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listeningin

"Perfect Storm" Brewing?

Value Investor Frank Martin Warns Credit, Stock Excesses Bode Very Ill

*Frank K. Martin is no ordinary Wall Street cat. The founder and senior partner of **Martin Capital Management LLC**, consistently marches to his own drummer; much to the benefit of the small coterie of wealthy clients his exertions have made far wealthier over the years through the highly patient application of the Ben Graham/Warren Buffett investing style to highly concentrated portfolios. Want more evidence? There's his place of business, Elkhart, In. There's also his firm's track record, which reads like an open book—because that's just what it is, thanks to Frank's, well, compulsion to record and communicate his investment process to his clients and anyone else who troubles to travel to its website, mcmadvisors.com. Not to mention to Frank's recently published book, **Speculative***

Contagion, a collection of his unflinchingly thoughtful and deeply informed contemporaneous reflections on the extraordinary market events of 1998-2004. But it was Frank's latest literary exertion, his annual report for 2005, that moved me to pick up the phone. In it, he minces no words in warning of an approaching "Perfect Storm". But let him explain—
KMW

Let's talk about this "Perfect Storm" that you see brewing. Is it perhaps because you're sitting in bucolic Elkhart, Indiana, that you're so pessimistic when you survey the world of finance?

I really hope that I'm not misinterpreted as being an utter pessimist—but as

someone who says that if there is a perfect storm, afterwards everything will return to something approaching normal and there will be a plethora of opportunities. So I'm willing to prepare for troubles and to look through them, in hopes that there will be opportunity on the other side. What's helpful about being in Indiana is that we're outside the fray. We're removed, to a degree, from Wall Street's madness, its groupthink. One of the reasons I write my annual report is so that I can literally sit back each November/December and, borrowing an expression from **Stephen Covey's** book—not the big favorite, *The Seven Habits*—but from *Principle Centered Leadership*, simply climb up a tree and try to survey things and ask, are we in the right jungle or are we in the wrong jungle?

I haven't read that one. The right jungle?

That's the book where Covey talks about the difference between a manager and a leader, explaining that a manager chops his way through a dense jungle, machete in hand, while a leader periodically climbs the tallest nearby tree, surveys the scene and reports, "right jungle," or "wrong jungle."

You actually express some reluctance, or mixed emotions, about making that report in your latest missive. But wrote that you were compelled to do so by your fiduciary duty to clients. Perhaps we should get on record right up front just what



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Victor Juhasz
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sort of money management firm Martin Capital is. We are a registered investment advisor, an independently owned partnership, or LLP to be exact. Our clients, with only one exception, are wealthy individuals. We have a \$5 million minimum and intentionally keep our client numbers very small so we can give them the kind of the boutique attention that they've come to expect. We tend, in a large but decreasing number of cases, to manage all their money. So we often are cast in the role of wealth managers, where we make the asset allocation decisions. But as we increasingly seem to be appealing to even larger accounts, with assets in the hundreds of millions, in those cases we only manage a slice of those assets and we have less influence over the allocation decisions than we'd prefer to have.

You actually want to make the asset allocation decisions? You realize, of course, that that is out-of-step with the way most consultants tell institutions money should be managed.

We prefer to have more control over those decisions. Maybe that, again, comes from being in Indiana, away from the crowd. The intimacy of the relationships that we have with our wealth management clients has certain intangible rewards that you'd never get by being simply a hired gun managing a subset of somebody's portfolio. You can't place a monetary value on that, but it's significant, particularly for someone of my age. People who start out as clients inevitably become friends because of the closeness of contact. Of course, when you're managing all of someone's assets, or at least all of their marketable securities assets, the bond of trust is critical. And it's naturally nurtured through social and professional interaction. So one thing that makes us a little different than Wall Street is that we do feel an acute fiduciary duty to the individual and not to some intermediary.

Not to mention an acute need to preserve their assets through any approaching storm, so that you have something to work with on the other side?

Exactly. And I think the only way you can do that is to do what we apparently have successfully done (I say this with tongue firmly in cheek), and that is scare the bejabbers out of everybody. I've gotten two kinds of responses from readers of this year's annual report. One is that they like its new smaller page size format and the other is, "Did you have to scare me this much?" My answer is, "You know, my fiduciary obligation really leaves me no choice but to tell you how I see it—and not to honey coat it in any way." In the end—people don't like it—but they appreciate the honesty. But it wouldn't make any differ-

ence if they didn't appreciate it, because that's the way I'm made.

You obviously don't have a marketing department saying, "Oh my gosh, you can't say that!"

