MARTIN

CAPITAL MANAGEMENT, LLC

Registered Investment Advisor

"Public opinion is a permeating influence, and it exacts obedience to itself; it requires us to drink other men's thoughts, to speak other men's words, to follow other men's habits … Being without an opinion is so painful to human nature that most people will leap to a hasty opinion rather than undergo [its absence]."
—Walter Bagehot, 19th-century British journalist, businessman, and essayist

"In science you need to understand the world, in business you need others to misunderstand it."
—Nassim Nicholas Taleb

"More money has been lost because of four words than at the point of a gun. Those words are 'This time is different.'"
—Regina M. Reinhart and Kenneth Rogoff, *This Time Is Different: Eight Centuries of Financial Folly* (2009)

This evokes an equally pertinent earlier quote:
"More money has been lost reaching for yield than at the point of a gun."
—Raymond DeVoe Jr., Wall Street analyst and author of "The DeVoe Report" (1995)

"During bubbles, it seems that the psychological ambience is rather one of public inattention to the thought that prices could fall, rather than firm belief that they can never fall. The new era stories are not new strongly held convictions—they are merely ideas foremost in people's minds that serve as justification both for the actions of others and of themselves."
—Robert J. Shiller, Nobel laureate

2016

ANNUAL REPORT

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February 13, 2017

Dear Client,

From our vantage point, 2016 provided more evidence of an aging bull market in complacency, during which the apprehensions of absolute-return value investors like ourselves were again elevated because of the generalized absence of fear itself. Not surprisingly, little attention was paid to valuation and tail risks, known as “Black Swans,” in an economic, financial, and geopolitical environment that might be characterized as the triumph of hope over experience.

We feel fortunate that the unpopular equity wallflowers in which we invested have begun to bloom, but we suffer under no illusions that finding similar equities will be any easier until a repricing of risk assets to more rational levels occurs. Stocks are priced for a future tinted by rose-colored glasses, so rooting out unloved, overlooked, and rejected companies and committing capital to their equity is arduous and devoid of anything approaching instant gratification. To develop sufficient confidence that the general disdain for a company is more than discounted in its stock price, we have to dig deeply into each investment. Opportunity of this sort is often overlooked because “it is dressed in overalls and looks like work,” so said Thomas Edison, the man who knew firsthand how opportunity was frequently disguised as misfortune or temporary defeat.

Moreover, we need assurance that the issues leading to undervaluation are not irreversible or fatal, but are instead temporary afflictions from which the company will recover. Such is the curse of being a value investor in late-stage bull markets. The conundrum is why we value practitioners are so small in number. The most difficult aspect of executing the simple adage “Buy low, sell high” is that one must invariably act counter to the natural instinct to buy on good news and sell on bad. A successful value investor must do the opposite. We have never witnessed a stock that’s cheap when its narrative is getting rave reviews.

A few bargains got our attention in the oil & gas industry. Industry conditions and outlook were both darker then than they are today. Over the arbitrarily selected post-2000 timeframe, the price of crude oil has averaged $70 per barrel, ranging from a high of $145 in 2008 to an improbable low of $26 early in 2016. We intuitively believed that the odds of this essential feedstock falling materially farther were considerably less than the likelihood that it would move back toward the average. Within the overall bull market, there clearly was a bear market in oil-related equities. That spelled both opportunity in specific companies and generalized opportunity in the industry when the force of headwinds abated.

The above segues into the constraints imposed by prudent diversification. Empirical studies have shown that up to 95% of random risk—that an investment unexpectedly produces an irreversible, goose-egg return—can be mitigated with a portfolio of 12–15 investments. That means an average position would theoretically be between 6.7% and 8.3%. However, these investments must also be prudently diversified in multiple dimensions, including among different industries. As convinced as we were that select companies in the oil and gas industry would be repriced at other than Armageddon levels in the future, we are ever mindful of other probabilities, particularly downside ones common for such cyclical industries.

Most investors instinctively imagine the future as a continuation of the present. Therefore, during a bear market, most industries and many companies within them trade at low prices reflective of the present mood instead of future opportunity. The inverse applies to bull markets, like the one we see today. Given that dynamic, complying with diversification constraints is a no-brainer in a mature bear market. While we will always carry enough cash to quickly seize unexpected opportunities, when we have more bargain-priced ideas than we have money, our reserve will shrink considerably.

