Martin Capital Partners

Quarterly Point of View
Mispricing Risk

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The past year was marked by intense geo-political turmoil and starkly divergent economic and market landscapes across the globe.

Geo-political headlines were particularly disconcerting, exemplified by the crisis in Ukraine and the rise of the Islamic State. In March the Crimean Parliament 'voted' to leave Ukraine in favor of Russia after armed, yet unmarked, Russian soldiers crossed their border the prior month, leading to a grim standoff between the two countries. The combination of sanctions imposed upon Russia after its aggression and the collapse of crude oil prices later in the year on which Russia is so dependent, caused the Ruble to sink 50% and drove that economy into recession. The rise of the Islamic State (ISIS) proclaiming a worldwide caliphate in Iraq, Syria and elsewhere shocked the region and the world with its brisk ascendance and abject violence. Due to the immediate threat of genocide against factions within Iraq, in addition to protecting American and Iraqi interests, President Obama ordered airstrikes in August against ISIS positions which continue today. Without a doubt, the proliferation of the Islamic State's influence across the Middle East, Africa and beyond, pose a grave challenge to the security of the United States and others given their jihadist goals.

From an economic and market perspective it was another year of the U.S. leading and the rest of the world lagging. Despite the discouraging aforementioned geo-political events, the S&P500 Index advanced like it had no care in the world. In its current form the S&P500 has been around since 1957 and Standard and Poor's launched its first stock index in the 1920's – but in either form it never produced what was achieved in 2014 – experiencing an entire year without even four consecutive down days[1]. For the calendar year domestically, the S&P500 rose 13.7% and the Russell 2000 advanced 4.9%, but elsewhere returns were dismal in U.S. Dollar terms. In Europe, Germany sunk 10.4%, France 9.9% and the U.K. 5.4%. In Asia-Pacific, Japan dropped 4.0% and Australia 3.4%. In emerging markets, Russia cratered 44.9%, Brazil fell 14.0% and Korea gave up 10.8%. It was an ugly picture outside of the United States.

The mixture of meaningful geo-political tension, relatively strong economic and market returns in the United States (versus sluggishness elsewhere), and the Federal Reserve winding down its bond buying program while other global central banks indicated more quantitative easing was forthcoming, stimulated broad based appreciation in the U.S. Dollar. To illustrate that strength the Intercontinental Exchange U.S. Dollar Index, which measures the value of the Dollar relative to a basket of foreign currencies, recorded a stretch of 12 straight weekly gains starting in July. This was the longest winning streak for the Dollar since the index was created in 1973 when the Bretton Woods system of managed exchange rates was dismantled. Since mid-summer the Dollar has risen an astounding 22 of 27 weeks.

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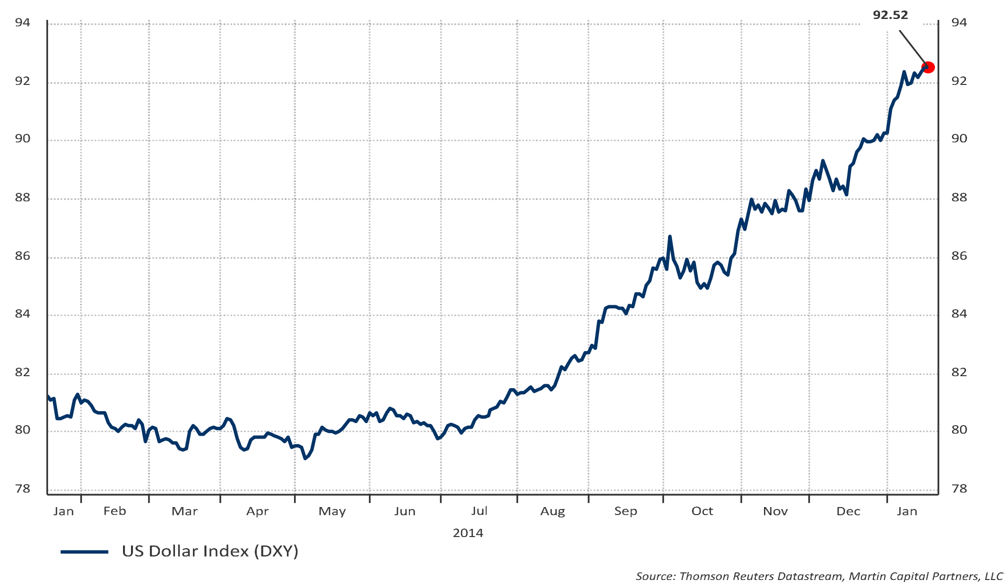

This is an important story line; one that has served to forge material divergences in valuations between industry sectors, creating opportunities for long term portfolio positioning while highlighting potential risks.

As a result of the substantial dollar strength, investors felt compelled to focus excessively on U.S. centric companies, those that derive the vast majority of their revenue domestically. On the surface this is understandable. Revenues created outside of the United States and paid for by customers using depressed currencies are subsequently converted to U.S. Dollars when reported at home – and currently those payments are not worth as much as dollars produced here not requiring conversion. As often happens when dealing with behavioral characteristics of investors though, this understandable intention gets taken to extremes and misses a much larger picture.

