MARTIN
CAPITAL MANAGEMENT, LLP
Registered Investment Advisor

QUARTERLY
CAPITAL MARKETS REVIEW

APRIL 2009

It May Be Darker Before the Dawn

This Quarterly Capital Markets Review will be different from its predecessors. We typically begin with a broad perspective that incorporates relevant economic, political, and financial developments that might impact our portfolio strategy. To avoid unnecessary redundancy, however, the recently released fourth edition of the ongoing "Fireside Chat" series will take the place of what is typically the first section of the Review. If you would like to read the Fireside Chat as the prequel to this Quarterly Review—or listen to it independently—it makes a case for continued caution and can be found at our website.

Additionally, you will find more stocks in your portfolio than has generally been the case in the past. There are several reasons for this, some of which are explained below, but for the time being we think it makes sense to focus more on equity strategy than attempting to comment on each of our holdings. We will temporarily follow a variation of the "management by exception" practice. That is, we will focus on those companies where changes in market price or business fundamentals have deviated enough from our expectations to warrant an explanation.

Our equity performance moderately trailed the S&P 500 during the first quarter of 2009. As we reported in our 2008 Annual Report, Martin Capital's longer-term performance has been well above the popular averages. We mention this only to make the following point: Our outperformance is not due to frequency (we outperform on a monthly basis about 50% of the time) but rather because when we outperform we tend to do so in large increments. Indeed, we sometimes underperform in rather large increments as well (like the first two months of 2009), but over time we have done considerably better than the indices, something few managers have accomplished in the relatively recent past.

While finance professors would tend to view the short-term variability of our returns as indicative of risk, we think that is wrong-headed. Short-term volatility is "risky" only if one needs or desires liquidity when prices are depressed. As long as we can take a longer-term view, short-term volatility is more apt to be our friend than our enemy. The market is not a guide to value as much as it is a daily price-clearing mechanism. Panicky marginal sellers—and sometimes determined short-sellers—can have a dramatic impact on daily prices. With widespread margin calls and other distressed selling from hedge and mutual funds facing liquidation, we have seen incredible price swings throughout the capital markets.

Given our more concentrated portfolios, it isn't surprising that one or two stocks can have an out-sized impact on our portfolios. Gannett (GCI) was such an outlier during the first quarter and accounted for 40% of our negative equity return and more than all of our underperformance relative to the S&P 500—even though it was only 3% of our consolidated portfolios (6% of equities). Accordingly, we will spend some time describing the challenges facing GCI.

Core Holdings

Most of our focus has been, and always will be, on wonderful companies managed by great people. These companies enjoy strong balance sheets, sustainable competitive advantages, and good economics that can be estimated into the future with far more certainty than is the case for most companies. In the context of 8,000 publicly traded businesses, there are only a relative handful of these companies.

In this kind of environment, perhaps the most distinguishing characteristics of a core holding are staying power and the capability to preserve and grow long-term intrinsic value—even during economic downturns. That doesn't necessarily mean that earnings will be stable or increasing. In most cases, short-term earnings power has been impaired by declining business activity. Great companies are set apart from the crowd during tough times (in fact, *especially* during tough times) because the thinking is strategic, proactive, and forward looking. The math surrounding the calculation of intrinsic value is clear; a year or two of below-trend earnings has a negligible impact on intrinsic value, so long as earnings per share (EPS) eventually gets back to some approximation of trend-line earnings.

The market's ongoing perception as to the degree to which earnings "snap back" can cause a great deal of volatility in the market price of a business. In bull markets, trend lines that are unsustainably high get extrapolated in order to explain an overvalued stock. The reverse is true in bear markets as pessimism spills over into expectations of a permanent funk. It's therefore easier in many cases to find outstanding companies selling at bargain-basement prices if there's some economic sensitivity in earnings.

There are different ways that companies lay the foundation for accelerated growth during the downturns. Some companies like Brown & Brown (BRO) have taken advantage of its strong cash flow and balance sheet to buy other agencies at compelling prices. Over the last two years BRO has acquired agencies with revenue that equal over 20% of its 2006 revenue. Berkshire, likewise, has been acquiring companies and securities at a rapid rate. One could argue that Warren Buffett has been a bit premature, but the same could have been said of his investment decision making in the 1973–74 period, a time that would come to define him as one of the all-time-great investors. Granted, Buffett was recently on the receiving end of proposals from Goldman and GE and had to decide whether to buy or take a pass. Alternatively, Lowe's has grown organically and now has 17% more stores than it had two years ago. The economic downturn has induced HNI and Mohawk to make large and permanent reductions in their cost structures. HNI, Lowe's, Walgreens, and many in the banking industry will see competitors disappear. All of these are fundamental improvements in the business, even if it isn't yet reflected in earnings.

