Martin Capital Partners

Quarterly Point of View
Show Us The Money

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Government balance sheets in this country and across the world are not in good condition, but the same cannot be said for corporate America. Non-financial U.S. companies hold a staggering $1.93 trillion of cash and other liquid assets as of the end of September. According to the Federal Reserve, cash accounted for 7.4% of these firms' total assets, marking the largest reserve since 1959. Along this line, Standard and Poor's analyzed 368 of what they termed the 'old' industrials, and the results illustrate the enormous cash reserve strength of these companies:

- 35.6% have more cash than long term debt
- 49.2% boosted their cash by more than 20% over the last year
- 63.0% had at least one year of estimated 2010 operating income in cash with 34.2% having at least 2 years worth
- 18.8% had more than 20% of their entire market value in cash

The buildup of cash to these levels demonstrates the deep caution many companies feel as the economic recovery remains slow, unemployment remains high and tattered household finances limit the ability of consumers to spend. It is true however that some companies have begun using cash to prudently hike dividends, as 19 of the 20 largest payers actually enhanced their annual distributions in 2010, with no recorded cuts. Stock buybacks have also picked up, with $79.6 billion of repurchases completed in the third quarter versus $34.9 billion in the year prior quarter. But the figures are simply not material given the corporate reserves in place and it is our opinion that we are close to an inflection point for this cash phenomenon.

The front end of retiring 'baby boomers' are coming, and starting this year, for the next 19 years, approximately 10,000 people per day will celebrate their 65th birthday - the age most notably linked to retirement. This group will begin to apply significant pressure in the board rooms of U.S. corporations, and demand companies to 'show us the money' through enhanced dividend distributions. Interest on fixed income instruments are near generational lows, and cash reserves are paying virtually nothing. Many 'baby boomer' investors are simply way behind in saving for retirement and when coupled with low interest rates on these fixed instruments, the negative 'real' (inflation adjusted) returns will only exacerbate the problem, forcing alternative solutions.

Dividend payout ratios (percentage of net income a firm pays to its stockholders in dividends) for S&P 500 companies are hovering near 30% versus a long term average of 54%, allowing for a meaningful dividend growth opportunity. A payout ratio average of 30% could only be remotely justified in an environment presenting plenty of growth opportunities - but this is not one of those environments. Many companies have not come to terms with their own maturity and are suffering through declining growth rates, paying trivial or non-existent dividends and have mountains of cash. Companies with these characteristics will be forced to recognize that if they chase the dreams of the past and waste shareholder cash hoards on consistently fruitless mergers and acquisitions and do not increase shareholder value, they will become direct targets for this dividend payout pressure. Though corporations on their own accord should be seeking constructive dividend policies, those that resist will run into a very serious demographic force that will, in essence, make that decision for them.

From a macro perspective this could have positive implications for the overall stock market as it should compel 'shareholder' focused management versus 'management' focused management. Additionally as overall stock market yields rise through higher payout ratios, it may have the effect of justifying higher price to earnings multiples for stocks in general. Both of these results would be very positive. As always we will continue to seek what we view as wise companies; those that are focused on long term shareholder wealth creation that includes sharing their success with share 'owners' in the form of durable and growing dividends. We take some comfort in the fact that we may have an even greater universe of potential investment opportunities in the years ahead as other companies realize the error of past decisions and begin to reward shareholders with dividend payments, over other less sound alternatives.

An article in the New York Times last month caught our attention. We have heard about high frequency, quantitative and program trading where computers push huge trading volume by exploiting (and often causing) short term price movements to their own advantage. As the article highlights, we now find that computers are being taught to trade financial assets based on text buried within anything from news articles to Twitter posts. In many cases the computers are parsing writers words, sentence structure, and even emoticons like the happy face **:).** At first blush it may seem to be another case where the resources and brain power of the math 'wizards' on Wall Street are lengthening the odds against the average investor - and that may be true when analyzed in extremely short time frames. But these developments may actually be a gift in disguise for investors with any reasonable timeframe beyond the next quarters report. The quantitative and computing brainpower continues to focus on ever shortening time horizons and the tiniest of gains on massive volume. These systems and those behind them are not focused on the next year or two; they're not dwelling on sustainable competitive advantages, long run earnings power or the lasting value of large and growing streams of dividend income. As Wall Street focuses ever more intently on short term movements, we believe this will ultimately create more opportunity for those investors whose time horizon reaches beyond a month, a day or an hour. The more these financial 'wizards' concentrate on the next few seconds, the less likely they are to identify the long term values that we diligently seek.

2911 Tennyson Avenue, The Inkwell Building, Second Floor ▲ Eugene, OR 97408
tel 541.636.4170 ▲ fax 541.636.4815 ▲ www.martincp.com

Unfortunately most investors feel they need to 'beat the market' in all quarterly or annual time frames. What they don't realize is that this need requires them to chase performance and inadvertently accept additional risk. By taking on this added risk, investors expose themselves to the full force of inevitable market declines. With the stock market as measured by the S&P 500 up 93% from the lows of March, 2009, we feel this would be a good time to reflect on this point and to consider returns that are produced in light of the risk taken to achieve them. In other words, to relinquish some near term upside may be wise if the portfolio is positioned to retain relatively more value when the seas are not so calm.

Please feel free to call or email with questions you may have regarding our strategies or Martin Capital Partners in general. You can also find information on our website at www.martincp.com.

We are humbled and excited to wake up each morning and serve those that have entrusted us with their capital. It is a sincere privilege.

Respectfully,

Martin Capital Partners, LLC

If you would like additional information on how Martin Capital Partners, LLC conducts business, we can provide a copy of our SEC Form ADV part II. As always, past performance provides no indication of future results.

Statistical and analytical data provided by Bloomberg Professional

The market views and opinions expressed above reflect the opinions of Martin Capital Partners, LLC and are not intended to predict or forecast the performance of any security, market, or index mentioned.

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