Beyond being unable to find enough truly diversified investment ideas to put all our cash to work in this very expensive market, the excess liquidity serves another more subtle purpose. It is our belief that investors may well face wealth-threatening uncertainties today for which a normal frequency distribution—the proverbial bell curve—is beguiling in its simplicity but dangerously inadequate. Broad diversification practiced by institutions (including domestic and international equity and debt, foreign-currency exposure, real estate, and private equity, to name just a few) can be effective in normal times. But we do not consider these to be normal times. Simply put, if one is going to use the bell curve as the measure risk, it should have pretty fat tails; i.e., the probability of extreme events should be presumed greater than what a normal frequency distribution would suggest.

When Black Swans unexpectedly appear, the scramble for liquidity tends to be an equal-opportunity scrum. Asset classes that under normal conditions tend to be inversely correlated (as one goes down, the other goes up) find themselves moving in the same downward direction under persistent and often panicky selling. During crises like 2008–09, the asset that no one wants to hold—cash—becomes the only safe haven in the sea of chaos. A universal currency in times of high uncertainty, cash holds its value and thus its purchasing power in the critical short run. Thus, though holding cash and sacrificing yield are spurned by virtually everyone, it could prove to be the most potent asset in our portfolio if the winds of popular sentiment unexpectedly change direction.

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In terms of the particulars to which our principles were put to the test, 2016 began with an uneasy calm in spite of the Fed's December 16, 2015, rate hike, the first since 2008. After all, the onset of the credit-tightening cycle has long been expected, its origins dating back to May 2013 when the so-called "taper tantrum" reverberated throughout global financial markets. The tranquility, though, was short-lived, as one of the worst stock market selloffs since the Great Recession immediately followed. The S&P 500 dropped an unexpectedly quick and deep 14.5% from early December 2015 to mid-January 2016, forming a double bottom in mid-January and mid-February at just over 1800.

Attention had shifted to the slowdown in China (and other emerging-market economies), which reported growth of 6.9% in 2015, the lowest official rate since 1990, thus raising concerns about global contagion risks. Simultaneously, the Shanghai Composite index's speculative bubble burst following its *one-year* sprint from 2000 to 5100 by June 2015, only to plummet 50% by January 2016. As the growth outlook for all major economic regions began to deteriorate, central bankers reacted by signaling more ease, with the Bank of Japan surprising markets with the introduction of negative interest rates in January.

With growth concerns mounting, losses in the commodity markets accelerated. Most notably oil (the benchmark is WTI, West Texas Intermediate, crude), propelled by both a supply glut and weakening demand, continued a slide from June 2014, which also was the crest of the long boom in commodity prices dating back a decade. From the peak of $104-plus, it swooned by more than 70%, trading under $30 in January and February of 2016. The lows in WTI crude and the S&P 500 coincided perfectly.

Overshadowed by headline-provoking news, including terrorism incidents and the midnight musings of a hair-trigger tweeter, the S&P's "earnings recession," which began in the fourth quarter of 2014, continued for any number of reasons, not the least of which was the rising dollar. Half the revenues of S&P

companies come from abroad, mainly Europe and Asia. The trade-weighted dollar index (DXY, 1973[1] = 100) climbed from the summer of 2014 to the spring of 2015, rising from 80 to 100 where it has remained within a tight range ever since.

The negative impact on sales and earnings of U.S. multinationals that sell their products and services in competitive markets globally—like pharmaceuticals and technology—was obvious. There are also corporate beneficiaries. Retailers like Walmart, which import 50% of their goods from China but sell domestically, are among them. The sales and profits of energy producers and suppliers, since most commodities are priced in dollars, were devastated.

Following the brief financial shock triggered by the U.K. Brexit vote, the S&P index held up well and credit spreads remained tight despite a late-year spike in Treasury bond yields similar to the taper tantrum. Duration risk—the fall in bond prices as market yields rise, amplified by the length of time to maturity—also surged.

The referendum on June 23 in which 52% the United Kingdom electorate voted to withdraw from the European Union had but a momentary impact on U.S. capital markets. It did, however, set a tone—a combination of populism, protectionism, nationalism, and perhaps even xenophobia—that echoed later in the U.S. presidential election and in the constitutional referendum in Italy in early December.

In broad-brush summary, our S&P 500 benchmark index, apart from the selloffs in August/September 2015 and January/February 2016, was range-bound on the upside at around 2100 throughout all of 2015 and up until July 1, 2016. The response to the two-day, 100-point (5%) air pocket on the unexpected Brexit news was followed by an equally unexpected rally to near 2200. Likewise, as apprehensions about the outcome of the presidential race escalated, the S&P settled back to below 2100 on November 3. In the year of the unexpected producing an unexpected market response (like the Brexit vote), the S&P greeted presumed disaster with a 4.6% Trump rally from the close on November 8 through year end. To keep current events in context, the index closed the year at 2239, which is 6.6% above the 2100 level where it had met resistance the last 24 months.