Well, some of my partners did ask, "Did you have to go that far?" But my reply was that we just don't have an opportunity for antipathy. As much as I recognize that we all have a natural aversion to dealing with unpleasant things, our fiduciary duty says we have to. Besides, from my perspective, if it turns out that my concerns are excessive, we will forego opportunities, and while that is costly, opportunity costs don't carry the same weight as actually losing real money. I can't tell you how many opportunities I've foregone in my lifetime—or what my financial circumstances would be had I capitalized on all

of them. I wouldn't waste any time trying to figure that out. But if I had big losses, believe me, I could recount them individually. Always erring on the side of missing an opportunity, rather than erring on the side of actually costing people capital, while theoretically not that much different, in reality, is *very* different. People feel entirely different about losing *money* than about losing *opportunities*.

Sure. One hits the wallet, while the other only

nicks the psyche.

Yes, and in today's world, as my annual report suggests, or if you listen to guys like **Peter Bernstein**—who I know you've interviewed and who is a remarkable guy—the equity risk premium is way too low. You're just not being paid to risk hits to the portfolio. Peter speaks very clearly on this point, as does **Warren Buffett**. There are not a lot of real opportunities out there. So the opportunities that we are foregoing are probably ones that should be passed on anyway. So the opportunity cost issue is that big a deal. Not that it would make a difference in what I'd say, but it makes it easier to live with what I say. Because you don't feel like you do when you're saying "You've got to be cautious," while the market is bounding ahead 20% a year.

"We screen the list down to a very small select group of companies. Then we get started analyzing them irrespective of what their price might be—knowing full well that we may never own most of them, because their prices might never get to reasonable levels."

Martin Capital Mgmt. Investment Performance

Period Ending	MCM Equities*	S&P 500*
12/31/2005	15.0%	9.1%
Ten Years	8.2%	0.6%
Five Years	11.8%	14.4%
One Year	-0.2%	4.9%

*Compounded annually, MCM data net of fees

Year	MCM Equities*	S&P 500
1994	-7.5%	1.3%
1995	19.1%	37.6%
1996	31.8%	23.0%
1997	45.1%	33.4%
1998	-7.4%	28.6%
1999	18.8%	21.0%
2000	29.3%	-9.1%
2001	22.7%	-11.9%
2002	-13.6%	-22.1%
2003	33.9%	28.7%
2004	4.7%	10.9%
2005	-0.2%	4.9%

* Net of fees

It was much more difficult for you or anyone to urge—or to invest with—caution back in the heady days of what I liked to call “the internet bubble.”

Yes, and that’s what is reflected in my book, *Speculative Contagion*, of course. As well as the fact that we did great in ’98 and ’99 [See nearby performance table], at the height of that mania—without ever owning a single single technology or internet stock. But those were the most agonizing years of my professional life because I am so steeped in the tradition of **Ben Graham**, (and particularly in the 1934 edition of *Security Analysis*), that I was constantly thinking, “This can’t be right. All of history says there’s something askew.” So I wrote back then (just as vigorously as I wrote in our 2005 annual report) that “This is no place for amateurs.” I was speaking particularly about the 100 times earnings on the Nasdaq and so on. But that was very, very tough. Even though we didn’t, surprisingly, get a lot of calls from clients admonishing us for not being in technology. Again, that may be one of the advantages of working in Elkhart, Indiana. The rumor mill just doesn’t churn that quickly here.

Most of your clients weren’t spending a lot of time chatting about Silicon Valley over cocktails?

Exactly. Conversations in proper social settings did not revolve so much around day trading and internet stocks and what’s hot—that sort of stuff. It’s pretty sleepy out here. Well, *you* know.

Indeed. I’m a Hoosier, born and bred. But I don’t know if I’d describe the Midwest as sleepy as much as I’d note that more people out there—to the extent they still have jobs—still seem to be engaged in real businesses, as opposed to the financial economy.

Yes. It’s remained much more Main Street. Less affected than the coasts by what my friend—and yours—**Marc Faber** has described as the financial (as opposed to real) economy of recent years. I assume those charts in the front of my annual report [see w@w page 4] resonate with you?

You’re talking about your charts of market cap versus GDP and total credit market debt to GDP? Sure. They speak to Marc’s point about the massive build up in financial transactions fueling speculative manias. Both charts trace out enormous, almost straight-up, mountain peaks.

Exactly. As you know, when things go exponential, they usually self-destruct. I’m convinced—and I know that another mutual friend of ours, **Doug Noland** feels the same way—that unwinding this massive of credit expansion just cannot be done easily. I also worry about **Ben Bernanke**. His credentials are impeccable as an academic, but I don’t know about his credentials as a guy who has actually been in the trenches. As best I can tell, his experience under enemy fire is relatively limited, so we don’t know exactly how he’ll respond in a real crisis situation.

And markets have a way of testing new Fed heads one way or another. I vividly remember that little market hiccup in the fall of ’87 that greeted Greenspan.

Yes, that was a real welcome, wasn’t it?

