MARTIN
CAPITAL MANAGEMENT, LLC
Registered Investment Advisor

QUARTERLY
CAPITAL MARKETS REVIEW

May 2015

The Confluence of Market Valuation and Behavioral Economics

The Q2 2014 QCM essay, "Slaying Goliath," tells the story of two modern-day Davids who outwitted and outlasted "the manic/depressive brute of a market that by dint of size and anonymity intimidates so many." Yale economist Robert Shiller incurred the ridicule of freshly-appointed Fed chairman Ben Bernanke in his inaugural speech on October 15, 2002. In testimony before the Fed on December 3, 1996, Shiller, using a rudimentary but reliable dividend/price regression model, deemed the market overvalued. In his address, Bernanke, intellectually cowering, conceded the superiority of Goliath: "*I do not know, of course, where the stock market will go tomorrow, much less in the longer run.*" Looking in the rearview mirror, he declared that Shiller's implicit estimate of the long-run value of the market had been too pessimistic and that any tightening of monetary policy in early 1997 "might have done more harm than good."

Another David, often referred to as Canada's Warren Buffett, more than a decade later stood figuratively shoulder-to-shoulder with Shiller in facing the monolith. Multi-billionaire Prem Watsa, iconoclastic founder, CEO and chairman of Toronto-based Fairfax Financial Holdings, a Berkshire-like insurance holding company, began aggressively hedging the company's risk assets in 2010 against the eventual "unintended consequences" of the Fed's desperate and unprecedented expansionary policies. No stranger to going against the grain of conventional wisdom, during the financial crisis years of 2007–2009, the book value of Fairfax *increased at a compounded rate of 40%*, growing from approximately $2.6 billion to nearly $7.4 billion, an outcome likely unmatched by any other similar company in the world. In his 2013 letter to shareholders, Watsa found himself once again in the role of David:

> In this environment, with zero interest rates and high debt levels prevailing in most developed countries, giving them limited flexibility to react to unintended consequences, we think it is prudent to have a very strong balance sheet with a large cash position and to be protected on the downside. When problems hit, only those with cash and very liquid assets can take advantage of them. While it is very painful and costly waiting, we think your (and our!) patience will be rewarded. We are reminded again of the warning from the distant past from our mentor, Ben Graham, which I have quoted before: "Only 1 in 100 survived the 1929–1932 debacle if one was not bearish in 1925." We continue to be early—and bearish!

Intent on getting to the bottom of the Graham quotation, I followed up in Q3 with an exploration entitled, "Why 1925?" The more history I read, the more credible Graham's insight became and, of no surprise, the more my admiration and respect for Bob Shiller and Prem Watsa grew.

On April 15, 2015, I found myself in the uncomfortable place of being a keynote speaker at the Ivey Value Investor Conference in Toronto. The subject? "Why We Worry Top-Down and Invest Bottom-Up." Staying with the centerpiece theme from the MCM 2014 annual report, the talk zeroed in on the two most important and interrelated determinants of total real investment returns for the seven major ebb- and flood-tide cycles since 1900: market valuation and behavioral economics. (The video and accompanying transcript of the speech can be found on our website at https://www.mcmadvisors.com/newsmaterials/)

Parenthetically, subsequent to distributing our 2014 annual report, Bob Shiller released his third edition of *Irrational Exuberance*. In an Amazon review written on the book my unabashed admiration for Shiller and his prescient and timely insights was made clear. Shiller, like few others, has been able to integrate art and science in identifying major market fluctuations. A leading proponent of the post-1980 resurrected art of behavioral economics, Shiller has challenged the supremacy of math-centric modern portfolio theory and its companion, the efficient market hypothesis. Tacit acknowledgment of this modern-day David emerged when the 2013 Nobel Prize in Economics was split between Shiller and leading efficient-market theorist, Eugene Fama. In his quantitative CAPE (Cyclically Adjusted P/E)—corroborated by Tobin's Q and the Market Capitalization to GDP Ratio—Shiller crossbred science and art. Those who studied and applied the lessons from the first and second editions of *Irrational Exuberance*, published in March 2000 and March 2005, respectively, were spared the two worst bear markets since 1973–74.