To be sure, there were industries that benefited more than others from the 4.6% Trump rally. Financials, presumed beneficiaries of deregulation and wider interest spreads, led the way, up 16.3% (and 22.9% for the year). Energy, as the price of crude oil doubled, was second, rising 10.6% during the Trump rally and 38.3% for the year. Consumer staples, healthcare, and telecommunications led the laggards, posting modestly negative to low-single-digit returns during the Trump rally and mid- to low-single-digit returns for the year.

2017 and Beyond

On January 20, Republican President Donald Trump took office, and Republicans control a majority in both houses of Congress. More than just a change in party, Trump's victory ushers in a distinctly different political atmosphere than that of the Obama era. The expectation for change is high. Trump's most unforgettable and colorful chants—"Build the Wall!, Lock Her Up!, CNN Sucks!"—differed markedly from his distinctly unoriginal official slogan. The campaign dusted off Ronald Reagan's 1980 mantra—dropping the "Let's"—and advocated "Make America Great Again."

[1] The index was established in 1973, soon after the dismantling of Bretton Woods' system of monetary management, which had established the rules for commercial and financial relations between the U.S. and its principal trading partners. China was not included since, prior to early 2016, its currency was pegged to the dollar.

Many presidential candidates run on a platform of change. It is there that the similarities between Trump and Obama begin and end. The capacity of a president to materially alter the state of the economy is, with the past as prologue[2], quite limited. A new Oval Office occupant, particularly one from the opposing party, inherits all the baggage from the preceding administration. Invariably, more power is ascribed to him as an agent of change than any person or group is capable of shouldering. Campaign rhetoric notwithstanding, presidents are largely victims—or beneficiaries—of the circumstances they inherit.

Especially given the intentional reference to Reagan, the current changing of the political guard, in both its similarities and its differences, warrants a comparison with the inauguration of the Reagan era in 1980, but also to the "change" under the newly elected Barack Obama in 2008. The two ideologically different administrations illustrate an important lesson about the relationship between political change and economic cycles. The case of Reagan is the most relevant; the case of Obama is the most recent.

The opening chapter of the Trump presidency has yet to be written; any similarity it will bear to the Reagan era is no more substantive than the prattle of pundits. Slogans aside, however, the two election wins saw similar reactions from the market. Like the Trump rally of late, in 1980 the market celebrated the election of the California conservative over Jimmy Carter by advancing 8.9% in November. For the next 21 months, however, it was all downhill. By August 1982, the S&P had declined 26.7%. Any accomplishments that eventually became part of the Ronald Reagan legacy were overshadowed by recession. Importantly, the economic contraction was unrelated to any direct action taken by the newly minted Reagan administration. Rather, it was an unavoidable response by the Fed to a clear and present danger whose origins can be traced back to August, 15, 1971 when President Nixon canceled the direct international convertibility of the dollar into gold. Inflation had become so rampant in the early 1980s that the risk-free nominal rate on 10-year Treasuries was roughly 15%. Equities traded at eight times earnings to compete with the yield on Treasuries. The capital markets were priced as if disaster lay ahead.

Fed Chairman Paul Volcker induced back-to-back recessions in 1981 and 1982 in order to break the inflation cycle. The unexpectedly positive consequence was the advent of a structural-reform mindset that was embraced throughout the economy, including a healthy respect for the downside of financial leverage. The cost of money imposed a circumspection toward capital spending that only sky-high interest rates could evoke. The pain and suffering for what was then the worst recession since the Great Depression reordered attitudes and expectations and, as so often has been the case, became the solid foundation for a lasting boom in productivity and a surge in real growth.

During the last six years of Reagan's presidency the S&P soared 200%, before taking a breather during the Crash of 1987. Consumer goods inflation was quiescent, and 10-year Treasury yields fell to 9%.