A true “Maalox moment,” as the T-shirts that were being handed out around Wall Street within days of the event proclaimed. Believe me, there were no such t-shirts distributed in Indiana. I had just started in the business back then but I had become very apprehensive about the market. So every single person on my modest list of clients



had all his money invested in either Treasuries or high-grade tax-exempt bonds. At the end of the day on October 19, 1987, it was pretty easy to call each of them and say, “You’re actually up for the day because the flight to safety drove bond prices higher.” That was an auspicious beginning.

I would say so. What’s your secret?

There is no secret. I think this business is mostly about keeping your head and doing what Warren Buffett does. That is, approach everything with a rational mindset. Ask yourself, does this make sense? Apart from what everybody else is saying, on a standalone basis, independently analyzed, does it make sense? Oftentimes, you end up reaching a different conclusion than the consensus, which never did bother me and hopefully never will.

So you’re a contrarian cuss?

I don’t think of myself necessarily as a contrarian. I just think you do what makes sense and forget about what others are doing and see where it comes out. Again, so long as you err on the right side, because we *are* going to err.

The right side?

I mean err on the side of foregoing the opportunity. Really, we don’t have a very good stop-loss discipline. We have a discipline that hopefully gets us into a situation where you don’t need a stop-loss because you’re buying off the bargain shelf. We hope that there’s enough margin of safety in those prices that we aren’t forced to have to decide, beforehand, when do we cut bait.

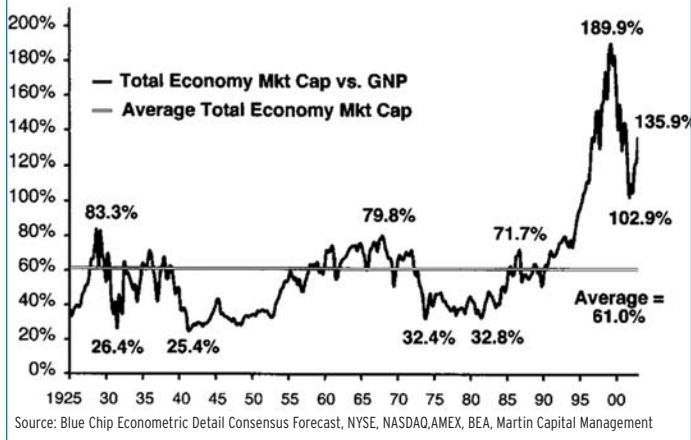
But just because something looks like a bargain doesn’t mean it can’t be marked down a lot further.

As we both know. We even have one holding in our portfolio that has tested us on that point, which means there’s always room for improvement in the way we process information and make buy or sell decisions. We are always aspiring to be better. The distance between where we are and perfection is so far, I hesitate to even talk about it.

That reminds me, you do all your own cooking, in the sense of doing all of your own securities analysis?

Well, not only does my own portfolio look exactly like a typical client

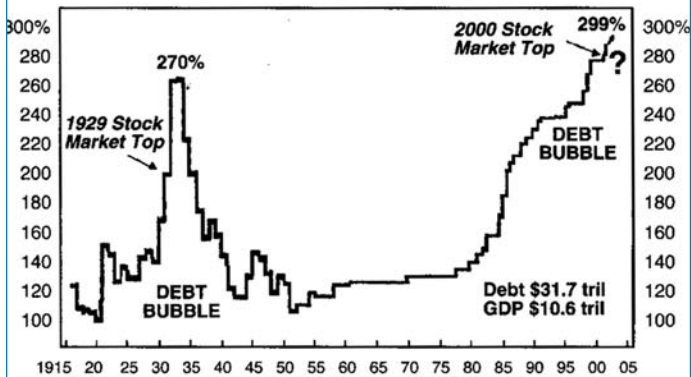
Market Cap vs. GNP 12/31/24 – 12/31/03
Consensus Forecast for 12/31/2003



portfolio, we do all our own research in house. In part, that's to avoid having to figure out whether the guy who's telling us the story has an investment banking conflict—or whether he's got an ax to grind. We keep our universe very small. We only follow about 65, maybe 70, companies with six analysts. So we screen the list down to a very small select group of companies. Then we get started on analyzing them irrespective of what their price might be—knowing full well that we may never own most of them, because their prices might never get to a reasonable level since we focus on good companies. But that allows us to function as a non-diversified manager reasonably well—with a reasonable workload. I just finished researching a company—I don't know how many hours I spent on it, but it's a great company. The stock trades around \$17. I think I'd buy it, if I ever get lucky enough, around \$10; that would give me a margin of safety. At \$10, I think it would be a slam dunk, but it may be on our shelf for a number of years. That's the way it goes. You hate to—I wrote a 35-page research report and spent a lot of time with the company, but there it sits.

You must have a lot of confidence that at some point Mr. Market is going to have a bad day and give it to you for that—
 Well, it *is* 93% owned by institutions.

Total Credit Market Debt (All Sectors) as % of U.S. GDP



That certainly raises the odds.

