JULY 2010

Animal Spirits

Fireside Chat Number Eight was posted to our website on April 22 and did double duty as the First Quarter QCM (Quarterly Capital Markets Review). The MCM 2009 annual meeting was held soon after on May 12. The webcast of the meeting was posted to our website shortly thereafter. Now close on the heels of the annual meeting comes the Q2 Quarterly Capital Markets Review. The phrase "enough already" is deafeningly ringing in my ears. ☺

Some months ago I read the book *Animal Spirits* by George Akerlof, a Nobel laureate in economics, and Robert Shiller, a leading proponent of behavioural finance. Both men hang their academic hats at Yale, and philosophically they are linked to John Maynard Keynes.

Keynes has said that changing psychology caused the Great Depression. He referred to the term "animal spirits" in his *General Theory* (1935). This, Keynes said, was "a spontaneous urge to action rather than inaction, and not as the outcome of a weighted average of quantitative benefits multiplied by quantitative probabilities."

Akerlof and Shiller have, in their book, resurrected Keynes' idea with a broader and more contemporary definition. They say "animal spirits" refers to all non-economic, non-rational emotions and motivations, including (often powerful) forces excluded from the conventional, neo-classical model of the economy.

Their timing is prescient. Fifteen months of zero interest rates and ongoing Fed spending (causing a budget deficit equal to a whopping 10% of GDP!) hasn't moved the needle much. As they might attest, current investor and consumer behavior is not rational.

They retort that mainstream economists overlook "predictably irrational" behavior. Confidence is the cornerstone of animal spirits. It is bedrocked on four subcomponents: fairness, corruption and bad faith, money illusion, and stories.

As such, businesses and governments are not currently evoking widespread confidence. Employers are cost-cutting; but employees see this as indifference to their plight. Americans believe that corruption and bad faith are rampant in corporations and governments—as hallmarked by the populist outrage against Wall Street institutions like Goldman Sachs. Consumers are responding in kind. Strategic defaults, or individuals choosing to default rather than struggle to pay debts, have taken hold.

One might conclude by revisiting the history of the 1930s that belief in our economic invincibility is, with each new troublesome data point, being called into question. The U.S. government has forgotten the mystery and majesty of capitalism in an effort to kowtow to the public's overall angst.

Animal spirits cannot take root in this anti-business environment. Without them, the chances of growing our way out of this slump grow dimmer and dimmer.

The evidence is clear. The recovery is beginning to stumble without the on-again-off-again injection of external fiscal and monetary adrenaline. The withdrawal effect is widespread, particularly in the economically-critical real estate sector. Absent the $8000 first-time home buyer tax credit, residential housing is hitting new lows. The 8000-plus financial institutions that financed the commercial real estate boom are attempting to "balance their sheets" with assets that are marked down nearly 50% on average from their highs and liabilities that remain unflinchingly unchanged.

Further, the impressive 15-month-old contra trend rally in the equity markets—and the less visible junk (bond) yards as well—has begun to get wobbly.

The S&P 500 appeared to have run out of steam on April 23 at 1217, several weeks after the put option strategy in which most of you participated was implemented. By June 7 the S&P had given up 14%, to close at 1050. After a halfhearted, low-volume rally to 1115 that petered out on June 21, the S&P has once again turned south, trading around 1027 as this QCM goes to press, leaving it in negative territory year-to-date.

The June 2011 put options with a strike price of 700, for which on average we paid $10, rose as high as $40 during the dramatic May selloff and are currently valued at about $32. They expire in 351 days. As we look toward a cloudy future, we may have until the end of the year before our strategy shifts from one of opportunism to making our exit at the best price luck and effort will produce. As for the best case outcome we yield to the advice of Kenny Rogers:

You never count your money, when you're sittin' at the table
There'll be time enough for countin', when the dealin's done.

