May 2016

"Capitalism is the astounding belief that the wickedest of men will do the wickedest of things for the greatest good of everyone."

—Attributed to John Maynard Keynes, 1936

First Quarter 2016 in Review

The first-quarter price pattern of a number of important markets resembled a "W," like a roller coaster that ends on the level where it began but with lots of screaming in between. After spending the last two months of 2015 attempting to ascend the old highs, the S&P 500 hit its first freefall beginning on the initial trading day of the New Year, slumping 11.3% by January 20. On an intraday basis, the S&P then bounded upward 7.4% by February 1, only to plunge again to retest the lows on February 11. Trading volume was about 50% above its average. It spent the last six weeks of the quarter ratcheting back to just above where the year began, thus completing the W. Legendary snoozer Rip van Winkle would've called it a yawner.

Seemingly joined at the hip for the ride, West Texas Intermediate crude oil (WTI) hit a double bottom at $26 on precisely the same days as the S&P. It finished the quarter at $38. Unlike the equity market benchmark, however, those lows were particularly disheartening. By sharp contrast to the S&P 500, oil's swoon started 18 months earlier at $107. By almost anyone's measure, a decline of 75% is a disaster, perhaps a portentous one?

In like fashion, Bloomberg's Commodity Index, which includes grains, metals, livestock, foodstuffs, and cotton, as well as hydrocarbons, double-bottomed within a day or two of the S&P. Like WTI oil, the index of commodity prices had been trending lower for a long time. After peaking at 175 in 2011, it fell to 72.50 in January, a decline of almost 60%. The bounce off the bottoms of both commodity measures certainly looks like the "dead cat" variety.

Also of note, the top 10 contributors to the S&P's performance in 2015, mostly new-economy favorites, were conspicuous by their absence in the first quarter. Only Facebook and Berkshire made an appearance, finding themselves in fourth and fifth place, respectively, behind prosaic Verizon, AT&T, and Exxon Mobil, which exhibited a stunning turnabout since it was the worst contributor to S&P performance in 2015. IBM and Walmart (WMT was No. 6 in the list of laggards in 2015), were among the top 10 contributors in the first quarter.

Four of the first quarter's five biggest laggards were Bank of America, Citigroup, Wells Fargo, and J.P. Morgan Chase. Amazon, in second place, was the fifth. In another striking reversal of popularity, Amazon was, by a wide margin, the greatest contributor to the performance of the S&P in 2015. The remainder of the top 10 laggards were pharmaceutical or biotech companies. "Today's darlings are tomorrow's dogs" is an aphorism as old as Wall Street. Its reciprocal, in much more modest proportions, is our theme song.

Looking Beyond the Moment

As an aside for the purpose of making the reading of this letter more informative, we, as your investment managers, fastidiously strive for continuity of thought in our communications with you, as if someone might actually sit down and read our letters sequentially—like the chapters in a book. Though trudging through *A Decade of Delusions*[1] (which originated as a series of Martin Capital Management annual reports by this writer) will test the mettle of even the heartiest, perusing MCM's 2014 and 2015 annual reports will be less daunting and arduous and nearly as informative.

Writing on the assumption that what you communicate will be given little weight today but will be judged for its efficacy in the cold light of a distant tomorrow, say five years hence, makes one rather circumspect—and tends to check the inclination toward irrationality. Our annual letters are our most earnest, thorough, and thought-provoking, if not provocative, endeavor. Quarterly letters are more concise and time-specific (quarterly versus annual), will build on the annual letter's themes, often re-emphasizing points made relevant because of subsequent market, financial, or economic developments as the year evolves.

Returning to the quarterly task at hand, other than the fact that the three indicators tracked similar W patterns, they are mentioned together because of the quizzical dichotomy they portray. From 1990, when the Bloomberg Commodity Index was introduced, until 2011, it correlated positively and well with S&P earnings. The post-Great Recession rationale has been that global demand was on average outstripping supply, and rising commodity prices were deemed a measure of economic resurgence. In 2011 that symbiotic relationship abruptly ended, with the commodity index collapsing while S&P earnings continued to rise through 2014.

Adding to the paradox, even though S&P 500 profit margins peaked in the third quarter of 2014—and began a steady descent from 9.7% to the current rate of 8.0%—the index itself has remained resilient, ending the first quarter of 2016 within 3.3% of the high established on May 21, 2015, and at a price-earnings ratio of 19, near a six-year high. To frame the current S&P fundamentals in the longer-term context, in the five years through the third quarter of 2014, profit margins tripled to a record, and S&P earnings expanded at an unsustainable average rate of 11% versus 5% for revenues.