It runs at about a 10% short interest. It has about a 20% monthly turnover and the fellows who follow this company in Wall Street specialize in the industry this company serves, but not in the industry from which this company comes. So there are all sorts of conflicting interests, and a panic or a stampede is clearly within the realm of possibility, in my opinion. In which case, we'd be ready. We can pull the plug in five minutes if someone pulls his plug first.

And you have that sort of patience?

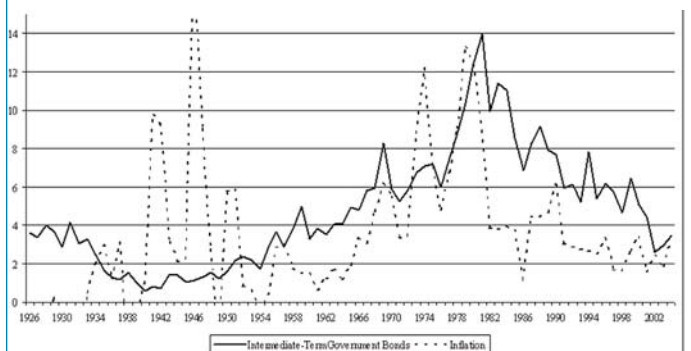
Yes, which means we're constantly talking to our clients about the importance of patience, of waiting for the sweetheart pitch. Of course, that's also one of the reasons I write such lengthy reports to clients. I want to be on record. Writing it all down also shows a level of commitment to our clients, because if I'm willing to commit myself, in writing, to my views, I am always standing the risk of looking like a fool. But that's certainly a risk I'm willing to take.

When we are living on this much borrowed money, we are also living on borrowed time. — Paul Volcker, Federal Reserve Chairman, 1979-1986

I suppose it also demonstrates that you're not just sitting around the office playing golf on your computer or something.

Well, that's the other thing. We actually publish all our own research in a formal way, which is fairly rare, I think, and send it exclusively to our clients. But I always tell my partners, whenever they write, to do so in a way that, should a **Ted Levitt** from Harvard, who is my dear friend, or a Warren Buffett read it, they would not be embarrassed by either the quality of the writing or the quality of the thinking. That, again, forces a discipline on us and also helps us calibrate our work. It all becomes part of a written record. Besides, when one of our rather fully invested portfolios holds maybe 12 stocks, clients kind of like getting up close and personal with those very large holdings in their portfolios.

Inflation Rates And Bond Yields



I can understand that.

Oftentimes they'll call us when they get a report. If they have questions, all the better. All this gets them to not be surprised if we suddenly get an opportunity and they suddenly find a sizeable chunk of their portfolio invested in something. At least, they recognize the name. We like to minimize the surprises. Occasionally, the purchase will actually precede the delivery of a report. But our experience with **Lands End**, years ago, was more typical. I can remember making 7 visits to the company over a period of three or four years, and lots of reports, before we bought the stock. It was well worth the wait, I might add. But keeping them informed about

this process is also a way that we communicate to our clients the importance of patience. In a sense, you hate to spend all that time writing a report on something you may never own. But even the exercise of writing a report is a good way to develop analytical disciplines and to calibrate them, which helps us grow cumulatively in terms of our understanding of our biases and weaknesses.

Another key to running a portfolio intelligently?

Yes, and it's hard work. It's also challenging to deal with your own biases—which all of us think we don't have—you have to get inside yourselves and get real. Which we have to do, so that we can learn from our mistakes.

"Mistakes?" What are those?

They're pretty conspicuous in portfolios of 10 to 12 stocks.

That's the usual argument against running a concentrated portfolio.

I wrote in my book about **Harry Markowitz** and his call for portfolio diversification, which of course all lead to "efficient" markets and Modern Portfolio Theory and whatnot. I don't buy it anymore than Buffett does. If you have, say, 12 really fine businesses in your portfolio—like the one that I was discussing, which has \$1 billion in assets and \$650 million in cash and, of course, no debt—but if I tell you too much, people will guess what it is—

Why not spare them the trouble and share the idea?

Our firm policy is not to disclose specific investments to anyone but clients. My purpose isn't to tout the stock, but to illustrate our investment process. So I would say that this company is somewhat overcapitalized, but the fortunate thing is that they are not stupid with their cash. They're not just holding cash to hold cash. They're holding cash in hopes that an opportunity will arise. And that opportunity is *not* likely to be an acquisition. It would more likely be a share repurchase or large dividend or something. It most likely wouldn't be irresponsible because all that money is retained earnings—money it *earned* after taxes and dividends.

This company didn't just raise cash by selling a ton of shares, then?

No deals. And its initial offering years ago was very modest. In fact, this company's cash *exceeds* its annual sales. Tells you that they're profitable, doesn't it?

So you like everything but it's current price. I have the impression from reading your latest annual that you've got lots of your clients' assets tucked into very liquid investments, rather like you did in 1987?