With the momentum well-established, the economy generally grew robustly, and interest rates fell through George H. W. Bush's and Bill Clinton's presidencies from 1989 through 2000. *Something insidious was under way, though.* Aversion to using debt faded into obscurity as the much-ballyhooed Great Moderation began to bloom. Total U.S. credit-market debt—measured against the ultimate means of its repayment, GDP—nearly doubled from 1980 to 2000 … from 150% to 275%. As sure as a thief in the night, the Great Moderation stole the cautious conservatism forged in the crucible of suffering in the early 1980s and fomented an illusion of economic and financial *stability*. Empowered by new Chairman Alan Greenspan's ability to stop the Crash of 1987 from metastasizing to the real economy, the Fed embarked on a path toward increasing intervention to tamp down economic and financial market volatility. In the years to come, Greenspan's interference with the normal functioning of the economy and

[2] The contemporary application of the Shakespearean quote from *The Tempest*, "What's past is prologue," is, simply and timelessly, that history sets the context for the present.

capital markets actually had the unintended consequence of perversely and systematically increasing fragility.[3]

As the new millennium dawned, the Fed's attempt to render business and market cycles obsolete backfired. *A sea change was at hand that continues to this day.* The Fed, already behind the curve and again fearing that the threat *de jure,* the dot.com bust, might migrate to the real economy, pushed rates down to 1% by 2003, which gave impetus to the emerging housing bubble. More perniciously, the "Greenspan put" incited a swagger of invincibility in both the private and public sectors. From Wall Street to Main Street, it seemed that everyone had a vested interest in the glorious process of enrichment. The cries of skeptics, who reasoned that the economic and financial system was getting dangerously out of kilter, fell on deaf ears. They were thought ignorant of the new era and seemingly lacked faith in the inherent wisdom of the market itself. In retrospect, when reforms were desperately needed, apathy filled the void.

Once it became clear that the Fed's easy money alchemy had shielded the economy from the dot.com-bust bullet, the speculative mindset became contagious, infecting both the financial and real economies—from investment bank securitizations to local bank homebuyer mortgage originations. Although seismic evidence had been accumulating all along, the volcanic eruption of the financial crisis broke the surface in September 2008, just before the election of Barack Obama. Once again, the Fed hastened to stop the hemorrhage, but this time, seeing itself as the only ER doctor in the hospital, overplayed its hand, perhaps fearing the patient would succumb. It kept the economy on a ventilator for years after it was no longer needed. It does get good marks for mitigating the liquidity crisis, but it never let the deleveraging cycle proceed with cleansing the accumulated financial excesses. Although it would've been painful, one must learn to breathe without a ventilator if one is to heal.

Returning decision making to the will of the millions who make up the economy and the markets would not have been painless, but perhaps far less painful than what might lie ahead otherwise. Sadly, Ben Bernanke (Greenspan's successor in 2006) didn't have the flexibility, or temerity, of Paul Volcker. The crisis hit, and damage control preempted all other considerations. Current inflated asset values and a lethargic economy are the effect of eight years of ad hoc reactionary and experimental measures. The latent cost may be revealed as the Fed's life support is removed.

Whereas Reagan *began* his term on the eve of back-to-back recessions, Obama entered the Oval Office just two months before the *end* of the worst economic and financial debacle since the Great Depression. Stated in more politically advantageous terms, Obama took office at the beginning of a cyclical economic upturn that continues to this day. Back then the capital markets were priced as though disaster waited in the wings, and the financial economy was making life miserable for the real one. The U.S. economy is a metaphorical battleship, and the best the captain should hope for is to make changes in course, a few degrees at a time. President Obama deserves some credit for standing watch during an economic recovery that has yet to achieve liftoff velocity, particularly given the exertions undertaken to stimulate it.

Updating the data from our Q3 letter, the total return of the S&P from the end of March 2009 to year-end 2016 is from the following three components: 65% from the increase in the P/E ratio, 15% from dividends, and 20% from earnings growth. From September 2008 through the 2009 inauguration and beyond, no glamorous remedies were discovered. All hands were on deck attempting something less

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[3] Taleb, Nassim (2012). *Antifragile: Things That Gain From Disorder* (Random House) makes a compelling case that complex systems, such as the financial and real economies, are weakened, sometimes critically, in the absence of stressors. Analogously, when the body's muscles are not stressed, they atrophy. When the downside of economic and financial cycles is truncated by the Fed, the short-term reprieve comes at the cost of increased long-term fragility. Occasional scarcity, rather than perpetual abundance, makes us stronger, to paraphrase Friedrich Nietzsche.

grandiose: to keep the ship from sinking. President Obama can thank the elixir of easy money for two-thirds of the booster rocket propelling the S&P to new heights, gaining 166% during his tenure.