If an investor reads just one book in 2015 it should be the third edition of *Irrational Exuberance*. In similar fashion, if one reads only one 10-K annual report this year, it should be Fairfax Financial's. Neither document is the talk of Wall Street. Because the world thinks only in the here and now, the warnings of those who are ahead of the times go unheeded. That's the way it is and that's the way it has always been. Were it otherwise, we'd all be rich! While on the subject of the deservedly and perpetually rich, we were in attendance at the 50th anniversary Berkshire Hathaway annual meeting on May 2. The percentage of Berkshire's $526 *billion* in assets committed to marketable equity securities gradually continues to shrink, and currently stands at 22%. Accordingly, Warren and Charlie are less inclined to opine on the markets. That said, the expanded 2014 Berkshire Hathaway annual report is a must-read for the serious businessman and/or investor.

Hummingbird Partners

In line with our long-held convictions and the implicit imperative from Bob Shiller and Prem Watsa, we have created an alternate vehicle that we believe positions us to navigate the wealth-threatening times that lie ahead. In essence, Hummingbird Partners allows us to play both offense *and* defense in our investments. We are confident, based on the great secular tides of the past, that there will be an opportunity set unparalleled in recent history; it will be, as has always been the case, camouflaged as a disaster.

Current clients will receive a copy of Frequently Asked Questions and a short presentation on Hummingbird Partners. We have received strong interest in this vehicle and will begin trading in the early third quarter of this year.

Frank K. Martin, CFA
May 2015
frank@mcmadvisors.com

First-Quarter 2015 Portfolio Review

	MCM Total Account Composite (net of fees)	S&P 500
1st Qtr 2015	-1.9%	1.0%
Since Inception *	4.8%	4.2%

* Annualized, Inception Date 1/1/2000

Martin Capital Management's Total Account Composite declined 1.9% in the first quarter of 2015, while the S&P 500 Index returned 1.0%. Overall, the equities in our portfolio were down 5.7%. The table below shows we sustained unusually large quotational losses during the first quarter in three specific, albeit relatively small, positions.

Company	Model+ Position Size	Q1 Price Change++
Berkshire Hathaway Inc	5.2%	-3.9%
Gentex Corp	4.8%	1.3%
Travelers Cos Inc	3.4%	2.2%
Wal-Mart Stores Inc	2.8%	-4.2%
Amgen Inc	2.6%	0.4%
Baker Hughes Inc	2.3%	13.4%
Helmerich and Payne Inc	2.2%	1.0%
Rosetta Resources Inc	1.6%	-23.7%
Stryker Corp	1.5%	-2.2%
AbbVie Inc	1.4%	-10.5%
Civeo Corp	1.3%	-38.2%
Garmin Ltd	1.2%	-10.1%
Colfax Corp	0.7%	-7.4%
Rayonier Advanced Materials Inc	0.7%	-33.2%

++ Price Change reflects only the market price difference from the beginning of the quarter to quarter end. It does not include dividends and interest.

• 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.

