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markets review

What's Up, Doc?

The title could be a catch-all rhetorical question for a flummoxed investment advisor—or a quizzical one for Ben Bernanke, Ph.D., or any of the Goldman Sachs alums who, like puppeteers, really pull the strings behind the curtain of the financial economy. The title also could be a chance for you to practice your Bugs Bunny imitation if the reading gets tedious or, simply, an allegory depicting the folly and farce that was the prelude to what became the 1972 hit comedy by that name. Take your pick! As for the detail provided, chaotic times require more of an explanation than stable ones. For those who prefer thumbnail sketches, you need not tread beyond the following bullet points. For those who desire a little suspense, skip the thumbnails.

- Using the analogy of waves and tides, to the trained eye there seems to be a once-in-a-generation tectonic shift in pricing risk under way, obscured temporarily with the ambient noise associated with a credit crisis and the headline-grabbing regulatory response.

- Most writings emanating from MCM are designed to exhibit continuity from one to the next so that these easily overlooked sea changes don't go undetected until it's too late to react.

- At this point the epicenter of the crisis is Wall Street and its environs, and it is there that we have found the fissures that triggered and will likely continue to exacerbate the crisis.

- The "Minsky Moment" provides a great but obscure economist's philosophical framework for what is happening in the day-to-day world.

- Was the Fed's double-barreled 50-basis-point cut in rates also double-barreled in attempting to stave off recession, as well as shore up asset prices? Probably, also proving that, public utterances notwithstanding, the Fed is not always rational and reflective in times of crisis.

- What will be the second- and third-order effects (unintended consequences) of the Fed's actions? Will the cut in rates have its desired effect? We think not.

- Given everything that we have read, studied and in part, assimilated, we have concluded that more financial and perhaps economic headwinds—separated by tempting respites—lie in waiting for the unsuspecting. While this is hardly a forecast, such an environment will not likely treat overall common-stock prices kindly.

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Cyclical or Secular? The Current Crisis in the Larger Context of Cause and Effect

Connecting the Dots Through Time

Readers who have paid close attention to the annual and quarterly reports received from Martin Capital Management over the years have no doubt observed that there is a continuity or flow to them—like chapters in a book still being written. This communication approach is intentional. As decision makers on your behalf, this type of disciplined, reflective, benchmarked thinking helps us maintain equanimity throughout the inevitable ups and downs in the financial markets and to remain focused and rational when others, less grounded, may allow emotions to get the upper hand. Even though we all live in the present, in our role as investors we must think like futurists: We must always try to visualize the environment in which we will reap so that, in the here and now, experience-based rationality will determine when and where to sow. Many corporate annual reports we read are discrete (though hardly discreet), marketing-oriented documents, written by PR people, with predominantly a one-year, rearview-mirror time horizon. It's unsettling to read five consecutive years in one sitting, all the while wondering if it's the same company as you go from one report to the next. That's a literary luxury that makes no business sense and one we seek to avoid at all costs.

As a telling case in point, those readers who saved our Quarterly Capital Markets Review written in late June 2007—and distributed with quarterly statements on about July 10—may be well served by rereading it carefully. (If you don't have yours, let us know and we'll e-mail you an electronic version or mail you a hard copy.) Sometimes it's easier to understand where you are by looking back at your footprints in the sand to see your route. This is particularly true when you find yourself in a crisis: shifting the metaphor, to see more clearly in what has, within a few short months, become a confusing, smoke-filled room. Is it little more than overcooked food on the stove (reminding me of the all-too-common announcement, "Dinner will be ready when the smoke alarm goes off"), or is the eye-burning, toxic signal more ominous? If at this moment you think the smoke has cleared, we strongly urge you to hasten to the nearest exit. What should be clear to everyone at this point is that nobody who's pushing products or ideas on or from Wall Street, as broadly defined, wants to see prices go down or a recession follow … under any circumstances. It wouldn't hurt to pass everything you read—and see/hear in the media—through that filter.

Of Waves and Tides (and the Crucial Difference Between)

To clear the air, at least in terms of the page 1 subtitle of this quarterly missive, *cyclical* refers to events that recur in irregular patterns. In the economic context, business expansions and contractions are often referred to as *cycles.* Their patterns are unpredictably asymmetrical and, though cause and effect are linked, the connection is tenuous at best. *Secular's* most common definition connotes worldly, as opposed to spiritual, happenings. In the economic vernacular, *secular* refers to a very long-term trend. If cycles are the waves, secular trends are the tides. The action of the waves is discernible to anyone in a beach chair at the ocean's edge. The tides, on the other hand, are as surreptitious as they are powerful: undetectable unless you sit patiently and watch by the hour as the waves ever so subtly creep toward you or away from you. That is precisely the perspective from which we write. It may become dangerous to your financial health to allow yourself to become enamored with the waves if this predilection causes you to lose sight of the tides.

Most of us are "anchored in the present," with the future being viewed as little more than simple extrapolation of the past. Business cycles have occurred with enough frequency in years gone by that most investors and business people are aware of their existence, if only with the benefit of hindsight. It's the tectonic shift of the secular trends that often go unnoticed until it's too late, and then the apparent cause-and-effect relationship appears shockingly disproportionate: to wit, the Asian tsunami of December 2004. It is the tsunami effect that Warren Buffett expects his successor as manager of Berkshire's marketable-securities portfolio to not only *under*stand but to be prepared to *with*stand.

Quoting Seth Klarman (Baupost Capital's brilliant manager), we have often challenged those who find it too arduous to think beyond the present with the notion that tomorrow's "opportunity set" may be shockingly different from today's. If you compare this report to the one written three months ago, there should be no lingering doubts about the practical relevance of Klarman's observation. For those looking for the philosophical underpinnings of that concept, please turn to Chapter 7 in *Speculative*

Contagion (2006) or page 5 of the 2004 MCM Annual Report and read the quote from Ernest Dimnet's *The Art of Thinking*.

