Martin Capital Partners

Quarterly Point of View
Tolerance Over Avoidance

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It's not hard to find things to worry about these days. In our role as portfolio managers, the responsibility of 'risk manager' is never far from the top of the list of surrogate titles, whether we like it or not. As the legendary investor Benjamin Graham once said, "The essence of investment management is the management of risks, not the management of returns." Our interpretation of this critical statement is that by better perceiving the landscape of risks, we'll have a higher likelihood of understanding and therefore navigating them – from an analytical and decision-making perspective, as well as the behavioral advantages acknowledgment of the risks provides.

With that concept in mind we need to once again circle back to one of the biggest near-term concerns we have for markets and economies, that of the trade impasse between the United States and China. We've discussed our negative views on the use of tariffs extensively in the past 18 months. This issue from our perspective, if anything, has only gotten worse. This is a specific political risk the economy has not faced since prior to WWII, and no one knows how it might end. Despite on and off negotiations that have yielded nothing, the markets are still behaving as if a positive outcome is all but certain, presumably because it serves both the United States' and China's best interests to find one. This doesn't account, however, for the very real potential of political miscalculations by one or more of the actors in this drama. At the least there is a current price to the policy uncertainty as it pertains to corporate decision making, supply chains and costs of goods. Much of the immediate toll is hard to quantify, but undoubtedly real, and has been expressed of late in company commentary surrounding earnings announcements, as well as global economic growth data. As of late June, after a meeting between President Trump and Chinese President Xi Jinping on the sidelines of the G-20 summit in Japan, negotiations for the time being are back on. We think the market, however, is assigning too high a probability of a very favorable outcome for the United States, which is likely partially responsible for the market remaining near all-time highs as of this writing.

The use of tariffs by President Trump has broadened. In late May, and seemingly out of the blue, the President announced escalating tariffs of up to 25% on U.S. imports from Mexico, apparently to punish them for the lack of help in solving the illegal immigration issue. The President said, "Mexico must step up and help solve this problem. For years, Mexico has not treated us fairly – but we are now asserting our rights as a sovereign Nation." [1] In analyzing this action, the Wall Street Journal Editorial Board declared that the Mexico tariffs "heighten economic uncertainty because they aren't even about trade. The risk is that Mr. Trump has come to view tariffs as a blunt-force tool to achieve any diplomatic goal." Mexico agreed to discuss the grievances, and the President subsequently called off the threatened taxes considering their compliance, though details were vague on what was negotiated outside of some commitment by our southern neighbors to do more to stem the immigration flow. Undoubtedly, some onlookers viewed this as a successful use of tariffs, but we believe it sets a dangerous precedent. Diplomatic credibility around the world is at stake, as just this spring a new trade pact had been signed between the United States, Mexico and Canada, replacing NAFTA, and thereby reassuring markets. Utilizing threats of tariffs before the ink was even dry on the new agreement will give all nations pause in any negotiations if they believe trade deals with Trump are subject to immediate reexamination on political whim. In addition, the use of tariffs on Mexico was invoked utilizing a 1977 statute which had never been used to apply border taxes. "This is a misuse of presidential authority and counter to congressional intent," said Senate Finance Chairman Chuck Grassley, Republican of Iowa.

Using these tactics ever more broadly as policy, we are seeing them applied beyond China and Mexico. Though he has postponed a final decision and says he enjoys a close relationship with Prime Minister Shinzo Abe, Trump hasn't exempted Japan from threats. Unless the two countries reach a favorable agreement, in which American farm goods receive greater access to Japanese markets, and Japanese automakers agree to build more U.S. auto factories, tariffs may be applied to auto imports. Threats against the European Union are also expanding. President Trump has stated "The European Union treats us, I would say, worse than China. They're just smaller." [2] In May the White House put off a decision to impose 25% tariffs on millions of foreign cars and parts, leaving six months to negotiate a deal to avoid them. Additionally, on July 1st the Office of the U.S. Trade Representative said as part of a long running dispute over aircraft subsidies it would consider tariffs on an additional $4 billion of goods from Europe, including items ranging from whisky to chemicals.

As a reminder, a tariff is a tax levied at a national border that raises the cost of imports, reducing the standard of living of consumers who purchase finished goods, and hurting businesses who buy inputs to make finished products. They are already starting to impede growth and business investment here and around the world. In May, the Institute for Supply Management's manufacturing index fell to 52.1%, its lowest level in three years. Surveys of Chief Financial Officers show that corporate investment plans for the coming year have slowed sharply. Furthermore, the Reserve Bank of Australia recently cut interest rates, emphasizing the decision was made mostly because of international trade disputes, saying, "growth in international trade remains weak and the increased uncertainty is affecting investment intentions in a number of countries." [3]

As we've credited him before, the President is right for addressing some very legitimate concerns surrounding fair trade, namely the issue of intellectual property theft and the rights of those aggrieved not being enforced. But let's not kid ourselves, these tariffs are tools of a protectionist variety we have not seen in generations. The last time they were utilized in this manner, via the Tariff Act of 1930, otherwise known as the Smoot-Hawley Tariff Act, economic growth was enormously diminished. Yes, other factors played a role at the time of the Great Depression, but undoubtedly tariffs were a prominent feature of the failed economic strategy of that era.