I would say we're about — it varies from account to account— but on average, we're 50% in cash. On top of that, we own LEAP puts due in December of '07 that in effect give us catastrophic risk insurance against some sort of a market meltdown. Obviously, if you're buying a LEAP put on the S&P 500, you're not going to get covariance to the penny or anything close. It could be favorable. It could be unfavorable. So our insurance is not precise. What we're trying to do would be to cushion ourselves against a catastrophic risk. Maybe our equity portfolios, if the market were really terrible, might be down 15% or so. But the combination of the proceeds of the sale of LEAP puts, and the 50% we have in cash, would give us an awful lot of buying power. And, equally important, would create in our clients' minds a propensity to assume the lesser risks that *then* would be available in the market. At that point, it would do us no good to have some big losses in our portfolios, and go

to our clients and say, "Boy, things are really cheap, it's time to buy."

You suspect they wouldn't be anxious to belly up to the bar?

They'd say, "I'm sorry, I've bellied up enough. Let's just ride this one out." Preparing ourselves and our clients for what's on the other side of the "Perfect Storm," if in fact that is what blows our way, is important both temperamentally and financially. I think we've done what we've needed to do financially. Now we are working very hard, like in the annual report, to prepare them temperamentally to take advantage of a "Perfect Storm." To have the courage to step up, when we are the only ones there. It's to step up, as you say, belly up to the bar, when you're the only one there. So it's kind of a perverse game, as you know.

One most institutional investors won't touch. They won't dare go 50% in cash because of the career risk in under-performing their benchmark for even a quarter.

That's another of the luxuries of being in Indiana and having intimate relationships with clients, where you can say to them, "Think Main Street. If you were running a business, you wouldn't be that hyperactive." We operate under a different mandate, partly because we cultivate that mandate—but it's a businessman's mandate. It's not a Wall Street or a day trader's mandate. We could not operate under those kinds of quarter-to-quarter comparison constraints. Just couldn't do it.

I'm guessing no one has ever called your trading frenetic.

Never. The irony is that the public market, as opposed to the private market, is the perfect place to be frenetic in your trading. That's probably one of the reasons people trade like that. But Warren likes to say that if the market shut down for six months, it wouldn't bother him. It wouldn't bother us at all, either. What I do like about the fact that the markets trade daily is that you get to pick your time and you get to pick your price. All you have to do is be patient about it and have a fair amount of conviction. Then, the game comes to you eventually. It's just that waiting can be hard to do while that darn little ticker keeps flashing. So I don't look at quotes, by the way.

You don't have a flashing Bloomberg screen in front of you?

I don't have any screens. I don't want to see screens. I don't want to see daily prices. I don't even want to see weekly prices—unless we're getting close to buying something because it has gotten down into a range where we think it's becoming compellingly attractive. *Then*, I'm interested in the price. The rest of the time, the heck with the price.

Seriously?

It's just noise. And a waste of one's time. I mean, people spend more wasteful time watching prices. Look at the market—for the last couple years it's basically been flat. Can you imagine watching prices for two years and having nothing to show for it?

The counter-argument is that it has gained and lost a lot of points en route to going nowhere—and there are traders who generate significant returns working that volatility.

To those people, I tip my hat. It's a game I wouldn't know how to play. It requires a completely different mindset. You know, we don't call ourselves financial analysts. We call ourselves *business analysts*, which implies a longer-term perspective. I would be a fish out of water trying to figure out who would take something off of my hands at a higher price. Finding the "bigger fool" is a game of psychology that I'm not equipped to play. Especially amid the headwinds that this "Perfect Storm" environment suggests, I just don't want to be without a chair when the music stops.

Before we get back into that, if daily price fluctuations are just noise, what's your take on investors' obsession with quarterly numbers and forecasts?

I wrote an essay, a year or so ago, that I'll eventually get around to publishing, called the "*Earnings Guidance Enigma*." The short answer is that we tend to just completely disregard earnings guidance. In fact, we tend to be turned off by companies that place too much emphasis on guidance. As **Seth Klarman** says, if you're looking for an edge and everybody knows the company's forecast, where's your edge? There's no mystery anymore. It's all laid out for you. Oh, maybe the mystery is, will they meet it to the penny or beat it by a penny or miss it by a penny, but that's—

A lot of false drama.

Exactly. I'm also outspoken about stock options. Give us a nasty, mean bear market for a while and the appeal of stock options will decline. People will rediscover a great preference for cash. But that is anathema to say in a time like this. When we go see companies, we just want to talk about their business and what they are going to be doing in five years. And how big is the moat? What is going to make it sustainable? Those sorts of things that will tell us if we can reasonably expect the intrinsic value of that business to grow in some jerky fashion.

Didn't I read you saying that sizing up the management is also a big part of what you do?