The Misalignment of Incentives and the Opaque World of High Finance

The epicenter of the current financial crisis is and remains Wall Street—and is therefore a good place to start in divining whether what we're seeing is an entire iceberg or only its tip. Hardly without precedent, the same can be said about the crises in 1987 and 1998, about which more is written below. Wall Street, long prophesied to become the mad financial alchemists of today, made the subprime-mortgage, hedge-fund, and private-equity overindulgence possible. Later you'll learn more about Hyman Minsky, the little-known economist who was recently "discovered" by the financial press but has been well-known to us (as the 2006 MCM Annual Report attests). His prophetical writings from the mid-1980s until his death in 1996 pinpointed the causes that have become today's effects.

Recently reporting third-quarter results were the large investment banks, originators and benefactors (at least until lately) of unprecedented and what have proven to be profoundly risky innovations in structured finance and other esoterica. Given the turmoil in the credit markets, including but not limited to the blight of subprime mortgages, the results appeared relatively benign, perhaps suspiciously so. Let's mention how they keep score because there's a world of difference between your portfolio with MCM and those of the "financial titans." Virtually all the securities you own are actively traded, and access to up-to-the-minute market-price information is instantaneous. Tangentially, any individual client can turn his or her portfolio to cash rather immediately and with modest concession to the prevailing market price. Of course, as Keynes noted, there is liquidity for some but not for all.

Under a new accounting rule, the titans live under different rules from the likes of you and me. The titans are required to distinguish between financial assets that have real market prices (Level 1) versus those based on models (Level 2) and those that are little more than management guesses (Level 3).[1] The bulk of the titans' financial assets fall into the mark-to-model category, or Level 2. The survival instinct manifests itself in times of financial turmoil. The panicking, drowning man is so singularly consumed with filling his lungs with air that his rescuer may himself become the second victim of the first victim's fear of suffocation. In like fashion, mark-to-model becomes mark-to-myth concurrent with a certain but unquantifiable migration in asset classifications from Level 2 to 3. Asset values thus become murkier as a financial crisis worsens. Not surprisingly, the short-term incentive to realize gains on whatever assets are above water in Level 3 assets (and to defer losses) justifies any means if there's an end that appeals to the most basic of instincts: survival. Postponing the probable in hopes that the winds will shift so that it won't become the inevitable is the kind of doomsday-deferral reasoning that permeates much decision making in times when rationalism is temporarily suspended. Complicating things is the effect of mushrooming financial leverage over the last four or so years, amplifying the effect of good and bad choices.

Finally, the hundreds of trillions of dollars in notional value of over-the-counter derivatives are not included in Level 3 asset totals. Thus far the sleeping giant, the one that dwarfs all others, has avoided being infected with the liquidity virus. Earlier dispatches have warned of what has come to pass. This one, peering into an always uncertain future, remains resolutely cautious, suggesting that the eye of the storm has yet to pass.

A 'Minsky Moment'[2]

Returning to Hyman Minsky, a sequence of financial events can foment a "Minsky Moment," often enveloped in the fog of uncertainty. The stage is first set by "a prolonged period of rapid acceleration of debt" in which more traditional and benign borrowing is increasingly replaced by borrowing that depends on new debt to repay existing loans. Then the "moment" occurs, "when lenders become increasingly cautious or restrictive, and when it isn't only over-leveraged structures that encounter financing difficulties. At this juncture, the risks of systemic economic contraction and asset depreciation become all too vivid."

[1] The firms began breaking down their financial assets into these "levels" at the start of their current fiscal year, which began in December, when they early adopted a new accounting standard related to fair, or market, value measurement. All U.S. companies will have to begin using it for financial years starting Nov. 15.

[2] References to Hyman Minsky are attributable to my friend and Minsky cohort, Charles Whalen, Ph.D.

Minsky's reading of John Maynard Keynes rests on Keynes' appreciation of the distinction between risk and uncertainty. According to Keynes, a situation involving risk is one where probabilities can be assigned with confidence, whereas a situation involving uncertainty is different—in that there are no precise probabilities to rely on. In a situation characterized by uncertainty, said Keynes, our knowledge is based on a "flimsy foundation" and is "subject to sudden and violent changes." Increasing financial leverage faster than means to service it can turn risk into uncertainty. Such an unstable environment is anathema to orderly investment in the pursuit of accumulation of wealth. Keynes' notion of uncertainty does not support the efficient-market hypothesis, but rather its opposite, which Minsky dubbed the financial-instability hypothesis (FIH).

According to Minsky's theory, the financial structure of a capitalist economy becomes more and more fragile over a period of prosperity—evolving from borrowers being able to pay back interest and principal when due right down the slippery slope to the terminal phase (Ponzi finance) when debtors must borrow even more to make interest payments on their existing liabilities. During the buildup, enterprises in highly profitable areas of the economy are rewarded handsomely for taking on increasing amounts of debt, and their success encourages similar behavior by others in the same sector (because nobody wants to be left behind due to underinvestment). Increased profits also fuel the tendency toward greater indebtedness by easing lenders' worries that new loans might go unpaid.

Concurrent with the growing demand for credit is that its suppliers begin to see lending as an innovative, profit-driven business. Minsky writes that bankers and other intermediaries in finance are "merchants of debt, who strive to innovate with regard to both the assets they acquire and the liabilities they market." Both the evolutionary tendency toward Ponzi finance and the financial sector's drive to innovate are easily connected to the recent situation in the U.S. home-loan industry, which has seen a rash of mortgage innovations and a thrust toward more fragile financing by households, lending institutions, and purchasers of mortgage-backed securities.

The expansionary phase of the financial-instability hypothesis leads eventually to the Minsky moment. The starting point is when it becomes clear that a high-profile company or a handful of companies have become overextended and need to sell assets in order to make their payments (read: Bear Stearns, et al.). Then, since the views regarding accepted liability structures are subjective, the initial shortfalls of cash and forced selling of assets "can lead to quick and wide revaluations of desired and acceptable financial structures." As Minsky writes, "Whereas experimentation with extending debt structures can go on for years and is a process of gradually testing the limits of the market, the revaluation of acceptable debt structures, when anything goes wrong, can be quite sudden."

The following segues nicely to the next section, the recent action by the Fed … Without intervention in the form of corrective action, usually by the central bank, the Minsky moment can engender a meltdown, involving asset values that plummet from forced selling and credit that dries up to the point where investment and output fall and unemployment rises. This is why Minsky called FIH "a theory of the impact of debt on [economic] system behavior" and "a model of a capitalist economy that does not rely upon exogenous shocks to generate business cycles."