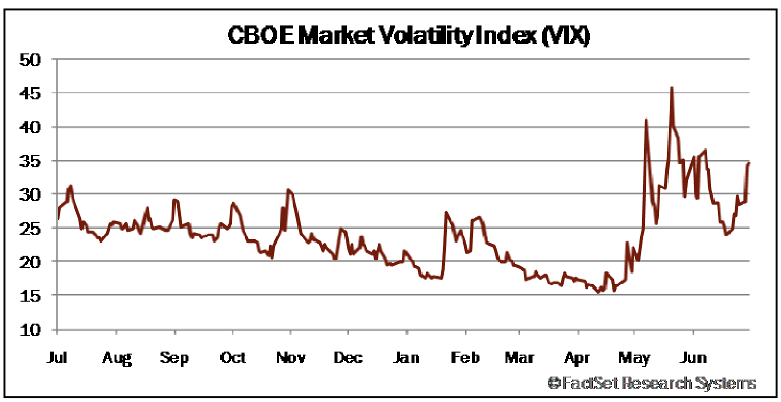
— Frank Martin, CFA

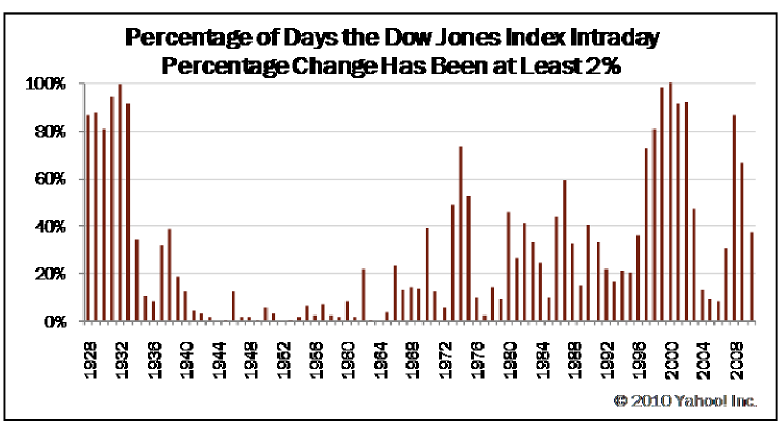
Portfolio Managers' Wrap-Up

If we had a theme during the second quarter, it would be "Re-emergence." This section of the QCM had, by necessity, taken a back seat to more pressing global macro-economic and asset market issues. While many of these issues continue to challenge us, we thought—and you told us—that it was time for a return of the "back section" of the QCM. Going forward, this section will review some notable dynamics in equity and fixed-income markets from the previous quarter. We will provide composite performance numbers, summarize changes in our equity holdings (the "BATS" table below), and highlight key company-level issues as appropriate. We'll close with a very general outlook and how it shapes our idea generation and portfolio management processes. We hope that this, along with the Recent Portfolio Activity section on our website, will help provide ample context to our actions on your behalf. Of course, if you have any further questions or comments, call us anytime!

Instability: Friend or Foe?

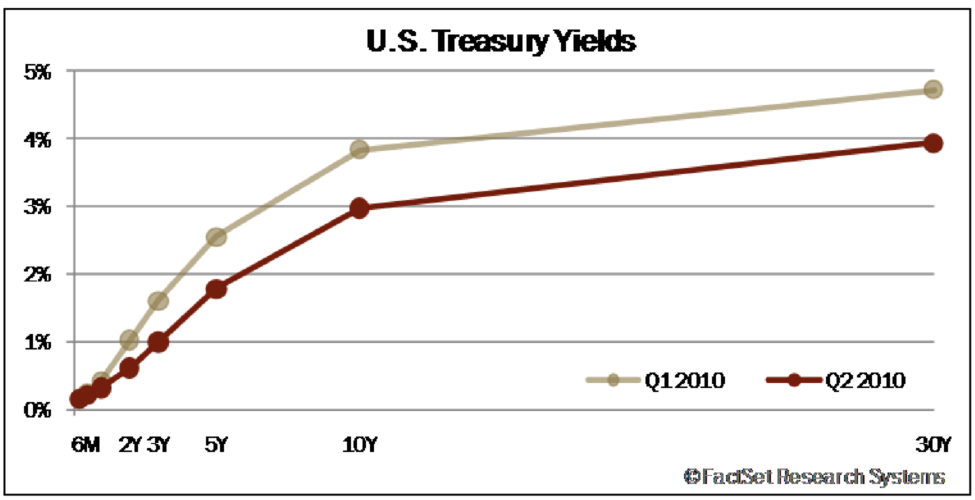
Volatility has re-emerged. The chart below shows that the volatility index (or "Fear Gauge," as some call it) has come to life after lying dormant for much of the past year. Additionally, the next chart shows the percentage of trading days in which the Dow swung more than 2% (intraday). Swings of more than 2% have taken place 37% of the time year to date, while swings of at least 1% have occurred almost 100% of the time. The sharp and rapid rebound in equity markets leading up to the quarter combined with intensifying doubts about the robustness of the economic recovery produced a market environment vulnerable to profit taking.





