MARTIN
CAPITAL MANAGEMENT, LLC
Registered Investment Advisor

QUARTERLY
CAPITAL MARKETS REVIEW

July 2011

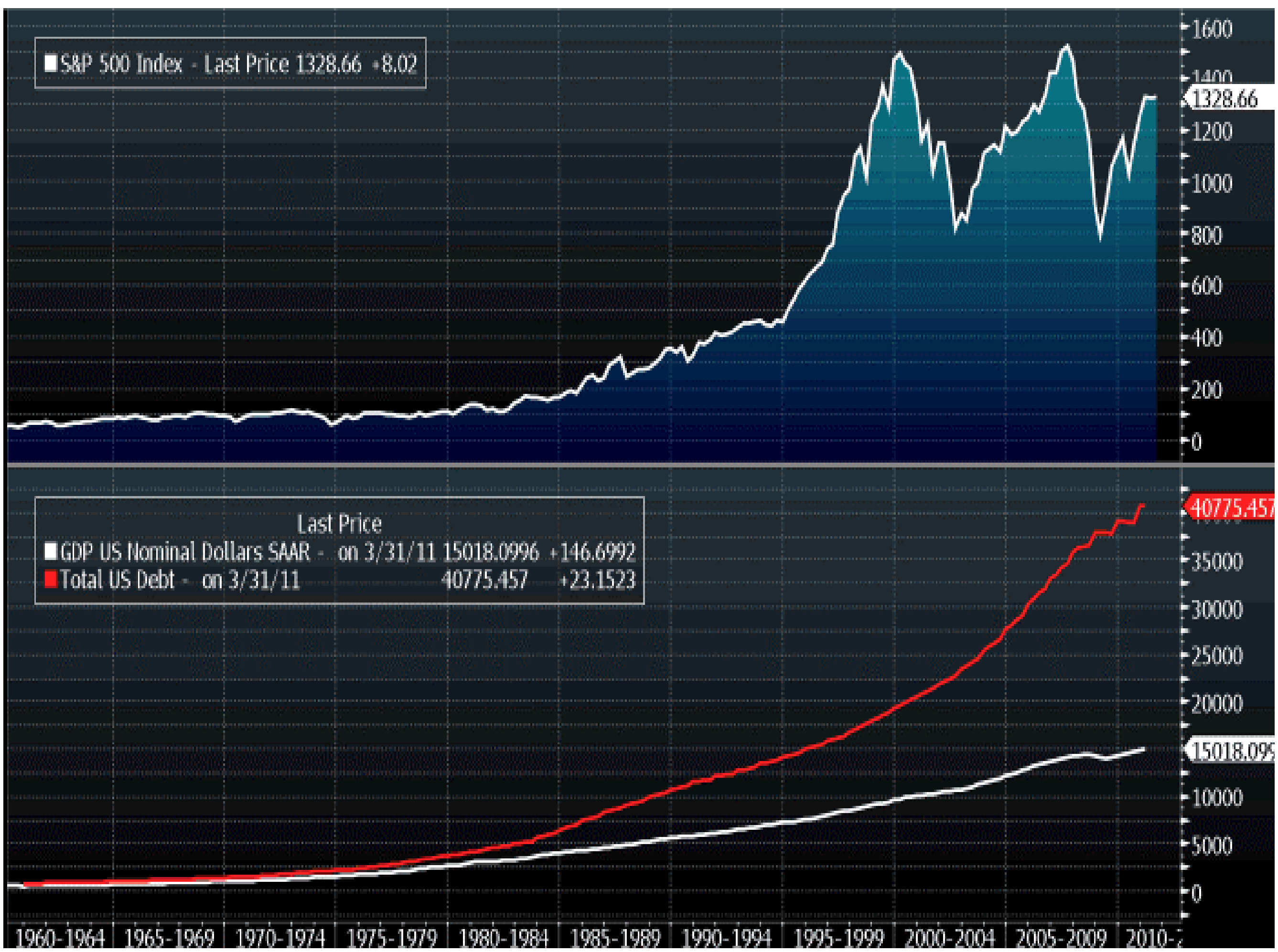
Finding Clarity in the Fog

The technology revolution has leapfrogged the limitations on immediate access to information. And it's literally at your fingertips. Gary Sieber and I were at a meeting in a restaurant and a question arose. Within seconds Gary handed the third party his iPad, displaying the answer in vivid color. To be sure, the increase in sheer volume is overwhelming. Often this leads to confusion, not enlightenment. When information pertains to the economy and the capital markets, clients tell us they frequently find themselves in a fog of obfuscation. In scientific terms, the "signal-to-noise ratio" is a measurement to quantify how much a signal has been corrupted by noise. We could adapt the term for economics and markets to refer to the ratio of useful information to false or irrelevant data we encounter. Moreover, what's signal and what's noise gets increasingly difficult to discern. With so many messages inundating us, it's nearly impossible to check the integrity and authenticity of the sources. Ten years ago the signal-to-noise ratio may have been 1 to 10. Today, maybe 1 to 50. Our clients say they don't need more information, only better filters. That's in part why we can be of value to you.