If left unchecked, the Minsky moment can become a "Minsky meltdown," a spreading decline in asset values capable of producing a recession. Still the question remains unanswered: Has the moment "Ben" checked by the Fed to avoid a meltdown?

Understanding the Fed's Motives: Shore Up Assets or Stave Off Recession?

In times of crisis, decisions are often made by selecting the least immediately threatening alternative among multiple evils. Think of it as a financial triage. In remarks on September 22 at a conference in Frankfurt, Germany, marking the 50th anniversary of the Deutsche Bundesbank, Federal Reserve Vice Chairman Donald Kohn defended the central bank's aggressive interest-rate cut, saying it was driven by concerns about the broader economy rather than an interest in protecting investors or the value of housing. Trying to disabuse investors of the notion that the "Greenspan Put" (that the Fed would react to falling asset prices by slashing the discount rate as it did in the bear market of 2000–02) would become the "Bernanke Put," Fed Governor Kevin Warsh reiterated that the Fed's next move depends on economic events, rather than on financial markets. "The goal of our policy ... is not to look at any particular asset class" but instead is to watch "what's happening in the real economy." Rhetoric notwithstanding, Bernanke looks more and more like a Greenspan with facial hair.

During a September 6 talk at the Brookings Institution, former Chairman Greenspan seemed to echo the case for a rate cut—but for a more esoteric reason:[3] "Business expansions are driven by euphoria and contractions by fear. While economists tend to think the same factors drive expansions and contractions, the expansion phase of the economy is quite different, [with] fear as a driver, which is going on today, is far more potent than euphoria. What strikes me about the current period is it's wholly consistent with my generalized view of how important innate human characteristics are in sustaining the business cycle." Greenspan questioned the prevailing notion that the housing-wealth effect is, in fact, symmetrical on the upside and downside. Citing academic literature (remember Daniel Bernoulli?), Greenspan confirmed his belief in the idea that, for most of us, the pain of a dollar of loss is far greater than the pleasure of a dollar of profit: "Fear is the driving force on the downside. Elements of wishful thinking and euphoria form the upside. When we look at the external world it's very obvious. Fear is a far more dominant projector of action than is euphoria or anything like that. The division of labor … essentially creates competition and specialization and hence rising productivity and growth. Fear invariably and universally induces disengagement, and disengagement is negative division of labor."

On that occasion Greenspan also shifted his commentary from the economy to the markets, saying the current market turmoil is in many ways "identical" to what occurred in 1987 and 1998, when the then giant[4] hedge fund Long-Term Capital Management nearly collapsed: "The behavior in what we are observing in the last seven weeks is identical in many respects to what we saw in 1998, what we saw in the stock-market crash of 1987, I suspect what we saw in the land-boom collapse of 1837, and certainly [the bank panic of] 1907." The euphoria in human nature takes over when the economy is expanding for several years, leading to bubbles, "and these *bubbles cannot be defused until the fever breaks*."

Bubbles can't be defused through incremental adjustments in interest rates, Greenspan suggested. The Fed doubled interest rates in 1994-95 and "stopped the nascent stock-market boom" but, when stopped, stocks took off again. "We tried to do it again in 1997" when the Fed raised rates a quarter of a percentage point, and "the same phenomenon occurred."

"The human race has never found a way to confront bubbles," he said. *What Greenspan neglected to advise was what, if anything, the central bank can or should do when the fever breaks … and the day of reckoning approaches? With the free markets reacting by pushing long-term bond prices down (and yields up), no doubt in response to fears of rising inflation and escalating uncertainly, simultaneous with the Fed calling for the presses to print more money, how can this bode well for home or stock buyers?*

Sounding eerily Greenspanesque, Mr. Kohn, while acknowledging that the Fed's actions—through low interest rates early this decade—helped fuel the start of the latest housing boom, he deflected the cause (appropriately, in my opinion) to the workings of crowd psychology. Said Kohn: "I suspect that, when studies are done with cooler reflection, the causes of the swing in house prices will be seen as less a consequence of monetary policy and more a result of the emotions of excessive optimism followed by fear experienced every so often in the marketplace through the ages." The following chart depicts credit spreads, how risk is priced for different-quality debt securities over time. When the spreads are narrow, lenders demand less of a premium in interest rates from less-credit-worthy borrowers and, according to Minsky, later in the cycle, from progressive relaxation of standards to overnight tightening, the opposite is true. As you examine the chart, the question that could immediately come to mind is: "Has the pendulum started to swing and, if so, when will it gain enough momentum to crush any resistance and run its course?"

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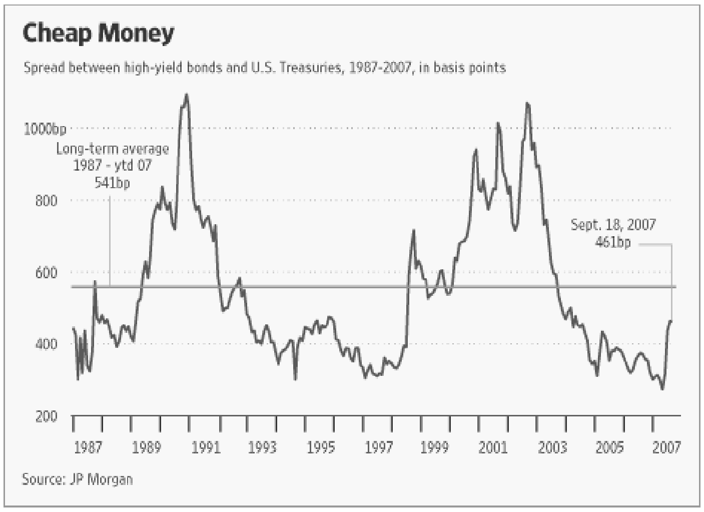
[3] On several occasions in the past Greenspan has departed from a straightforward probabilistic approach to decision making, as he is doing now. Because of the asymmetry of outcomes, particularly in these times, Greenspan (and Ben Bernanke) fear the consequences of consumer-price deflation more than they do incipient inflation. By erring on the side of excessive accommodation, they risk triggering another asset bubble, a crumbling dollar, and other second- and third-order effects.

