Martin Capital Partners

Quarterly Point of View
The Unexpected, as Expected

January 13, 2017

Most years are filled with the unexpected, but 2016 packed in quite a bit more than usual. The year began on a sour note, with the Dow Jones Industrial Average dropping 1,000 points in its worst-ever five day start, closing more than 10% lower at 15,660 in early February. By March, however, the stock average had climbed into positive territory. Despite what a bad 'January effect' is thought to mean for stocks, the Dow flirted with the 20,000 mark at year's end for the first time - closing just a few hundred points short.

Meanwhile, Crude Oil plunged to a low of just over $26 a barrel in February, down 75% from its 2014 level of $107. This was the lowest settlement price since May of 2003, and was a significant influence on the Dow's poor start. Within three short months though, the price of oil had doubled, and at 2016's close a barrel of oil was $54, up 45% for the year.

The yield on the 10 Year U.S. Treasury Note fell to 1.366% on July 8th, marking the *lowest-ever* yield for the government note in the history of our nation. Though bond yields had been dropping for three decades, the trigger to reach the all-time low yield (and conversely highest-ever price), was a rush to 'safety' following another unexpected event – 'Brexit'. Despite polls showing it was very unlikely to happen, and the market pricing in a 'No' to exit vote as a virtual certainty, British citizens decided to end their 43-year relationship with the European Union. Since that time, the 10-year yield skyrocketed to its highest level in more than a year, hitting 2.61% in mid-December before closing the year at 2.44%, handing big losses to bond investors who were buying immediately after Brexit.

As if the year hadn't yet delivered enough of the unexpected, the biggest was saved for the U.S. elections in November. Donald Trump was elected President, defeating Hillary Clinton, and becoming the first person in the history of the United States to be voted into the highest office, without having any prior experience in either the government or the military. Though the vast preponderance of prognosticators predicted a Clinton victory, or a subsequent market sell-off should they somehow be wrong – neither prediction was accurate. Since the election, the market has soared on hopes of tax and regulatory reform, and a general unleashing of 'animal spirits' as John Maynard Keynes might have described it. The four major U.S. stock indices – the Dow, S&P 500, Russell 2000 and Nasdaq Composite – all set records on back-to-back days for the first time since the technology bubble at the turn of the century.

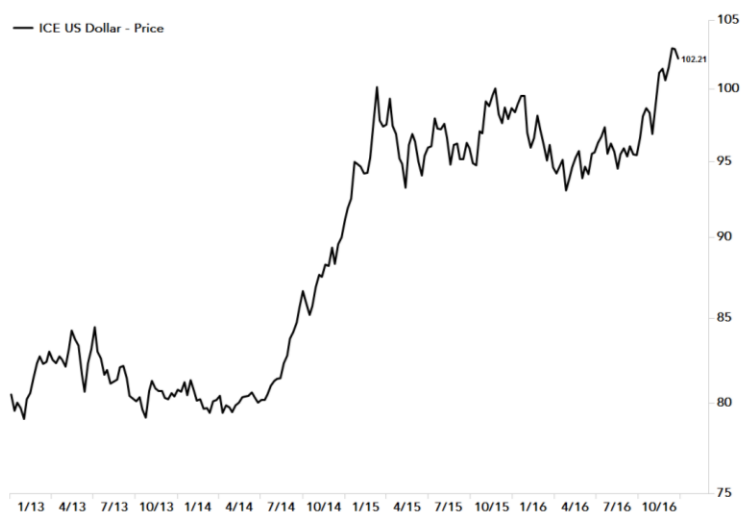
There is a quick lesson in all these 'unexpected' events in 2016, and it's a reminder that managing investments via 'prediction' is a non-repeatable process. The year once again showed, and the 'flow of funds' proved, how many investors simply get whipsawed by the action. In our view, investors are rewarded by following a sound strategy based on fundamentals, and then doing all they can to insulate themselves from the market's 'noise' - and staying committed to that strategy through time. The movements in stocks, crude oil, bonds and the political elections, were all highly unpredictable events where most everyone got it wrong. Economist John Kenneth Galbraith once said, "there are two types of forecasters; those who don't know and those who don't know they don't know." We'll all be better investors in the long run remembering this truism.

As always, our fundamental, time-tested strategy seeks ownership in profitable, high-quality companies with a culture of sharing profits with us in the form of durable and growing dividends. This is the lens through which we view our investments, often considered a 'bottom-up' approach. While this is true, the 'top-down' events of 2016 we've noted above have continued to shape the investing landscape, producing some relatively fertile pockets of opportunity we'd like to highlight.

Currency Impact

Our Core Dividend Strategy owns many high-quality 'multinationals', as well as garners international exposure through investments in American Depositary Receipts (shares in foreign companies traded on U.S. exchanges and denominated in U.S. Dollars, referred to as ADRs). This results in a high level of globally diversified revenues – which we view as a structurally advantageous characteristic. Our strategy holdings currently derive 46% of their revenues outside of the United States, which is roughly 16-17% more than the S&P 500, for comparison's sake. For a U.S. domiciled company, this means revenues generated overseas need to be converted back to U.S. dollars from the local currency in which they were transacted. When the U.S. dollar is strong, it makes those local currencies temporarily 'worth less' during conversion, and can have the effect of diluting profitability. Though there is a time lag for those quarterly profits to be reported, the market often tends to price that concept in gradually and continually during trading. For ADRs specifically, a more immediate 'conversion' occurs, resulting in a direct impact on daily pricing as the value of the stock is adjusted for currency fluctuations.