Let's start bold and brash. Since the Great Recession began 3½ years ago in, yes, December 2007, the headlines have focused on the lethargic recovery, the ever-present trade imbalance, the short-term ups and downs of the nation's income and spending statement (GDP), and the component parts of consumer, business, and government spending. That information is the effect. Without knowing the cause, it's little more than noise. Tracking GDP without also looking at the country's balance sheet is a bit like examining a skin rash without considering whether it was caused by poison ivy or measles. The crisis of 2008 and what might lie ahead for Europe can be traced to the failure of reconciling both statements: the amount of debt on the liability side of the balance sheet, along with the ability to service that debt, which can be found on the income statement.

The cause for today's uncharacteristic economic malaise has remained elusive until recently because the economics profession is simply not schooled to look beyond the national income statement. Ever since World War II, GDP has been a sufficient tool for analysis and opinion. Business cycles cropped up irregularly, but once under way, they followed a crudely predictable pattern. As you may have already suspected, we are today talking about a balance-sheet recession—and about the deleveraging it precipitates. This is not in the textbooks. The fact that you've heard about it from us for a long time is no statement about our brainpower, but simply that we have not been programmed to think as narrowly as most economists do. With our wide-angle lens, it wasn't terribly difficult to extrapolate the easy money- and financial innovation-induced Housing Bubble into its inevitable implosion as the financial crisis and the Great Recession. Further, unlike professional economists, we aren't worried about straying from the pack. We don't have a peer-pressure problem. In the pursuit of truth, we'll even take the risk of looking stupid.

Several weeks ago Aaron Kindig, Clint Leman, and I were discussing the matter of how to communicate the possible GDP impact of widespread deleveraging in an easily understandable way. Knowing my weaknesses in that area, they put their heads together, thought the matter through, and created the following graphic. After examining their work, I mused about the memorable St. Augustine quote, "Lord, make me chaste, but not yet," substituting in my mind "redundant" for "chaste."



A Picture Worth a Thousand Words (or $40 Trillion)

Take a minute to become familiar with the chart. Notice, for example, that it covers a 50-year time span and that the Y axis is arithmetic, not logarithmic. Now focus on the white curve in the bottom half of the chart. It's a graph of inflation-adjusted GDP, which has grown at a comparatively consistent and steady average rate. This is the economic indicator that gets the attention of economists. Now look at the red curve, the total U.S. debt, excluding that of financial institutions. Since 2000 it has doubled, whereas GDP has increased by only 50%. Spending financed with borrowed money (think of consumer spending in the last decade funded by home-equity loans) is of lower quality than that done without borrowing. Of greater concern, it has taken more and more debt to move the GDP needle. This pattern contains the seeds of its own destruction. It's a worldwide problem that now seems to be coming to a head. This is a situation where in an uncertain world one has to choose between being generally right and precisely wrong. There should be no doubt as to which fork we have taken.

If the growth in debt slows to equal that of GDP, or worse, grows at slower rate—precisely what we're seeing in Europe and what is being debated in the U.S.—paying down debt will, as is becoming increasingly apparent, pour cold water on the economists' GDP growth forecasts. Deleveraging is a process that, once it gets a toehold, takes years, not months to complete.

Zeroing in on the consumer sector, which still represents 70% of GDP (but is fading), it's easy to see the connection between deleveraging and spending. This is what the *Wall Street Journal* recently had to say on the subject:

> The biggest problem may be household indebtedness. At the peak of the economic boom in the third quarter of 2007, U.S. households collectively had borrowed the equivalent of 127% of their annual incomes to fund purchases of homes, cars and other goods, up from an average of 84% in the 1990s. The money used to pay off that debt means less available for new spending. Households had worked their debt-to-income levels down to 112% by the first quarter, in [large] part because banks have written off some debt as uncollectible.
>
> Getting rid of debt could be a long and slow process. To get back to a 1990s debt-to-income ratio of 84%, households would either need to pay down another $3.3 trillion of debt, or see their incomes rise $3.9 trillion. That's equivalent to about nine years' worth of income growth in normal times, estimates Credit Suisse economist Dana Saporta.
>
> Debt constraints are especially hard on consumers who before the crisis relied on credit cards or home equity lines to keep spending when they needed money. Now many of those lines have been limited or cut.
>
> With less access to credit, many families are finding the only way to make ends meet is to cut spending.

