Martin Capital Partners

Quarterly Point of View
Voting and Weighing

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We have often taken the position over the course of the last few years that the Federal Reserve's zero interest rate policy (ZIRP) is no longer passing the test of common sense.

These policies, with the near zero rates employed since 2008, no doubt helped end what appeared, at the time, to be a near apocalyptic financial crisis. But the United States economy is no longer under emergency conditions and the medication given to the economic patient, uninterrupted for the past seven years now, is likely having unintended consequences – increasing the odds the recovering patient will get ill again. Given the political system's failure to address broader fiscal challenges, enormous pressure has been placed on the Fed, despite its inherent limitations. Though it could be argued the Fed deserves a level of credit for attempting to do 'all they can do,' monetary policy is best suited as a temporary solution, not as a structural fixture. Doing 'all they can do' now, would be to realize their own limitations and the unfavorable risk for reward they have created by maintaining rates this low, for this long. Deutsche Bank's head of global research, David Folkerts-Landau, recently summarized the issue succinctly, "To stay here [at zero], I believe, would be a mistake of historical proportions. They should have done it [raised interest rates] already. You may think that is an arrogant statement, but remember central banks make mistakes. If I had told you in 2003 that Greenspan was wrong, you would have said that was an arrogant statement, but he was wrong… So we shouldn't be afraid to say central banks make mistakes and I think this has been a fundamental mistake."[1]

Short run, the market votes…

Warren Buffett was a student of Benjamin Graham's at Columbia Business School, and credits Graham with teaching him the concept that in the short run the market acts as a voting machine, but in the long run it serves as a weighing machine. This is a simple and effective way of illustrating a truth about how markets work. As time is condensed, factors that matter most to the value of a business do not have time to demonstrate their worth, leaving a vacuum often filled by sentiment and emotion, driven by noise disguised as news. Within that space, stock prices are influenced by an extreme number of factors, and behave much more like a popularity contest than an arbiter of real value. This can last for years, but generally does not last over a full market cycle that includes both a bull and bear market. At that point, the market serves to weigh fundamental factors.

In the current environment the market is voting based on the influence of the Fed's extended zero interest rate policy, creating risks and ramifications for those not paying attention, and opportunity for investors willing to weigh fundamental factors over a longer time frame. From our perch, the

Fed's policy has had the effect of drowning out fundamentals, and inspiring a 'risk on' mantra in pockets of the market not seen since the heyday of the tech/telco bubble at the turn of the century. After years of continued 'quantitative easing,' investors became so conditioned by 2013 not to 'fight the Fed,' that the quaint concept of valuation was tossed aside, and risk assets were bought aggressively without much regard for the fundamental basis of those purchases. The following extraction from a research report earlier this year by Epoch Investment Partners vividly illustrates this point:

> *We went back and divided the stocks in the S&P 500 into two baskets at the end of every month: those whose trailing twelve-month earnings were positive, and those whose earnings were negative. Then we looked at how the two baskets performed over time. Normally, you would expect stocks with negative earnings to underperform stocks with positive earnings. And over the long term, that is what we observed. We went back to the end of 2002 for this analysis (based on data availability), and found that cumulatively, stocks with positive earnings rose 202.9% over the twelve years through the end of 2014, while stocks with negative earnings fell 20.7%. But for much of the last three years, stocks with negative earnings actually did quite well — at times, considerably better than stocks with positive earnings. From the end of 2011 through August 2014, stocks with negative earnings gained 94.9%, while stocks with positive earnings rose 68.0%.*[2]

This is a phenomenal concept to digest - that for over 2.5 years - stocks that did not produce earnings vastly outperformed stocks that actually did produce earnings.