[4] Eight years later the commodity hedge fund Amaranth lost $6 billion—or 75% of its value—in the month of September 2006 alone. While eclipsing Long-Term Capital Management in size, the event was soon to be relegated to afterthought. Conditioning helps take surprise out of the unexpected.



Source: *Wall Street Journal*

Second- and Third-Order Effects of Central Bank Intervention

Far more interesting are the second- and third-order effects—those unintended consequences of the Fed's discount-rate cut, along with the Open Market Committee's parallel action that often has a more powerful impact on human behavior, the financial markets, and the economy than the more obvious first-order changes.

Friend Jim Grant summed up the relative strength of the dollar (compared with what it would be on a trade-weighted basis) in one short sentence: "The 21st-century dollar is a miracle of suspended disbelief."

"Without financial failure," the governor of the Bank of England adjured on September 12, "genuine financial success is impossible." He went on to warn that if "wayward banks and their careless depositors could always depend on their hovering governments for timely succor, the world would be impoverished." Moreover, he continued, "the provision of large-liquidity facilities penalizes those financial institutions that sat out the dance, encourages herd behavior, and increases the intensity of future crises." Five days later the British Treasury moved to squelch an old-fashioned run on Northern Rock, the United Kingdom's fifth-largest mortgage lender. That UK depositors were acting a bit squirrelly likely reflects their lack of experience with such uncertainty. A day later the Fed announced its 50-basis-point reduction in each of its twin target interest rates. Given the global nature of what seems to be unraveling, perhaps it's not only a flight from the dollar but a flight from money in general, the aforementioned Jim Grant opines. The 6.5% year-over-year change in consumer prices in China has not caused a ruckus … yet. Continuing debasement of currency may be one of the most pernicious second-order effects.

Lest we forget, in a zero-sum game one person's gain is another's loss. By reducing the cost of short-term money to borrowers, the Fed, in exact proportion, cuts income of savers, including foreigners financing our twin deficits. Think about the second-order effects of that on both parties. What will be the effect on economic activity if the income to savers is reduced at the same time the rate cut does nothing to cause the lenders to trust their recalcitrant lenders any more than they did before? If lending contracts at the same time that income to savers falls, the scenario begins to look a lot like Japan in the 1990s. In a similar vein, although gross debt outstanding has increased dramatically worldwide, there has been no change in net debt. For every borrower there must be a lender. What will be the second-order effects of engaging in activities that shore up the market value of damaged assets on the lenders and borrowers alike? See the admonition of the governor of the Bank of England above.

It's common knowledge that the consumer is financially stretched, but it's still a dirty little secret that corporate America is not as flush as it appears. Far too deep a subject for this report, it's mentioned only to caution you from thinking that the business sector—both public and private—has the wherewithal to stem the tide. I'll leave you hanging with a teaser. Because real assets are carried at cost plus depreciation, whereas financial assets (equal to just 30% of tangible assets and net worth in the U.S. back in 1952, they represent more than 80% of them today) are marked to market, financial accounting and the Bureau of Economic Analysis national-income accounting differ importantly in determining how corporate earnings are calculated. Incidentally, the BEA doesn't count the profits on the trading of financial assets because no real value is created.

Publicly traded companies account for just 20–33% of corporate debt as defined in the national-income accounts but earn two-thirds or more of corporate profits. Do the math on the private companies and ponder this: The risk of bankruptcy isn't just a function of the total amount of debt, it's about the distribution of debt.

Here's a little more information. The U.S. national-account data show that non-financial companies have been paying out more than 100% of their profits in dividends and share buybacks. Until 1984 a combination of retained earnings and new issues allowed a steady rise in quarterly net worth. Since then, however, buybacks have overwhelmed retained earnings to the extent that net reductions in equity have averaged more than 3% a year. And with investments in plant and equipment exceeding depreciation by $400 billion a year, the United States' national-account data point to rapidly rising leverage.

Conclusion

If the inflationary and all the other derivative effects of the Fed's actions don't perplex you, recall what happened after the Fed embarked on a series of rate cuts to blunt the potential economic effects of a fall in asset prices almost seven years ago. On January 3, 2001, the Fed surprised the markets with a half-point rate cut. The markets soared on hopes the tech bubble would deflate only a bit, not burst. In actuality, the lows wouldn't be reached for nearly two years. Comparison with 1998, when the Fed flooded the markets with liquidity to bail out Long-Term Capital Management, is so fraught with dissimilarities on many fronts as to render it irrelevant.

While not as suspenseful, think of this report and its predecessors as reading the book before you see the movie. If it's suspense you're looking for, lay the book aside. Even though we're human and enjoy excitement (and even a little levity), when it comes to managing your money we become deadly serious. Following the lead of Keynes, we drill down wherever possible to reduce the element of uncertainty and replace it with something more quantifiable and statistically predictable, getting as far beneath the surface as possible what Keynes called risk. In times like the present, when emotions have outsized influence on decisions, we return to our understanding of crowd psychology until rationality returns.

–Frank Martin, CFA

Equity Holdings: Business Updates

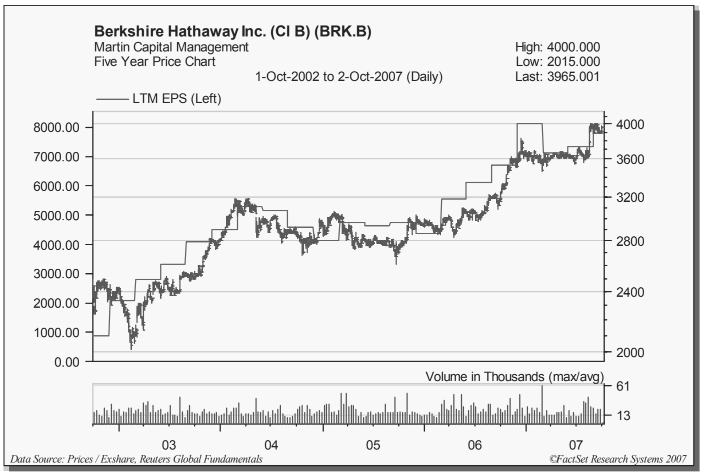
It should be obvious from the preceding section that we are not oblivious to the pressures facing banking, housing, and consumer-related businesses. Many companies in these sectors have already reduced guidance and expectations due to economic and market dynamics, causing Wall Street to turn tail in favor of businesses that are experiencing better short-term business conditions. We believe many of today's market favorites are enjoying unsustainable levels of profitability. Short-term earnings visibility seems to be the watchword on Wall Street. As value investors, however, we are mindful of the title of one of Warren Buffett's essays: "You Pay a High Price for a Cheery Consensus." As a result of increased uncertainty about near-term earnings, valuation levels for several outstanding consumer-related companies have plummeted and are much more attractive than they have been for a long time.

