MARTIN
CAPITAL MANAGEMENT, LLC
Registered Investment Advisor

"The aim of education is the knowledge not of fact, but of values."
– Dean William R. Inge

"Human beings, who are almost unique in having the ability to learn from the experience of others, are also remarkable for their apparent disinclination to do so."
– Douglas Adams

"Automobile stocks were to the stock market of the 1920s what electronics would be to that of the 1950s; by the time the really big market advances of the period were under way, General Motors, Fisher Body, Du Pont, and Yellow Cab were called the Four Horsemen of the boom, and it was a standard Wall Street joke to speak of the market collectively as 'a product of General Motors."
– John Brooks

"Practical men who believe themselves to be quite exempt from any intellectual influence, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back"
― John Maynard Keynes

2020
ANNUAL REPORT

For further information, contact Client Relations
at ClientRelations@mcmadvisors.com

Dear client:

The S&P 500 was up 18.4%, including dividends, in 2020. A typical client following our recommended allocation to put option contracts was up 13.2% and avoided entirely the stressful drawdown in Q1. Individual client performance varies and can be found on the Asset Reconciliation in your quarterly documents.

Market performance was highly varied by economic sector this year. As context, the tech-heavy NASDAQ handedly outpaced the S&P 500. The asset-heavy DOW trailed significantly.

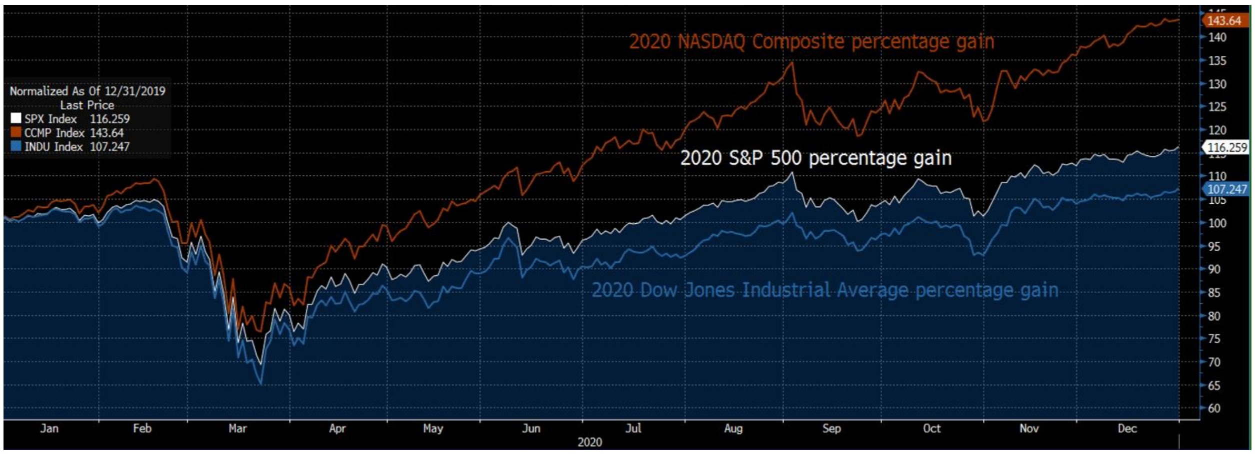


Figure 1 Bloomberg Data. Indexed gains for the three major indexes.

Chapters in a Book: One Cannot Rush History

Our quarterly and annual letters are written under an internal mandate that differs markedly from most communiqués of this genre. Warren Buffett's chairman's letters, most notably before wholly owned companies began to materially eclipse Berkshire's portfolio of marketable securities, typify the approach to client communications that we've attempted to emulate.

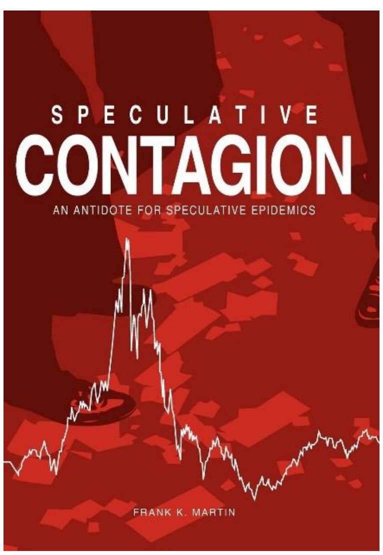
Buffett's annual letters read as if each year were another chapter in a most atypical book. Unlike many nonfiction publications, however, no one knows what this book's last chapter will contain, when it will be written, or who will be its author. His diaries chronicling the Berkshire Hathaway story transcend the personal to serve as a teaching tool for millions the world over. Thus, the "book" serves two very different masters. Initially, it must offer sufficient commentary on the business to be relevant for contemporary readers. Ultimately, though, it must tell a compellingly consistent, understandable, and timeless story of how the wealthiest diversified investor in modern history applied his genius. This latter story is what will earn its rightful place within the pantheon of business and investment literature.

Beginning in 1965, Buffett's annual chairman's letters provide a real-time account of the business and investment decisions of the "Oracle of Omaha" through both the best and the worst of times. Those who know Buffett well claim one of his most satisfying asides is to interact with young and impressionable college students. His "book" will convey his ever-relevant messages into a time he shall not see.

Evidence that Buffett, 90, is fully aware of his literary legacy is everywhere. On many occasions Buffett has alluded to the company's growing size as almost guaranteeing that future performance will not keep pace with the past. Since 2000, the conglomerate's book value and share price have grown at 10.33% and 8.07%, respectively, the latter less than half its average back to 1965.

At Martin Capital Management, we have sought to follow Buffett's literary lead. Everything we write, including this letter, must pass through the two aforementioned filters: Is it relevant today and will it, five or 10 years hence, reveal our capacity to view the present within the grand sweep of history? Although our ambitions are comparatively modest, we are no less compelled to strive for continuity and compatibility of thought in our writing and action over time.

Our story carries far less contemporary weight than Buffett's, but we hope its installments—books—will be given credence by history. Still, the likelihood that a host of screenwriters will clamor for our writings as fodder for a blockbuster movie is akin to a mosquito harboring grandiose delusions floating down the nearby Caloosahatchee River (here in western Florida), hollering, "Raise the drawbridge!"



