Quarterly Point of View
Windshield, Not Rear View Mirror

January 15, 2014

Stock markets of developed economies around the world enjoyed a prosperous 2013. The bellwether Dow Jones Industrial Average rose 27%, posting 52 record highs on its path to the best calendar year gain since 1995, while Japan's Nikkei Stock Average shot up 57% for its biggest gain since 1972. Europe trailed those lofty advances but still managed commendable performances, while emerging markets finished the year negative, notably lagging the developed markets success.

Treasury bond yields rose sharply in the United States and because yield and price move inversely, performance for bond indices was negative. The Barclays U.S. Aggregate Bond Index lost 2%, its worst year since 1999 and the Barclays Long Term U.S. Treasury Index declined almost 13% on a total return basis. Though financial media always seems to claim such things with assurance, no one ever knows for sure when money leaves one asset class for another, but it seems safe to speculate that the much ballyhooed 'rotation' from bonds was one significant factor propelling stocks to the best calendar year gains in well over a decade.

Following a very good year like 2013 - and nearing five years removed from the worst memories of the global financial crisis with returns from the lows exceeding 25% on an annualized basis for the S&P500 - one of the risks investors face will be behavioral.

Behavioral economics, or its subset, behavioral finance, analyzes the effects of social, cognitive, and emotional factors on the economic decisions of individuals and institutions and their consequent impact on returns and resource allocation. Primarily concerned with investor rationality (or lack thereof), the analysis typically integrates psychology and sociology with microeconomic theory. One of the central issues in behavioral finance is examining cognitive biases, or simply defined - mistakes investors make in reasoning or evaluation, often occurring as a result of holding onto certain preferences. One particular bias that investors will now need to be keenly aware of is 'recency' bias, sometimes referred to as 'availability' bias. Recency bias is straight forward - we have a strong tendency to use our most recent experiences as the baseline for what will happen in the future. For example, researchers have found that individuals were likely to overestimate the chances of being in a car crash if they had seen a wreck on a recent road trip. The recent memory made the prospect more vivid and retrievable in their mind - and therefore more likely. In a similar fashion, when asked to recall a list of items in any order, people are inclined to begin recall with the end of the list, as those are the most striking in memory. The huge problem with recency bias for investors is that during bear markets it magnifies perceived risk (as stocks seemingly continue to fall) instead of illuminating opportunity, and in bull markets it magnifies perceived reward (as stocks seemingly continue to rise) instead of illuminating risk. The result is that good investments are sold during bear markets, and in bull markets more aggressive exposures are accumulated as risk seems like a silly thing to consider when there is so much 'obvious' opportunity ahead. In both instances the effects are detrimental to long-term investment success.

Considering the results of the past five years we need to realize that if we aren't careful, our behavioral tendencies as investors will be to pay much less attention to the risks of allocation decisions then we should. Due to the mathematics of compounding, large losses have a disproportionate effect on long term cumulative returns. Avoiding this math by de-emphasizing near-term results, which often lead to inadvertently accepting additional risk in an attempt to keep up, is significantly important.

Howard Marks, the billionaire co-founder of Oaktree Capital and someone whose memos Warren Buffett says he reads as soon as he receives them, penned the following in his book The Most Important Thing: *The road to long-term investment success runs through risk control more than through aggressiveness, over a full career, most investors results will be determined more by how many losers they have, and how bad they are, than by the greatness of their winners. Skillful risk control is the mark of the superior investor…. Rather than just trying to do the right thing, the defensive investor places a heavy emphasis on not doing the wrong thing. Because ensuring the ability to survive under adverse circumstances is incompatible with maximizing returns in good times, investors must decide what balance to strike between the two.*

In last quarter's letter we wrote about the key lessons we have learned in the five years since the financial crisis. One of them is 'staying committed as an investor' where we outlined that in order to achieve long-term success we believe it is of immense importance for investors to think of themselves as just that - investors - not market timers or speculators. Given our belief on this subject we are not advocating in the least, a market timing move from equities. We are advocating however an approach that incorporates a risk adjusted judgment into returns, and one that does not inadvertently take on excess risk in an attempt to keep up with a miscellaneous basket of stocks, benchmark or index.

Benjamin Graham, Warren Buffett's mentor, said many decades ago: *The risk of paying too high a price for good-quality stocks—while a real one—is not the chief hazard confronting the average buyer of securities. Observation over many years has taught us that the chief losses to investors come from the purchase of low-quality securities at times of favorable business conditions…* And speaking of Buffett, during the dot-com frenzy in 1999 he warned that investors were projecting out into the future what they were currently seeing, saying *That's their unshakable habit: looking into the rear view mirror instead of through the windshield.* Recency bias leads to this mistake. We would all be wise to acknowledge it, and do our best to limit its consequences in our own investment decisions.

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.

It is a sincere privilege serving those that have entrusted us with their capital.

Respectfully,

Cameron K Martin
Chief Investment Officer
Martin Capital Partners, LLC

Statistical and analytical data provided by Thomson Reuters

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, firm brochure. As always, past performance provides no indication of future results.

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.