Now in the eighth year of the most extravagantly excessive monetary policy experiment ever, the Fed has enabled a bubble in domestic nonfinancial debt borrowed by households; non-financial businesses; federal, state, and local governments; as well as in the many nonproductive investments it financed. The over indebted economy is becoming even more so this year. In the latest statistical year ending September 30, 2016, debt of the domestic nonfinancial sectors increased by $2.6 trillion, while GDP gained only $450 billion, with the ratio reaching a new high. To provide a sense of proportionality, GDP totaled $18.7 trillion, compared with $47 trillion in debt (households, $14.6 trillion; nonfinancial businesses, $13.4 trillion; and total government, $19 trillion).

Last year business debt, excluding off-balance-sheet liabilities, rose $630 billion, while total gross private domestic investment rose just $210 billion (which includes fixed and inventory investment). By inference, the difference went to support financial engineering, including share buybacks, dividend increases, etc. Such noninvestment spending increases shareholders' per-share results, but only investment in capital goods generates an income stream to meet the additional interest in principal repayment requirements. Corporate growth in revenues, income, and productivity suffers while stocks climb higher.[4] Equity prices are not the only assets affected by debt. The story of its influence on real estate prices and the financial health of the middle class is told in the appended essay below.

The broader story of debt, including that of the government, is told relative to GDP; as debt increases, it loses its potency to underwrite economic growth. Known as the "law of diminishing returns," a fundamental economic principle, it plays a central role in productivity theory. In the decades before 2000, the number of dollars of debt necessary to create a dollar's worth of growth in GDP steadily increased, averaging $1.70 of debt for every $1.00 growth in GDP. From 2000, the ratio doubled, requiring $3.30 of debt for each $1.00 increase in GDP. For the latest statistical year, ending September 30, 2016, it had risen still further, requiring $4.90 of debt to generate $1.00 in GDP.

It is at this advanced stage in the credit cycle that President Trump is proposing economic stimulation through fiscal policy—tax cuts, infrastructure spending, and the like. Political posturing aside, the expected expansion of debt and deficits could not come at a worse time; it will likely be counterproductive to promoting economic growth and stability. The over indebted economy that President Trump is inheriting may stonewall government attempts to finance infrastructure spending by borrowing—and may lay waste to his largely untested assertions about the salutary effects of tax cuts being considered. The much-touted tool known as "dynamic scoring" that President Trump has embraced—which attempts to measure the effect of tax policy changes on jobs, wages, investment, federal revenue, and economic growth—is yet another experiment likely to be remembered as a fancy way of justifying massive increases in the federal debt, further borrowing from the future. The problem is, the past has already caught up with the future.

Whatever real or imagined policy similarities might exist between Reagan and Trump—whether tax cuts, infrastructure spending, deregulation, or other presumably pro-growth initiatives—the economies they inherit are starkly different. What we do know is that Donald Trump will take office *after* a seven-year bull market during which the S&P rose 350%; Reagan's eight-year presidency began at the end of a secular bear market dating back to 1966. Trump rides in on the back of a seven-year, historically long-in-

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[4] With capital utilization at 75% and unit demand and pricing weak across many industries, corporate execs are understandably reluctant to add to capacity. As for borrowing to buy back stock at record PE ratios in the aggregate, that simply leaves us scratching our heads.

the-tooth economic expansion. Reagan, on the other hand, walked into a brick wall of double-digit inflation, and it took two years and two back-to-back recessions to restore price stability. Trump steps into a market priced for perfection, with the S&P 500 trading at a nosebleed trailing 12 months price-earnings ratio of 20.9 times.[5] The preceding footnote discusses the dynamics surrounding this fundamentally important phenomenon. The market that Reagan inherited, selling for 8 times earnings, had nowhere to go but up. Bond yields are currently 2% plus and rising. During Reagan's presidency, bond yields were 15% and falling—giving impetus to PE multiples. An icon among most Republicans, Reagan is viewed favorably in historians' rankings of U.S. presidents, and his tenure constituted a realignment toward conservative policies in the United States. If Trump also proves to be iconic, he must overcome more obstacles than Reagan. The harsh reality is that the hand you're dealt is often more important than how you play it.

While of no pressing concern for us as investors so long as we are aware, several very long-term (secular) trends do not bode well for economic growth getting out of its rut anytime soon, regardless of who resides in the White House or which party controls Congress. The digital-age optimism that permeates our culture, along with the belief that the technology revolution will be the wellspring of future growth, may have a tough time measuring up to the per-capita standard of living gains achieved from 1870 to 1970.[6] Perhaps the future isn't what it used to be.

