



## Quarterly Point of View *Black Swans & Buffett Lessons*

April 9, 2020

Our firm will be a decade old in a few months, with a lot of letters and strategy briefs written in that span, but none as difficult as this one. It's clearly not for lack of subject matter, because honestly, where do we even start this discussion? What makes it so difficult is that this crisis combines the risk associated with financial distress, which is never any fun, and adds to it a tragic loss of life that we are hearing about daily – and that's if we're fortunate enough not to see it in person, as many are.

In light of that fact, we offer our heartfelt thoughts and prayers to those who are suffering, and most assuredly to those brave doctors and nurses, as well as everyone else in the healthcare system and beyond, that are putting themselves directly in danger to serve others. Thank you.

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This will be a longer than normal letter, as we seek to address some important topics, so thank you ahead of time for your patience. Included ahead we'll discuss:

1. Black swan events: Covid-19 pandemic, oil market crash and the record setting stock market volatility that ensued
2. Economic impact, unemployment, monetary and fiscal measures
3. Impact on earnings & dividends for the market
4. Dividend decile performance, risks to avoid and potential opportunity
5. Strategy for investment survival
6. Final thoughts

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### **Covid-19 Pandemic, Oil Crash, Record Setting Volatility**

The concept of black swan events was popularized by professor and former Wall Street trader Nassim Taleb, in his 2007 book, *The Black Swan, The Impact of the Highly Improbable*. A black swan is simply an extreme, unpredictable, and rare 'tail risk' event that plays out with severe consequences.

The novel coronavirus pandemic, or COVID-19, certainly meets the black swan description. In late February and early March, as the world was coming to terms (virtually overnight) with the potential global economic impact of the virus and measures needed to fight it, another shock hit. A dispute between Russia and Saudi Arabia escalated into an all-out oil price war, with excess supply flooding the globe and causing crude oil prices to plummet. Clearly a global pandemic is enough trouble for markets to endure, but add the combination of destabilized prices (and political order) in one of the world's most important commodities, and what we saw next can only be described as a crash in equity markets.

I've witnessed, first-hand now, three very serious bear markets in almost a quarter-century career in the investment business, but the speed and force of recent price action is without comparison. It took just 16 trading sessions from its all-time high for the S&P500 to reach bear market territory, defined as a drop of 20% or more, by far the fastest ever to a bear market. In a continued retreat, the index found itself down 34% by March 23<sup>rd</sup>, then mercifully rallied into the quarter-end. In what may best encapsulate the psychological trauma of this market is this statistic: **The month just ended was the single most volatile ever for the index, with an average daily move one way or another of 4.8%**<sup>1</sup>. To add an exclamation point to the insanity of that price action, the new record was at a 23% greater level of volatility than the previous record – a tie between November of 1929 and October of 2008.

The declines have been deep, widespread and spared very few. Given the velocity of the panicked selling – far more than I've ever witnessed – it was a “shoot first, ask questions later” environment. We will circle back to this concept later in the letter when we look forward, but suffice to say this market did very little in the way of differentiating between strong and weak long-term enterprises, it simply sold with force most anything it could. Below, performance for the quarter for some important indices.

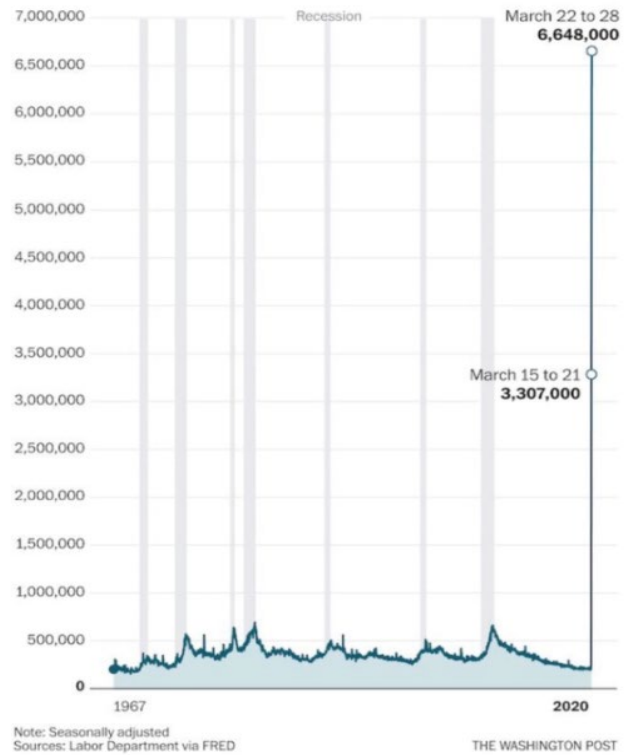
Index / Asset	Q1 2020 Performance
NASDAQ Composite	-13.96%
S&P 500	-19.60%
MSCI World High Dividend	-21.59%
Dow Jones Industrial Average	-22.73%
S&P High Yield Dividend Aristocrats	-25.06%
S&P 500 Equal-Weight	-26.70%
Russell 1000 Value	-26.73%
Dow Jones Select Dividend	-29.35%
S&P MidCap 400	-29.70%
S&P SmallCap 600	-32.64%
Value Line Composite	-35.82%
Crude Oil	-67.20%

### Economic Impact

It's consensus knowledge now that COVID-19 is still gaining ground in the United States, though some hopeful signs of plateauing are emerging. The economy's fate, however, is already sealed, destined for a serious recession as the country takes required steps to “flatten the curve” of the virus. This to allow time for the healthcare system to deal with the crisis without becoming completely overwhelmed. The extent to which curve- flattening mandates are required to stay in place will go a long way in determining if the economy ends up in a place worse than a recession.