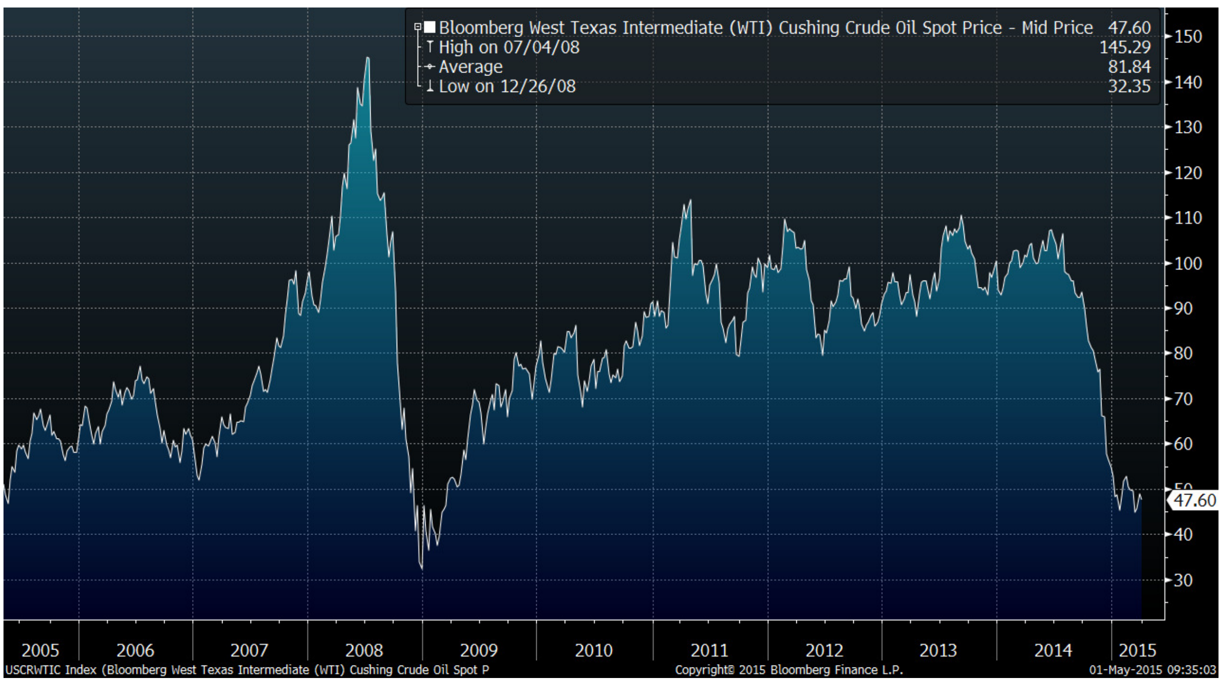
• The MCM Total Account Composite is managed in accordance with our Model Portfolio. The Model Portfolio is a representation of fully discretionary accounts positioned to conform to our ideal investment process. The primary investment objective for both the Total Account Composite and Model Portfolio 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.

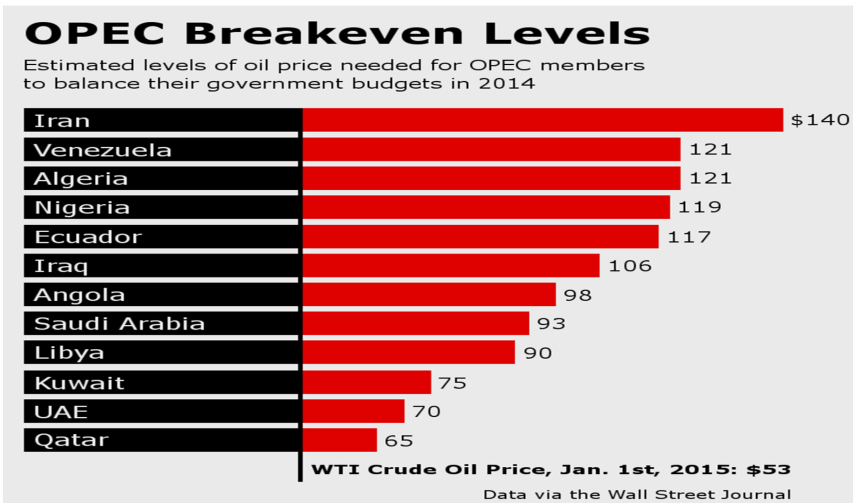
As *long-term value* investors we often find ourselves looking for undervalued investment ideas in *presently* unpopular sectors. The "whys" of unpopularity are too numerous to list, and predicting when a particular company or asset will grow or wane in popularity is not something we attempt to do. Concerned with short-term performance, many market participants ultimately buy or sell stocks based on the latest headlines and short-term estimates instead of long-term fundamentals. This is what Benjamin Graham meant when he said, "in the short run the market is a voting machine." That is, investor sentiment drives prices in the short run.