Although energy producers are the headline margin collapse culprits, six of the other 10 S&P sectors are forecasted to report lower margins in the quarter just past. The S&P profit's soft underbelly may well be stubbornly low productivity or employee output per hour. While not the stuff of cover stories, over the last five years, productivity gains averaged 0.5%, the weakest showing since 1978–82. Without additional monetary (or fiscal) stimulus, profit-margin erosion of this magnitude has signaled every recession since 1952. Stated another way, on only one occasion since 1948 did a significant eight-quarter profit contraction not precede a recession, albeit the variance in lead times renders the indicator largely ineffective from a timing point of view. Though it may be mere coincidence that the bull market is within a week of becoming the second longest on record, it might be unwise to be flippantly dismissive of such a range of reality checks, particularly when market valuation measures are at nosebleed levels.

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[1] Martin, Frank K., A *Decade of Delusions: From Speculative Contagion to the Great Recession*, John Wiley & Sons, 2011.

Tobin's Q, to offer a change in vantage points from Bob Shiller's CAPE (cyclically adjusted price-earnings ratio), is currently in rarefied air and, if history is any guide, will eventually suffer from acrophobia. It is the ratio resulting from the division of the total market value of U.S. equities by their replacement cost, which (fortunately), given the nature of the task, is regularly provided by the Fed in its Z.1 statistical release. The ratio topped out between 98% and 109% during four of the five secular bull market peaks since 1900, which were followed by bottoms between 28% and 32%. The outlier on the upside was 2000 when the ratio reached 161%. At the bear market lows in 2009, the Q ratio declined to 54%, well above the prior secular lows. Today the ratio is 102%, having reached 109% in 2015. Dr. Tobin's data corroborate the secular ebb-and-flood tides, which were the primary subject of Martin Capital Management's 2014 annual report. If the markets have become a casino, of which Keynes warned in 1936, I'd rather be the house.

The Invisible 800-Pound Gorilla

Most investment managers declare themselves macro agnostic. After all, research and portfolio management are difficult enough in their own right. Attempts to blend top-down factors into the equation, including the macroeconomic and all its subsets—or, for that matter, social or psychological forces (i.e., behavioral economics)—add, managers would argue, enough to the degree of difficulty that the process is rendered so unwieldy as to be an exercise in futility. Most of the time we find ourselves sympathetic with that point of view. There are occasions, though, when a sense of the big picture proves to be invaluable. That there would be a meltdown of epic proportions following the escalating financial, real-estate, and other interdependent madness during the first half of the first decade of the new millennium was self-evident to those with a wide-angle worldview lens.[2] That the complex system, in a critical state for some time, would implode in 2007 to 2009 was unknowable, as was the U.S. government's response. As for the timing, not knowing precisely *when* seems rather insignificant now.

Rather, it has been the ad hoc and forever reactionary randomness of the governmental response that has made the post-2010 economic and financial environment so problematic for investors. Those macro agnostics without a top-down view must feel they are stumbling about in a maze. Or, worse yet, things have become so complex and unpredictable that they have simply defaulted into the posture of "disaster myopia."

The aforementioned gorilla is the growing burden of largely unproductive debt about which we have written on numerous occasions in the past, including last year's annual letter. From 1955 to 2000, it took about $1.70 of debt to generate $1.00 of nominal GDP. Since 2000, when non-financial debt-to-GDP ratios reached extreme levels, it has taken an average $3.30 of incremental debt to generate that same $1.00 in GDP. The trend continues. In 2015 nominal GDP rose by $549 billion, whereas non-financial debt rose by $1.912 trillion, 3½ times faster.[3] Borrowing to consume shifts future spending to the present. Accordingly, GDP was given a modest boost last year, but as debt levels rise relative to GDP, any gains today will be overshadowed by suffocating debt tomorrow.