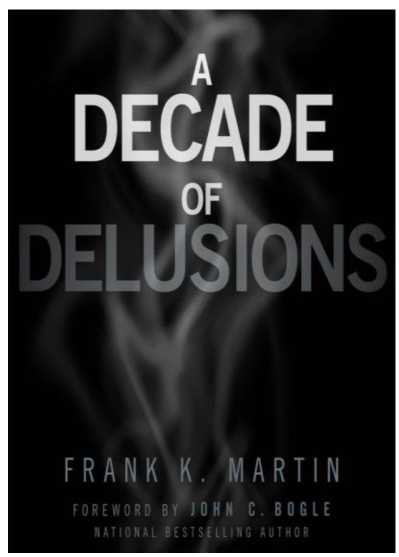


Figure 2: *Speculative Contagion: An Antidote for Speculative Epidemics* was published in 2005 and *A Decade of Delusions: From the Great Moderation to the Great Recession* was published in 2011.

Admittedly, we find ourselves in the position of a squeaky wheel. Each of our first two volumes traced a narrative through a compilation of previously published writings, which mitigated any impulse to cherry-pick. Unlike most books on financial and economic history, they were conceived without being compromised by the bias of hindsight.

If there is to be a final book in a would-be trilogy, it must do justice to its working title, *The Song of the Phoenix: The Value Investor's Score*. Following Buffett's script and our own practice, most of the writing is already irreversibly published in Martin Capital Management annual and quarterly reports, plus 3½ years' worth of biweekly blog posts. As surely as winter follows summer, the book's central thesis will be that the most persuasive case for optimism is the pervasiveness of its polar opposite. The vision is there, but it must patiently await the winter of despair to vindicate it. One cannot rush history.

In the meantime, we impose an uncommon investment constraint on ourselves, which is made clear to clients upon engaging our services. As self-identified absolute-return investors, we will go to great lengths to avoid one inexcusable sin of commission—portfolio positioning that results in capital drawdowns of, say, 40% or greater. Such an occurrence results in all but the most grounded clients or readers throwing in the towel. Our self-imposed charge is to never (a) subject clients to that psychological stress and (b) have them risk capitulating to their fears and booking permanent losses.

Our commitment to absolute-return investing, shared by our partners at Palm Valley Capital Management (PV), becomes particularly burdensome during long bull markets when relative-return investing is the rage. As history makes clear, just at the time when the seemingly endless upward trajectory of markets renders the absolute-return paradigm apparently irrelevant, the opposite occurs.

To be sure, holding the purveyors of mainstream relative-return investing to account before its second-order effects are made manifest is well-nigh impossible.[1] Often their clients are so traumatized by paper losses that some give in to despair and leave investing forever. The real losses those clients book aren't reflected in the hypothetical performance their manager offers prospective clients. Such survivorship bias is a relief to the paid purveyors of this strategy. Selective accounting easily promotes the false notion that a manager or firm has some secret sauce for success when real client experiences may be distinctly and incontrovertibly negative. Remember Bernie Madoff.

Sins of omission, though less immediately catastrophic, can also have a decidedly negative effect on long-term compounding. Cutting to the chase, the undersigned has advocated being underexposed to equities during an uncomfortably long portion of the post-Financial Crisis bull market.

In the aggregate, our client portfolio returns, net of fees, since 2000 were double the S&P 500 through 2009. Our concern about economic fragility since the Financial Crisis and the

[1] Relative-return investing seeks to outperform a benchmark index, regardless of whether it is up or down. Thus, if one's fund is down 39% when the market losses 40%, the year is judged a success. Conversely, absolute-return investing seeks to avoid such aforementioned capital drawdowns, as these are detrimental to investors' psychology and fantastically successful at destroying long-term compounding of returns.

corresponding fantastic growth of asset bubbles have left us underexposed to equities since then. We slowly gave up our lead and, since 2016, no client having engaged us in 2000 has been ahead of the index, though dramatic gains in Q1 2020 did help close the gap. Riding a historic wave of speculative contagion, the index today is a bubble on the brink of a perfect storm. We remain unperturbed. While our clients currently trail the S&P 500 by low single digits since 2000, a precipitous fall would validate our long-term approach and could offer outsized returns after the market cycle reverses. Additionally, those participating in our options strategy may achieve asymmetrical gains during a pervasive bear market.

Transparency in Investment Strategy and Business Plan

Aware that history will judge the integrity and efficacy of our decisions, transparency is our only communication option if we want to appeal to the historians (and be able to sleep at night). Since we openly aspire to compound client assets at long-term average rates of return well above the passive index to more than justify our fees—and, with the further proviso of never exposing clients to the trauma of the huge and potentially destructive drawdowns mentioned above—how do we propose to do it?

Our firm's business plan must leave no doubt in client minds about our priorities. The client must come first. If I were a consumer of investment-management services, the most prized data in judging a manager would be the portfolio's construction prior to past bear markets and, sequentially, the firm's portfolio performance during the drawdown. If a firm has demonstrated willingness to risk client attrition by positioning portfolios to mitigate the damage of large drawdowns—given no foreknowledge of when one might occur—it would pass the test of the manager's priorities.

The plot thickens when the manager offers a fully invested portfolio that is hedged. Hedge funds, as the name would imply (think "hedging one's bets"), should be the obvious example. Many hedge funds, however, have drifted from that vanilla model over the years. Consider whether their commitment to clients is at odds with their incentives. If a firm's non-negotiable and inflexible fee schedule is, say, the sum of 2% of assets on an annual basis and 20% of periodic portfolio appreciation above a high-water mark, the potential for conflict of interest seems too obvious to ignore. It appears fair to question whether the fully invested/hedged posture is in the best interests of the clients or the managers.

The single differentiating advantage of a portfolio of marketable securities is precisely that it is marketable. Although most managers rarely consider it a portfolio-management alternative, holdings can be sold, in part or even in whole, if extreme and pervasive overvaluation appears to warrant. None of the operating businesses, the shares of which compose a portfolio, can voluntarily hit the pause button. For example, consider the limited options for industries adversely impacted by the pandemic.

Our business plan is much simpler. We believe that broad diversification in the face of the breadth and depth of systemic risks we face today will invariably disappoint, particularly if it's marketed as a risk-mitigation practice. Perhaps the first business step for an honorable manager to take is to slash management fees—to the bone if necessary. Our base fee is 50 basis points.[2] Such a willingness to sacrifice allows for a wider range of portfolio risk-mitigation strategies, ones that may ultimately serve clients better.