Beyond the aforementioned burden that an overleveraged economy imposes, there's the vast disparity in income and wealth not seen since 1928–29. This disparity may be the catalyst behind the myriad social and political upheavals in recent years. Rising inequality in conjunction with rapid economic growth seems to have been bearable, but may become less so as growth slows. In addition, the size of the Baby Boomer generation, combined with women entering the workforce, spurred an economic tailwind from hours worked that is now weakening as swaths of prime-age workers have left the labor force and "boomers" continue retiring. The diminishing quality of our educational system is nothing short of a national calamity that will only compound this problem.

We believe it is critically important to know:

- Which direction and how strongly the economic and financial winds are blowing
- Whether tail risks, which by their nature cannot be handicapped, are more or less prevalent today
- Whether the overall valuation of the market favors buyers or sellers

It is not, however, by those metrics that we will be judged. What really counts is whether our investment process results in us purchasing a company for, say, 50% of its intrinsic value, and then consistently selling it later for some multiple of that value. The principles of compounding means the positive contribution above easily negates the handful of instances when the opposite occurs.

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[5] As a point of reference, at the bull market peak in October 2007 the PE was 17.4 times earnings. The future value for the S&P 500 will be a combination of the earnings growth of companies that make up the index and the multiple of earnings investors are willing to pay. As for the earnings variable, the growth rate from 1980 through 2016 was 6.2%. Take careful note, though: The growth rates for the two distinct periods addressed in this report, 1980–2000 and 2001–16, were quite different. The rate of earnings growth for the first was 8.4%; since 2000 it has dropped to 4.9%. *We find it beyond extraordinary that the Bloomberg S&P consensus estimate of the earnings growth rate for 2017 through 2019 is 14.7% per year*. Such irrational exuberance goes some distance in explaining why investors are willing to pay 20.9 times current earnings. Extravagance in expectations of that magnitude may well exceed the insanity of the late 1990s or even the fateful last years of the 1920s.

[6] Gordon, Robert J. (2016). *The Rise and Fall of American Growth: The U.S. Standard of Living since the Civil War* (Princeton University Press).

Obviously, when we're talking about companies, it is their aggregate characteristics that define their quality. The aggregate measure of a company's quality is analogous to the measurement of an individual's intelligence. You actually want to avoid those outstanding IQ scores. As Michael Lewis's book *Moneyball* makes quantitatively clear, the highest-quality "anything" invariably commands a disproportionately high price. A company with a quality equivalent to an IQ of 100–119 ("superior intelligence") is going to be less perfect, and thus, more volatile, creating better opportunities for return, than one with the genius IQ of 140 and above.

Moreover, cyclical companies with "superior intelligence" generally exhibit more price volatility than genius companies. The latter are typically earlier in their life cycles and have yet to exhibit other than growth characteristics. Returning to the preceding paragraph, and remembering that what is simple is not always easy, companies of superior intelligence, not genius, provide the best opportunities for investment. Their cyclicality is our gain. We have long held that any investment approach that does not respect the dictum, "Buy low, sell high," is doomed to mediocrity at best.

There's another factor that favors the less-than-genius companies. In the real world of business, industry, and commerce, it seems no company is able to hold onto the genius classification indefinitely. By contrast, there is no such ceiling for the merely superior.

Turning to what we at Martin Capital Management (MCM) will be doing day in and day out in 2017, our first duty is to pay close attention to the companies we already own. We are constantly on the lookout for warning signs of impending structural change in a company's profitability or financial stability. As much as we might admire a particular company, which often includes those who manage it, we must always wear the hat of a skeptic, questioning everything. Dating is OK, but falling in love is *verboten*.

We are careful to always monitor valuation. When the market price of a company's stock rises to the level where the five-year expected return falls into the mid-single digits, we will likely reduce the position size or sell the holding outright, ideally replacing it with another whose expected return is above our hurdle rate. Likewise, if an existing company's shares fall to a price where the expected return from that level is above our hurdle rate, we will generally add to the position.

The greatest advantage investors in securities have over the owners of private businesses is the existence of organized markets in which to buy and sell fractional interests at modest cost. We believe that investors who judiciously and prudently apply the privilege that a ready market provides, are in a better position to produce investment returns that are greater than those generated by the underlying businesses themselves. Were it not for fluid capital markets, the wide universe of quality cyclical companies would likely be off limits to us. Moreover, because market prices tend to be far more volatile than the underlying fundamentals—which includes individual companies, as well as the broader S&P 500 index—serious mispricings often occur and are the icing on our investment cake.