	3rd Quarter	Year-to-Date
S&P 500	2.0%	9.1%
Nasdaq	4.0%	12.5%
Dow Jones	4.2%	13.3%
MCM equities *	**-7.8%**	**0.8%**

** approximate, net of fees*

We are not simply looking for opportunistic purchases in depressed sectors. We're looking for companies with good and sustainable business models that produce attractive returns on capital, good management, and capital structures that will not put the company at risk in the event of an extended downturn. We own Mohawk and have nibbled at a few others, including Lowe's and Pool Corp. We may add to these positions and are looking at several other high-quality companies that are experiencing headwinds.

Berkshire Hathaway (BRK)



Berkshire continued to report good results through the second quarter, as earnings were up more than 38%.

Quarterly and annual reports, however, are a poor basis for evaluating the performance of this company, given the potential volatility of its operating results. Earthquakes and hurricanes in particular can play a spoiler's role in any given year. So far this year weather has been relatively friendly, and the company has harvested some investment gains, which we believe are sustainable, albeit irregular. The redeployment of earnings and insurance float constitute our main focus as we try to ascertain what the future holds for Berkshire.

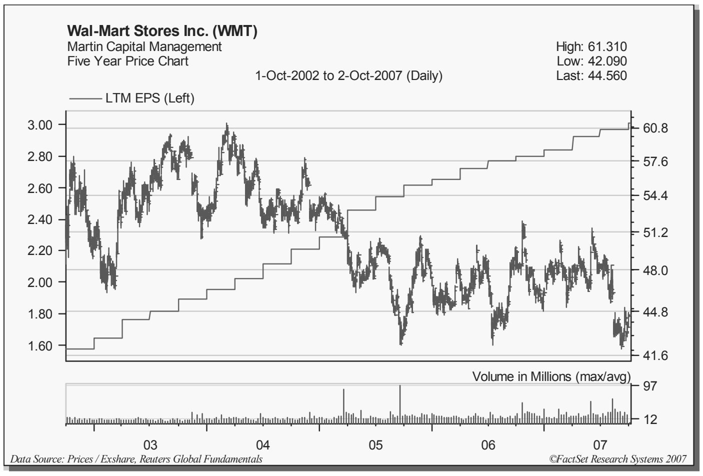
There is latent earnings power if Warren Buffett can take some of the $60 billion in cash and fixed-income securities and reinvest in higher-return acquisitions or public equities. Of late Buffett has picked up his pace of investment. He has invested $11 billion in equities through the second quarter, but he hasn't made any large acquisitions. During the first half of the year Berkshire generated more than $7 billion in cash from operations (including a large one-time retroactive insurance policy), so Berkshire has yet to make much of a dent in the $60 billion of cash and short-term debt securities on the balance sheet. At the end of the second quarter we said, "Unless there is a major market disruption—or what Buffett calls "a seizure" in the markets (where he could quickly redeploy assets)—this investment will likely be in the singles and doubles category." We have seen a seizure of sorts in the third quarter and, if it is just the beginning, this investment could become a lot more interesting.

–Dennis Blyly, CFA

Wal-Mart Stores (WMT)

After a disappointing second quarter (EPS was flat), Wal-Mart is accelerating its effort to get back to its roots. Merchandise margins eroded during the last quarter as the company hastened the pace of clearing out apparel and homegoods that were perhaps too trendy for its core base of customers. Management is further slowing store expansion, sharpening its prices, and re-emphasizing the value and savings available at WMT in its marketing and merchandising strategies. More recently, comparable store sales improved during the back-to-school period, and inventories of home and apparel are at comfortable levels.

Wal-Mart is a financial powerhouse. The company owns most of its stores, and the returns on capital are robust. Indeed, the company generates far more cash than is necessary to grow the business; WMT is using the excess cash for share repurchases at prices we believe increase intrinsic value per share. WMT shares are no higher than they were eight years ago, even as earnings per share have tripled. Expectations and valuations are now much lower, so we don't need earnings to triple (they won't) over the next eight years to earn a respectable return on our investment.

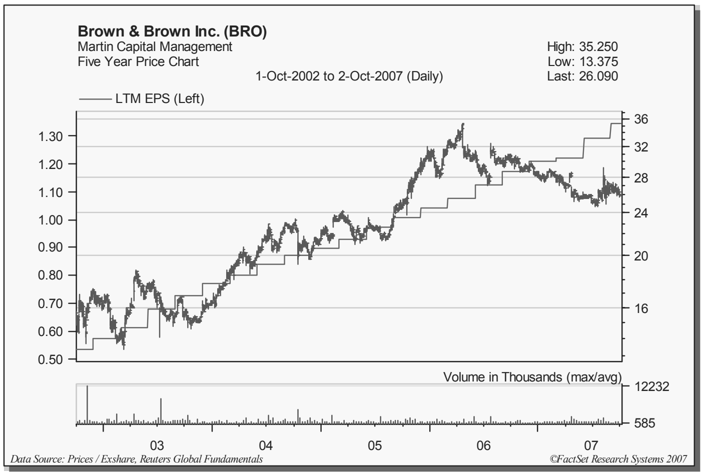


–Dennis Blyly, CFA

Brown & Brown (BRO)

BRO is one of the largest insurance brokers in the country, focused primarily on small- and middle-market corporate accounts. We are well into a weak underwriting cycle (insurance rates are trending down) in the property-casualty industry. As premium rates erode, pressure increases on the commissions collected by insurance brokers. Furthermore, the current chaos in the Florida insurance market is adding to the uncertainty with respect to near-term results. Predicting a turn in the underwriting cycle is nearly impossible, but with a terrific corporate culture and leader in Hyatt Brown we are confident BRO will remain highly profitable through the down cycle. Indeed, core operating earnings were up over 5% (EPS actually increased 17% due to non-recurring gains) in the second quarter.