Subordinating our self-interest, we are employing a strategy that worked exceedingly well for us during the Financial Crisis. It presumes that the surest and simplest way to protect portfolios against unsettling drawdowns during the prevailing episode of extreme overvaluation is to hold the preponderance of assets in short-term U.S. Treasury securities. The versatility such a large position in cash affords is addressed below. Coupled with the Treasury portfolio, 5% or less of assets is committed to generic asymmetric-payoff derivatives, i.e., long-term, out-of-the-money put options on the S&P 500 that appreciate in value as a market falls at a ratio of 10:1 or greater. Such atypical portfolio positioning, about which we've often written, is known as the barbell strategy championed by Nassim Taleb.

Since October 2020, our partners at PV have been providing Martin Capital Management (MCM) with equity recommendations through a daily model portfolio that approximates their mutual fund, the Palm Valley Capital fund. The most compelling price-to-value investment opportunities they unearthed this year were the obscure and unloved. Those companies currently represent less than 10% of our portfolios. Since engaging their services, we have only purchased their holdings that are still trading at a significant discount to intrinsic value and thus offer an attractive margin of safety. We expect to track their model more closely in the quarters to come as new names are added or the prices of their current holdings fall.

As of Q3, their fund's equity exposure was 30%, yet bested the S&P 500 for the year (+19.12%).

[2] To be more specific, our management fee is the greater of 50 basis points (0.5%) annually, *or* 10% of gains above a high watermark. Only when we grow client capital above the management fee rate and to a greater total than the account has ever reached before do we enjoy the greater compensation.

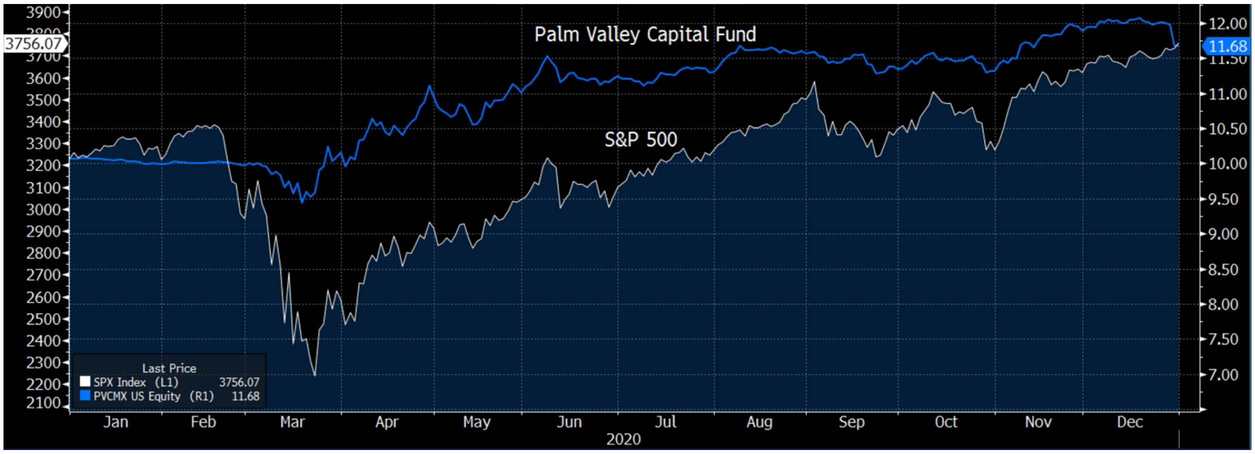


Figure 3 Bloomberg Data. S&P 500 (left y-axis, white). Palm Valley Capital Fund (right y-axis, blue).

Palm Valley Capital Fund's [annual report], including portfolio composition, will be available soon. The presence of larger companies, though generally less than $10 billion in market cap, will grow noticeably when their price-to-value metrics warrant inclusion.

The Unifying Philosophy of the Federal Reserve

On June 25, 2009, following an unexpectedly spectacular 36.1% spike in the S&P 500 in just over three months from the low point of the index on March 9, the *Financial Times* published an op-ed piece by former Fed Chairman Alan Greenspan.

Greenspan predicted that the 2009 rally was but a prelude of things to come.

> Global stock markets have rallied so far and so fast this year that it is difficult to imagine they can proceed further at anywhere near their recent pace. But what if, after a correction, they proceeded inexorably higher? That would bolster global balance sheets with large amounts of new equity value and supply banks with the new capital that would allow them to step up lending. Higher share prices would also lead to increased household wealth and spending, and the rising market value of existing corporate assets (proxied by stock prices) relative to their replacement cost would spur new capital investment. Leverage would be materially reduced. A prolonged recovery in global equity prices would thus assist in the lifting of the deflationary forces that still hover over the global economy.

Greenspan was arguing that higher stock prices would increase household wealth and, consequently, increase spending. Furthermore, he warned, "If political pressures prevent central banks from reining in their inflated balance sheets in a timely manner, statistical analysis suggests the emergence of inflation by 2012, earlier if markets anticipate a prolonged period of elevated money supply." Thus, the op-ed's title: "Inflation—the Real Threat to Sustained Recovery."

Grander improvidence, miscalculation, and unmitigated fatuousness in economic soothsaying have rarely so burdened modern financial history. Greenspan's arrow didn't hit the bull's-eye, the target, or even the hay bale. The improvement in the market's valuation of bank-equity capital, which had no effect whatsoever on banks' financial statements, did not move reticent, backward-looking bankers off the dime. Commercial and industrial loans outstanding slid almost 25% by August 2010 when Fed Chairman Bernanke, in a watershed Jackson Hole speech, implicitly pledged the Fed's powers to guarantee the downside risk on just about every financial asset.

While the market did launch into a breathtaking advance, inflation was nowhere to be found in the official data. At least that was true of the consumer variety. Asset-price inflation, on the other hand, was experienced in spades, as is discussed below.

The former chairman's comments reveal a flawed rationale that plagues the profession of central bankers: prediction. While I've traversed this beguiling turf before, it bears repeating to remind myself and readers that the risks of the future are more assuredly mitigated by preparedness, not prediction.

Prediction Is Perilous

Greenspan rationalized his inflation prediction thusly:

> As always, though we wish it were otherwise, economic forecasting is a discipline of probabilities. The degree of certainty with which the so-called hard sciences are able to identify the metrics of the physical world *appears* to be out of the reach of the economic disciplines. But forecasting, irrespective of its failures, will never be abandoned. It is an *inbred necessity of human nature*.
>
> Introspectively, we know that we have a limited capability to see much beyond our immediate horizon…Today, both fortune-tellers and stock pickers continue to make a passable living. Even repeated forecasting failure will not deter the unachievable pursuit of prescience, because our nature demands it.[3]

While Greenspan grounds this tendency in human nature itself, a worthwhile insight, he apparently made no attempts to *be* publicly introspective and mitigate the particularly ruinous effects of prediction exercised by a public figure. Society has never considered unbridled human impulse as an acceptable state of affairs, so it's unclear why Greenspan gives himself a pass in this instance.