Yes. I know that there are widely differing views on the importance of looking at and talking to management because a slick management can sell you right down the river. We all know that. But I've read your stuff over the years and I think you've got great intuition. We're all fooled on occasion, but generally, I'm also highly intuitive. It's rare that someone, if I get enough time with him, can pull the wool over my eyes in any meaningful way. And if I do have any doubts, we just walk. Generally, I want to understand motives.

Options programs can give you some clues about that.

They can. A guy can tell me everything he wants to tell me or that he thinks I want to hear. But if his company has a very top-heavy options program and his compensation is egregiously out-of-line with what I think is reality, his words would ring fairly hollow.

You're not a fan of obscenely inflated executive compensation?

Not a chance. I like to keep my own salary, for instance, at somewhere around three to four times what we pay our support staff.

Boy, you are out-of-step with corporate America.

Well, in terms of my academic preparation and my experience, I'm probably worthy of a higher income than our support staff. Then again, because I'm a 70-hours-a-week kind of guy, my hourly rate is probably pretty low. But am I worth a hundred times? I don't think so. Am I worth 500 times? Not on your life. But then again, I don't think it's all about money, either, while for too many people, it is—and that's a very poor measure. You many have noticed my reference to the existentialist and eminent psychiatrist **Viktor Frankl**, who wrote the perennial best-seller, *Man's Search For Meaning*, early on in my latest annual report. More particularly I referred to Frankl's definition of success as the unintended byproduct of one's dedication to a cause greater than oneself. I've read and reread his book. I like discovering motives and I like people who focus on the means and not on the end. In fact, I really don't like earnings targets because they're not realistic in terms of what most businesses can do in the real world. We just want to find out if a business is doing the right things that would logically result in growing sales and improving or holding its margins—those sorts of things. I don't want details and

I don't want specific targets because people can manipulate things to achieve targets.

No! Really?

On occasion, yes. That's part of the whole enigma of earnings guidance. Sometimes we run into wonderful companies that simply don't give guidance. A lot stop giving guidance when guidance doesn't work out for them.

Which tells some analysts to suspect the motives of a company that won't give guidance.

Yes. But if you go to Omaha every year, you can sit there for six hours while Warren uses that as his bully pulpit to talk about everything at Berkshire Hathaway, *except earnings*. He really wants you to get to understand how the business works. I mean, that's why the turnover rate among his shareholders is 2-3% a year, which means that he has got a bunch of contented shareholders. So yes, I have strong opinions about earnings guidance. It makes for too cozy a relationship between the analysts and the management. It also makes for lazy analysts. It encourages a very direct form of dependency. This is all tied into the "Perfect Storm" scenario. If you look at the totality of it, the pieces fit together pretty well.

Let's talk about just what you see coming together to create this "Perfect Storm" – It's more than the lofty market valuation and the credit bubble illustrated in your charts, isn't it?

Those are big parts of it, but there are many variables in the mosaic. First, though, look again at the chart of stock prices to GDP. Why are stock prices 126% of GDP when the 80-year average is 61%? Looking more closely, if we think the post-1990 period is an historical anomaly (as it appears to be) then the average ratio is more like 45%. Trendline earnings growth rates have been just slightly better than 6%, albeit with some dramatic short-term deviations. Meanwhile, profit margins are currently artificially inflated by the financial services industry—a point I'll get to in a bit. On the other side, sure, we're enjoying productivity improvements from advances in information technology—but I think, for myriad reasons, that they are unlikely to result in a permanent improvement in economy-wide profit margins. Meanwhile, as the third chart shows, in the study of long-term interest rates, averages mean nothing. But the decline in bond prices from 1964 to 1981 and their subsequent rise from 1982 through 2005 rather precisely and not coincidentally parallels the movement in stock prices through the two major secular cycles over that stretch. Of course, as the second chart shows, credit has been ballooning like mad since the early 1980s. The easy money "financial" economy, rather than promoting consumer price inflation (an impossibility against the powerful deflationary impulse coming from China and India, etc.) has precipitated asset inflation instead. It's like someone has been squeezing on the economic balloon. We've seen the malinvestment brought about by the internet and stock market bubble, but the speculative disease has just metastasized into residential real estate—where the fallout looms closer every day, and threatens to be of incalculable proportions.

Okay. Then what are the other ominous signs you see?