To use GE CEO Jeff Immelt's terminology, many businesses across the United States have undergone a "reset." Companies that were used to conducting business when 16 million automobiles were being sold every year will have to adjust to a new lower level of future production for a minimum of a few years. The same can be said of housing-related industries. Business as usual will simply not be good enough to sustain intrinsic value, especially in the above-referenced industries. Without exception, we have been pleased by the performance of the management teams associated with our core holdings during this downturn. While these people have made many difficult decisions to permanently reduce cost structures, they recognize the importance of continuing to invest in new technology, sales, and marketing. There is plenty of uncertainty about future levels of demand, but we have few doubts about the moats that surround our castles (core holdings). Even with the many improvements made by Mohawk and Pool Corp., it is doubtful they will overcome the aforementioned reset. Pool has largely been sold and, while MHK is unlikely to be a disaster, it is also unlikely to meet our original expectations. It should, however, perform quite well from current levels.

Non-Core Holdings

As you know, most of our client portfolios have an abundance of liquidity that is rarely matched in our industry. We have long labored under a clear and stringent mandate: if it is possible that we will err, let it be on the side of missing an opportunity rather than permanently losing principal. Accordingly, we have added some holdings that we believe would have more "spring" if we get a stronger and longer-lasting recovery in stock prices than we currently expect. Generally speaking, we classify certain holdings as “alternative” if they fail to pass through any of our three filters. Specifically, these investments will have the following criteria: (1) inadequate long-term rates of return on capital, (2) uncertainty with regard to product cycles or competitive positioning, and (3) lingering questions about management or leverage. Companies that fit this profile include Brunswick, Gannett, Lamar, Garmin, Sotheby’s, and Fifth-Third.

We started buying GCI at a multiple of free cash flow that approximated 5.0 times. Given the secular issues facing newspapers and other traditional media, we assumed there would be a “rate of fade” in the earnings power over time that would be offset to some degree by growing online revenue (especially Careerbuilder.com). What we didn’t expect, given the interest coverage, was the extent to which nervous investors would question GCI’s business viability. At its recent lows, the equity market value of the entire business was $450 million. As recent as early 2004, the equity market value of GCI was $25 *billion*. Given the ongoing financial crisis, any company that has even a whiff of potential financial distress has been taken to the woodshed and flogged repeatedly.

A declining stock price can become a self-fulfilling prophecy. In GCI’s case, a new accounting rule required the company to take large write-offs in the value of certain assets due to the declining value of the stock. Even though the company repaid almost $300 million in debt during 2008, these write-downs pushed the debt/total capital ratio from 31% to 78%. The negative industry “headlines” certainly didn’t help the company during this period. Bankruptcy filings and announcements of closures of community newspapers have further soured many investors on anything related to newspapers.

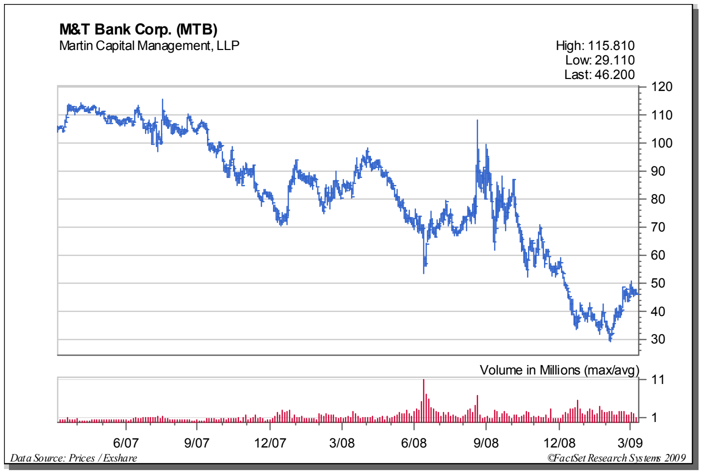
Whether Gannett proves to be the exception to the rule will not be known for some time. What we do know is that GCI’s newspaper business generated close to 20% pretax cash-flow margins, and its broadcasting business enjoyed 40% margins. Interest coverage was 7.5 times in 2008 and should be above 5.0 times in 2009. Among traditional media companies, perhaps only *The Washington Post* is in better shape financially. We acknowledge the significant challenges GCI faces. While its traditional media businesses are healthy, they are declining on a secular basis. Moreover, the nature of this recession has made this economic cycle particularly difficult for newspaper classified advertising (housing, auto, employment). But the industry has always been cyclical (industry revenue declined 10% in the 1990–91 recession before the Internet was part of everyday life), and we believe GCI’s management was far out in front of the rest of the industry in embracing and preparing for the challenges. Another interesting fact: In 2008 the far-smaller online and broadcasting businesses made $0.50 per share after allocating all interest and corporate overhead to those two divisions. We are keeping our position in GCI.