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[3]Alan Greenspan, *The Map and the Territory: Risk, Human Nature, and the Future of Forecasting* (Penguin Books, 2013.

In marked contrast is Austrian economist Friedrich Hayek. In humbly accepting the Nobel Prize in Economics in 1974, Hayek did not, winner's check in hand, stoop to fabricating rationalizations. Said he straightforwardly to those assembled: "Yet I must confess that if I had been consulted whether to establish a Nobel Prize in Economics, I should have decidedly advised against it." His acceptance essay, "The Pretense of Knowledge," summed up his apprehension cryptically yet convincingly:

> It is that the Nobel Prize confers on an individual an authority which in economics no man ought to possess. This does not matter in the natural sciences. Here the influence exercised by an individual is chiefly an influence on his fellow experts; and they will soon cut him down to size if he exceeds his competence.
>
> *But the influence of the economist that mainly matters is an influence over laymen: politicians, journalists, civil servants and the public generally.*
> There is no reason why a man who has made a distinctive contribution to economic science should be omnicompetent on all problems of society—as the press tends to treat him till in the end he may himself be persuaded to believe [italics added].[4]

Greenspan, as Hayek implicitly warned 60 years earlier, had been conferred the title "Maestro" by the media, a sobriquet he openly wore like the emperor of yore who was unaware of his nakedness. Blinded by the stage lights, the Maestro seemed unaware that forecasting economists were the most dangerous among those "making a passable living" prophesying about the future.

From antiquity to the present, from innovative and enlightened thinkers Adam Smith to Nassim Taleb, the preponderance of evidence leaves little doubt that the square peg of political economy, with its millions of variables in a constant state of flux, simply cannot be forced into the round hole of the physical sciences. Pursuing such an illusion cannot be justified by identifying within humanity a penchant for forecasting the future, as if adults are toddlers with little acquired ability to control ill-advised impulses.

The Fed's Primrose Path: 20 Years in the Making

In practical terms this means that pronouncements from Fed Chairman Jay Powell, recently deemed by former Central Bank officials as the most transformative chairman since Paul Volcker, are to be taken with a stout chaser of Hayekian skepticism. In fact, Powell has given heed to the very logic Greenspan pressed into service in his 2009 op-ed.

Eleven years ago Greenspan also effused: "The rise in global stock prices … is arguably the *primary cause* of the *surprising positive turn* in the economic environment." This captures perfectly the foolishness of the Fed predication. Convinced of its own reasoning, that a consumer

[4] His essay argues that central planners presume to know more about a market than the broadly dispersed knowledge latent in the pricing mechanism. He believes that such complexity of knowledge is impossible for a single institution to reasonably command.

economy runs on spending and consumers will spend more if their portfolios grow, the Central Bank has developed a rigid orthodoxy. *We must do whatever it takes to prevent stocks from ever going down*. This aphorism has painted the Fed into a corner. Either rates remain low and foster malinvestment, or rates rise and the paper wealth of the decade dissipates into thin air.

In this the economic tables have been turned. The market now drives the economy. The tail wags the dog. The central bank's attempt to reverse the direction of influence is a pristine example of Hayek's "Pretense of Knowledge." This failed notion is in truth culpable for many of the economic and social ills that now plague us in this country.

The priority assigned rising markets fails to account for the growing disparity in the distribution of income. The marginal propensity to consume by those with high incomes is a fraction of that propensity among the six of 10 Americans who don't have $500 in savings. Higher income earners spend their marginal dollars on cars, homes, and financial assets. These last two classes in particular contribute to growing wealth disparity *and* asset-price inflation, which has had little direct impact on economic growth despite Greenspan's hopes. Instead, rising equity markets have exacerbated the wealth gap as the stagnant wages for the bottom half of the population over most of the last 10 years prevented them from gaining a foothold in the market and a share in the paper prosperity.

From the second quarter of 2009 to the third quarter of 2020, the dollar amount of wealth owned by the top 50% of American households rose from $18.3 to $32.7 trillion, a nearly double gain of $14.4 trillion. For the bottom 50%, their wealth rose from $600 billion to $2.4 trillion, growth of $1.8 trillion.[5] If the top 50% is buying real estate and stocks, the rest consume most of their income monthly on food, rent, and limited medical options. Since the market bottomed out over a decade ago, 90% of the total gain in wealth accrued to the top 10% of the population. In the totality of the economic landscape, most citizens did not experience the boom Greenspan foretold.

Greenspan was also off the mark when concluding that a failure to address the "inflated balance sheet" of the Central Bank would lead to consumer price inflation. His piece appeared seven years before the Fed finally began reducing its Treasury holdings, yet inflation remained curiously quiescent. Simultaneously and consequently, interest rates remained at historic lows. This added insult to the injury of the average worker. In addition to weak wage gains, such low rates made establishing wealth through traditionally conservative means nearly impossible. At the same time, rock-bottom mortgage rates drove monthly payments downward and home prices upward, slamming the door on renters wishing to buy. Finally, the policy offered no incentive to abstain from another human impulse: to consume in the present rather than save for the future. With no incentive to play chess, checkers is the board game de jure.

[5] https://fred.stlouisfed.org/series/WFRBLB50107

The broad-based capital spending boom Greenspan envisioned didn't come to pass. As we have written on too many occasions already, 2% real economic growth, along with a nettlesome output gap, is not the demand backdrop for a capex (capital expenditures) boom. In its place, though, emerged an even bigger boom in financial engineering, where companies recapitalized by retiring shares with borrowed money. Monopoly finance, like the board game itself, creates no real value. The illusion, implied by rising stock prices, is ephemeral, Greenspan notwithstanding.

A Note on What Is Newsworthy

The reach of false or inaccurate information, sometimes motivated by the attempt to deceive, is extending well beyond the political realm, in which it has become notorious these last four years. As we look into 2021, optimism is resurfacing. Headlines about vaccines, not the pandemic, are vying for page 1 primacy. Similarly, pundits are predicting that the near-depression economy is increasingly poised to boomerang spectacularly.

