

Quarterly Point of View *Pendulum Plotting*

April 11, 2017

The post-global financial crisis bull market turned eight years old last month, making it the 2nd longest since WWII. On the 9th of March 2009, the Standard and Poor's 500 Index closed at 677 and traded at a price to earnings ratio of 10.3x. The index closed this last quarter far above those levels, 2,363 to be exact, producing a breathtaking total return, including dividends, of 314% since the lows. The market now trades at 17.5x earnings.

The current bull market has endured a "Flash Crash" in 2010, the downgrade of the United States credit rating in 2011, followed then by a "Debt-Ceiling" crisis, the "Taper Tantrum," a "Fiscal Cliff" and "Brexit." Despite these events, disciplined investors that stuck to their plan through the dark days of the crisis in 2008 and 2009, and brief episodes of alarm with those intimidating titles since, have been rewarded – and should be commended. It's not fancy formulas that make good investors, but a combination of factors built on a solid 'behavioral' foundation of patience and discipline. "Successful investing requires a quality of temperament," Warren Buffett has said¹.

Last month I had the good fortune of meeting, and thanking, someone who (previously unbeknownst to him) has had a significant impact on the philosophical underpinnings of our firm's strategies. Howard Marks is chairman and co-founder of Oaktree Capital Management in Los Angeles, and in addition to being an ultra-successful investor, is the author of well-regarded market memos and the book *The Most Important Thing: Uncommon Sense for the Thoughtful Investor*. One of the many important themes in his book and other writings, is the concept of the market's inevitable cyclicity, and the critical obligation investors face in understanding where they are within an economic/market cycle. Economic prognosticators and market forecasters add little to no value (and prove so on a consistent basis), and yet the act of investing itself clearly consists of dealing with an unknowable future. If prediction isn't a repeatable process, thoughtful investors are left with the need to determine where they are in the cycle by contemplating factors such as:

- Are the investor masses exuberant or fearful?
- Is credit readily available or hard to obtain?
- Are valuation multiples, such as price to earnings ratios, high or low in a historical context?
- Does the media currently talk the market 'up' or 'down' to entice viewers and enhance ratings?
- Are esoteric investment products eagerly embraced or impulsively rejected?

These are the kinds of questions we need to answer in determining where we are in a cycle. Even if we can't know precisely where we are going, we need to have a good idea where we stand – and act accordingly. Marks has further described the concept this way:

The mood swings of the securities markets resemble the movement of a pendulum. Although the midpoint of its arc best describes the positions of the pendulum “on average,” it actually spends very little time there. Instead, it is almost always swinging toward or away from the extremes of its arc. But whenever the pendulum is near either extreme, it is inevitable that it will move back toward the midpoint sooner or later. In fact, it is the movement toward an extreme itself that supplies the energy for the swing back.²

Are we nearing an extreme point in this cycle? It is hard to say exactly, but I don't think we have to know *exactly*, to be positioned wisely. One piece of evidence illustrating to me where we may find ourselves in this cycle is behavioral, and it happens to pertain to a recent initial public offering. Snap Inc. (SNAP) went public last month, trading at an opening price that valued the hotly anticipated photo messaging company, led by 26-year-old Evan Spiegel, at about \$33 billion (for reference the company posted a \$515 million loss last year). Though SNAP made headlines by breaking a long drought for tech IPO's, the news that should matter to investors are the 'cycle clues' it gives us. The not-so-subtle hint here: Snap Inc. issued stock that does not vote. Shareholders have no voting rights. Only Evan Spiegel can vote. Many of the new age tech concerns (Facebook and Google for instance) do have unique structures, but SNAP is even more unique, and it's an unhealthy development. If you become a *shareowner* in a company, yet have no voting rights, what do you *own*? Who will hold the CEO accountable for decisions he makes on behalf of *owners* who can't vote? Those are serious governance issues for the SNAP shareholders, which do not include us. The question it does pose for us that's important, is whether eight years ago (or even a couple years ago) the market would have gobbled up shares of an initial public offering for a one-trick pony tech company with no dedicated main headquarters, and that does not allow its *owners* any right to vote on corporate matters – or is this simply a sign in the cycle? We think it's the latter.

You may be thinking by now I am predicting the markets next move, and implying investors should consider making market timing calls. I am not. Market timing is a notoriously difficult and dangerous task that often poses much more risk than reward – particularly for those that have a longer-term need for stock ownership beyond five years, which should be almost all market participants. As we highlighted in a past letter, Morningstar, Inc. studies investor return data measuring the results of mutual funds and the actual returns investors received in those funds. They analyze 'investor return' by taking the stated return of the fund, and then adjusting for cash inflows and outflows to determine how the typical investor fared. The results consistently illustrate self-destructive investor 'timing' behavior. For the decade ending in 2013, which included both bull and bear markets, and taking all 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%³. This performance gap of 2.49% per annum is often referred to as the 'behavior penalty', and clearly illustrates the perils of trying to time the market. Staying committed as an investor is foundational to long term success, as the penalty of trying to time based on prediction is just too steep.

To us the evidence indicates we may be in the later innings of the current cycle, so investors may want to contemplate this and act accordingly. What is acting accordingly? Benjamin Graham, Warren Buffett's mentor, said many decades ago (emphasis mine), "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** ..."⁴ We have favorable conditions currently – the 2nd longest post-war bull market and an unemployment rate at 10-year lows are signs of that. Heeding

Graham's advice seems plainly prudent now, and would direct us to focus our attention on high-quality enterprises at this point in the cycle. In our mind, high-quality companies have enduring characteristics such as strong and established competitive positions, high returns on invested capital, and thoughtful management able and willing to share a portion of profits with us via durable and growing dividend payments. Quality companies also maintain another extremely important characteristic – conservative levels of debt financing. Debt leverage can work wonders for a company when sailing is smooth, but those needing to access capital at points of market stress, may find raising funds to be extremely expensive, or simply not available.

In our view, now is not the time in the cycle for excessive risk, exposure to low-quality securities or investment products that can't be illustrated with a crayon. It is the time, however, to stay patient and committed to a long-term strategy focused on quality companies that have a high probability of standing the test of time this cycle, and future cycles.

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. Berkshire Hathaway 2006 Annual Conference, Buffett.
 2. The Most Important Thing: Uncommon Sense for the Thoughtful Investor, Marks, 2011.
 3. Morningstar, 2014.
 4. The Intelligent Investor, Graham, 1973.
- Statistical and analytical data provided by Factset.

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