Another is the "inexplicable complacency," as **Jim Grant** has called it, that we see in the market today about risk. This utter disregard for risk can only happen on occasion when you haven't been taken out to the woodshed for quite a while. The point I made at the beginning of that essay was that people didn't really care whether the levies in New Orleans were sound. They *should* have, but they instead focused on other things. Then there is this whole credit explosion, which exacerbates the increase in housing prices and new housing construction,

which has gotten completely out of hand in certain regions. And when you listen to Comptroller of the Currency John Dugan talk about these reverse amortization interest-only mortgages that surprisingly are often assumed by people who really are marginal in terms of their credit worthiness, you can't help but think, "Man, there are a lot of people at the margin who could cause a tipping point to be crossed." So you've got unchecked credit creation and bank balance sheet-asset growth and liability growth, which are matched, of course in an accounting sense, but what tends to get overlooked is that bank assets are often things whose value can only be estimated, while their liabilities are accurate to two decimal places. Then you've got the down-streaming of all these credits through the Fanny Mae's and the Freddie Mac's into institutional hands-

Though no one really knows where all that credit ends up-

Well, the best we can figure is that it is in pension plans and insurance companies and with other long-term holders. Still, while everybody wants to get their rake as it goes through, they don't really want to own it. Nonetheless, when I look at a typical bank balance sheet, it's pretty loaned up. Of course, now banks are getting into owning their own commercial real estate which is -

A perfect thing for banks to be getting back into, right at the top of the cycle. After all, they did so well in real estate in the Depression.

Well, I have been very unkind in my annual report this year to banks in general. Obviously, there are wonderful exceptions. But moving from one folly to the next is the history of banking-and it goes way back, before the 1930s. They have an uncanny knack for diving headfirst into the next big problem for the markets. Then we have these enormous financial intermediaries, besides the banks-I don't think that either Fannie or Freddie has produced a 10-K since 2003. They have their own problems with derivatives.

And if they do, their counterparties probably do, too- except that they haven't owned up to it.

No, they haven't. I don't know if you happened to read Berkshire's annual report this year.

Sure.

So you've read Warren again lamenting his ongoing travails in unwinding the derivatives book at General Re. If it's that hard for him, I mean, just imagine how hard it would be for others. The whole incentive system is all mucked up. You've got two traders on every contract, each trying to price a profit into the same trade- and how they mark these things to market is beyond me.

My suspicion, after interviewing Frank Partnoy, is that in many cases a "perfect security" is created in derivatives transactions-one that each side of the trade can book as a profitable position for their separate accounting purposes. At all relevant times. A feat that is greatly facilitated by the utter lack of transparency in the market.

It really does bother me that Alan Greenspan on one hand still *says* at least-whether he believes it or not-that derivatives actually *reduce* risk (and I presume that Ben Bernanke either is not experienced enough to decide otherwise or will simply follow Greenspan's lead). Of course, on the other hand, you have Warren Buffett who says that derivatives are actually increasing risk, which also is my position.

Isn't that a matter of perspective-or whether someone has climbed that tree you mentioned at the outset? Individual

derivative transactions are structured to allow people to assume that in any given accounting period each party has probably reduced a *specific* risk and increased its "profit." But at the same time, these can be incredibly long-tailed transactions with nobody policing reserves. So in the aggregate, they probably increase systemic risk terrifically.

I have to believe that's the case. Then there's another element of the "Perfect Storm" to consider. One of the reasons that the equity risk premium is so small is because we have not had, beyond the bursting of the technology bubble, a pervasive, *Devil Take The Hindmost*, if you will, bear market, going all the way really back to 1973-'74. That was the most recent one. So most people in the business really don't know what it means to have a long and painful, agonizing bear market experience. On top of which we have this overpopulation of buyers. By which I mean the 8,000 plus hedge funds, and the trillion or so dollars in them. There's a new book out about them with a very clever title by-shoot, I can't think of his name right offhand-

Do you mean *Hedge Hogging*, by Barton Biggs?

That's it. I haven't read yet, but I can guess what the message is. With \$1 trillion looking for an edge with some hot money guys, many of whom have not had the experience that would suggest that they're qualified to run that kind of aggressive leveraged money, the proliferation of hedge funds is just one more item that factors into the potential for a "Perfect Storm." Then, getting more esoteric, we could delve into the issues of the trade deficit and its companion budget deficit. Now, I realize that the problems resulting from those last two issues could surface tomorrow, or they could surface five years from now. So you wouldn't want to trade on the assumption that we are going to have a run on the dollar tomorrow. But when you combine all these things and stir them up in the same pot you can see that there are a lot of potential tipping points out there. The tsunami was a result of a rather minor shifting of the tectonic plates that then expanded into something considerably bigger, as you know. What has me worried-and why you ought to be worried-is that there are so many tipping points out there and any one could create some sort of cascade effect.

So you're not worried merely because we're living on the kindness of the strangers (foreigners) who are buying our debt?

That's just one part of it. Any of the tipping points could trigger the "Perfect Storm."

You spilled quite a bit of ink on the banks in your latest missive. Yet the financials have been doing pretty well.