The incoming administration in Washington, including veterans Janet Yellen as presumptive secretary of the Treasury and Jay Powell, Fed chair since February 2018, is unlikely to depart from the playbook of accommodation. Yellen is a technocrat, and in her new position at Treasury she is unlikely to advocate against her signature dovish policy from her time as Fed chair, where she preceded Powell.

Together, Powell and Yellen may be the architects of a more invasively interventionist economic policy. "Command and control" will likely encroach further onto the turf of the market-based model. Public authorities will attempt to mandate not only the economic performance to be achieved but the means by which it's to be accomplished.[6] Does one not hear echoes of Hayek resounding in the conch shell of the perpetual promise of a public panacea? See footnote 6 above.

Not every news outlet is drinking the Kool-Aid. In late 2020 Bloomberg called Powell, "Wall Street's Head of State." Opining on the dominant and distorting effects of Powell's actions on 2020's asset prices—despite a pandemic, divided Congress, weak economy, low buybacks, and trade wars—Bloomberg went on to claim his actions to be "exuberantly asymmetric."[7] *Time* wrote that the scale and manner of Powell's actions in 2020 are "changing the Fed forever" and shared concerns with other notable publications that he had conditioned Wall Street to unsustainable levels of monetary stimulus to artificially sustain high asset prices, likened to a continual Greenspan put. The current state of the economy has been coined "The Everything Bubble."[8]

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[6] As so often is the inclination, even at the highest levels, the following (variously attributed) adage applies: "To a man with a hammer, everything is a nail."

[7] Authers, John, August 4, 2020, and Greifeld, Katherine, November 6, 2020.

[8] https://www.wsj.com/articles/stocks-bonds-oil-bitcoin-are-all-up-the-everything-rally-is-back-worrying-some-investors-11557048630?mod=article_inline

The Myth of Economic Equilibrium

A fundamental reason why luminaries like Powell and Yellen are prone to miscalculation is the predominant metaphor by which the profession understands the economy. Capitalism found its philosophical moorings during the Industrial Revolution as mechanization took Western economies by storm. The machine became the primary analogy for economic functions. The components required for proper operations included an educated workforce to produce desirable goods, shared legal frameworks to mitigate disputes, and basic rights for citizens that foster the competition necessary to stimulate incremental innovation.[9] Combined with capital, labor, and land, these parts generally created a well-oiled "machine" that could be understood by linear directional forces propelling an economy upward.

This view of economies, however, is rather rudimentary. Though not incorrect insofar as it goes, it connotes a vision of stability and linear progress. Neither is the observable case in reality. A fresh undergraduate student in economics will be taught the ubiquitous supply-and-demand curves. This theory attempts to reconcile how the supply of a good (which is necessarily limited) and the demand for that good (which is supposedly unlimited) intersect at one specific point: the price. Any change in underlying conditions—like a more efficient manufacturing system, which would increase supply for the same cost—will disrupt this stasis. Demand, though, quickly readjusts as the market settles on a new price.

In narrow scope, this model of economic operations is likely *somewhat* accurate. If the supply of bananas doubles, consumers will "likely" buy more bananas. We cannot say more, though, as bananas are already cheap and not everyone likes them. Conventional wisdom dictates that an increase in supply will result in a falling price until a market "clears"—that is, to sell through the remaining inventory. But this is only a "somewhat" reasonable expectation. There is no price low enough for bananas to create demand from those who wouldn't buy bananas at any price. Even if you love bananas, there is simply a physical limit to how many you will ever desire to eat of this perishable commodity at a time.

This silly example illustrates an important point. Economic relationships are not ultimately static and predictable. Contrary to popular belief, unfettered markets may be inclined toward equilibrium, but that is not the state in which they permanently or even more than momentarily exist. The model above only roughly depicts economic transactions. It is an ideal representation of reality, perfect and symmetrical only in form, not in practice. Models help us see a legitimate

[9] A distinction between incremental innovation and creative disruption seems germane. The former is improvement on a process that increases efficiency, lowers prices, and drives multiple benefits for consumers. This is what characterized the rise of the "Asian Tigers" in the late last century. Japanese automakers took the success of American auto manufacturers and improved upon it. Creative disruption is Nikola Tesla's invention of alternating current. It had enormous profit potential, but his pursuit was more religious-fervor, self-interested entrepreneurship. Often the most important inventions in history fail to enrich the inventor. Creativity, after all, is latent in the human spirit. Strong patent laws and the opportunity for self-enrichment are by no means the key catalysts for such activity. https://www.forbes.com/forbes/2002/1223/258.html?sh=58c1e3c066e6

phenomenon (supply and demand affecting price), but they cannot articulate the entirety of experience. In the time it takes for demand and supply to equalize in one market, a whole host of knock-on effects occur, further jostling the system, sometimes acutely, out of balance.

Equilibrium is not the typical economic state. Such a vision would make economic instability impossible, occurring only as the result of some external shock or event. An automatically balancing economy should not allow for depressions and banking crises, but their endless recurrence in economic history, which we might call "cycle therapy," betrays that logic.

Economist Hyman Minsky pioneered integrating the effects of money and banking into economic projections, which mainstream thinking tends to ignore. He concluded that they add a distinct element of fragility to the system. Criticizing the prevailing view, he writes:

> The abstract model of the [mainstream] synthesis cannot generate instability. When [it] is constructed, capital assets, financing arrangements that center around banks and money creation, constraints imposed by liabilities and the problems associated with knowledge about uncertain futures, are all assumed away. For economists and policy-makers to do better we have to abandon [this] synthesis. (Minsky, 1982)

Equilibrium does exist, but more as an economic point of gravity in relation to which economies fluctuate. No sooner do economies arrive at that point, then they subsequently are propelled in a different direction.[10] That does not mean all is chaos. There is order, but movements away from equilibrium and into excess can be long and irregular, reversions violent, and velocities unknown. This does not violate the principles of mean reversion, but complexifies the path along which that process takes place.

This economic vision is distinctly different from that of the Federal Reserve, which is inclined toward the mainstream model. It sees the economy mechanically. Incremental adjustments to interbank lending rates and bank reserves are its levers. It is right that small changes can have large impacts. It is wrong in believing it knows what is required to achieve them. If history is any guide, its preferred methods are likely not the means to its end.

The primary artistry ascribed to Maestro Greenspan was precisely such minute adjustment of rates. In truth, his tinkering was probably at best mostly irrelevant prior to the dot.com bubble, which was driven by investor sentiment rather than rates. In the wake of its popping, lower rates attempted to stave off a deeper recession. Far from nudging the economy toward balance, they seeded the housing bubble.

