Quarterly Point of View
Undermined Incentive for Responsibility

July 13, 2015

The term 'moral hazard' found its roots in the insurance industry, with one of the first recordings of this 'risk' appearing in *The Practice of Fire Underwriting*[1] in 1865 where it was defined as:

> "…the danger proceeding from motives to destroy property by fire, or permit its destruction…interested carelessness." (Ducat, pp 164-165)

The concept of moral hazard centers on the premise that people insulated from risk behave differently than people exposed to risk. Insurance companies are well aware, requiring policy deductibles, in part, to promote a shared responsibility by the insured. The term applies to many areas beyond insurance, notably finance and economics, referring to undue risks individuals or institutions are apt to take if they don't bear the consequences of their decisions.

Examples of the concept are everywhere in life. A simple example might be the lax or even careless way we treat a rental car versus the car we actually own, knowing we don't bear the long term consequences of mistreatment. A more complex, recent and well-documented example would be one of the root causes of the subprime mortgage crisis, whereby loan securitization enabled mortgage originators to pass on the risks they would have historically assumed, by selling what they underwrote to another party who then 'packaged' and again re-sold the contents. In his book *Financial Shock*[2], economist Mark Zandi wrote, "The risks inherent in mortgage lending became so widely dispersed that no one was forced to worry about the quality of any single loan. As shaky mortgages were combined, diluting any problems into a larger pool, the incentive for responsibility was undermined."

The consequences of moral hazard are impossible to quantify, but that doesn't make them any less real. Albert Einstein once said, "Not everything that counts can be counted and not everything that can be counted counts." Moral hazard certainly fits in the 'not everything that counts can be counted' category.

Greece

Greece remains on center stage in world finance, though it ranks just 44th in global output, two spots behind Pakistan and two spots ahead of Iraq[3]. It's still a focal point though as debt has reached 180% of GDP, meaning this year it will produce scarcely half as much as it owes. Greece recently became just the second country ever to move from an economically 'developed' nation to 'developing' (Argentina the other) when it defaulted on its loan payment to the International Monetary Fund on June 30. Its banking system currently would not exist if it were not for the European Central Bank's Emergency Liquidity Assistance (ELA) program whose support is estimated to have exceeded $120 billion[4] and continues to climb. Greece only has about 11 million people, so that unbelievable 'per-citizen' math is what the rest of the European Union's tax payers are subsidizing for Greek systemic dysfunction. This is moral hazard.

U.S. Federal Reserve

As we discussed in our Point of View letter last fall, the Federal Reserve is heading down two potentially ominous roads. The first road is ZIRP (zero interest rate policy), which has been in place since 2008 and poses significant risks of staying too accommodative for too long. The second road the Fed is traversing is

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one littered with moral hazard. The Federal Reserve was created in 1913 to provide the nation with a safer, more stable monetary system. With the Federal Reserve Reform Act of 1977, the mandate was re-formulated to include the dual goal of promoting maximum employment and price stability. The boundaries now are getting blurrier as the institution that once upon a time very rarely intervened in financial markets continues to push its limits. Janet Yellen and other central bankers are in the process of adopting new economic management techniques under the guise of *macroprudential* regulation. This means attempting to manage and reduce systemic risks through regulating financial system behavior. It's a troubling sign, believing for instance they can hold interest rates at zero for lengthy periods in an attempt to attain one goal, and at the same time thinking they can control the associated risks of that easy money by using 'behavior' regulation tools. The chances of pulling off that kind of balancing act effectively are preposterously low, but more importantly, it's what it reinforces to the capital markets and investors that is of grave concern – that the Fed is there at every turn. This is moral hazard.

China

China is currently providing a sensational example. Despite a roaring market rally producing one year gains of almost 150% to mid-June and inter-bank borrowing rates and corporate bond yields not indicating undue stress, Chinese authorities stepped in to support flailing stock prices in a recent market correction. The Chinese Securities Index 300 had barely exceeded a 20% retreat recently when the following were just some of the measures initiated[4]:

- The announcement of a state sponsored stock market 'stabilization' fund geared to fund open market purchases of Chinese stocks.
- The People's Bank of China (Central Bank) laid out plans to inject capital into China Securities Finance Corporation, the provider of margin financing to the country's brokerage firms. The purpose of the funds will be to expand financing of investors' stock purchases. Additionally, investors will be allowed to use apartments as collateral on margin loans.
- China Securities Regulatory Commission issued a notice encouraging executives, directors and other major shareholders to increase holdings of their companies stock – emphasizing that former requirements about the timing of insider transactions would not apply.
- Coordinated through state influence, brokerage firms and mutual fund managers pledged to buy stocks, and China's sovereign wealth fund, Central Huijin, stated it had already been buying shares of exchange traded funds in the country and would continue to do so.
- China's Central Bank also cut its benchmark lending rate to a record low and reduced reserve-requirement ratios for some lenders.

These actions followed vocal cheerleading by Chinese policymakers from earlier this year, which included consistent editorials in government controlled media predicting big returns, as they targeted the equity market as part of an overall economic agenda. All of these moves are likely prompted by fears of social unrest, the state espoused view that national security is inextricably linked to economic and market strength, and a very difficult transition attempt from a state-controlled to an open market economy. Either way, China's reaction to recent market action smells like a panicked, desperate attempt at control that could have long term consequences for its market and investors. "The problem is that everyone knows your hand, so fine, whenever the market corrects 25%, the government is going to come up and bail you out, but that is extremely dangerous," says Tai Hui, Chief Asia Market Strategist for JP Morgan. This is moral hazard.

How do we invest in a world that presents these kinds of unquantifiable risks? If you've been reading our letters over the last five years you might recognize the next paragraph, which we believe is just as timely and important now as when we wrote it in April of 2012[5].

To navigate a world with risks as described above, 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

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however, is important and timely. In an 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 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.

The characteristics below exemplify briefly how we implement the concept of a shorter duration equity strategy for our Core Dividend portfolio[6]:

- Average holding dividend yield of 3.3% is currently 75% higher than the S&P500 and 42% higher than the 10 year US Treasury Note.
- Three year growth of dividend income for current holdings has been 18.3%.
- On a weighted average basis, the strategy holdings have paid an annual uninterrupted dividend for 62 years, dating to 1953.
- An incredible one of every four strategy holdings has paid an uninterrupted dividend starting prior to the stock market crash of 1929 - and through the Great Depression.
- Dividend payments have been raised every single year for a decade and a half on a weighted strategy basis.

Designing an investment strategy for a paradise scenario or an apocalyptic scenario is not difficult. However, as we've discussed and attempted to quantify in past letters, it's virtually impossible to repeatedly execute and far too costly trying to time the implementation of one or the other extremes. We need a strategy that is fundamentally sound, time-tested and constructed for durability in an uncertain world – because 'uncertainty' is the only 'certainty' in investing.

This June marked the fifth anniversary of Martin Capital Partners, LLC and we've built the foundation of our firm on a dividend growth philosophy we believe will stand the test of time for our investors. We want to sincerely thank those that have entrusted us with their capital; it is a sincere privilege to work as your investment partner. We do not take the assignment lightly, or for granted. Thank you.

Respectfully,

Cameron K Martin
Chief Investment Officer
Martin Capital Partners, LLC

1. Ducat, A. (1865). *The Practice of Fire Underwriting.*
2. Zandi, M. (2008). *Financial Shock.*
3. International Monetary Fund, 2014.
4. The Wall Street Journal, July 2015.
5. Martin Capital Partners (April 2012). *A Bird in the Hand is Worth Two in the Bush.*
6. Statistical and Market Data provided by Thomson Baseline.

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.