US Dollar Index



With that as some context, it's important to note the latest currency developments. As the chart above illustrates, the U.S. Dollar was very strong in 2014-2015, before taking a bit of a breather in 2016, until November. Spurred by interest rates rising dramatically in the wake the Presidential election result, it then exploded anew to 14-year highs versus a basket of foreign currencies. The intensity of the U.S. Dollar rise has had a 'wet blanket' effect on share prices of many multinational holdings, and an even more acute impact on international ADR investments. In the short term, it has impeded performance of those holdings, but may actually provide a longer-term opportunity.

Elroy Dimson, Paul Marsh and Mike Staunton, authors of *Triumph of the Optimists: 101 Years of Global Investment Returns*, are considered leading authorities on long-term investment returns. In their roles at the London Business

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School (LBS), the trio of academics have published meaningful work on the impact of currency fluctuations on global portfolios. They find that the currency exposure of foreign equities is a "valuable benefit" over time, primarily because it assists in alleviating a level of home country inflation risk, and that attempting to hedge currency exposure "is on average, counterproductive." Looking at data from 1900-2011 in 83 countries, they go on to argue that contrary to popular thinking, future equity market returns for dollar based investors are better in countries whose currencies were weak performers in previous five-year periods. Paul Marsh, emeritus professor of finance at LBS, says "…the 'strong currency is good' school does not get much support from research."[1]

In that light, we think opportunities exist for better future performance from ADR investments, particularly those based in the United Kingdom. Some of the U.K.'s most high-quality dividend payers have been impacted by these currency moves, specifically 'post-Brexit'. From Brexit voting on the 23rd of June, the British Pound had declined an incredible 17.7% vs. the U.S. Dollar at year end. This weakness has had more than just a wet blanket effect, instead impacting some price moves materially. We currently own four stocks based in the U.K., all leaders representing different industry groups, and together they sport an average dividend yield of 5.9%. Furthermore, the United Kingdom has a tax treaty with the United States and therefore withholds no foreign tax on dividends, allowing us to get the full effect of these highly generous – and importantly in our mind – durable dividend yields.

Healthcare Sector

Healthcare was the worst performing sector of the market in 2016, posting a decline of just over 4%. No other sector finished in the red. Concerns over intervention in drug pricing, potential regulation, pipeline approval risks and uncertainty recently over the fate of the Affordable Care Act, have pressured shares. The pharmaceutical sub-industry group alone underperformed the S&P 500 by over 30% while the broader Healthcare group experienced contractions in earnings and cash flow valuation multiples of more than 20% from the previous year. When compared to another 'defensive' group, the consumer staples sector, healthcare has not been this relatively inexpensive for 30 years.

Though there are certainly risks, we view tremendous opportunity here looking out the next several years. We have continued to add to holdings in this area through the end of the year, and the sector currently is our heaviest weighting. We own six stocks with extremely strong balance sheets, enviable competitive positions and very strong dividend cultures – all trading at favorable valuations. As a basket, the healthcare companies we own in our Core Dividend Strategy pay an average dividend yield of 3.4% (significantly higher than the market's yield), have grown those payments an average of 18% the last five years, and all the while trade at a 20% P/E discount to the S&P 500. We believe patience here will be rewarded.

Dividend Growth over Yield

As interest rates have stayed persistently low the last handful of years, dividend 'yield' has courted a bit more favor than dividend 'growth'. In other words, those stocks with the highest current yield garnered more interest than those with slightly lower yields yet higher rates of dividend growth – sometimes referred to as 'total return' stocks. Given that the highest yields can often portend an enhanced level of 'stress' with a company, our strategy has always favored the attractive, above market, yet sustainable yields with attractive dividend growth rates. We simply prefer not to 'reach' for yield, and instead seek to make up for it, and more, as future dividend growth produces attractive yields on cost and total returns. Academic studies bear this out.

An analysis by Morningstar[2], using Kenneth R. French data, dissected the U.S. market into non-dividend payers, and deciles of yield for all those that paid dividends, from 1945 to 2015. Total return using monthly data was studied, ranging from non-payers on one end, all the way up to the 10th decile representing the highest yielding stocks on the other end. The best performing group, both on an absolute return basis, as well as a risk adjusted return basis (using Sharpe Ratio), was the 8th decile. Those 8th decile stocks represent very attractive - though not the currently 'most attractive' - dividend yields. Imbedded in the 8th decile style companies, however, are characteristics of durability & sustainability that win out over the longer term. According to a Bank of America analysis through the end of October[3], when the P/E multiple for the highest quintile of S&P 500 dividend 'yielders' is compared to the highest quintile of dividend 'growers', it shows the growers trading at a 10% discount to the yielders. This may not sound like much of a discount, but looking back over the past quarter century the average grower typically trades at a 17% premium to yielders, so the current disparity between the two segments is quite significant. As a result of this disparity, and with rising interest rates acting as a bit of a catalyst, we could see a leadership change from the dividend yielders to the dividend growers over the next year or so. We believe we are attractively positioned for that outcome.

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. Financial Times, March 30, 2012.
2. Morningstar Dividend Investor, March 2016, Volume 12, No. 2.
3. Bank of America Merrill Lynch, US Equity Strategy Year Ahead, November 22, 2016.

Statistical and analytical data provided by FactSet.