As for additions to the portfolio, the wallflower theme continues to appeal to us as a safe and productive strategy. Since investors are paying high multiples for companies on the mere anticipation of high growth rates—especially those presumed beneficiaries of President Trump's proposed growth initiatives—we will take an entirely different tack, thereby avoiding the spectacular fallout when projected earnings are missed and P/E ratios follow suit. Again, we would highlight footnote four.

Judging by past shifts in economic political policy, the effect of change has more often than not been overrated at the outset. For example, in some industries overregulation can end up being less costly than underregulation. Without sufficient boundaries, incentives encouraging reckless behavior, particularly in the absence of rewards for prudence, are conspicuously common in the financial services sector. In a fiercely competitive industry where the participants' services are largely undifferentiated, unregulated behavior inexorably leads in the direction of disequilibrium, not stability. There seems to be little argument that the absence of regulatory oversight of the financial industry was a precipitating precursor of the financial crisis.

Ironically, iconic Wells Fargo actually grew stronger because of the crisis but, perhaps due to hubris, its lack of internal controls subsequently tarnished the image of the estimable institution. Not one to mince words, Warren Buffett's partner Charlie Munger cuts to the chase: "I do not think you can trust bankers to control themselves. They are like heroin addicts." Given what you will read later in the report about easy-money-financed bubbles in assets other than marketable securities, it may be wise to remember this axiom from Jim Grant: "No bank fails for lack of capital; unprofitable lending is always the underlying cause."

Trump's proposed initiatives have likely spirited the increase in longer-term rates and given license to Fed Chair Janet Yellen to tighten monetary policy on the assumption that stimulus will shift more toward fiscal policy. Accordingly, as the dollar rises, both importers and exporters are finding it more difficult to compete on the basis of price. In a number of industries, corporate tax cuts will not be the free lunch for shareholders that had been presumed. Rather, the benefit of any real reduction in taxes will be indirect, first allowing the companies to be more competitive on the pricing front. If these moves are executed well, it will be the company's bottom line, rather than its customers, that will reap the benefit.

There are many essential consumer products and services companies, including a number whose businesses are cyclical, now on our "under review" list. We are particularly interested in those not perceived as prime beneficiaries of Trumponomics, but whose anti-fragile characteristics are likely to stand them in good stead should the tide take an unexpected turn. The absence of a bargain purchase price is the only investment variable keeping them out of our portfolio.

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During the several years preceding the financial crisis, a bubble in residential real estate was inflating. Because it was a seemingly unrelated asset class, investment managers failed to note the breadth of the speculative contagion. Are we making the same mistake a decade later? Toward that end, two of our junior analysts set about examining "unrelated asset classes." In their own words, this appended essay is the result of that inquiry.

Top-Down off the Ground: High Rises, Interest Rates, and the Reality of the Middle Class

We make investment decisions built on the rock of bottom-up research. But it behooves such builders to take leave of their craft at times and note how the neighborhood is changing.

In 1932 the *New York Herald Tribune* ran a Sunday photo supplement featuring the now famous black-and-white photograph, "Lunch atop a Skyscraper". It depicts 11 steelworkers casually eating lunch seated upon an I-beam of the Rockefeller Center some 840 feet above the New York City streets. Even today, the photo leaves the viewer with a distinct sense of vertigo. More unsettled, however, is the seemingly calm obliviousness of the workers.

This is, unfortunately, our own feeling when we look at individuals buying assets currently priced at record highs. And high rises are a case in point. As our photographic history intimates, Manhattan, home of Rockefeller Center, is at the center of this story. With prices for Manhattan office space up 340% since 2010, it's not hard to spot the bubble. Rising real estate prices are not limited to the notable altitudes of New York City construction projects, however.

Suburban office space is up 64% since 2010, retail space up 69%, and commercial real estate overall is up 87%. This, despite a decline in office jobs and serious pressure on brick-and-mortar retailers, courtesy of the Internet economy. These changes are all facets of the foundational story, namely that commercial real estate prices are up significantly across the country since 2010, but GDP has grown only 17%.

This paradox is replicated, but in grander form, in the housing market. Apartment prices are up 250% nationally since 2010, and the Case-Schiller index for single-family homes has now reached 2007 levels. That is a 200% increase since 2000, yet average and median incomes adjusted for inflation have actually *declined*. As is true for all sectors, when prices go up without the purchasing power to pay them, prices will fall.

So, why this inflation? Interest rates.