[10] Mathematically, this is the Lorenz model from meteorology in which three variables of storm cells were found to be correlated nonlinearly. A small change in one would affect the direction of storms in diverse ways that were not proportional to the magnitude of change. Economically, this model contrasts with the linear effects depicted in supply-and-demand curves that treat economic calculations as binary choices with only first-order effects. Most importantly, these dynamic systems have more than one point of equilibrium and don't develop stasis in any of the systems. See Keen, Steve, *Debunking Economics* (Zed Books, 2011), 191.

Instead of managing the economy, the Central Bank seems to be driving enormous distortions in it. Record-high asset valuations, obscenely low interest rates, growing wealth disparity, the Rust Belt tragedy, and low capital investment all seem to us examples of disequilibrium exacerbated if not caused by Fed policy.

While the Central Bank sees its economic role as something of an engineer, physics is not the proper metaphor for economic systems, as Hayek noted earlier. Biology is a better science for comparison. This is evident in the language used to describe economic phenomena. Technologies “spawn” new industries. Economies “grow.” Risks “metastasize.” Thus, finely tuned interventions by the Fed seem to compare more aptly to the introduction of an invasive species to solve a pest problem, with myriad unknown consequences, rather than a plumber carefully relieving the pressure on a valve.

A Crack in Finance

Conceptualizing the economy as a writhing, complex, natural organism is much more useful than seeing it as a machine. First, it’s simply more accurate given history and mathematics. Second, it helps explain the nature of finance.

Finance is the numerical impression of the economy communicated through price. In the absence of mathematics and financial technology (accounting, lending, return calculations), the value of a bakery is a very different question than it is for a modern MBA graduate. In a nonfinancial sense, its value is how much bread it can produce, how many people it can feed, the burden or joy of the work, and the quality of its goods. With financial language we have a very different discussion. Finance can quantify those same values numerically. It describes the bread made in terms of annual revenues, the cost of the ovens and labor relative to the amount of bread sold, and the margin the business enjoys relative to competitors. Most importantly, with these numbers an investor can determine a price for the business.

Finance forever and always originates in the real economy. It describes the real stock of productive capital and its possible productive capacity when paired with available labor in the current environment. This link can never be severed.

Finance is, however, more than the economy, and the link between the two does not bind them tightly. While the economy is real, finance is imagined. Theoretically, the price of a financial asset is the sum of the future cash flows it will produce, discounted by some rate that reflects the minimum return that could be earned elsewhere with that same amount of money.

This exercise requires an imagined future. Because a restaurant with no outdoor seating has earned $150,000 a year for the last five years, we expect it to do the same going forward. Or, with more sophistication, since this city is growing rapidly at 5% a year and the restaurant is well positioned in the new downtown walking district, it should grow those earnings going forward.

From that information, a price is determined. The price is a snapshot at a point in time. As projections of future revenues change, so does the price.[11]

Pandemics are so infrequent an analyst can hardly be faulted for failing to include the possibility in a restaurant's valuation. Quite obviously, though, our restaurant may have struggled this year and likely didn't return to its owners what they had forecasted, particularly if its cuisine was not suited to the takeout process.

Though finance is grounded in the real economy, we should never expect it to continuously or precisely reflect the real economy. There is a gap between the two. It is a crack in finance that renders any attempt at engineered stability folly. No financier or central bank can remedy the breach. It is endemic to the very nature of finance.

As discussed already, economic change is not readily predictable, and there is no equilibrium on which economic constructivists can idly rest. Small changes have outsized effects that mainstream models don't predict. In addition, since finance is an imagined corollary to this disequilibrium without a means to track what it represents, it tends to be perpetually behind the curve.

Raising the Power of Narratives

Pandemics are not the real problem here. They are swan events that, while not as uncommon as popularly believed, are certainly not routine. The underlying problem is the toxic elixir resulting from popular narratives mixed with the notion of equilibrium. While MCM and PV adhere assiduously to a conservative valuation methodology, many other professional investors make a different valuation case to justify their purchases. The prevailing zeitgeist, though, often distorts the reading of a business's fundamentals. While not applicable to momentum investors, day traders, and passive-index funds, active managers as well as the public often become ensconced within the prevailing economic discourse.

Whether the dot.com notion that any Internet-based company could grow ad infinitum or the ubiquitous belief that housing prices never go down, narratives distort the imagination required for financial projections. The narrative phenomenon takes the crack between the real economy and the imagined financial one and raises it to some power. It exacerbates an already tenuous relationship, compounding the fragility already latent in the arrangement.

If such mistaken judgments were confined to the markets in which they occurred, the danger of miscalculation might be contained. But economies are complex systems not generally in equilibrium. While one isolated market could conceivably balance, multiple markets interconnected through fungible cash, interpersonal relationships, and emotions are in a constant

[11] Nimi Wariboko, *Economics in Spirit and Truth: A Moral Philosophy of Finance* (Palgrave Macmillan, 2014).

state of flux, moving from one phase to another in relation to equilibrium rather than toward it. Miscalculation in the housing market thus rearranges the pieces across the economic board.

Therefore, as we've noted in prior publications, attention to narratives—and especially suspicion of them—is an essential investment practice.

IPOs and Bubble Woes

We see such concerning narratives today. They are rarely addressed in Fed communications, as most economists assign them little or no utility in crafting their predictions. Einstein describes this phenomenon well: "Everything that can be counted does not necessarily count; everything that counts cannot necessarily be counted."

Last year we cited the story of WeWork, the office-space provider, as an example of a speculative contagion catching fire. Its absence from the headlines now is not on account of the pandemic, which has made the couch the newest trend in work spaces. WeWork imploded before the pandemic struck as its clearly unsupportable valuation plunged in the wake of its cancelled initial public offering (IPO).

But WeWork was the end, not the beginning, of such contagion. The public was spared losses at the hands of WeWork, but they have piled into similarly unstable companies with abandon in 2020. Undergirding this trend is a notion closely tied to the zeitgeist of the 2000 bubble. It is believed that technology can revolutionize a multitude of legacy business sectors and create fabulous wealth for the owners of these companies. These prodigies are mostly united by their utilization of digital interfaces. For example:

- Doordash is a food-delivery service scheduled via smartphone.
- Airbnb offers travelers independently owned short-term lodging.
- Asana is a project-management cloud software.
- Snowflake offers cloud data storage and analytics.
- Lemonade sells an artificial intelligence that assigns prospective customers rates on renter and homeowner insurance.