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[2] Martin, Frank K., *A Decade of Delusions: From Speculative Contagion to the Great Recession*, John Wiley & Sons, 2011. Chapter 9 (2005 and 2006 MCM annual report excerpts) includes subtitles "The Perfect Storm?," "The Blossoming of the Financial Economy: The Cataclysm in the Creation of Credit," "Bubbles Are Indigenous to the Financial Economy," and "If Housing Prices Roll Over." Chapter 10 (2007 MCM annual report excerpts) included a draft of a letter to clients in 2007 proposing a strategy to buy put options on selected investment banks, as well as subtitles that included "Edging toward the Precipice" and "Credit-Default Swap Alchemy: Transmuting Junk into Gold."
[3] *Hoisington Quarterly Review and Outlook*—1Q 2016

Although much publicity has focused on the reduction in the ratio of household debt-to-GDP, at 78.3% as of year-end 2015, it is still 20 percentage points above the average dating back to 1952. After a period of repentance, credit standards are once again trending lower. Subprime auto loans are the highest percentage of total auto loans in the last 10 years. According to Fed data, 34% of auto sales last year were funded by 72-month loans, with negative equity likely to reach a 10-year high of 31.4% later in 2016. Because leasing has regained popularity, this off-balance sheet activity causes household debt ratios to be understated. Student loans, another potential flashpoint, are simply too susceptible to whimsy in this highly politicized environment to warrant the attention they would otherwise deserve.

In 2015 on- and off-balance sheet business debt rose by $793 billion, whereas total gross private domestic investment (including spending on fixed assets and inventory) grew by only $93 billion. Re-emphasizing the increasingly unproductive nature of debt-financed spending, $700 billion in borrowing went to share buybacks, dividends, and other financial activities, none of which undergirds growth at the micro level. In 2015 the ratio of business debt-to-GDP reached 70.4%, almost 20 percentage points above its historical average. Only once in the last six decades has the ratio been higher, and that was 2008.

Much has been written about U.S. government debt, excluding off-balance-sheet items, which totaled $18.9 trillion as of year-end 2015. That's 104% of GDP compared with a six-decade average of 55.2%. Perhaps the pre-eminent scholars on the subject, Ken Rogoff and Carmen Reinhart,[4] argue that GDP growth slows to a snail's pace once government-debt levels exceed 90% of GDP. It also needs to be said that their conclusions are steeped in controversy among economists.

Wrapping up this argument, the over-indebtedness of the four largest global trading blocs that constitute 60% of global GDP—the U.S., the EU, China, and Japan, in that order—have emasculated the impact of the most expansive monetary policies ever imagined, let alone implemented. Nominal GDP in the U.S., staying close to home, grew at 5.8% in 2010, compared with 3.6% in 2015, the worst since the Great Recession year of 2009. Based on historical experience, central banks appear to lose control over money growth when debt is extremely high. Once again we turn to the productivity of debt. When it's low, as it is today, unproductive or counterproductive debt—that used to finance consumption or financial engineering rather than investment spending—results in declining money growth (M2) and velocity. China is a story unto itself and may be addressed in next quarter's letter. Suffice it to say, the world's major developed economies may have reached the point at which further stimulus, whether monetary and/or fiscal, could prove to be increasingly counterproductive.

Value and Price: Joined at the Hip

"The proof of the pudding …" is an oft misused adage because, as stated, it is incomplete: "… is in the eating" finishes both the thought and the sentence. The term *value investing* also is frequently misapplied at least insofar as the proof cannot be found in the eating. The portflios of presumed value investors sometimes fail

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[4] Reinhart, Carmen M., & Rogoff, Kenneth (2009). *This Time Is Different*, Princeton University Press, Kindle Edition.

to resemble their name. The conundrum value investors face—and the reason managers often drift from their philosophical moorings—is that the here-and-now pressure to produce short-term results out of fear of losing one's job is in inherent conflict with the near-stoic patience that is the hallmark of true value investing. Moreover, in deep down cycles, the only catalyst—and we're all looking for catalysts by which undervaluation becomes fair valuation—is often the depressed price itself, as if cause and effect were one and the same. Not much to hang your hat (or career) on …

For chief investment officers in their role as portfolio managers, there are means to mollify the probable short-term underperformance misery of value investing in other than the made-to-order, utopian environments of desperately cheap markets overflowing with ridiculously underpriced companies. First and foremost, one must never waver from the discipline required to live out this mantra: "Make your purchase so attractive that even a mediocre sale gives good results." The majority of the companies we own, weighted by position size, are out of favor in general and were purchased when they were particularly unwanted. Sir John Templeton advised, "Buy at the point of maximum pessimism." While that moment is never known until after the fact (sometimes *long* after the fact), to live by that maxim it is only necessary that one be generally right. If you happen to be early, as is often the case (and the reason why our initial purchases are usually comparatively modest vis-à-vis what we would really like to own if the prices were much lower), falling prices provide a real upper, a chance to buy more of a good idea even more advantageously.