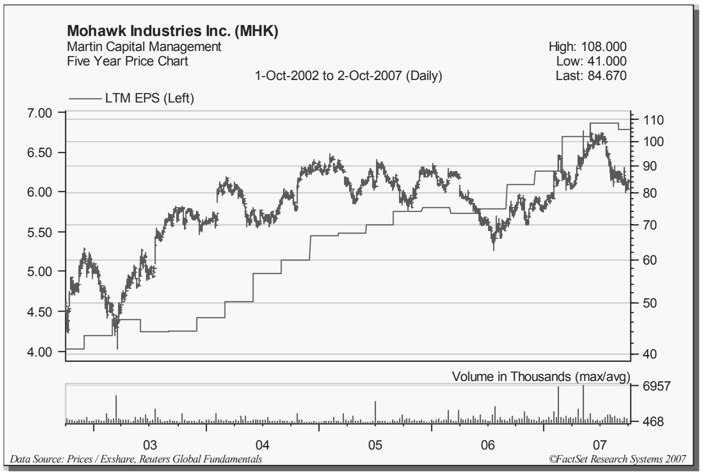
We added to our BRO position in the third quarter. One of the key variables for both short- and long-term growth is the company's ability to acquire additional agencies. Through the second quarter the company had added $65 million in annual revenue, a growth rate of almost 8% of the prior year's revenue. Acquisition prices remain reasonable, and we're encouraged by the continued acquisition pace during the third quarter.



–Dennis Blyly, CFA

Mohawk Industries (MHK)

We have been pleasantly surprised by how well Mohawk has navigated the downturn in its core markets. The management team has done an excellent job managing margins and allocating capital. The company had rapidly paid down a good deal of the debt associated with the Unilin acquisition (a home run, no matter how you slice it), in addition to making a very good purchase of a wood-flooring manufacturing business.



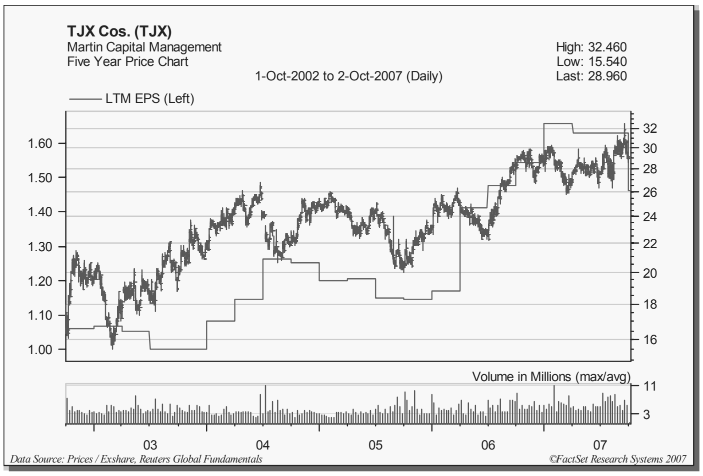
It's a pretty sure bet that conditions will continue to deteriorate in the short run. Roughly 50% of MHK's business comes from the repair/remodel market, and the rest is split almost evenly between residential and commercial construction (the latter continues to grow, at least for now). We have great respect for the management team, which has done a superb job of taking advantage of the vertical-integration opportunities that leverage its logistics and distribution system, a key competitive advantage in the marketplace and one that's nearly impossible to duplicate by smaller rivals.

Jeff Lauberbaum, the CEO who owns nearly 18% of the company, is our kind of manager. His interest is aligned with ours. To be sure, this is not the first downturn he has seen in the flooring industry. We believe he will continue to find ways to leverage the business model and increase shareholder value, even if it isn't fully evidenced until there's some improvement in the flooring markets.

–Drew Wilson, CFA

TJX Companies (TJX)

Much of the uncertainty surrounding the ultimate cost of the breach of TJX's computer systems earlier this year was reduced when the company and the class representing customers settled for approximately $130 million in damages. This charge, together with previously booked remedial expenses, brings the total after-tax cost of the unfortunate incident to under $150 million. This is a far cry from initial estimates floated when the true scope of the breach was disclosed; some estimates exceeded $1 billion. To be sure, a degree of risk will remain until participating banks (which had to oversee the replacement of millions of cards) and the credit-card companies (who insure illegal purchases) have had their "day in court." However, indemnification of customers represented much of TJX's exposure. Further, it doesn't appear that the franchise value was significantly affected because traffic counts and comparable store sales continue to climb.



As for operations, the company continues to generate strong sales, both domestically and internationally, in most of its divisions. Burned by bloated costs in the past, TJX shrunk its cost structure to the extent that comparable store sales greater than 2–3% are accretive to margins. This shifting of the expense fulcrum, combined with higher realized markups, drove a strong improvement in operating margin; a 9% increase in sales translated to a 21% increase in operating profit (excluding the breach charges). The company contends there are still costs to be trimmed. Finally, in the second quarter, TJX completed one-third of its planned $900 million share repurchase, shrinking the share base by 2.25%.

TJX's business is less susceptible to economic cycles than are most retailers'. It has a unique discount model, and apparel sales haven't declined for more than 30 years. Nonetheless, there is variability associated with various clothing seasons and the company's ability to acquire close-out merchandise. As such, consistent quarter-to-quarter EPS growth is unlikely, notwithstanding more recent results. TJX, however, has a huge moat that protects its high returns on capital, which should lead to good earnings growth on a per-share basis over time.