While our non-core holdings tend to have more upside potential, there are also more potential problems that could arise. We will exercise discipline as we manage this part of the portfolio with respect to position sizes—and we will limit this part of the portfolio to less than 1/4th of the total equities owned. We'll keep you posted on how this part of the portfolio performs over time.

Financials

The biggest change during the first quarter was the addition of three banks (Wells Fargo, US Bancorp, and M&T Bank) to the MCM portfolio. In our view, banking does not fall under the category of great businesses. In simplistic terms, banks are highly leveraged and sell a largely undifferentiated service. We acknowledge, however, that service levels vary dramatically across the industry. Banking is among the most management-intensive industries. Peter Lynch once said, "Buy a business so good any idiot can run it, because eventually one will." Well, that's not banking. The discipline, choice of product lines, and the service and underwriting cultures will have an enormous impact on the performance of a bank. We believe the management teams at the three banks we added to our portfolios are first-rate, with the possible exception of Wells Fargo. Although Warren Buffett owns 7.2% of Wells Fargo, the CEO doesn't exhibit the character traits that distinguished Buffett when he saved Salomon Brothers in the early 1990s. While we think that Wells Fargo was one of the great franchises, we are less sanguine today. Sometimes the significant can be found in the trivial. And thus alerted, we will continue to look for both confirming and disconfirming evidence until we get the issue resolved. While we clearly considered myriad factors in choosing these banks, a few things caught our eye in particular. First, all three banks have very high levels of return on tangible equity. This important metric not only reflects strong core profitability but also helps these companies support their capital bases during a prolonged credit cycle. Second, we noted that these banks were adroit in slowing balance sheet growth during the heady days of 2006–07 when lending spreads fell as risks rose. The day of reckoning is at hand for those who forgot about risk…

We have been monitoring these banks for years but avoided them due to our concerns about the credit cycle. It is now obvious that this country is in the midst of a severe credit crisis and, as the following charts suggest, stock prices reflect this reality. Indeed, we purchased our shares when there was widespread concern about a large part of the banking industry being nationalized. Those fears have not abated. We have provided for significant potential dilution (issuing new stock at severely depressed prices) in conducting our own "stress tests" and the resulting impact on our estimates of intrinsic value. Given the volatility of these stocks, however, we may trade them as we wait for the credit cycle to play out. By nature, we are long-term investors. In a volatile, flattish environment—if that's what it looks like with the benefit of hindsight—our small size and flexibility constitute a competitive advantage against our larger brethren. While we prefer long-term gains over short-term ones, we favor gains of any type over losses!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40
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Volume in Millions (max/avg)
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3/09
Data Source: Prices / Exshare
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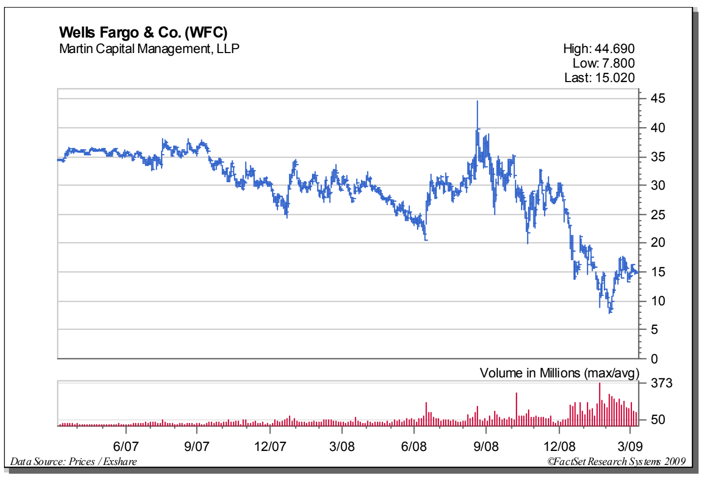
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3/09
Data Source: Prices / Exshare
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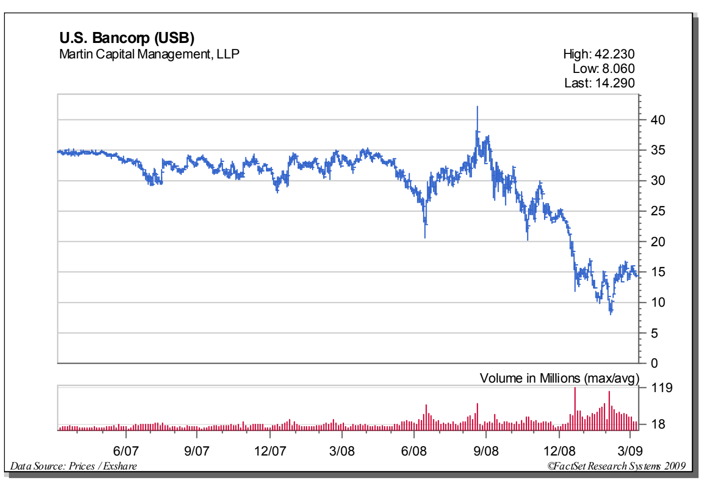
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Volume in Millions (max/avg)
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18
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12/07
3/08
6/08
9/08
12/08
3/09
Data Source: Prices / Exshare
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Options