Let's look for example at a valuation divergence that's been created. Utilities were the headliners of the market last year, gaining 29% and leading all sectors of the S&P500. Not coincidentally this sector gets virtually no revenue outside our borders except for the occasional foreign held subsidiary. Yes, this sector was also supported by the continual decline in interest rates, but without question the dollar strength trade was a big factor in this sector's huge gains. Despite being highly regulated, labored with relatively large sums of debt and inherently slow growing, this section of 'pure domestic' stocks is currently revered. In spite of a three decade average discount of 16% to the S&P500, this group now trades at an 11% premium to the index on a price to earnings basis. From a dividend yield perspective, the sector's current payout of 3.17% is just fractionally shy of its all-time nadir - and a hefty 27% below its median yield of the past 30 years. Those that would dismiss the earnings multiple risk might seek to defend the yield valuation premium versus its history in light of the current low interest rate environment, which might be understandable to a point, until comparisons are analyzed. This leads us to a group at the other end of the spectrum recently, U.S. multinational companies.

'Multinationals', who derive a large portion of their sales from customers all over the globe, are not currently favored. Broadly speaking, in our view these companies have been penalized more by perception and bias than any structural damage to their competitive positions brought on by currently weak earnings translations from overseas. We evaluated the top ten domestic companies in our portfolio by highest percentage of sales outside of the United States. Collectively this portion of the portfolio returned 7.5% last year and as a group makes a compelling study sample, as three are Information Technology companies, three are in Health Care, two are Consumer Staples and one each in Energy and Industrials. On a weighted basis these ten generated a bit shy of 60% of their revenues in foreign countries. This is vastly higher than Utilities and also higher than the average company in the S&P500 which is estimated to be in the mid-40% range. It is interesting to compare meaningful characteristics of the two groups below.

	P/E Trailing	*Div Yield*	*Yield to 10 Yr Med*	*5 Yr Div Growth*	*S&P Quality*	*Return on Equity*	*LT Debt to Cap %*
'multinationals'	14.3	3.10%	120%	13%	A	23.3%	37%
Utilities Sector	18.7	3.17%	80%	3%	B+	10.0%	53%

Top 10 U.S. Firms in Core Dividend Strategy by Foreign Revenue exposure, TXN, MCD, IBM, BAX, AAPL, PFE, KO, JNJ, GE, CVX 12/31/14

Looking at price to earnings, there is a large premium (precisely 24%) that investors are currently willing to pay for a domestic utility versus a company that has the 'burden' of doing business all over the world. That differential in valuation seems excessive, even in the most pessimistic scenario of a foreign currency to dollar 'translation hit' to earnings. There has to be something else investors are seeking for that premium, right? Maybe it is interest rates, and with a 10 Year US Treasury Note back under 2%, the appeal of a dividend yield north of 3% is possibly just too compelling? But that isn't it, because the same yield is being paid by the multinational basket, yet with a much better dividend growth profile. Even if one conjectured it was the quest for owning quality that was driving investors away from multinationals to utilities, that couldn't be justified by the characteristics above either. Return on Equity, debt levels and financial quality ratings – high importance in our research process – all favor multinationals. It is our opinion the market is really seeking something else altogether, low perceived price volatility. Historically, Utilities have exhibited the lowest price volatility of the 10 Global Industry Classification Standard (GICS) sectors. With the dollar spiking and interest rates declining the combination has baited investors into believing they can get the best of both worlds, the highest return in the short term and price stability should the markets turn sallow. We believe that view underappreciates the potential risk. Put simply, how comfortable will those investors be, should current trends reverse and the dollar declines while interest rates spike? That's why valuations ultimately matter, with a cushion (or as Benjamin Graham would call it, a 'margin of safety') those trends reversing may not do as much harm. At historical premiums however, it could easily be another matter.

Our contention is that opportunity is found on the multinational side. Current headwinds do exist, but buying high quality assets at a discount despite near term price/performance pressures is usually a recipe for long term investment success. Collectively these companies enjoy significant competitive advantages, produce sustainably high returns on equity without significant debt, and share their profits in stable and growing streams of dividend income. Geo-political headlines and divergent global economies have put an international & emerging markets 'penalty' on U.S. multinationals with businesses abroad, which is evident in current discounted valuations. We do not believe, however, this will be permanent condition.

Clearly portfolio asset allocation is not a zero sum game, but we believe the above mispricing of risk, if you will, certainly highlights one major discrepancy in the market today amongst others. Investors in one of the world's biggest dividend funds, the Dow Jones Select Dividend Index, which currently allocates an enormous 37% to Utilities shares, likely partied hard this past New

Year's Eve. In this particular case, we'll give up some of those near term returns, head home a bit early from the gala and attempt to avoid the hangover. Referring again to Benjamin Graham, we'll finish with a quote from the father of value investing, *"The essence of investment management is the management of risks, not the management of returns."*

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 Eikon, Datastream & MSCI.
[1] Wall Street Journal, 12/30/2014

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.

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