When spending is cut, regardless of the economic sector, economic activity slows. The employment reports from May and June 2011 revealed the extent of the negative-feedback loop. With the labor force growing an average of 150,000 people a month, the lethargic economy generated only 25,000 and 18,000 jobs, respectively, during the two months. It should be noted that the economy is still receiving injections of monetary and fiscal stimulus, which are about to wind down … unless, as is likely, the policymakers panic again.

We turn next to corporate profits, the residual on the corporate income statement, which have been on a tear. In many industries topline growth has been anemic and input costs have been rising. Businesses did what they felt they had to do—become more efficient. Labor is one of the most expensive and least malleable of inputs. Technology is displacing labor for many activities. This is a positive development in the long run (remember Matt Ridley and the *Rational Optimist*), but it causes great dislocations among workers, which is often the primary incentive for change in the short run.

Corporate profit margins are at all-time highs as a result. Without topline growth, and with a populist revolution gaining steam, margins are likely to shrink back to levels closer to historical norms.

The Economic Landscape: Painting by Numbers

Given what you now know about the bottom half of the chart as the ultimate determinant of stock prices, look carefully at the white line on the top half of the chart, the S&P 500 index, using monthly data, going back to 1960. Take in the chart as you would a painting, viewing it in its totality. It's obvious that there were two peaks, in 2000 and 2007, and two valleys, in 2002 and 2009. The question of the day is rather straightforward: Are the valleys, each around 800 on the S&P, the springboard for a new bull market that will eventually take us to new highs above 1500? Or, are the two peaks likely to prove insurmountable for some time, and could the markets make new lows before they make new highs in the long run? If it weren't for the data in the bottom half of the chart, a simple coin toss might suffice.

As has been obvious to readers of Martin Capital missives for a long time, as well as a central theme in my 2011 book *A Decade of Delusions*, I have reasoned that 2000 represented the high point following two decades of accumulating speculative excesses. Were it not for the Fed's fear-driven intervention after each of the peaks, the excesses would likely have been purged quickly and efficiently, though admittedly not without financial distress for many people. Instead of allowing markets to do what they do, intervention resulted in the easy-money "fools rally" from 2003 to 2007, where financial excess replaced overvaluation as the catalyst *du jour*. Since 2009, an ever-more-desperate Fed has once again opened the monetary floodgates. Predictably, the Fed will be no match for the economic ravages of deleveraging and its ultimate impact on corporate profits. My gut says the peaks will stand, while the valleys will not.

Hemlock, Arsenic, or Cyanide? Choices in a Balance-Sheet Recession

Picking one's poison is never very appealing. The easiest way for sovereign debtors to deleverage is to surreptitiously depreciate their currencies through inflation or, more dramatically, through currency devaluation. That may ultimately be the only option for U.S. policymakers but, in the meantime, excess capacity throughout the system has made stoking inflation nearly impossible.

The most dramatic method of deleveraging is default—and, in fact, most of the deleveraging by U.S. homeowners has been accomplished through simply walking away. Make no mistake, defaulting does not get rid of the debt, it just moves it from one balance sheet to another. That's precisely why the ECB (European Central Bank) and the IMF (International Monetary Fund) are loath to let Greece do now what it almost certainly will do later—default. The banks of France and Germany would end up holding the bag.

Programs of austerity are the most painful and frequently politically unpalatable. As noted in the above discussion about U.S. consumers—and as is evident currently in Ireland and soon in Greece, and perhaps in Italy, Portugal, and Spain—the price of austerity is often sub-par economic growth. Damned if you do, damned if you don't.

Portfolio Strategy and Risk Management in an Era of Tail Risks and Disaster Myopia

(Tail Risks and Disaster Myopia were the subject of the last quarter's Quarterly Capital Markets Review, which is available to clients on our website at www.mcmadvisors.com.)

By sheer coincidence, I recently received a most *apropos* essay from James Montier, a fellow I've come to know reasonably well. The essay's title: "Ode to the Joy of Cash." Montier is a fiercely independent thinker and prolific writer, as well as a strategist for GMO, the $100 billion institutional money management firm led by Jeremy Grantham. Montier's eight-page essay is attached in its entirety, and I recommend that you study it carefully. Here I will hit some of the highlights.