Then swine flu re-emerged. Not to be confused with the strain that caused widespread fear that a virus affecting pigs would spread to millions of people around the world, this strain caused wide-spread fear that sovereign fiscal sickness among PIIGS (Portugal, Italy, Ireland, Greece, and Spain) would spread to the rest of the world. The prospect of global banking assets being eroded by a collapse of European sovereign debt resurrected the searing memories of the recent liquidity-cum-confidence crisis. Complacency gave way to fear. Throw in a devastating gusher of oil in the Gulf, a dollop of contentious financial reform, and a pinch of still inexplicable "flash crash"—and v*oilà* … volatility. We believe that heightened volatility in the equity markets is here to stay for the near- to mid-term. All things considered, this should be advantageous for stock pickers such as MCM.

One of the most crowded trades among hedge funds and professional managers is shorting mid- and long-term Treasuries (betting that interest rates will go up). The chart depicting U.S. Treasury Yields shows this was not a winning position in the second quarter. As the European debt issue unfolded, our dollar and our debt benefited from a flight to quality—or to the least bad, if you will. Consequently, interest rates notched down in the quarter. While we believe we will see higher rates across the curve in the next couple of years, persistent fear and short-term deflationary—or disin-flationary—pressures may continue to weigh on rates in the near term.



Portfolio & Performance Review

The following table reflects the returns on the composite for a fully discretionary portfolio (both equity and total) for the second quarter and year-to-date periods. Our equity portfolio continues to outpace the S&P 500 and the put options (included in Total Account) performed very well on a mark-to-market basis, contributing handsomely to the total return. Our cash balances remain high, reflecting a relative paucity of bargains in the equity markets.

	2nd Quarter	YTD
MCM Equities *	-6.9%	1.8%
MCM Total Account *	**3.0%**	**5.0%**
S&P 500	-11.4%	-6.6%

** 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.

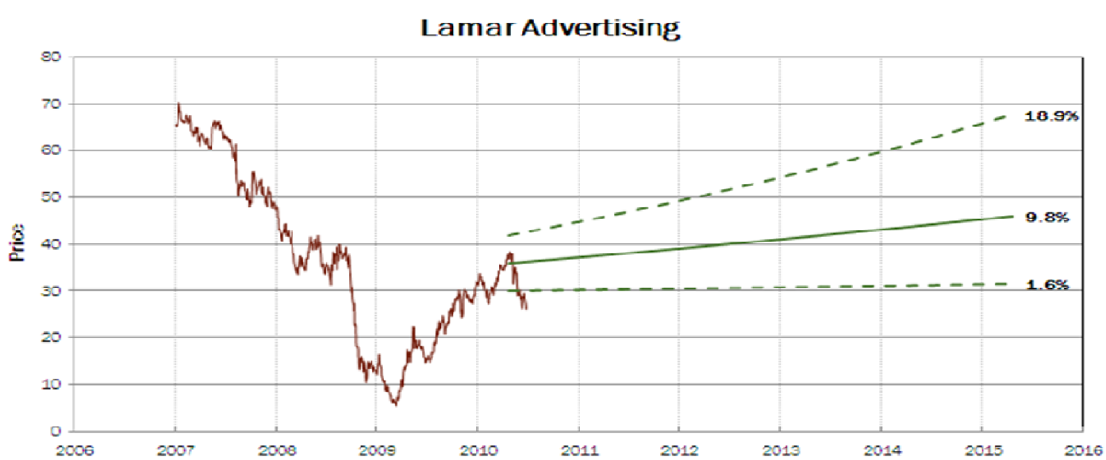
Due to client nuances including equity allocation constraints, start date and cash flow differentials, derivatives constraints, tax issues, etc. an individual's account performance may differ materially from the composite. ***Past performance is no guarantee of future results****.)*

The BATS Table below summarizes changes to equities and options in fully discretionary portfolios during the quarter. At the time each trade was consummated, we posted a brief commentary explaining our action to the Recent Portfolio Activity section of our website. Please feel free to visit the site when you receive a trade confirmation in the mail.