One of the explanations for why banks, which constitute about 20% of the S&P500 by market weight, contribute some 29% of S&P earnings is that, because there have been so many consolidations among banks since bank deregulation started in earnest in the 1980s, the total capitalization of banks within the S&P 500 has naturally grown along with those consolidations. But if you look at the Bureau of Economic Analysis' National Income & Profit Accounts (which include all companies, public and private, in the financial services industry and so are not affected by consolidations) you actually see even scarier numbers in terms of bank earnings's explosive growth as a percentage of total corporate earnings. In the last five years, that percentage has probably averaged close to 40%, after being around 15% in the 1930s, in the mid-single digits in the 1940s, and in the teens in subsequent decades-until the 1990s, when financial earnings expanded to represent an average of roughly 25% of corporate profits. More recently, as I said, that percentage has gotten up around 40%. Well, when the money changers-in what is ultimately a commodity business with very little room for differentiation in the long run-are contributing that much to

corporate profits, something is askew.

Okay, but don't those NIPA figures on financial services include more than just banks?

Yes, they include insurance, which is a very large industry. But what's interesting there, as I wrote in the annual, is that neither the banking nor the insurance industry actually report cash earnings. They report earnings based on reserve estimates that may or may not prove true. I think even my conservative banker friends would like to reserve more than they do, but the regulators, who base their reserves on past experience, say that the banks can't do that; that they are just trying to save on their taxes. Yet I could imagine a scenario where, if things got really bad on the financial side, banks would suddenly appear to be grossly under-reserved. Their charge-offs would be great and the expenses that they would incur to bolster their reserves might throw their earnings into a real tailspin. And since they account for such a big piece of the S&P earnings, that could be problematic for the stock market. Again, these are the thoughts of an intuitive right brain gestalt-type thinker who's says, "Geez, I'm looking at all these pieces of this puzzle. I don't really see them as discrete elements, I just see them in their totality and they're all pointing in the same direction; to the kind of mindset that would allow something like this to come to be. The willingness of bankers to lend and of people to borrow—without any rational expectation of actually being able to have the loan repaid by the borrower—is mindboggling. The flipping of condos in Florida, of interests in these pre-construction condos, was very similar to the kind of madness that went on in technology in the late '90s. That largely speculative market has already cooled, but where cooling in real estate will really start to bite is when it hits owner-occupied residential real estate, where people have been borrowing against *seemingly* ever-rising home equity to fund consumer purchases. Should the value of residential real estate go into a prolonged flattening or a slide or even worse, where is consumer spending going to come from to sustain the economic growth?

You mean the house as ATM could run out of money?

Exactly. If the assessed value or the appraised value of your house begins to decline, your banker should be less willing to lend against that asset—and I can see that migrating into an economic slowdown, since consumers have been 70-75% of total spending in this economy of late.

Meanwhile, banks are beginning to be squeezed a little bit more by the interest rate situation—

Spreads of course are extremely narrow and the curve being what it is—those factors are clearly hurting banks' short-term profits. But down the road, I wonder if other issues will trump those. We can probably fix the spread issue by widening them somehow. But I don't know how you get rid of a lot of bad loans except by taking write-offs.

Then again, if spreads widened because interest rates increased dramatically, that would generate a whole set of new issues, which would not be all that good for many bank borrowers. Home equity lending is the loan category that has really mushroomed lately, and those are floaters, which are highly susceptible to interest rate risk. That's the margin risk that I see in the residential lending market. Have you seen the movie, "*Cinderella Man*?"

Not yet.

Well, none of us—certainly not you or I—have ever experienced anything like what happened during the Great Depression. What 25% unemployment is like. Nor have we had to live in a Hooverville. But the disparity of incomes issue, another part of the "perfect storm" could raise all sorts of questions about capitalism, should we—heaven forbid—ever fall on similar hard times. The egregious compensation arrangements that too many CEOs have engineered for themselves are so shortsighted; they are bound to blow up in their faces, and then in our faces, down the road. As you know, capitalism was much-maligned in the '30s, and the Nazis and Fascism were spawned, when clearly things weren't as out of whack as they are now.

One thing is clear, Frank. You are no bull.

True enough. I would categorize myself as a non-bull—but not as a bear. By saying I'm a non-bull, I am simply saying that I really am not finding a lot of things attractively priced for investment—selling at a significant discount to what I think they're worth. But I'm not saying anything in using that label that implies anything about when regression to the mean might take place. I am simply saying that this market is not a good place to invest money because the expected returns can't rationally be determined to be adequate at these levels.

You don't have an inkling when your "Perfect Storm" might hit?

To make that sort of prediction, I think, would be irresponsible on my part and actually irrelevant to our goal, which is to earn somewhere between 10% and ideally 15%, compounded average returns on our money over long periods of time. From current market valuations, I don't see how total returns from common stocks, say for the next 12 years, could greatly exceed 6% without unusual anomalies in the relationship between labor and capital and so on. Using the rule of 72s, that implies a double over that span. But given that I can put money in Treasuries at 4.5%, forgetting for the moment about taxes, that 1.5% premium in return that I might get from common stocks hardly appears to me interesting or exciting or compelling compensation for the additional risk. There's no way I see an adequate margin of safety here, so I'd rather wait for a fat pitch.

Thanks, Frank.

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