In the economic, financial, and market environment I described above, we face a plethora of risks.

Valuation Risk

In a chronically expensive market, value investors argue that future returns are likely to be subnormal and that the risk of unexpectedly large "drawdowns" (street talk for bear markets) is elevated accordingly. Montier's discussion of valuation risk begins on page 4 of the attachment. John Hussman's scatter diagram on page 5 speaks volumes. Interestingly, if not self-servingly, Montier considers cash an excellent hedge against valuation risk. One of the more compelling paragraphs in the essay is the first one on page 6. If you read nothing else …

Fundamental Risk

As discussed in the first segment, earnings quality and growth are sure to be impacted as deleveraging spreads throughout the world's economies. Policy responses could result in either inflation or deflation—or perhaps both—in the years ahead. Montier makes what I think is a compelling case that cash is the most robust (although not optimal) hedge in the event that you are unsure of which malady is the more likely. If you are as nervous as we are about the fate of the purchasing power of the dollar, don't leave home without reading this section (beginning on page 6). If you can find the time, also take a moment to read the comparison between Black Swans and "predictable surprises." Many argue that 2008 was a Black Swan event. We feel it was a predictable surprise. Looking forward, at least based on the costs of protecting assets against such "surprises," more people have come to share our view this time around.

Financial Risk

We don't use financial leverage in your portfolio, and we avoid companies that rely on leverage to amplify their returns. (In the spirit of full disclosure, we do employ synthetic leverage when we use index options.) While the risks associated with a "crowded trade"—everybody jumping on the bandwagon as is apparent in today's markets—are those we try strenuously to avoid, Montier no doubt included this one-off risk in the financial category because there was no other convenient place to put it! To the extent that he's referring to the eventual unwinding of what Nouriel Roubini called the "mother of all carry trades" (first introduced in Fireside Chat No. 7, December 11, 2009), it does belong here.

There is an additional risk that remains below almost everyone's radar. Because of a dangerous mix of "complexity and tight coupling,"[1] isolated risks can become systemic ones through the process known as contagion or the domino effect. For example, European banks are inextricably linked to Greece's sovereign debt crisis. Most people know about those dominoes. Few, however, know that almost 50% of the $2 trillion in U.S. money-market funds assets are invested in the short-term debt of European banks. And further risks from complexity and tight coupling run even deeper than that. An important part of our job is to not only be aware of such threats—but to protect you from them.

[1] *A Demon of Our Own Design: Markets, Hedge Funds, and the Perils of Financial Innovation* by Richard M. Bookstaber (December 2008) and *Adapt: Why Success Always Starts with Failure* by Tim Harford (May 2011).

Burning Off the Fog

It is always darkest before the dawn. When the markets eventually burn off the morning fog, something even the Fed will be powerless to stop, the dawning of investment opportunity will be at hand. In the meantime, as you'll read below, Adam, Aaron, Zack, and Clint are looking for, and finding, a few hardy fish that are capable of swimming upstream even in the cloudiest waters. Therein lies the clarity of what we try to do at MCM: By protecting your capital from permanent loss, we intend to enhance the miracle of compounding over time; and by hunting down investment opportunities with strong upside potential within an adequate margin of safety, we strive to grow your capital in a rational, patient, and disciplined manner.

–Frank Martin

Second Quarter 2011 Portfolio Review

Because of the ongoing conditions described above, we continued our defensive posture with regard to equity exposure in the second quarter of 2011. On average, we were roughly 30% invested in equities, and thus client portfolios continue to lag a generally rising U.S. stock market. Through the first half of this year, the average total MCM account was up 0.7%, well behind the S&P's total return of 6% year to date.

As long-time clients, you understand that these are the periods in which we, as tortoises, look slow in comparison to the faster-moving hares. Experience has taught us that we will go through such periods—as we did, for example, in the market run-up before the 2008 financial crisis. While nobody likes trailing in the race, we know in the deepest marrow of our bones that this slow-but-steady approach is precisely what allows us to generate a superior long-term capital compound on your behalf. If the race were only one lap around the track (one quarter, one year, or even several years), we would be concerned that we were going to fall permanently behind. As long-distance runners, however, we know that the race covers much more ground than is currently in view. It is precisely by conserving our energy—in the form of idle cash—that we believe we will continue to outpace the averages for you. When the market hares inevitably go off course or slow down, we will be there trotting along, ready to widen our overall lead. This will largely be accomplished by putting our excess cash to good use at the appropriate moment—as bargains inevitably abound during market stumbles.