Ground-level interest rates have driven sky-high asset prices. With historically safe investments yielding essentially zero, investors have sought returns anywhere they can, seemingly regardless of risk. Equities, real estate, corporate debt, and even fine art have all become havens for the huge reserves of cash and easy credit created by quantitative easing—and largely concentrated among the wealthy.

It is the middle class, however, not the price of assets, that is the engine of our economy, and the middle class has long been sputtering, despite the best engineering efforts of monetary policy. A significant strain is debt. Low interest rates have resulted in risky borrowing on the part of many Americans aspiring to improve their lot. A 900% increase in federal student loans since 2007 contributes to the $1.26 trillion-plus in education loans burdening U.S. students and workers. Default rates already top 11%. Additionally, auto loans total more than $1 trillion. The subprime auto sector has current defaults of 10%, and even prime loans are seeing increases.

While the S&P makes new highs, the narrative of public companies serving the middle class is telling a different story. Starbucks, Dollar General, and Casey's General Store have all described their customers as "under pressure" in recent earnings calls. If coffee budgets are tight, how much higher can housing prices rise? The juxtaposition should be anything but humorous for the financiers sketching a new Manhattan skyline and the investors whose money they manage. Even low-interest loans must be repaid, and with construction work averaging $36,550 a year, it's not clear who will be moving downtown.

Whether in real estate, equities, or nearly any other asset class, the ground looks very far below current valuations. We are investors, not steelworkers—and certainly not speculators—so you won't find us seated above a New York street. We're content to wait until reality reverses the trajectory of current optimism. Then the companies we track, those that have built their businesses like we build our research theses—solidly, on a firm foundation—will be priced to sell, and we will be buying.

With Gratitude …

Reluctantly inching my way toward the time when I will no longer be lead dog at MCM, cross currents of conflicting emotions sometimes nearly overcome me. Established ways are hard to change. Though I expect to be a swing or pull dog indefinitely, I've spent my professional life in the position of final authority and accountability that Harry Truman popularized with the phrase: "The buck stops here." The opposing feeling is that my successor is almost certain to be a better lead dog than I've been. I dream of being remembered as a man wise enough to know when that time has come.

And without you, our clients at MCM, even musing about a long future of serving others would be out of the question. Your encouragement and patience during this time of temptation continue to cause me to figuratively bound out of bed every morning to fully embrace my passion. This year was particularly agonizing because, had I suspended my disbelief and been fully invested, our results would have us in the lead in the Iditarod. However, the race is long, and imprudent and/or irrational choices along the way all but guarantee that we would not be ahead when it counts the most—at the finish line. Principles wouldn't be principles if they were subject to the capricious winds of circumstances.

Peter Wong, the lead dog in waiting, is already providing encouragement and leadership to our analyst team, including veteran Clint Leman, CFA as well as prepping his young pups for the future. Two years ago he started an internship program using his contacts at Yale University. In the summer of 2015 we were home for five interns: two from Brown University, two from the University of Chicago, and one from Princeton University. This past summer another group of interns—from Brown, Yale, and the University of Michigan—again brought both high energy and high intelligence to our offices. In addition, and Peter's long-term reason for the intern program, Ho Jun Yang, a rising senior when he interned for us in the summer of 2015, accepted our offer to return to Elkhart to join us full-time when he graduated from Brown last spring.

All of our interns have been academic standouts, which, as we know, is no guarantee for investment success—but it's a very good place to start. Another good place to start is Elkhart, Indiana, as a number of interns have demonstrated. While it isn't easy to attract top talent to Elkhart, Peter's forward thinking recognized that most interns are less concerned about location than opportunity. Interestingly, after a summer here, most have taken a liking to "The City with a Heart." We've also discovered impressive talent within our own community. Lane Miller, a graduate of Goshen College, is currently proving his mettle as a part-time intern.

The summer of 2017 looks to be another season of high stimulation: Peter has received many applications, including from Harvard, Yale, and a number of other highly regarded institutions. Stay tuned!

In addition to growing our talent pool stateside, we are also expanding in geographical reach: Cecilia Hung is now leading our Hong Kong office, with a goal to scope global opportunities. We are excited about what's ahead of us as we grow into a global firm.

In our profession the operations team members are the unsung heroes. No outward glory comes to those who make the administrative side of your experience as partners seamless, nor to those who relieve analysts and portfolio managers from the burdens of day-to-day business management detail. Peter and I are deeply in the debt of Jeff Robbins, chief operating officer; Dallis Miller, chief financial officer; Kristen Smith-Myers, client service associate.

Very truly yours,

Frank K. Martin, CFA

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