We need look no further than weekly initial claims for unemployment insurance for the two weeks ending on March 28<sup>th</sup> to gain a quick understanding of the impact lockdowns and social distancing mandates are having on business. The accompanying chart is almost unfathomable. The lines on the right at the current month are two separate data points, occurring in back-to-back weeks. In total almost 10 million people filed unemployment claims in a 14-day span. The highest weekly level recorded during the Global Financial Crisis, for comparison, was 665,000. The chart's history traces more than a half-century, and nothing remotely close to this has occurred<sup>2</sup>.

Policymakers have reacted to this damage with relief and stimulus measures of immense scale. On the monetary side, the Federal Reserve has reduced interest rates to practically zero, commenced unlimited quantitative easing while backstopping a host of markets including municipal securities, commercial mortgages, money markets, commercial paper and more. On the fiscal front, Congress just passed the Coronavirus Aid, Relief, and Economic Security Act (CARES), the largest ever in size and scope, totaling \$2 trillion. Included are major expansions of unemployment benefits, and a broad combination of loans, grants and guarantees for an array of businesses, schools, state and local governments, hospitals and non-profits. Discussion is already afoot for additional stimulus measures.



This will expand the United States already 'unattractive' budget deficit to possibly \$2.5 trillion this year, without counting any potential added stimulus. The measures taken by Congress, however, are needed, as without them the probability of something worse than a recession would rise materially. It's highly regrettable though that discipline was not displayed by either political party this past decade when the economy was expanding, and unemployment was low. The idea of 'saving for a rainy day' was clearly lost on many in leadership, making future issues with debt and deficits all the more difficult to surmount. In any event, that is a challenge to be confronted at a date down the road.

Though the economy has a very tough road ahead, both monetary and fiscal policy have responded swiftly, with force and magnitude, hoping to cushion the blow from mandated reductions in economic activity needed to fight the virus.

### Impact on Earnings & Dividends

The economic impact on individual companies will start to surface very soon as quarterly earnings reports begin to be disseminated. It will be ugly. Before I start with a few thoughts that may look like forecasts, it might be wise for me to invoke Warren Buffett's thoughts on the matter when he said, "*I have no use whatsoever for projections or forecasts. They create the illusion of apparent precision. The more meticulous they are, the more concerned you should be.*" Following that advice, these will not be meticulous forecasts, but instead a starting framework for understanding and decision making.

Given the sharp economic contraction coming, it would not be unreasonable to see S&P500 earnings decline by 35% in 2020<sup>3</sup>. Historically, dividends have been much less volatile than earnings, tracking them at about 1/3<sup>rd</sup> the rate. But because cash dividends are paid out of earnings (really cash-flows, but we are going to keep this non-meticulous) they too are clearly impacted. If dividends therefore tracked the above earnings decline by 1/3<sup>rd</sup>, then we would be looking at dividends in the S&P500 reduced by 11-12% in 2020, versus 2019. It will, however, likely be worse than that. Reasons for this include the record high level of leverage being employed by the average company in the S&P500, greatly reducing their flexibility when it comes to capital allocation decisions including the dividend. Any company that receives government assistance will find it particularly difficult to justify paying a dividend or will simply be mandated from a regulatory perspective to cut or suspend it altogether. Finally, given the high level of fear regarding an uncertain economic future, we may see many companies – despite having the financial capacity to sustain payments – back away from prior commitments and adopt an ultra-cautious approach.

Given the factors outlined above, dividends for the S&P500 as a whole, could conceivably drop to a range around \$45 per share, or 25% lower than the roughly \$60 the index was paying out at the end of 2019. This development helps explain a first quarter performance riddle, hints at certain risks and possibly foreshadows an opportunity.

### **Dividend Decile Performance, Risk, Opportunity**

Historical monthly performance data based on dividend yield deciles tells a compelling story for “durable” dividend payers. When segmented with ‘no dividend payers’ on one side as a ‘zero’ decile, all the way to the 10<sup>th</sup> decile containing the biggest market yielders on the other side - some enduring patterns exist. With data back to 1945, the best performance, both on an absolute and risk-adjusted basis, is found in the 8<sup>th</sup> decile. The 2<sup>nd</sup> and 3<sup>rd</sup> place segments are the two on either side, the 9<sup>th</sup> and 7<sup>th</sup> deciles. These three groups tend to be loaded with financially strong companies, who have the wherewithal and inclination to pay attractive and (importantly) sustainable dividends.