A singular advantage—apart from the many disadvantages—we have over the owners of private companies, is that the shares of public companies are on the auction block every business day. Most of the time those markets are orderly and businesslike, but sometimes they act like, well, Ben Graham's allegorical Mr. Market. Mustering the courage to go against the grain of popular sentiment time and again, to live with the stigma of always being a member of the seemingly out of touch minority, is why the technique is not widely practiced.

Markets That Drive Even the Best Crazy

The second book I read as a young investor was Gerald Loeb's *Battle for Investment Survival*, first published in 1934, the same year Ben Graham's seminal *Security Analysis* hit the bookstores, which was my first. Both backward looking, they poignantly explained to the reader what one should not do in heady times; that is, they were of no value for those who had been wiped out by the time the books were originally published. When treasure troves of wisdom and experience are most needed, perhaps even today, they are least sought after. Graham's 1934 edition is ranked No. 81,165 on Amazon's bestseller list. We consider that information a powerful and easily obtained competitive advantage. If everyone is thinking alike (i.e., they are not studying Graham), then somebody isn't thinking. No dust is gathering on our treasured copies of Graham's '34 edition.

More pragmatically, Berkshire's Charlie Munger is famous for the pioneering concept of inverting as an investor, of thinking backwards to find one's way to the beginning of an idea or concept. In our application, an advantage can be gained in the competitive world of active investment management by preparing for the unknown by inverting, reasoning backwards to attempt to learn how others in the past have coped with the unforeseeable and the unpredictable. Graham's *Memoirs* are better for that purpose than *Security Analysis*. Yet a step further, it seems more instructive to study the behaviors of those who have fallen short. As outsiders, we'll never know whether the successful were lucky or smart, whether or not serendipity played an outsized role. With the failures, particularly among the contrite, it's much easier to separate bad luck from bad judgment.

Two hedge fund luminaries, for whom we have great respect and whose long-term track records are most impressive, racked up dismal performance in 2015 and, at least in one case, has continued to seriously underperform through the first quarter of 2016. Both have written extensively about where they think they went wrong with at least some degree of objectivity. We've learned much, and so far it has all been vicarious. We will make mistakes, although we would not expect them to be of that magnitude, which then will be acknowledged in a contrite letter of our own sometime in the future. Moreover, as we survey the landscape of those we admire most, the performance of many has sunk well below their historical norms in the surreal investment environment that has existed since 2010.

While much of what we have gleaned will remain proprietary (our intellectual property being our principal asset!), some behaviors are simply so audaciously institutionalized that to call them out will not so much as move the needle in changing the way the vast majority do business. One of my favorite Gen. George S. Patton quotes is this kernel of wisdom: "Don't fight a battle if you don't gain anything by winning." Much of this quarterly letter is bent on arguing that the odds do not currently favor the fully invested, buy-and-hold investor. And yet, even at the risk of losing the war, most of our competitors are fully engaged in a battle that, even if they're lucky enough to win, they will gain little—and in the process risk much.

We protect portfolios against catastrophic risks by first owning anti-fragile[5] businesses purchased when, because of impassioned selling that seems out of proportion with the realities, they were fundamentally cheap. If we have more cash than ideas (the unpleasant predicament in which we currently find ourselves), we safe-harbor what we don't invest in the most "abhorred" asset of all—cash. We know of no one who has been successful in a falling market selling something that is cheap to buy something that is cheaper. The psychological complexities are simply insurmountable. Cash, and not collapsing stocks, may be the only viable currency when pandemonium reigns.

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[5] Taleb, Nassim Nicholas (2012), *Antifragile: Things That Gain from Disorder*, Random House, Inc.

First-Quarter 2016 Portfolio Review

Broadly speaking, there are three variables we at MCM consider as we assess companies and estimate their intrinsic value: (1) the stability and quality of the current business, (2) growth opportunities, and (3) the cost of money or the return a prudent businessperson would require to invest in the business. To be clear, an assessment of a company's management is interrelated to making a judgment about (1) and/or (2).

We purchase a stock when the difference between the market price and our assessed value is wide and in our favor—when a "margin of safety" exists. On the other hand, we sell as the margin between price and value narrows.

Market prices have a tendency to be volatile, and more often than not they are the reason for a material change in price-to-value relationships. However, the growth or deterioration in a company's business and future prospects also affects the relationship in ways that can produce cause for action.

During the first quarter of 2016 we bought more shares of Baker Hughes and sold our positions in Colfax and Garmin.

