



## Quarterly Point of View *Earnings Only a Means to an End*

July 18, 2011

The preceding ten years produced an annual compound total return of 3.3% for the S&P 500 through March, even after including a couple of very good years at the end of that stretch. Underwhelming when compared to a median ten year rolling return of 10.8% going back to 1926<sup>1</sup>. The average investor, during the past decade, was rewarded with temporary gains at best and large losses at worst, while persistent volatility brought on by a myriad of domestic and international concerns kept many investors from reaching their goals.

There is no doubt that a massive valuation adjustment was one of the main culprits for the well below trend return over this time. The S&P 500's forward price to earnings ratio exceeded 25 in 2000 and 2001 and currently stands at roughly 14.5 while averaging 15 over the last half century<sup>2</sup>. The magnitude of this P/E multiple compression served as a heavy weight around the neck of the average stock, requiring robust earnings growth just to keep a level stock price as valuations sank. This is an obvious factor in past returns and one that shouldn't be nearly as burdensome when we look to the next ten years. But there is another factor that contributed to these poor returns; it is the unfortunate truth that most American corporations didn't, and still don't recognize or treat shareholders as true owners. Even as the economy muddles its way out of the worst recession in 70 years, corporate profits are soaring. Yet the vast majority of these earnings, like those of the last decade, aren't finding their way into investor's wallets. Instead these piles of profits are redirected to ill conceived tactics like over priced/empire building acquisitions, poorly timed share buy-backs and shameless executive compensation packages. Profits for companies composing the S&P 500 Index stand to exceed \$900 billion in 2011, while dividend payments are running at just over \$200 billion, a relatively small portion of overall earnings. This amounts to a current yield on the average stock in the index of less than 2%, well below historical – or capable – yields.

The encouraging news is that there are companies that do value shareholders, treating us as rightful partners in business by distributing large and growing streams of dividend income as part of a prudent overall corporate strategy. For example the stock only portion of Martin Capital Partners Core Dividend Strategy has a weighted average yield of 3.4% which has been growing each quarter. The average five year rate of dividend growth for our portfolio holdings was 12%, versus -3% for the S&P500. These enterprises are generally highly profitable, relatively unburdened by debt and have management teams and boards of directors who consider shareholders as actual partners. To have success over the course of the next decade, in our opinion, consistent and disciplined focus will need to be placed on continuing to find these types of businesses.

We look for these companies through characteristics we term *QDG: Quality, Durability and Growth*. Generally businesses fail or are at risk due to some combination of intense competition, low returns on capital and unmanageable debt levels. Additionally complacency and/or arrogance manifest's itself in insufficient attention to the balance sheet when times are good – in turn putting the enterprise at risk when times aren't so good. As these are the characteristics often associated with failure, we look to turn that around and focus on *Quality* franchises with very strong competitive positions (often global leaders in their industries), with consistently high returns on capital, favorable gearing ratios (debt to capital levels) and

other important marks of balance sheet attention. Identifying the *Durability* and *Growth* of dividend income are the next steps to finding those companies that view us as genuine co-owners. We look for a history of dividend payment through market cycles, an identifiable, established and committed dividend culture or one that is making a rapid and decisive conversion to an attractive dividend payer. Strong cash flow and prospects for earnings growth to support payout growth is crucial. We would rather accept a lower yield that consistently grows, than stretch for a higher yield we believe may not be sustainable. Ultimately we believe a portfolio of quality companies with durable and growing dividend payments - where we're treated as an owner, sharing in the profits consistently on a cash basis - has the opportunity to produce attractive risk-adjusted returns.

*"Earnings are only a means to an end, and the means should not be mistaken for the end. Therefore we must say that a stock derives its value from its dividends, not its earnings. In short, a stock is worth only what you can get out of it. Even so spoke the old farmer to his son: A cow for her milk, a hen for her eggs, and a stock, by heck for her dividends. An orchard for fruit, bees for their honey, and stocks, besides for their dividends... The old man knew where milk and honey came from, but he made no such mistake as to tell his son to buy a cow for her cud or bees for their buzz."* John Burr Williams, *The Theory of Investment Value*, 1938

History demonstrates that dividends are more than just pocket change or simply interest to help fund retirement. Dividends are the integral link between investors and the businesses they own. Investment success in the next decade will not come by accident, it will take discipline and patience and an ability to disregard Wall Street's fast-money mentality and insist on being rewarded as a business owner through attractive and growing cash dividends.

We are pleased to note the passing of June marked the one year anniversary of Martin Capital Partners, LLC. Our one year composite return for the Core Dividend Strategy was 29.18%, a very gratifying performance, particularly in light of the lower than average risk profile of the portfolio. We are extremely thankful and humbled to serve those that have entrusted us with their capital. It is a sincere privilege.

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](http://www.martincp.com).

Respectfully,



Cameron K Martin  
Chief Investment Officer  
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.

1: The Leuthold Group, LLC  
2: Bank of America/Merrill Lynch  
Statistical and analytical data provided by Bloomberg Professional

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