On the contrary, over the longer-term a business' value is ultimately tied to its underlying operating performance (profits). It isn't a coincidence that since the beginning of the 20th century the price of the S&P 500 and its underlying earnings has grown at a rate of 6% per year. That is why Graham also said, "in the long run the market is a weighing machine." That is, profits drive prices in the long run.



A recent example of short-term sentiment trumping long-term fundamentals may be the recent decline in oil. Oil prices have garnered a lot of attention lately, declining ~50% since July 2014. The declines come after a period of domestic production growth, strong investor interest in energy, and roughly three years of stable prices averaging well over $90/bbl. Paired with the increase in domestic oil and gas supplies, demand has weakened since the financial crisis amid slower economic growth and greater energy efficiencies, particularly in developed economies. These factors combined to have a dampening effect on oil prices. Then, in November 2014, oil prices fell to fresh lows in response to OPEC's decision to maintain production in spite of growing supplies and oil prices that had already fallen 30% to ~$80/bbl.

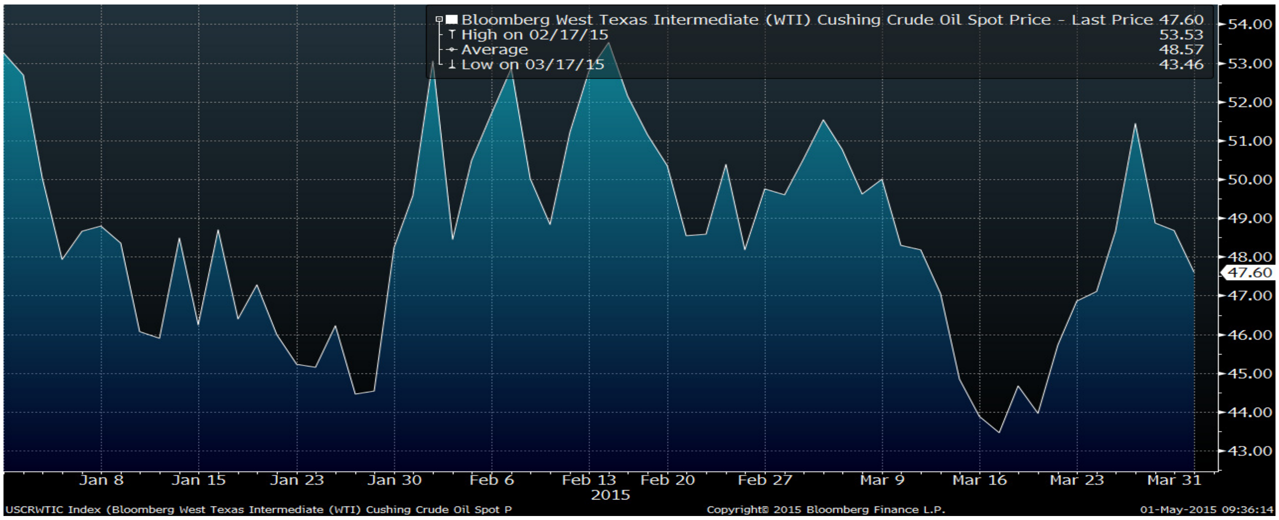
This decline in oil prices caused shares of oil related stocks to fall sharply, affording us the opportunity to buy shares in four companies at attractive valuations from investors we suspected were predominantly concerned with the recent decline in prices. When we wrote to you in December, having committed approximately 8% of your capital to the energy sector, WTI (see chart above) had already fallen to $60/bbl. We could not have known nor did we try to predict that oil would fall below $45/bbl during the first quarter of the year. As of this writing, WTI is back above $60. The number of variables involving world supplies, demand challenges and geopolitics in the Middle East makes such an analysis not only difficult, but subject to constant change. Nonetheless, and ignoring the potential for an extreme geopolitical event to take place among large energy suppliers (the Middle East, Russia and Venezuela, to name a few) that could send the price of oil sharply upward, we note that many energy-dependent economies in the world require substantially higher oil prices merely to balance budgets. Although we have no idea where oil prices are headed in the short run, in light of anything short of a global economic recession, we would not be surprised if prices were higher several years down the road.



