MARTIN
CAPITAL MANAGEMENT, LLP
Registered Investment Advisor

QUARTERLY
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‘The Market Can Stay Irrational Longer Than You Can Stay Solvent’

—John Maynard Keynes

It has been a “lifetime” in terms of the financial-crisis time clock since we last communicated with you in writing. The next Quarterly Capital Markets Review is not due to be in your hands until mid-October. In fact, the only ongoing and no doubt somewhat confusing communiqués you are receiving from us are a rash of purchase and sale confirmations. This short missive has two simple purposes:

■ First, to allay any concerns or fears you may have as the result of being deluged by the media as they spin the financial crisis in so many ways as to leave you dizzy.

■ Second, to inform you regarding the stewardship of your assets as we tiptoe, not through the tulips, but through the minefield.

While individual portfolios differ in their composition, on average our portfolios have about 70% of their assets in short-term U.S. Treasury securities or short-term tax-exempt bonds, themselves backed by U.S. Treasury securities. As long-standing clients know, we have never compromised on credit quality in the “default asset class,” the securities in which we safe-harbor your money when we can’t find businesses to own at prices low enough to provide us with an adequate margin of safety. In an attempt to squeeze a little more yield out of fixed-income securities, it is common in our industry for investment managers to purchase insured municipal bonds (MBIA and AMBAC, among others), auction-rate securities, the debt or preferred shares of such government-sponsored enterprises (GSEs) as Fannie Mae or Freddie Mac, and “enhanced yield” or even plain-vanilla money market funds. We have long held the view that all of the above are susceptible to rare but potentially devastating systemic risks and that such events are unpredictable as to their timing. Our view toward the default asset class is quite simple: When we need that money, it had better be there. None of the above securities have ever found their way into any of your portfolios. It has always struck us as intemperate to reach for a couple extra basis points in yield at the risk of being denied access to or losing part or all of your principal. Of course, even for risk-averse investors, no asset is absolutely safe. The proposed bailout plan being rushed through Congress diminishes the credit-

worthiness of the debt of the United States, negatively impacts the standing of the dollar vis-à-vis other currencies, and risks long-term debasement of the currency by the politically expedient yet insidious force of inflation. Nonetheless, we intend to stay solvent, as the title warns, while the markets remain irrational—and in the safest asset class extant. To be sure, over the last several years we have received ample criticism for retiring to the sidelines too early. We have no defense for that accusation except to note that, as is being demonstrated before our very eyes, it is sometimes better to be a year or two early than a single day late.

Getting a Leg Up in Turbulent Times

As wealth managers our investment philosophy can result in outperforming our peers in bad times and underperforming them in good times. Buying high-quality, comprehendible, well-capitalized business below their value is the smart thing to do…and sometimes it looks smarter than others. That was true at the beginning of this decade, and it appears to be so today. The seemingly trite adage, "To win, first you must not lose," is actually rooted deep in the simple mathematics of compounded returns. The trailing 10-year compounded annual rate of return on our equity securities of 10.5% exceeded the 1.8% on the S&P 500 by nearly 9 percentage points.

Turning to the flurry of confirmations you have received, they are the result of several windfall profits that were by-products of the extreme volatility in the markets, as well as the harvesting of the gains in several securities where the margin of safety was deemed no longer sufficient. You are sure to be less elated at tax time. We can only hope that you prefer gains, regardless of the tax bite, over losses.

Is the Socialization of Risk Following Years of the Privatization of Gain (and Loss) the Solution to What Ails the Capital Markets and Threatens the Real Economy?

"At first it was 'Thank goodness the cavalry is coming,' but what exactly is the cavalry going to do?"

—*Douglas W. Elmendorf,* former Treasury and Federal Reserve Board economist, on the $700 billion bailout plan.

That question has precipitated a head-on collision between three rather intractable forces: pragmatism, politics, and philosophy. If we have thus far kept your capital out of harm's way, getting a handle on the question posed in the header above will help us to determine when the risks are sufficiently manageable that we might venture forth in search of gain? Words uttered by the man who

	2008			
	Q1	**Q2**	**Current QTR***	**YTD***
MCM Equities**	**-6.2%**	**-4.3%**	**24.9%**	**12.0%**
S&P 500	-9.4%	-2.7%	-1.4%	-13.2%
Nasdaq	-13.9%	0.8%	-0.8%	-14.3%
Dow Jones	-7.0%	-6.8%	0.3%	-14.1%

* *through 9-19-08*

** *approximate, net of fees*

at present is among the two most powerful men in Washington are not exactly encouraging. "There are no atheists in foxholes and no ideologues in financial crises," Fed Chairman Ben Bernanke told colleagues last week. As the essay posted to our website ("The Slippery Slope to Interventionism") argues, when panic causes those in authority to slip their philosophical moorings, the results of actions taken, often appearing random in retrospect, rarely meet the expectations of their original design. As surprising (alarming?) as it may sound, the fervor arising from the "mother of all bailouts" might just be the tip of the iceberg.

