Martin Capital Partners

Quarterly Point of View
Intelligent Investor

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Knowledge of history is a necessary attribute of the successful investor. For the studious, it assists in providing a frame of reference for decision making as historical patterns repeat themselves, or at least rhyme, as the saying goes. "Prudence suggests that he have an adequate idea of stock market history, in terms, particularly, of the major fluctuations in its price level and of the varying relationships between stock prices as a whole and their earnings and dividends. With this background he may be in a position to form some worthwhile judgment of the attractiveness or dangers of the level of the market as it presents itself at different times" wrote the 'Father of Value Investing', Benjamin Graham in *The Intelligent Investor,* many decades ago.

Warren Buffett, Graham's most famous student wrote this in his 2012 Annual Letter, "Since the basic game is so favorable, Charlie and I believe it's a terrible mistake to try and dance in and out of it based upon the turn of tarot cards, the predictions of 'experts', or the ebb and flow of business activity. The risks of being out of the game are huge compared to the risks of being in it." The basic game he's referring to of course is stock market investment, leaving no doubt it's a terrible mistake to try to time it, with entries and exits based on projections, forecasts and feelings.

These two points of view may appear on the surface to conflict a bit. However, Buffett has called Graham's *The Intelligent Investor* "the best book about investing ever written," and though Buffett's investing philosophy has evolved on the margin from his days as a Columbia Business School student under Graham, they share core philosophical investing tenets. Examining these statements as one concept, we can infer an important application for us today.

'Dancing In and Out'

Morningstar, Inc. studies investor return data measuring the results of mutual funds and the actual returns investors received. They analyze this 'investor return' by taking the stated return of the fund, and then adjusting for cash inflows and outflows so they can determine how the typical investor fared. The results consistently illustrate self-destructive investor 'timing' behavior. For the 10 years ending in 2013, which included both bull and bear markets - and taking all of the funds in the Morningstar Universe into account (domestic, international, fixed income) - the average investor return was 4.81%, yet the funds themselves produced a return of 7.30%[1]. This performance gap of 2.49% per annum is often referred to as the 'behavior penalty', and clearly illustrates the perils of trying to 'dance in and out'. In this scenario, an investor with $1 million at the beginning of that time period, that had stayed committed to the strategy for which they originally set course, would have accumulated $2,023,006, versus the $1,599,658 they realized.

The behavior penalty turned out to be a pricey $423,348 over ten years. Additionally, market research firm DALBAR, Inc. performs similar studies, and its results illustrate an even bleaker behavior penalty picture. Famed investor Peter Lynch even asserted that trying to time was so difficult he didn't know anyone who had been right doing it more than 'once in a row'. Staying committed as an investor is a critical conclusion - foundational to long term success, as the penalty of trying to time based on prediction is just too steep.

'Idea of Stock Market History'

From a historical perspective, the current bull market is aging. Since the crisis lows in 2009 the S&P500 has exceeded a 200% return, double the median return of bull markets over the last 85 years[2]. Price to earnings multiples, the most commonly referred to metric, but certainly just one of many for stock market valuation, have risen from 10.7 to 17.6[3]. The post-WWII S&P500 median P/E has been 15.8[1], indicating by this measure a market that is priced 11% above its seven decade norm. We should recall however, that long stretches of low asset multiples are usually accompanied by high inflation and interest rates, which is certainly not the case at the moment. In fact, since the end of WWII, interest rates as reflected by the 10 Year US Treasury Note have been higher than current levels 97% of the time[4]. Digesting the market valuation statistics above, while adding uncertainties like the timing of potential interest rate increases by the Federal Reserve later this year, and it doesn't take too long to incite some concern.

If an adequate idea of stock market history then seems to suggest the smooth sailing could end sooner than later, but trying to time the market is clearly a losing strategy for the long term investor - how best do we proceed? We believe by employing a sound, fundamental, time-tested strategy that minimizes complexity and confusion, which can lead to poor decision making at times of market volatility and stress, is the appropriate course. By engaging in a strategy that mitigates the volatile forces of the market over a cycle, it alleviates the temptation of making 'equity timing' decisions and the potential of being whipsawed. Please allow me to refer again to Buffett: "To invest successfully over a lifetime does not require a stratospheric IQ, unusual business insights, or inside information. What's needed is a sound intellectual framework for making decisions and the ability to keep emotions from corroding that framework."[5]

'Sound Intellectual Framework'

At Martin Capital Partners we have a strong conviction in what counts as a sound intellectual framework, and it centers squarely on the tangible and essential link between shareholders and the companies they own - cash dividends. We term our framework *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 manifests 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, 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 key steps in finding those companies that not only survive the turbulent times, but strengthen their position to then thrive during prosperous business phases. 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 - is a sound framework that gives us the luxury of focusing more on our strategy, and less on the impulses of the market.

As we've learned, timing makes application of any knowledge of stock market history, however accurate it may ultimately turn out, incredibly difficult. Instead, it's the *behavioral conditioning* knowledge of stock market history promotes, that ultimately provides the biggest rewards to the serious and self-aware investor. At six years old, this bull market is starting to get long in the tooth, and history does suggest that we should expect volatility ahead, maybe even to a significant extent. We are closing in on four years without so much as a drawdown of 10% for the S&P500, yet when looking back to 1980 the average *annual* intra-year drop from highs has been almost 15%[2]. If we prepare ourselves through knowledge of stock market history for the certainty of future volatility, yet stay committed with a sound and durable strategy, without dancing in and out, we'll have a much higher likelihood of long term investment success.

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

1. Morningstar, 2014.
2. JP Morgan Guide to the Markets, Q1 2015.
3. Market Data provided by Thomson Baseline.
4. Martin Capital Partners, LLC.
5. Warren Buffett, Preface to the Fourth Edition of Benjamin Graham's *The Intelligent Investor*

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.

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