We have been using more options over the last few years. We believe that two general strategies are appropriate for our clients. Hedging our equity positions via market index puts and generating income via covered call writing represent those two primary strategies. When volatility and the price of options are low, index put options prove to be an effective hedge when the market turns south. Put options helped moderate our losses during 2008, although with 20/20 hindsight we lifted our hedges early. When the market is highly volatile, premiums become very expensive and it generally makes more sense to be a seller of options than a buyer. Hedging becomes very expensive, but writing calls on existing equity positions can be a good way to generate additional portfolio return. To be sure, every strategy has its trade-offs. Selling covered calls does not protect us against continued declines in the stock or, on the flip side, doesn't allow us to participate if the stock advances way beyond our strike price. We attempt to ameliorate those risks by (1) monitoring each company's underlying fundamentals closely and (2) selling in-the-money call options due a month or two hence, during what we anticipate will be intermediate-term rallies. By staying very short we minimize exposure to longer-term price fluctuations, counting on market ripples and not waves.

These are the most extraordinary of times. We refused to let greed undermine our rational assessment of egregiously underpriced risks from 2005–07, and we remain resolute in not letting fear, a far more pernicious emotion, override our businesslike approach to investment as we navigate the unknown, when risk is likely to be grossly underrated. In the midst of financial and economic sea changes, equanimity of temperament is the equivalent of a steady hand at the tiller.

	1st Quarter
MCM Equities *	-16.3%
MCM Total Account *	**-9.2%**
S&P 500	-11.0%
Nasdaq	-2.8%
Dow Jones	-12.4%

** approximate, net of fees*

The MCM Equities Composite shows the performance of equity investments and equity-based options included in the accounts we manage at Fidelity. The equity percentage that each account holds at any given time may vary from 0% to 100% of the portfolio depending on each individual investment policy. Consequently, the returns shown do not necessarily reflect the returns any individual client actually obtained and are certainly not an indication of how your account will perform in the future. The MCM Total Account Composite shows the performance of all assets held in fully-discretionary fee-paying accounts that we manage at Fidelity, who have given us authority to invest 100% of the account in equities, and are managed per our model portfolio. Due to timing related to the QCM and MCM's desire to provide timely information to clients, a complete detailed calculation of returns is not done on a quarterly basis and both composites are therefore approximate. Both composites are net of all management fees and include the reinvestment of all income but do not reflect the effect of taxes.

The S&P 500 Total Return Index is an unmanaged market capitalization-weighted index of 500 common stocks chosen for market size, liquidity, and industry group representation to represent U.S. equity performance. S&P 500 returns do not include consideration for fees or taxes.

The NASDAQ Composite Index is a market capitalization-weighted index of over 3,000 domestic and international based common stocks listed on the NASDAQ Stock Market, and is used to represent broadly the performance of the U.S. and international stock markets. The NASDAQ returns do not include consideration for cash dividends paid by securities.

The Dow Jones Industrial Average is a price-weighted index of established U.S. companies selected at the discretion of the editors of The Wall Street Journal from diverse industries, including financial services, technology, retail, entertainment and consumer goods, and is used to represent broadly the performance of the U.S. stock market. The DJIA returns take into account stock splits and dividends paid by securities comprising the index.

Due to client nuances including equity allocation constraints, start date and cash flow differentials, derivatives constraints, tax issues, etc. an individual's account performance may differ materially from the composite. ***Past performance is no guarantee of future results.***

Website Information

www.mcmadvisors.com

Fireside Chat #4 was added to our website in April, both in audio and transcript version.

To log in to our site, please enter either your email address (if on file at MCM) or your Fidelity account number into the **Username** box and MCM into the **Password** box. You can change your password to whatever you would like once you've accessed the client site. Should you have any questions, or any suggestions as to how we can make the website more useful to you, please don't hesitate to contact us.

Please remember to contact Martin Capital Management if there are any changes to your address, in your financial or investment objectives, or if you wish to impose, add or modify any reasonable restrictions to our investment management services. A copy of our current written disclosure statement discussing our advisory services and fees remains available for your review upon request.