–Drew Wilson, CFA

Lowe's (LOW)

During the peak of the mortgage/housing excitement in mid-August, we added to our original purchase at cheaper prices. We'll keep doing so if the market continues to further discount this venerable franchise. LOW is a very well-managed business, with many levers to pull/push, depending on the environment. Comparable store sales for the second quarter were down 2.6% as home-improvement customers remained hesitant to take on longer discretionary projects. Despite that decline in store-level sales, LOW gained a full percentage point in market share during the quarter. Home Depot, LOW's primary competitor, continues to struggle with outdated stores and a largely failed foray into building supplies. The market is therefore ripe for LOW to continue to take share.

We're not sure where the housing market goes from here. As of this writing, the inventory of unsold homes is at an 18-year high, and existing home prices continue to decline. Add to that a fairly tight credit situation and one can easily postulate that housing might remain in the doldrums for quite some time. There's no question that the correlation between LOW's sales and the housing environment is high; we don't disagree with that premise. However, the market's pricing of LOW's today suggests a rather low level of earnings growth going forward. Therein lies our edge in that we believe that (1) housing will not go the way of the buffalo (demand will eventually return); (2) consolidation in home-improvement retailing has produced an oligopoly (Lowe's and Home Depot) where returns on invested capital have become quite high; and (3) LOW is the kind of retailer that will certainly boost its competitive positioning in this listless environment, without compromising its primary mission. Remember the phrase, "You must buy your straw hat in the fall."

–Todd Martin, CFA

UnitedHealth Group (UNH)

As UnitedHealth continues its efforts to improve healthcare affordability and access, headlines associated with the presidential election and legislative activity clearly have an impact on investor sentiment and, therefore, share price. While initial reform proposals made by candidates span the spectrum—from individually determined, free-market reform to more government-controlled and rationed programs—the devil will be in the details over the next few years.

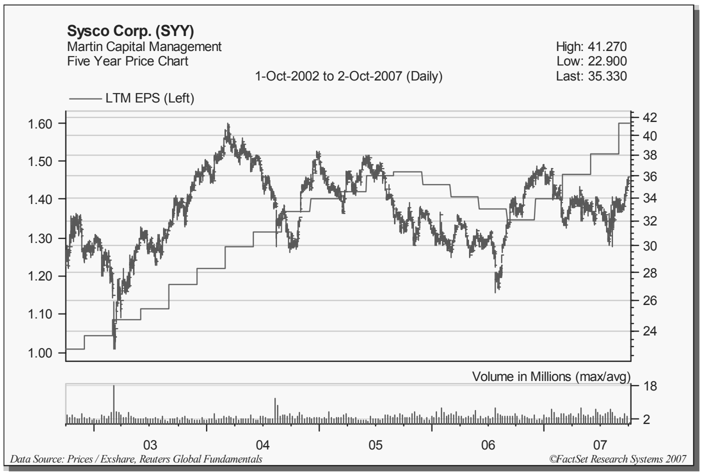
Even with the political uncertainty, UNH continues to deploy its substantial free cash flow to advance shareholder value. First, the company has received required state approvals for its $2.6 billion acquisition of Sierra Health; we expect the deal to close by the end of 2007, pending approval by the U.S. Department of Justice (other approvals at the state level have been received already). Second, the company estimated it would spend $2 billion on share repurchases in the second half of the year, and the current share price represents an attractive opportunity for our *pro rata* ownership to be increased.

Recent quarters have seen some difficulties growing membership in the commercial side of the insurance business, and the company is undertaking efforts to improve results. Nonetheless, one of the key drivers for the company's economic model is underlying healthcare cost inflation. Various reports have estimated the inflation to be at least 6%, and we expect the company to remain disciplined in maintaining its premium yields. Additionally, United continues efforts to integrate past acquisitions and improve network strength by adding new hospitals and physicians, along with other healthcare providers. This company enjoys large economies of scale that allow it to earn good returns on capital in a business that, contrary to what the popular press would lead you to believe, does not enjoy high margins.

–Wes Goebel

Sysco (SYY)

It would be hard to find a more durable and entrenched franchise than Sysco. SYY is considerably larger and far more profitable than its two closest competitors. We feel that the moat around SYY's castle continues to widen as a result of recent initiatives the company has undertaken. The new redistribution center (RDC) in Virginia is fully operational and is meeting expectations. SYY has broken ground on the second RDC in Florida; this one should come online much faster, given the fact that most of the kinks were removed after the slow and methodical roll-out of the first RDC. At the same time this initiative will enable SYY's operating companies to grow without adding additional warehouse space—effectively boosting overall capacity via the RDCs—SYY's competition has been hurt by the fact that Sysco now orders nearly all its inventory by the full truckload. In the past, SYY couldn't order a full truckload of, say, Tabasco sauce because it would sit for quite some time in an operating company's warehouse. So it would "share" a full truckload with some of its rivals in order to save on shipping. Now that the 800-pound gorilla is going it alone, the competition can no longer work with SYY in sharing transportation costs, resulting in higher costs for the competition. Not a bad deal for Sysco!



That said, we're struggling with the fact that SYY hasn't been able to leverage these additional expenses in producing better margins. Make no mistake, food distribution is a mature industry, and SYY's top line shouldn't be expected to grow more than upper single digits. Therefore, we must get margin improvement over time to translate modest revenue growth into low double-digit EPS growth. At 20x earnings, the margin of error is not particularly high. Operating margins peaked in fiscal 2005 and haven't rebounded back to those levels. Unless we see material growth in operating income well in excess of sales growth (better margins), we may reduce or even eliminate our position in SYY. At the outset of our investment in SYY, we felt that its competitive advantages would expand along with margins. We were right regarding the first premise, but the second has yet to materialize …

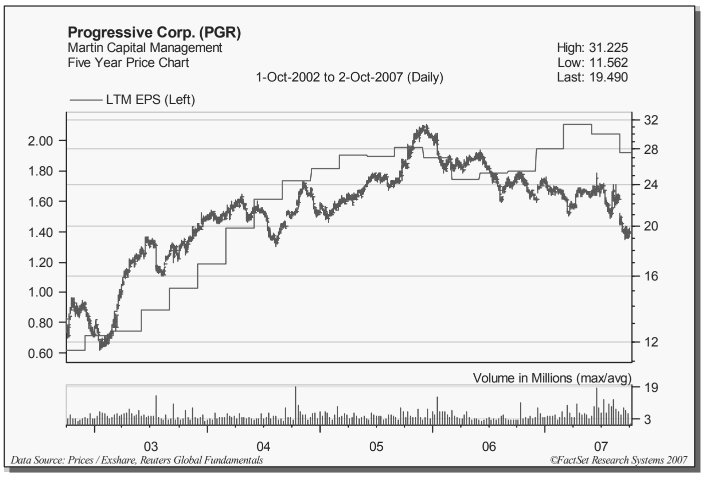
–Todd Martin, CFA

Progressive (PGR)

We bought more Progressive this quarter, far from a full position, but enough to elevate it from its "orphan" status to one deserving of its own section in this report.