The list is long and could easily include previously IPO'ed companies like Pinterest, the online bulletin board platform, or Zoom, the now ubiquitous video-conference provider.

Many of these companies are primed to benefit from the stay-at-home trend. Therefore, if a company relies heavily on a digital infrastructure, its profit potential is considered unlimited. The market cap of these companies is almost as astonishing as their current nonexistent profits.

	Doordash	Airbnb	Snowflake	Tesla
Market cap	50,135	82,710	93,396	591,717
Revenue	2,214	3,626	489	28,176
Net Profit	-283	-1,048	-423	556
Debt	167	381	193	12,590

	Yum!	Hilton*	Berkshire	GM
Market cap	32,468	31,424	521,359	59,263
Revenue	5,603	90,452	246,497	115,793
Net Profit	1,060	881	35,845	3,214
Debt	10,770	8,993	70,286	66,924

*2019 numbers pre-pandemic

Let us reflect on these numbers. Doordash, as noted, coordinates food delivery for restaurants to, primarily, sufficiently wealthy urban dwellers. In the best of times (for Doordash), when most customers literally cannot go to restaurants, the company still loses money. Yet it is valued nearly twice as high as Yum! Brands—which owns Taco Bell, Kentucky Fried Chicken, and Pizza Hut—despite robust competition from other delivery services like Ubereats and Grubhub. Airbnb, which owns no hotel properties itself, is worth nearly three times Hilton Hotels, though it lost more last year than Hilton made. Tesla, which doesn't exactly fit the paradigm of a classic tech company but does enjoy excessive public optimism in the growth of its technology, yields a sixth of the profit that GM does, yet it's valued 10 times higher. Unbelievably, it's more valuable than Berkshire Hathaway!

It is now almost routine for a "tech" IPO to double in its first days of trading, the fundamentals be damned. As our colleague Eric Cinnamond at PV sardonically puts it, "Doordash has such an impressive technology—delivering sandwiches via automobile."

If the Fed is right that rising stock prices lead to growth, then growth will be hard to come by. The market prices of these company's shares cannot continue their parabolic rise, at least such cases never have before. We argue that the Fed is assuredly wrong, and it isn't stock prices but sustainable gains to worker earnings and a decline in unemployment that propel an economy forward. In effect, the Fed's hands are tied.

The Price of Optionality Is Patience

In the face of such unprecedented times, our portfolio allocation is unconventional, so much that even a casual observer might take note. Our equity allocation has increased incrementally since the March 2020 selloff as the coronavirus gave rise to a selectively bifurcated market. While tech stocks and the "stay at home" sector soared, taking equity indexes to new all-time highs, many segments of the economy were negatively impacted. The share prices of companies in those industries did not recover so stupendously. There were especially good deals in the oil-and-gas sector, but our research affiliate at PV also found insurers, document processors, a pawn shop, and other durable businesses that were trading below their fair value.

Still, our equity portfolio is modest, just 10% of assets. In addition to continuing to hold a portfolio of put options, most of our assets are in short-term Treasury bills, which yield next to nothing. The first quarter of the year saw dramatic gains as our puts appreciated many times over in value. With few examples to the contrary, though, we haven't purchased stocks and participated in the rally that has driven the popular indices to new highs.

We've detailed the underlying weakness facing the economy before. Taking off the hat of the macro analyst, we want to explore our cash position from the perspective of the portfolio manager. Put simply, holding large cash reserves gives us many options. Like being a kid in a candy store, a fat wallet allows a great variety of purchases either now or later.

When I was 6, there was a literal candy store just down the street from our house. Sometimes we were given 50 cents and sent down the hill to enjoy ourselves. One of the joys in shopping is trying to get a good deal and maximize return. Is a large bag of Skittles better than a package of three small candy bars? The choices of children are generally short-term oriented. Living in the moment is part of what makes childhood so free and fun.

But investing is not child's play. What I didn't understand in adjudicating between candies was that the biggest values were not between the choices, but *when* they're bought. After Halloween every year, candy goes half off, sometimes more. Saving that 50 cents over the months and buying at the right time would have yielded much better results—deferred gratification at its most elementary level.

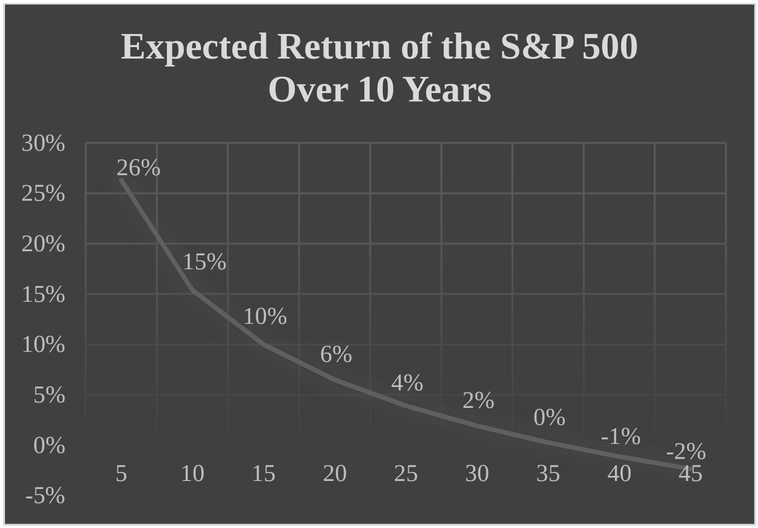
The same general rule applies to stock purchases, but in the world of wealth management saving your pennies is not as simple. Inflation slowly eats away at their value, and the big stock sales aren't advertised in advance, aren't annual events, and aren't even guaranteed. It's agonizing to watch the opportunity of increasing your purchasing power pass you by while the value of your pennies slowly declines.

The erosion in value is the price of waiting, and it is real. It functions according to the same basic principle of our options contracts, but slower. The value of the instrument—option contract or cash—declines with the passage of time. This diminishment is the acceptable price of leaving yourself open to opportunities that offer much greater returns, namely, more candy for less. The real benefit is earned only by the most enterprising kids: selling that discounted inventory when prices rebound.

The psychological price to pay is patience. Despite its lauding by parents and philosophers, patience is not very popular. Sometimes it's downright painful. Waiting for a good value is a drain on investors' psyches, as well as their portfolios.

Beyond the metaphor, let's look at a hypothetical 10-year total-return scenario based on the price paid for the S&P 500. By price we mean the multiple paid times the index's earnings, i.e., the

P/E. The lower the multiple at the time of purchase, the lower the price and the higher the return over time. The chart below shows the expected compounded annual returns on the y-axis for the different multiples paid on the x-axis.