Recent short-term performance, however, was not true to historical form. With the S&P500 and Dow Jones Industrial Average down nearly 20% and 23%, respectively, in 2020’s first quarter, we might figure that the 7<sup>th</sup> through 9<sup>th</sup> deciles of dividends would perform better, but they didn’t. For the quarter, the long-term best, 8<sup>th</sup> decile, saw an average group decline of 32%, followed by 42% lower prices for the 9<sup>th</sup> decile, while the 7<sup>th</sup> decile dropped 24% on average. The 10<sup>th</sup> decile, making up the market’s highest yielders that often indicate stress given their stretched yields, declined an incredible 52% for the three months. For comparison, deciles one and two, both yielding considerably less than the market average, dropped just 16-17%.

This is clearly a very short analysis period, and we don’t believe for a minute there’s a paradigm shift when true investment time periods are evaluated, but as the disparity developed through the quarter it seemed to indicate several things to us. First, the market believes there will be a significant reduction to the average company’s dividend payments in 2020, as we postulated above.

Second, some investors may have been more reluctant to part with big winners of the last decade, in many cases the ‘cultish’ style growth stocks that come with their own acronyms. This may be telling in and of itself, as bear markets generally aren’t truly finished wreaking havoc until they have punished most companies, particularly those that produce a better ‘story’ than cash flows.

Third, it’s evidence of the market’s “shoot first, ask questions later” behavior we referred to earlier. Many high-quality dividend paying companies, who will emerge on the other side of this with strong, if not

stronger business positions, appeared to be sold indiscriminately (conceivably because of their attractive liquidity) when panic was extreme.

With stock prices now lower across the board, and dividend yields higher, there exists opportunity in certain areas for long-term investors, particularly those types of high-quality companies mentioned above that may have been caught in the panicked “crossfire.” But before we can address the opportunity, we should recognize the potential risk. For our way of thinking, the specific risks are dividend cuts, reductions and suspensions, as we believe, and empirical evidence supports, reinvested cash dividends are a huge force in powering long-term investment returns. Dividends are anything but ancillary. We are remaining continually vigilant in our analysis of those firms that have the highest probability of weathering this crisis without dividend impairment. There will likely be some unexpected casualties along the way in this regard, as the economic impact will be too deep to fully avoid, but we’re confident the same analytical process that has served us well in the past will continue to do so now, and in the future.

### **Strategy for Investment Survival**

This is clearly a period of significant economic unknowns. Famed investor Howard Marks captured this fact a few days ago by saying, “These days everyone has the same data regarding the present and the same ignorance regarding the future.” Will it be a V-shaped recovery where the economy snaps back quickly due to pent-up demand, while society immediately returns to pre-pandemic behavior? Will it be a U-shaped recovery, spending a few brutal quarters in recession as society slowly but eventually returns to travel, sporting events, and the like into 2021? Or, will it be an L-shape, with years of tough and tedious economic slog ahead where many features of the future economy don’t resemble the recent past? None of us know, so as an investor we should prepare for any environment.

In thinking about this my mind drifts to one of my favorite investment quotes, again from Warren Buffett: “Only buy something you’d be perfectly happy to hold if the market shut down for 10 years.” This is a great exercise when considering an investment at any juncture – but it hits the bullseye right now. What kinds of characteristics would we want in a company if all stock price quotes shut down, and we ‘woke up’ in a decade to get our first glimpse of where our businesses were valued? We’d want:

- An identified competitive leadership position, guarded by advantages such as scale, switching costs, intangible assets, network effects or low-cost production.
- Patterns of high return on equity, produced without excess leverage.
- Strong balance sheets evident through favorable credit and financial strength ratings.
- Disciplined corporate cultures that viewed shareholders as business partners, distributing an attractive but prudent level of ‘profit-sharing’ in the form of rising cash dividend payments.

Would we miss out on some new ‘game-changing’ company because we concentrated on the factors above? Yes, we probably would. The positive trade-off though, is a portfolio of companies built to survive the very tough periods, and then thrive on the other side. In our view that should always be the goal, and that is how we are continuing to manage portfolios now, during a very tough period.

### **Final Thoughts**

In October of 2008, as the financial crisis was revving up, Warren Buffett wrote an Op-Ed in the New York Times entitled “Buy American. I am.” History has shown that decision to be another prescient move by one of the great all-time investors, with the market up over 250% in the timeframe since. The moral to this quick story is that before the market started to go up, it went down. Significantly. If someone had

followed Buffett's advice that day in October and invested \$1 million in the S&P500, they would have had roughly \$720,000, or a 28% loss, by the market lows the following March.

The point is that good decisions can look bad in the short-term, so the fear of looking bad (or feeling bad) in the short-term shouldn't prevent us from making good decisions in the first place. Successful long-term investors do not let emotions dictate decisions. It's encoded in our DNA, both for professionals and amateurs alike, to overweight current events and extrapolate them far into the future. That's dangerous when times are good, and it's dangerous now, when times are not so good. This economic period will be tough, but it doesn't mean it will be permanent.

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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. Bespoke Investment Group, April 2020.
2. St. Louis FRED, Washington Post, April 2020.
3. Goldman Sachs Portfolio Strategy Research, March 2020.

Statistical and analytical data provided by Factset.

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