	2nd Quarter	YTD
MCM Equities *	-3.8%	3.4%
MCM Total Account *	**-1.1%**	**0.7%**
S&P 500	0.1%	6.0%

** 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.)

Second Quarter 2011 Portfolio Activity

Bought:

We initiated two new positions and added to a third core holding late in the second quarter. While we are convinced that stock prices today generally don't reflect the grim macroeconomic picture, we also believe that certain stocks are so unloved and misunderstood that they are bargains even in this environment. Although they will likely suffer along with the rest of the market during a correction, their current price suggests that they will do well over the long term. Meanwhile, we have not taken what we consider to be a full position in any of them, so that if the market does sell off we can buy more on your behalf at better prices.

Berkshire Hathaway is the position to which we added during the quarter. Warren Buffett's company is well known and well run; the stock market, however, is currently eager for high fliers that will continue to appreciate, thanks to the artificial rocket fuel generated by QE2 and, perhaps, a soon-to-be-announced QE3. In stark contrast to the market's 30% rise over the last year, Berkshire is unchanged and thus offers investors a compelling price versus value bargain. At $75-80/share for the "baby B's," we are buying on your behalf the best-run, best-capitalized insurer/conglomerate in the world at only a 15–20% premium to its book value. This price represents the lowest levels in more than a decade and a discount to the stock's intrinsic value. Berkshire's stock often trails the market during heady (read: speculative) times. Historically, these are the perfect times to buy it: when it's "hiding in plain sight"—boring, solid, and attractively priced.

Investors often ask us about overseas exposure, particularly to Asia. Our response has been consistent: When we find well-managed, attractively priced U.S. businesses that have a significant foreign presence we will eagerly buy them on your behalf. In Yahoo we think we have found such a business. As a No. 2 in search to Google, its core U.S. operations are not doing particularly well. However, that is more than offset by its tremendous exposure to wonderful Internet businesses in both China and Japan. Yahoo owns 30%

of Yahoo Japan, a separately traded company that has a 60% share of the large and growing search market in Japan. As a result, it can be rightly considered the "Google of Japan." It also owns 40% of Alibaba Group, a Chinese juggernaut with Google/eBay/Amazon-type businesses in that nation's young and rapidly growing economy. While we are generally suspicious of technology companies, we are by the same token attracted to what might be called "non-tech tech"—i.e., businesses whose economic characteristics resemble more a consumer or media company than a fast-paced technology company.

Yahoo's Asian assets reflect this type of play. Alibaba Group's businesses have anywhere from 50% to 80% market share in everyday Internet activities like online shopping and electronic payments. These large market shares, combined with the habitual nature of Google/Amazon/eBay-type transactions, make it difficult for competitors to dislodge them once consumers become used to their services. The market, however, is not giving sufficient credit to these valuable Asian franchises embedded in Yahoo. We think that even if the core U.S. business is worthless—which it is not—the value of Yahoo's balance sheet at least equals the current stock price. While it's somewhat worrisome that CEO Carol Bartz has not handled relations with her Chinese partners particularly well, the price-to-value disconnect here is simply too compelling to pass up.

Finally, we initiated a position in Walmart, a holding we've owned before on your behalf and one which, like Berkshire, is hiding in plain sight. Over the last decade, Walmart's earnings have quadrupled, but the stock has remained flat, leading to its lowest relative valuation ever. The company is suffering from what we consider relatively transient problems, including anemic same-store sales. Meanwhile, Walmart has an excellent new CEO who understands Walmart's competitive advantage—its low-cost retail status—and is focusing on it like a laser beam. When excellent companies with sustainable economic moats are temporarily out of favor, experience has taught us that this is precisely the time to buy. Walmart is not going to double or triple in a year, but we can easily see it appreciating 10–15% annually over the next decade—what might be called "a steady earner." The Walmart investment case is not sexy and won't spice up many cocktail-party conversations, but as Buffett has said, the best investments are often those that are initially greeted by a large yawn.

Sold:

In our first quarter 2011 portfolio review, we wrote that we had begun to reassess our holdings of Brown & Brown, a leading regional insurance brokerage. That reassessment is now complete, and as a result we have sold all client holdings in this security.

The case for selling Brown & Brown was clear. While we still like the underlying business of insurance brokerage (as intermediaries, brokers put up no capital but merely collect a commission), Brown & Brown failed to meet our standards on our other two critical variables: price and, especially, management.