Despite today's uncertainty surrounding oil prices, we are confident the underlying investments we have made in businesses tied to the oil and gas industry will generate positive returns in the long run. Our confidence derives from three sources:

- Each company possesses specific competitive strengths in their respective markets.
- With one exception, we invested in firms that make their living by serving exploration and production (E&P) companies.
- We sought to purchase companies with conservative balance sheets or the means to improve their financial condition.

For these reasons, we have confidence in the ability of these businesses to weather a period of low oil prices, and to prosper as valuations stabilize and rebound. In the short-term, though, their stock prices and operating results are not immune to falling oil prices or negative investor sentiment. As noted in the performance table, we did not buy these companies at their lows! At quarter end, Helmerich & Payne and Baker Hughes were trading above cost, while Rosetta Resources and Civeo were not. Read on for further detail regarding each of these positions.



Equity Updates

Rosetta Resources (ROSE)

ROSE is an independent oil and gas exploration and production company with low cost reserves and a significant portion of its 2015 and 2016 production hedged. Its operations are primarily in the Eagle Ford Shale (Texas), where it can produce profitably so long as prices are above ~$30/bbl. Additionally, wells drilled in the company's newly acquired Permian Basin acreage have thus far shown promise, being able to produce oil profitably at ~$45/bbl. What is more, approximately 75% of its 2015 projected oil production is hedged at $90 and a further 40% of 2016 production is hedged at $90, helping to protect cash flow despite today's low prices. ROSE is reasonably well capitalized, with no long-term debt maturities prior to 2021. As long-term investors, the company's low-cost assets, strong near-term hedges and reasonable balance sheet give us confidence in our investment. We expect the market to place a higher valuation on ROSE as oil prices stabilize. This, paired with ROSE's ability to increase production and earnings as prices rebound, provides our investment with two potential drivers of returns in the future.

Civeo (CVEO)

CVEO was our other poor performer tied to the energy sector. A provider of permanent, long-term and temporary accommodations, often referred to as "man camps", CVEO largely serves workers associated with the Canadian oil sands and the Australian metallurgical coal ("met coal") mining industries. Aside from lodging, CVEO also provides catering and housekeeping services, recreation facilities, and utilities to its customers.

We made our first purchase in CVEO after it its share price had already collapsed 70% from its highs, in response to its decision not to convert to a REIT structure. The company's shares then declined further after announcing it would suspend its dividend amid falling oil prices. These two events elicited selloffs that resulted in a virtual 100% turnover in shareholder base. Contrary to the market's response, we believed both decisions were prudent measures for the company to take in light of its balance sheet and its sensitivity to

E&P companies' capital budgets. We also believed buying into such distress would alleviate much of the downside risk at the time of purchase.

We have devoted much work to gaining a better appreciation for the company's ability to weather a sustained period of low commodity prices, and also increasing our understanding of the competitive landscape. Our work has led to us to believe the company has the capacity to take measures over the coming months to strengthen its balance sheet and increase its flexibility in the face of continued weakness in commodity prices. We also feel confident that investor sentiment will improve once the Company finalizes its refinancing arrangements in conjunction with its redomicile, thus alleviating much of the uncertainty surrounding its balance sheet. Our average cost in CVEO is $6.15/share, having bought half our position at ~$8.16/share and the other half at ~$4.11/share. The stock arguably has the best risk-reward potential of our four energy-related investments. Oil price stability, even absent a return to $90 oil, will help drive capital investment decisions into new oil sands projects in Canada. In the meantime, as the market-leading provider of third-party accommodations, we anticipate continued success for CVEO as opportunities to win contracts for maintenance projects in the oil sands and new projects in natural gas pipelines and liquefied natural gas (LNG) arise.