Another way to gauge the effect of excessively low rates on investor decision making is to look at what has been dubbed the FANG market. FANG stands for: Facebook, Amazon, Netflix and Google (Google just recently re-named itself Alphabet). These four stocks are all included in the S&P500 Index, and not at insignificant percentages. Included together and accounting for both sets of share classes in Google's case, they make up a combined total nearing 5%. On a year-to-date basis through October 9th these four had produced an average return of 63% - compared to a loss of 2% for the S&P500 as a whole and a 6% loss for large value stocks as represented by the Russell 1000 Value Index. This is an incredible discrepancy, the kind that hasn't materialized for many years. It also means that when those year-to-date gains are combined with their hefty weighting within the index, three full percentage points of the 'market' performance is attributable to just four companies! Making the issue even pricklier in our view, investors continue to pile into these stocks without regard for valuation. Their average P/E multiple currently stands at 64x (four times higher than the average stock), with no cash dividends being paid by any of the four. We only need to look back 15 or so years to see a similar valuation pattern for internet leaders and be reminded how poorly that turned out.

Maintaining interest rates this low for this long has, without a doubt, influenced the voting patterns of investors in this market, smothering fundamentals and recasting incentives for market participants. That won't last forever, so it's important to have our eye on characteristics that ultimately get 'weighed.'

Long run, the market weighs…

As time frames lengthen, critical fundamental factors trump short term voting patterns. What ultimately matters are durable cash flows produced by competitively strong businesses that have a propensity to share that cash in a consistent and growing fashion with their shareholders. An important factor we evaluate, that most certainly gets weighed over time, is the 'yield on cost' of the purchases we make in our portfolios for clients. Yield on cost is calculated by taking the current annual dividend payment of a company and dividing it by original cost basis. This way we can analyze the impact of dividend growth - expressed as a yield - on the original cash outlay to purchase a stock.

We purchased the securities in the table below within the first full year of inception of our firm, five years ago, and these companies are still components of the portfolio today. They provide powerful evidence of the impact of growing, compounding, dividend income from a total return and yield on cost perspective.

Security	Symbol	Price Paid	Annualized Dividend Rate on Purchase	Purchase Month	Current Annualized Dividend Rate	CAGR Div Growth	Current Yield	Yield on Cost	Price Performance	Total Return
Pfizer	PFE	$14.26	$0.72	June 2010	$1.12	9.2%	3.3%	**7.9%**	135%	167%
Texas Instruments	TXN	$23.28	$0.48	June 2010	$1.36	23.2%	2.6%	**5.8%**	121%	141%
ConocoPhillips	COP	$37.84	$2.20	June 2010	$2.92	5.8%	4.8%	**7.7%**	64%	100%
Johnson & Johnson	JNJ	$59.06	$2.16	June 2010	$3.00	6.8%	3.1%	**5.1%**	65%	86%
Coca-Cola	KO	$25.06	$0.88	June 2010	$1.32	8.4%	3.4%	**5.3%**	57%	77%
Raytheon	RTN	$45.89	$1.50	Sept 2010	$2.68	13.0%	2.8%	**5.8%**	109%	156%
Microsoft	MSFT	$25.72	$0.64	Nov 2010	$1.24	15.2%	2.8%	**4.8%**	72%	91%
General Electric	GE	$18.67	$0.60	June 2011	$0.92	11.3%	3.5%	**4.9%**	42%	49%
Averages						**11.6%**	**3.3%**	**5.9%**	**83%**	**108%**

Martin Capital Partners, LLC. Thomson Baseline. 6/30/15

As can be gleaned above, with the help of durable and growing dividend production, this basket of blue chip stocks produced a yield on cost of 5.9%. In the current environment, where a 10 year US Treasury Note yields barely above 2%, the BofA Merrill Lynch US Corporate Bond Index yields 2.94% and the average S&P500 stock pays a dividend yield of 2.07%, who wouldn't love a yield approaching 6%? But the market 'votes' in short time frames and things that are 'weighed,' and ultimately matter, take a bit of time and often some patience. As former British Prime Minister Benjamin Disraeli once said, "Patience is a necessary ingredient of genius." Now is not the time to be swayed by how the market is voting, but instead, to focus on the things that are weighed in time.

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,

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1. Bloomberg.com, October 2015.
2. Epoch Investment Partners, Inc, March 2015.

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.

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