The Iceberg Below the Water Line: Has Spontaneous Optimism Faltered, and Have Animal Spirits Dimmed?

Admittedly, the observation that "no one in our age was cleverer than Keynes nor made less attempt to conceal it," contains more than a germ of truth. The accusation of arrogance notwithstanding, reflect on the genius of Keynes' insights for a moment.

> Even apart from the instability due to speculation, there is the instability due to the characteristic of human nature that a large proportion of our positive activities depend on spontaneous optimism rather than on a mathematical expectation, whether moral or hedonistic or economic. Most, probably, of our decisions to do something positive, the full consequences of which will be drawn out over many days to come, can only be taken as a result of animal spirits—of a spontaneous urge to action rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities. Enterprise only pretends to itself to be mainly actuated by the statements in its own prospectus, however candid and sincere. Only a little more than an expedition to the South Pole, is it based on an exact calculation of benefits to come. *Thus if the animal spirits are dimmed and the spontaneous optimism falters, leaving us to depend on nothing but a mathematical expectation, enterprise will fade and die—though fears of loss may have a basis no more reasonable than hopes of profit had before* [italics added].

The tectonic shift from the pursuit of gain to the avoidance of risk (of which I have written regularly in the past) seems to be moving inexorably along its continuum. The great imponderable that the amateur architects of the bailout plan face is, because of all the damage that has been done to the psyche of investors and consumers alike, will the "animal spirits" remain dimmed and the "spontaneous optimism" falter? If that great intangible propensity—spontaneous optimism—has been crippled by the harsh realities of the last year, the actions of frantic policymakers in Washington are not likely to turn the tide.

From Theory to Practice

The volatility in the market—rising sharply one day only to drop like a brick the next—is generally not a harbinger of good things to come. It's widely thought that bear markets go through three psychological phases: denial, concern, and capitulation. During the concern phase the fundamental news significantly worsens, and investors realize that that a bear market is in force. Each down leg in the 2007–20?? bear market thus far has ended with a duct-tape solution to an impending financial

crisis. The first was the Bear Stearns bailout in March, and the most recent, as noted, has been dubbed the "mother of all bailouts." We haven't likely seen the end of the consequences in the broader economy (on Main Street, not Wall Street, as the wonks are wont to say). At the capitulation phase, the majority become exceedingly bearish and throw in the towel, fearful of further declines and the potential disappearance of their assets. As to when and under what conditions that may occur, I defer to Supreme Court Justice Potter Stewart's famous 1964 oblique attempt to explain "'hard-core' pornography, or what is obscene." I might argue the existence of the state of capitulation by extracting Stewart's vague yet strangely exacting wording from its original application: "I shall not today attempt further to define the kinds of material I understand to be embraced…[b]ut I know it when I see it…"

All bear markets come to an end. And as for the other side of the valley, the aphorism, "Bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria," has intuitive appeal, as well as empirical support. While we'll never know John Templeton's "point of maximum pessimism" until it's history, one is on pretty safe ground being "generally right than precisely wrong." Those who have a hard-bitten respect for Mr. Market's manic-depressive nature will tend to fare best. As long-term investors, we must guard against being excessively pessimistic, as over the very long term stock prices will rise in concert with the growing value of businesses. As we position ourselves for the future, we will continue to focus on managing risk and letting the returns take care of themselves. Within the crisis in which we find ourselves embroiled, there can be found the seeds of the next opportunity.

One sure sign of opportunity is when exceptionally well-managed, solidly capitalized companies with well-defined and well-defended market niches—which are usually the last to be discarded in the increasingly frenetic search for liquidity—sell at giveaway prices. Thus far most of these companies on our wish list have remained largely unscathed. When the capitulation stage becomes so irrational and indiscriminate, however, as to "throw the baby out with the bathwater," expect your mailbox to be periodically stuffed with purchase confirmations. In the period of transition we wait impatiently, still rather having money burning a hole in our pocket than in someone else's.

Frank Martin, Senior Partner

MARTIN
CAPITAL MANAGEMENT, LLP
Registered Investment Advisor

300 NIBCO Parkway, Suite 301 ■ Elkhart, IN 46516 ■ Phone 574.293.2077 ■ Fax 574.293.2153 ■ www.mcmadvisors.com