Baker Hughes (BHI)

Baker Hughes (BHI) is the world's third-largest integrated oilfield services company, after Schlumberger Ltd. (SLB) and Halliburton Co. (HAL), and it provides technology and tools to oil producers. On November 18, 2014, Halliburton announced its intent to acquire Baker Hughes for $34.6 billion. Upon completion of the acquisition, Baker Hughes stockholders will receive 1.12 HAL shares + $19 cash per share (76% stock/24% cash). If the merger is successful, it would marry two of the three largest North American oilfield service providers and create the world's second-largest oilfield service company. With increased scale and complementary product lines, the company would have a more competitive and comprehensive global offering.

If the deal is not completed, Baker Hughes will receive a breakup fee worth $3.5 billion from Halliburton. That cash would give Baker Hughes options, some of which could conceivably include paying a special dividend or paying off some of its $3.8 billion in debt. Regardless if the deal is approved or rejected by the U.S. Department of Justice, Baker Hughes stands to benefit.

When we first purchased Baker Hughes in December 2014 for approximately $57/share, we were effectively buying Halliburton at a 15% discount. On the other hand, if the deal gets rejected, the company would receive a breakup fee worth approximately 14% of its market cap. The merger was originally expected to be finalized in the second half of 2015. Regulatory challenges have been raised, however, and questions remain concerning the consummation of the deal. This uncertainty has created opportunity in our eyes, and we doubled our position in January for roughly $39/share. At that price, the discount had widened to 40%, and the breakup fee amounted to 20% of Baker Hughes' market cap.

Colfax (CFX)

Colfax (CFX) is global manufacturer of pumps and welding equipment used in general industry and large-scale infrastructure projects. Although these products and the markets that utilize them may seem rather mundane, they are necessary to much of human existence as it is known today.

In the face of falling commodity prices and a rising U.S. dollar, the exposure Colfax has to cyclical commodity markets and international markets has caused its earnings and stock price to decline. Our original thesis was not predicated on correctly predicting economic cycles but on the track record of the company's founders, Steve and Mitch Rales. The Rales brothers, who are also the principal owners of Danaher Corporation, have diligently and consistently purchased undermanaged businesses and created value by using their management and lean manufacturing skills to improve operating efficiency and profitability.

As long-term investors, we anticipated that when Colfax's end markets were facing headwinds, opportunities would abound for it to buy assets on the cheap. That has not proven to be the case; Colfax has made just one relatively small acquisition since commodity markets have been in decline. The company was aggressive in making acquisitions prior to the decline, but it does not have the financial capacity to be opportunistic now. Additionally, the prices for businesses that companies are looking to sell are still too high. The result is our return as investors in Colfax is largely dependent on the broad commodity cycle and the length of time for growth to return. That is not something that we have strong opinions about, and it's a situation that won't likely result in above average returns from holding Colfax. Consequently, we sold CFX in early February around $24–25/sh.

Although we sold Colfax, we continue to keep an eye on companies the stock prices of which are down because of their exposure to commodity markets. However, we are focusing on companies that have the capacity to invest today and that will consequently grow at faster rates when commodity markets get reinvigorated. We believe those are the companies that will provide investors with above-average returns in the long run.

Garmin (GRMN)

A forerunner in making GPS devices for civilian use since the '90s, Garmin has faced headwinds as wireless networks have improved and as smart phones have become ubiquitous. But thanks to Garmin's creative culture and devotion to research and development, it has largely been able to offset declining sales of its automotive products by developing GPS-related products for other markets. Today, though, GPS technology is not the novel innovation it once was due to expanding wireless data networks and the declining cost of electronics. The edge that dedicated GPS devices once had over cellular devices in certain geographical areas and applications has eroded as a result.

From our perspective, this means many of Garmin's current products face intensifying competition on two fronts: from companies making products that utilize GPS and from other technologies. This also means growth opportunities for the company will likely need to come from outside the company's core competency in GPS. While Garmin does possess engineering and manufacturing capabilities, where and how the company chooses to employ those resources are very important to Garmin's return on investment and sustainable growth. Up to this point, Garmin has been choosing to invest in such consumer-product markets as fitness "wearables." Garmin produces fine, well-reviewed products, but with low barriers to entry, the competition is proving to be fierce.

Our assessment has resulted in placing a lower valuation on the company, which makes Garmin an unattractive long-term investment at current prices. As a result, we sold the stock in February for approximately $39/sh. We will continue to monitor Garmin and watch for new developments. Whether we buy it again will depend on the price and whether Garmin's management gives us reason to place confidence in the company's ability to grow sustainably and reinvest capital in ways that will produce attractive returns.

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