



Quarterly Point of View *A Bird in the Hand is Worth Two in the Bush*

April 20, 2012

It appears we are getting to the point in this market cycle where we, as investors, need to overcome temptation. The temptation will be to keep the return train rolling by doing whatever we can to match the indices as they climb. Therefore, it will be incumbent on us to resist doing 'whatever we can', ignore these temptations and focus intently on the fundamentals of our holdings while being alert to excessive risk. In becoming too focused on short term results and the desire to 'keep up' at times like these, investors become highly susceptible to the inadvertent acceptance of additional risk, the burden of which leaves portfolios exposed when inevitable turbulence arises. Given the handsome stock market advance through March, it has become all the more important to remind ourselves to stick with what matters. To us, what matters is strong adherence to our focus on high quality franchises that generate durable and growing income.

By the end of the first quarter of 2012, the U.S. stock market, as measured by the S&P 500, had risen a muscular 122% from the crisis lows of March 2009, and the NASDAQ enjoyed its strongest first quarter start in 21 years, highlighting robust gains for many of the major averages. However, underneath the surface of the quarterly returns, the gains appeared to be somewhat concentrated and narrowly focused, particularly on lower quality enterprises. The top 25 stocks in the S&P 500 Index, which comprises just 5% of its holdings, contributed a full 35% to the returns of the quarter. Within that basket of stocks, just three sectors-- financials, information technology and consumer discretionary-- comprised 92% of the constituents. In other words, only two companies in the top 25 performing names lay outside those three sectors. Even more indicative of the characteristics that drove market performance is the fact that only one company in the top 25 had a Standard & Poor's earnings and dividend quality ranking of A or better, and that company did not meet investment grade criteria when evaluated by S&P's credit (bond) rating department. More succinctly put, the start to 2012 appears to be a narrowly concentrated rally of the low quality variety.

One year ago this month, we wrote, in our quarterly 'Point of View', about global government balance sheet disrepair, the end of the decades-long debt super cycle, and the need for a host of countries to deal with their unsustainable levels of debt. We stated, "The only fundamental fix for any economy plagued by over-indebtedness is austerity and time; there is no quick or easy fix." Though this theme will be thoroughly worn out over the coming years, there is no way around it. It is better for both

governments and individual investors to acknowledge this reality and navigate it to the best degree possible, than to ignore the economic environment and wind up in worse shape.

Let's consider Greece, a country which declared, in late 2009, that there was "no possibility" of default. By late 2010, the declaration had changed to "Restructuring is not going to happen." The country now stands in an 'orderly' default. So what happened? Due to a massive fiscal imbalance repeatedly ignored by leadership, the bond markets could no longer stomach Greek debt and coughed it up in the form of skyrocketing government funding costs that reached 34% for a 10 year government note. Bondholders were eventually forced to agree to a haircut on principal exceeding 50%, and now the previously trimmed and newly issued Greek debt trades at another steep discount in the open market. Why do we re-hash all of this? Because the bond markets of the world have reached their tipping point and have lost confidence. By eschewing the paper of non-compliant nations, markets will now force austerity action on economies that don't put their own fiscal houses in order. It is increasingly likely that we will hear much about Spain (to be presumably followed, but just as possibly preceded by Portugal, Italy or Ireland) in the months ahead, as its funding costs continue to rise while it enters its second recession in three years. Spain's unemployment rate currently exceeds 23%, after a particularly devastating 2.4% increase in February. Meanwhile, the jobless rate for those under the age of 25 now tops a startling 50%. Adding to the pain, Spain's IBEX 35 stock market index still resides 55% below its 2007 peak. While austerity measures are the only real long term solution, a disquieting issue is their potential to create a vicious cycle that further depresses growth at the point where growth is most needed. Yet that is the world that we live in; one burdened with the culmination of years upon years of additional debt. The de-levering of this debt will unfold bit by bit and the road to a full recovery, though not without opportunities, will be both long and erratic.

To navigate this road, we look to tangible cash payments. There is a concept discussed predominantly in bond markets called duration. Duration, which is used to analyze a bond's exposure to interest rate volatility, considers the present value of all coupon and principal payments to be received in the future. Expressed in years, it is the weighted average time until cash flows are received. The longer the duration, the greater the interest rate risk for the security. Because equities do not share the fixed payment schedules and principal maturities of bonds, measuring equity duration is less precise. The concept however, is important and timely. In a high-volatility environment where unrealized capital gains built on paper have a tendency to erode as the next crisis develops, possessing a shorter duration equity portfolio is critical. That is to say, if durable, high and rising cash dividend payments by quality companies are produced in an equity portfolio, more of the investment return is realized by the investor 'up-front', and less is required at the back end (as sales for capital gains) to produce the same total return. By virtue of focusing on the cash payments of corporations with well-established dividend cultures, we can eliminate some level of risk through the

consistent and incremental capture of return; in this way, we need not attempt to leave all of our return to a final 'maturity date' sale. From an investment positioning standpoint, this shorter duration-- which can be referred to as *a bird in the hand is worth two in the bush* attribute-- will be important for a portfolio to exhibit during the continuing environment in which a volatile, unpredictable path will mark the road from A to B.

Years ago, Warren Buffett stated "... an investor will succeed by coupling good business judgment with an ability to insulate his thoughts and behavior from the super contagious emotions that swirl about the marketplace." At this juncture, the "good business judgment" in our mind is the constant analysis of the fundamentals of the companies we own; for each, we are careful to ascertain their continued ability to grow and share profits with us as pro-rata owners in the business, while producing consistent and incremental 'bird in the hand' cash dividends. Likewise, insulating our thoughts and behavior from the emotions of the marketplace means avoiding the temptation of the crowd, which is often manifested in 'index chasing' and consequently, the inadvertent acceptance of additional risk. By following these principles as investors, we decrease our odds of making major mistakes, and increase our odds of longer term investment success.

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Respectfully,



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