Q2 2010 Portfolio Activity			
B Buy	**A** Add	**T** Trim	**S** Sell
S&P 500 LEAPS*	Walgreen	Emmis	Lamar

* 700 strike maturing June 2011

Summarizing the second quarter, we sold half of our Lamar position at $32.50 and the remaining shares at prices just north of $38. As you can see in the "value channel" analysis, the stock price had reached a level where the *forward-looking* return no longer offered attractive rates. Shortly after this sale, the stock fell to $25, a point where we were again salivating over the possibility of owning this great franchise for the third time.



We're preparing for EMMS' final sign-off … finally. CEO Jeff Smulyan found a financial backer and has offered to take the company private for $2.40 per share. It is likely that Smulyan will ultimately do what we and other investors have thought he should do: opportunistically sell underperforming properties, pay down debt, and focus on running the remaining properties better. That said, we are anxious to close this chapter and have tendered our shares. Our walls don't have enough space to hold all the degrees we have received from "Emmis University." We know that lessons learned during this experience have already begun paying off. In the end, we hope it was worth the tuition paid.

Walgreen (WAG) was involved in high drama this quarter that will most certainly become a Harvard case study on game theory and competitive strategy. On June 7 Walgreen announced it will withdraw from the provider network of pharmacy benefit manager Caremark—which, coincidentally, is owned by arch-rival CVS—over the next three years. Two days later CVS Caremark (CVS) retaliated by saying its members would be barred from filling prescriptions at Walgreen within 30 days. During this competitive stare-down, the shares of both WAG and CVS fell more than 5%. An accord was eventually reached (though neither party disclosed who blinked), but the often confusing relationships in pharmaceutical distribution are becoming more tenuous. Late in the quarter, we added to our Walgreen position when it sold off after a mediocre quarterly earnings release.

Prospective Perspective

One-month Treasury bills are yielding 0.13%, meaning investors are being paid a mere $1,300 for a year, or $108 for a month in return for lending the Government $1 million. To put this paltry sum into perspective, over the last 83 years T-bill yields have averaged 3.7%, which would boost the monthly return to $3,083! Inflation over the same 83-year period has averaged 3%, resulting in a long-term *real* yield (nominal yield less the rate of inflation) of 0.7%. Today inflation is running at about 2%. So today's investors buying one-month T-bills are experiencing a 1.87% *decline* in the purchasing power of their money (negative real yield).

While disinflation/deflation risks exist, we believe that the longer-term risk is inflation. We find simply too much debt, unfunded entitlements, and deficits as far as the eye can see to think the dollar (a fiat currency) can maintain its current purchasing power. We further believe that inflation will likely emerge within a relatively low-growth economic context (re-emergence of stagflation?). Under this scenario, the yield curve will probably steepen as longer-term rates begin to price in a more inflationary environment, while the Fed continues to hold down short rates in an effort to stimulate growth and capital formation. With that scenario as a backdrop, we are looking at ways to capitalize on a possible rise in long-term interest rates.

Even after the recent pullback, there are few obvious bargains in the equity markets. That said, our idea development is focused in areas that we think will produce opportunity in the months ahead: property casualty insurance, healthcare, oilfield services. In addition, we're maintaining our inventory of wonderful businesses in order to be ready to capitalize on increased volatility. As Charlie Munger, our mentor in absentia, has proclaimed (with deference to Louis Pasteur), "Opportunity comes to the prepared mind."

— Todd Martin, CFA
— Drew Wilson, CFA

Website Information

www.mcmadvisors.com

Fireside Chat #8 was added to our website in April, both in audio and transcript version.

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