* The initial P/E ratio paid (x-axis) versus the 10-year expected returns for the S&P 500 (y-axis) [12]

Purchasing the index with a multiple of 10 (left side) provides an expected annual return of 15% for 10 years. Conversely, buying at a multiple of 35 (right side) yields a 0% annual return over the same period. An even higher multiple yields a negative return (far right side).

The cyclically adjusted price to earnings (CAPE) ratio was at 33 for November 2020. Few investors realize that a purchase today means flat, 10-year, prospective total returns. The most observable constant in the markets is that stocks fluctuate in price. If, in the likely event that stocks can be purchased more cheaply in the months and years ahead, the patient investor should outperform an investor who buys or holds today.

While holding cash in Treasury bills costs the portfolio in terms of inflation and the investor in terms of some psychological stress, it is the “price to pay” for having the option of buying on sale.[13] We hope that viewing the situation mathematically helps to settle the restlessness resulting from sensationalized headlines about an inconsequential and distracting market statistic, new highs.

The irony is not lost on those who attempt to scale Mount Everest. In the “death zone,” the last 3,000 feet before the summit, each new toehold gained means nothing if carelessness or haste

[12] This information is pulled from John Hussman, March 2018 Market Comment, and assumes a 60% starting dividend payout ratio, a 6% nominal growth in earnings and dividends, and mean-reversion to 15 P/E and a 4% dividend yield. It also assumes earnings are not cyclically distorted.
[13] Earning the 1-year Treasury yield minus the CPI saw a portfolio entirely in cash since 2010 decline 10% in value.

causes you to lose your footing. Oxygen deprivation and gravity then get the upper hand. Mitigating the risk of an often fatal outcome requires uncompromising and deliberate patience, as well as the steely management of both fear and exhilaration.

Reaching your goal in investing is much like mountain climbing. You must not fall, or all the patience and hard work in the world are for naught. Sustainable gains are the goal we seek, and buying low is the means to get there. The present paucity of such bargains must not alter the care we take. The summit of this journey is not the peak of the market. Rather it's earning returns that aren't consumed by the inevitable cycles and vicissitudes of the very markets we traverse.

Final Thoughts …

The year 2020, which witnessed the most unsettling, topsy-turvy assault on normalcy in recent memory, will not soon be forgotten. For the undersigned, though, it will be remembered as one of those times when the surest way to navigate survival-threatening, storm-tossed seas is to keep a steady hand on the tiller and a watchful eye on the compass. In the midst of the tempest, disorientation and confusion often overwhelm rational thought. Endless winds deafen. Nausea grows in the pit of your stomach as crashing waves threaten to capsize your vessel. The following swoons make you feel as though the deck is falling away beneath your feet. Exhaustion comes from clinging to anything you can grab as the boat pitches and yaws.

A tour of duty as a junior officer on a destroyer in the Atlantic in the mid-1960s proved a lasting call to seafaring. Sailing has been part of my life ever since. Even today, racing remote-controlled sailboats is a respite from professional rigors. It wasn't apparent 55 years ago that the disciplines learned would prove to be of value for the turbulent times in which we find ourselves.

More than six decades ago our commanding officer's demeanor was mirrored in the faces of his crew. It mattered that he showed mastery of fear, but he didn't feign its absence. Our willingness to undergo hardship hinged on whether we could see his equanimity overcoming anxiety and resolve dwarfing indecision. Those intangibles manifested themselves among all on board, each in his own way. As the commanding officer of the USS MCM, the undersigned is acutely aware of the obligation, nay the necessity, of inspiring confidence in staff and clients alike.

To this skipper's good fortune, almost all of our passenger clients are predisposed toward the long hand-on-the-tiller, eye-on-the-compass view. Rather than criticisms, frequent words of gratitude and encouragement keep my morale high. Thanks to you, at 78 I arise every morning energized and excited about the problem-solving challenges that lie in the hours ahead. My debt of gratitude knows no bounds. To be sure, most of you have been aboard for many years.

Regardless, together we've safely and profitably navigated the memorable storms of the past: recently the dot.com bust in the early 2000s and the financial crisis in 2007–09. Today we're in the midst of what history will surely record as the most threatening of the three. We are disinclined at this point to give the storm a name without unintentionally narrowing the field of possible outcomes. Having gained our sea legs after years of on-deck experience, we humbly but resolutely sail into the future expecting the unexpected, wary but not fearful, weary but not exhausted, ready to confront internal demons and external foes with calmness and composure. As the title of the third book in the trilogy suggests, the greatest of opportunities are usually found in the ashes of adversity. Heartfelt thanks to all of you, my fellow sailors.

The officers in the USS MCM/PV squadron of two are among the best. At long last, all the line and staff billets are filled by top-flight professionals. Lane Miller and I assess the macro environment, analogous to the role of a ship's navigator. Our job is not glamorous but most essential—making sure our course steers clear of hurricanes and subsurface rocks and shoals. Kristen Smith-Myers (and Lane, wearing two hats), our operations team, execute their roles flawlessly. The line officers, Eric Cinnamond and Jayme Wiggins, steer the ship through often tricky and treacherous waters. Minefields abound and often sink the unwary or the untrained. Both Eric and Jayme, academic standouts during their preparatory years, have decades of experience as security analysts and portfolio managers. They are prime examples of iconic Green Bay Packer's football coach Vince Lombardi's aphorism: "Practice does not make perfect. Only perfect practice makes perfect." Their relentless, day-in and day-out pursuit of perfection, no matter how elusive, has chiseled them into outstanding performers.

Moreover, the organizational structure of our two firms—nearly equal parts good sense and good luck—results in an ideal alignment of incentives. Prior to their PV partnership, Eric and Jayme were officers and employees of firms in which they had no ownership interest. Together they own the majority of PV. Virtually overnight they assumed the risks and accountability of entrepreneurs. Having been in that role my entire professional life, I observe their business management with admiration and the talent they bring to their craft with awe.

The whole of MCM/PV is greater than the sum of its parts. The synergy between two legally separate but intellectually and philosophically intertwined entities is palpable. Together we face an uncertain future with the humility and confidence that arise from preparedness. We know history. As Danish philosopher Soren Kierkegaard once remarked, "Life can only be understood backwards; but it must be lived forwards."

Very truly yours,
Frank K. Martin, CFA
Lane K. Miller

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