan's consulting firm caters to the likes of PIMCO, Deutsche Bank, and hedge fund Paulson & Co. (by which he was engaged, interestingly, in January 2008), while Bernanke found a home as senior advisor to Ken Griffin's hedge fund Citadel. While the speaking-circuit lifecycle for retired Fed chairmen is not particularly long, it is lucrative. The stipend for Bernanke's first big speech, in symptomatically extreme Abu Dhabi (where New Year's Eve skyscraper fireworks out-trumped Trump), was an immodest \$250,000—more than Bernanke earned at the Fed the entire preceding year.

Some lessons about accountability transcend time. Among the architectural feats in ancient Rome, perhaps none is greater than the aqueducts. Built without structural steel or similar modern technologies, and withstanding two millennia of wars and natural disasters, many still stand as a tribute to design, engineering, and building skill. How have these aqueducts survived when later generations of buildings long ago crumbled into rubble? The key, I believe, is the way Roman builders were held personally accountable for their efforts. Legend has it that as the supporting scaffolding and other temporary buttressing were removed for the first time, the designers and chief engineers were required to stand beneath the arches. It was their code, their standard of professional performance, to be the first proof of their respective talents. It represented the ultimate show of confidence that the job was done right and the resulting product was ready for presentation to the world.

What if, as a condition of accepting the appointment to the aforementioned second most powerful post in the nation's capital, Greenspan and Bernanke had been required to stay until the buttresses and scaffolding of easy money supporting their monetary architecture were removed, not as a means of punishment but as an incentive for excellence? Might they have done things differently? À la Milton Friedman, might they have done nothing at all? What if the code were applied more universally? What about all the other governmental institutions? What about corporate America? Were this ethic embraced, the emperor would indeed have clothes. For the skeptics, among whom we would include ourselves, we certainly agree that, without taking that first step, one can never walk a figurative mile. As the gospel song states so simply, yet powerfully, "Let it begin with me!"

Very truly yours,

Frank K. Martin, CFA

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