Helmrich & Payne (HP)

Tulsa, Oklahoma-based HP drills oil and gas wells on a contractual basis for producers in three different market segments: U.S. Land, Offshore and International Land. HP's U.S. Land accounts comprise 84% of FY 2014 revenues, making it the leader in the U.S. onshore drilling market with one of the most modern and capable land drilling fleets. It owns over a third of the market for AC drive rigs, the most efficient drilling technology available today. Overall, HP has a 16% share of the total U.S. land rig market. The company is conservatively financed, with long-term debt amounting to 11% of total capital. We believe the current downturn will ultimately prove to be an opportunity for HP to take additional market share and further strengthen its position in the rig market.

Baker Hughes (BHI)

Last, but certainly not least among our energy-related positions, is BHI. On November 18, 2014, Halliburton announced it would acquire BHI for $34.6 billion. BHI, with revenue of $22.4 billion in 2013, is the world's third-largest integrated oilfield services company, after Schlumberger, Ltd. (SLB) and Halliburton (HAL). The combined company would have a dominant position in North America with 39% market share, double the size of Schlumberger in North America. More important, it will become a much stronger competitor to Schlumberger in international markets. At the time of our investment in BHI, an approximate 15% discount existed between BHI's share price and the terms of the acquisition. The discount reflects investors' uncertainty regarding whether or not the proposed deal will actually be completed and the potential of further weakness in oil prices. While shareholders of both companies have approved the transaction, the deal is awaiting regulatory approval, however, and is expected to close in the second half of this year. At quarter end, the discount had narrowed to roughly 7%. As we look ahead in anticipation of the deal receiving regulatory approval, we believe the combined company is a strong position. It should have strong liquidity with an interest coverage ratio of greater than 8 and $3 billion cash on hand. We believe the merger ultimately will create a stronger company with sound financials to weather oil price volatility and the ability to leverage its combined competitive position to gain market share in the future, especially in a low oil price environment.

Rayonier Advanced Materials (RYAM)

Another position that faced considerable headwinds in the first quarter was RYAM. It is the world's leading supplier of specialty cellulose, a relatively high-value, organic polymer used for cigarette filters, LCD screens, coatings, food products and pharmaceuticals. Specialty cellulose is technologically demanding in its production and is engineered to exacting customer standards, providing significant barriers to entry. As evidence, there has only been one new entrant to the industry in more than two decades.

RYAM was spun off from its parent, Rayonier (RYN), at over $40, though share prices had fallen by half at the time of our purchase at ~$22. The decline was in response to multiple headwinds. Several acetate tow manufacturers, which purchase specialty cellulose from RYAM, announced plans to destock inventory, which has created a temporarily over-supplied market. The recent departure of a large customer has also raised uncertainties about the stability of long-term contracts; RYAM, however, has been able to replace most of the lost volume by increasing volume with other customers. Last, yet not insignificantly, RYAM generates approximately 55% of its revenue in overseas markets, so the strong dollar of late has created foreign exchange headwinds. In every case, we are confident these are temporary hurdles for the company.

Simply stated, the market appears to be undervaluing the company's assets, which we value to be worth ~$24/share based on the replacement value of its production capacity. We believe this not only protects our downside but also provides our investment with upside. Additionally, management is focused on reducing costs by $40 million and re-energizing product development following the spin-off from its former parent company. Progress on either front, in addition to the reversal of the temporary headwinds we have already discussed, will increase the value of the business and, ultimately, the stock.

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The first lesson in Investment 101 is "buy low, sell high." It sounds so obvious, but it's anything but easy. What the instructor often fails to mention is that when prices are low, there is usually a reason. And that reason, more often than not, is that the news is bad and getting worse. This kind of environment favors those who keep their heads, tune out the news and concentrate on rationally determining the value of a business. Since only a novice would expect to buy at the bottom, it is almost a certainty that the price will fall further after an initial purchase is made. That's why we don't expend all of our powder on the first shot! Two wonderful outcomes occur if the price happens to fall further. First, the margin of safety expands and secondly, the potential return increases.

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