On the price front, Brown & Brown had appreciated respectably since our initial purchases in 2007. Earnings, however, have been flat, and at $25/share the stock appeared fairly priced at best and expensive at worst. Even if we extrapolated a recovery in insurance prices, which would've boosted the company's bottom line, the stock was by no means cheap.

Compounding this problem was the fact that management succession at Brown & Brown had not been going well for some time—and got considerably worse in early 2011. We had our doubts about the plans of legendary founder Hyatt Brown to turn leadership over to his son, a former self-described ski bum. Businesses that go through leadership restructuring sometimes emerge even stronger and more vibrant on the other end, so we paid close attention as the situation unfolded at Brown & Brown. The results, however, were disquieting. The company has been on an acquisition binge over the last few years with little to show for it. Then, in March, the company announced that the former No. 2 was leaving the company along with other key management personnel to start a rival brokerage firm. It wasn't initially clear that such a move was legally possible. Like all brokerage companies, Brown & Brown had non-compete clauses—and it might even ultimately be able to block the move.

Nevertheless, three things are quite clear: The founder is increasingly out of the picture; recent acquisitions made by the new leadership are not paying off; and top executives who had been critical to Brown & Brown's success have become unhappy and have either left or want out. This latest development was the last straw: Faced with a mediocre price, we found it relatively easy to exit the position.

–Adam Seessel

Options Program Update

In the 2010 annual report you received in January of this year, we updated the progress of put-option hedges placed in the spring of last year:

> In April [2010] we instituted a program of purchasing modest amounts of one-year, out-of-the-money index puts to insure portfolios against loss of capital. Since your interest and approval were solicited beforehand, an update at the midpoint to expiration of the put contracts might make it clearer how we focus on sound process, not on specific outcomes that are simply unknowable. The update is posted to the client section of our website. *Though we prefer investing in solid companies for the long haul, on rare occasions, protecting portfolios from, and in fact capitalizing on, the possibility of a sudden market reversal can be a rational risk-avoidance and wealth-enhancing strategy. The war to protect your capital is joined but is not yet finished. Victory hinges not on a single battle but on the combined results of many battles over a long period of time* (emphasis added).

The last two sentences explain the arduous road ahead. Understandably, given the complexities of buying and selling these securities in a timely fashion, there were only a couple of takers from the invitation for all MCM clients to participate. Hedging of this type is not for the faint of heart. To begin, it is a "negative carry" trade; i.e., money is paid out with no assurance of a payoff down the road. Because timing is unknowable, this unrewarded outlay can go on for some time. If the markets eventually prove our judgments right, there may well be a carrot at the end of that long stick.

Fifteen months and QE2 later, the S&P 500 is around 1310, up 100 points, or about 8%, from when the option program was initiated. At a Shiller price-earnings ratio of 24, the wet-blanket effect of deleveraging in all sectors of the U.S. economy, as well as in Europe and China, does not appear to be priced in. As noted in the James Montier attachment, cash is a solid hedge against valuation and fundamental risks. Few managers have hedged their clients against the above risks anywhere near to the extent we have. The risk-adjusted opportunity cost has, in our judgment, been more than acceptable thus far. If our fiercely independent and contrary strategy is proved misguided, we and our clients will pay the price of falling behind. That said, the invitation to participate in the options program remains open to anyone who believes that inevitable failures are more likely to be cataclysmic because of the "complexity and tight coupling" mentioned earlier. If you are interested in taking part, please call your account service representative at MCM to discuss the suitability of the program for you. Of course, you are always most welcome to call or email me directly.

–Frank Martin

Website Information

www.mcmadvisors.com

- For additional periodic updates on both investment research and portfolio activity, visit the client section of our website at www.mcmadvisors.com.
- To log in, 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.
- We recommend you change your password once you've accessed the client site. Passwords using combinations of upper-case and lower-case letters, as well as numbers, offer more security than simple names or numbers alone. 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.
- If you would prefer to receive the MCM Quarterly Capital Markets Review in hardcopy format by regular mail, please call or email Kristen Smith-Myers (574-293-2077; kristen@mcmadvisors.com) and she will make the necessary arrangements.
- We'd love to hear your comments on this, or any other, communication from Martin Capital Management. Please call or email Gary Sieber (574-970-2926; gary@mcmadvisors.com).
- 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.

MARTIN
CAPITAL MANAGEMENT, LLC
Registered Investment Advisor

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