Recounting part of the PGR thesis, the personal auto-insurance market is in the midst of a softening rate environment. During these soft cycles, industry margins erode, and growth is harder to come by, but those with the lowest cost structures fare better during and after the cycle. These cycles purge the industry of reckless capital and give patient, long-term investors an opportunity to own sterling businesses like PGR at attractive prices (you own another such company, Geico, through Berkshire Hathaway). Navigating these cycles is not without trial, and PGR has experienced its fair share this time around. CEO Glenn Renwick is attempting to lower premiums in order to grow policy count (through retention and new business) without overreaching and driving underwriting margins below the company's 4% goal.

While we believe that Renwick and his team will be successful over time, policy growth has been disappointing after several months of premium decreases. The tepid response from prospective customers is one sign of just how competitive the environment is; you aren't compelled to shop if your carrier is lowering your rate. One catalyst for firming rates would be the re-emergence of such loss factors as accident frequency and/or severity. There are early signs that severity trends are increasing, which could squeeze smaller or poorly capitalized carriers and improve PGR's competitive position—and ultimately lead to the next "up" cycle for the industry.



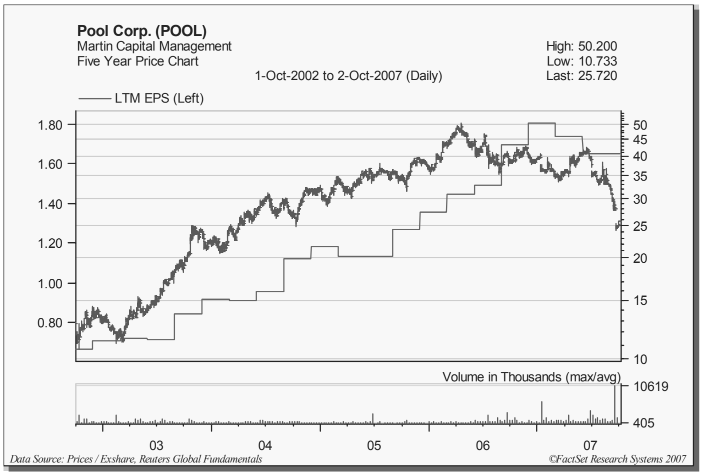
Progressive has completed most of its recapitalization plan announced in June. As a result, the company increased its debt and paid a special $2 dividend. As expected, the stock price fell by $2 when it went "ex-dividend" at the end of August. Unlike the Emmis special dividend, this didn't affect your reported cost basis, so what looked like an unrealized loss of $2/share on that day actually was not.

It's likely that PGR's results—and the market's reaction to them—will remain volatile. We'll continue to build our position as opportunities arise.

–Drew Wilson, CFA

Pool (POOL)

The pace of pool construction has declined 20–25% over the last 18 months. At the same time, Pool Corp. has invested heavily in its business, including new branches, launching a new business model aimed at the company's retail customers, and establishing a non-recourse specialty finance business that will be sold through POOL's wholesale builder channel. While we might quibble with the timing of some of these investments (particularly the new branches), most of the investment is in time and people. In other words, these investments are largely expensed, rather than involving large amounts of capital. In any event, EPS will likely be down 10–20% this year.

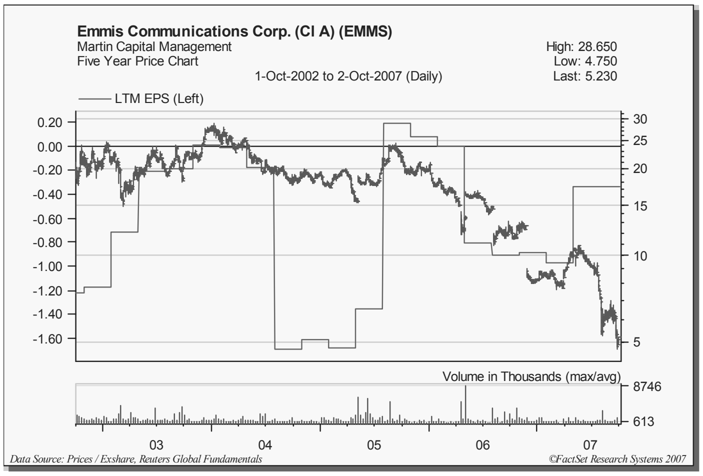


These incremental investments will not be recurring next year, and we think POOL will be in a much better position to manage margins even if there's no recovery in pool construction on the near horizon. Roughly 65% of revenue is largely recurring (maintenance, repair, and replacement) and is a function of a growing, installed base of pools. In the meantime, the company continues to increase its market share and add products to its distribution networks. We like the business and are further assessing the performance of management through this downturn in its markets.

–Dennis Blyly, CFA

Emmis Communications (EMMS)

We have two choices in addressing our mistake with regard to Emmis. We could, of course, sell our position (which is not as easy as it sounds, given our position and the small size of the company) and move on to a better business—with a management determined to grow intrinsic value for all shareholders. Indeed, Emmis sticks out like a thorn among roses in terms of the quality of business and management within our portfolio. Alternatively, we can put additional pressure on the board and management to unlock at least some of the considerable latent value that exists in the company's valuable set of properties. We have chosen the latter. We prefer not to disclose some of the current developments under way, but what we have done publicly can be found at the following link: www.mcmadvisors.com/library.php?page=6.



–Dennis Blyly, CFA

Website Information

www.mcmadvisors.com

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