Deciphering how and when a potential risk, like the one described above, plays out in the future and how it pertains precisely to investment portfolios can be very difficult to ascertain, if not impossible. We believe this potential risk exists, however, and that it may be a higher probability with potential for greater impact than some other risks currently. Designing any investment strategy for an extreme positive or negative scenario is not difficult, the problem lies in the near certainty of 'implementation failure' via market-timing of the 'either/or' strategy that is potentially so costly to long-term investors. Two statements can offer us some valuable perspective on this concept. In his 2012 annual letter, Warren Buffett stated:

> *Since the basic game is so favorable, Charlie (Buffett's business partner) and I believe it's a terrible mistake to try and dance in and out of it based upon the turn of tarot cards, the predictions of 'experts', or the ebb and flow of business activity. The risks of being out of the game are huge compared to the risks of being in it.*

In a 2013 Barron's story, Atlanta-based money manager Jim Barksdale said:

…trying to live an investment life via prediction is a nonrepeatable approach.

There are boatloads of wisdom in these statements. A recent survey, the Schroders 2019 Global Investor Study, which measured views of more than 25,000 market participants across 32 countries, illustrates the average investor's difficulty with staying committed to their long-term investment plan. Only 13% of investors said they were able to stay committed to the 5-year plan they had previously designed, while 41% didn't even stay committed for one year. During 2018's year-end volatility, which lasted only about three months, just 18% held their nerve and stayed the course with their plan, meaning most investors likely missed out on the subsequent and significant move higher for most global markets.

If the costs are too high trying to dance in and out of markets, and managing investments based on prediction is not repeatable, how do we proceed? For those of you who are familiar with our approach and previous writings, you might be able to guess what's coming next.

As investors, our chief responsibility should be the implementation of a strategy that is fundamentally sound, time-tested, and constructed for durability in an uncertain world. Our attention now, and always, is focused on owning high-quality enterprises with enduring characteristics such as strong and established competitive positions (what MCP terms *competitive leadership duration*), high returns on invested capital, and thoughtful management that are able (and willing) to share a prudent portion of profits with us via durable and growing cash dividend payments.

Let's end with an impressive piece of data that may help reinforce this approach. The table below contains important dividend statistics for 14 companies we currently own in our Core Dividend Strategy.

Security	Symbol	Dividends Paid Since	Dividends Raised Since	Current Yield
JPMorgan Chase	JPM	1827	2011	2.8%
Bank of Nova Scotia	BNS	1832	2011	4.8%
American Express	AXP	1870	2012	1.2%
AT&T	T	1881	2005	6.1%
Exxon Mobil	XOM	1882	1982	4.5%
Procter & Gamble	PG	1891	1954	2.7%
Coca-Cola	KO	1893	1962	3.1%
General Mills	GIS	1898	2004	3.7%
Pfizer	PFE	1901	2010	3.3%
Royal Dutch Shell	RDS.B	1906	2017	5.7%
PSE Group	PEG	1907	2012	3.2%
Chevron	CVX	1912	2001	3.8%
Unum	UNM	1925	2009	3.0%
U.S. Bancorp	USB	1930	2010	2.8%
Averages		**1890**	**2000**	**3.6%**

Martin Capital Partners, LLC. Factset. 6/30/19

The information we find so remarkable is that these stocks began paying dividends prior to the last significant use of tariffs through the Smoot-Hawley Tariff Act, some 89 years ago! This does not mean these stocks were always worth owning every decade since then, though the compounded rates of returns if we did would be astounding. What it does mean is that companies exist with the enduring characteristics we seek, and they can be worth owning for long periods of time if consistent, rigorous analysis of those merits is continually performed. It also means that despite our real concern for the risks posed by tariff driven economic policies and their potential impact on global markets, we will be better off as investors owning companies built to survive for the long pull, than facing the potential costs of avoiding stocks altogether.

One final quote, from author and investor Morgan Housel, sums up this concept nicely.

> *There's more to learn from people who endured risk than those who seemingly conquered it, because the kind of skills you need to endure risk are more likely repeatable and relevant to tomorrow's risks…This is true for managers, marriages, countries, products, and businesses – compounding favors endurance over sprints and tolerance over avoidance.* [4]

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. Tariff Man Unchained, Wall Street Journal, 6/1/2019
2. Global Fronts in Trump's Assault on Free-Trade Dogma, New York Times, 6/1/2019
3. Australia Cuts Rates for the First Time in Nearly Three Years, Wall Street Journal, 6/4/2019
4. Things I'm Pretty Sure About, Morgan Housel, Collaborative Fund, 1/8/2019

Statistical and analytical data provided by Factset.