Quarterly Point of View
Don't Reach

October 10, 2019

A year or so ago, it appeared as if the era of low yields might finally be coming to an end. Interest rates on U.S. government debt stood at multiyear highs, nearing 3.50% for the 30-year bond and 3.25% for the 10-year note. Other rates were also rising as the Federal Reserve was in the process of taking the Fed Funds rate up to 2.50%, while at the same time investors were expecting the European Central Bank to also begin a pattern of raising rates. That all appears to be ancient history now, as the Fed instead cut rates twice this summer, in the hopes of sustaining a long-in-the-tooth economic expansion that started to show signs of slowing, mostly outside of the U.S. It's our view that the Fed action, taken at this point in the cycle with unemployment at 50-year lows and prices stable, is a short-sighted maneuver that only winks at their structural mandates. Nevertheless, the quarter that just ended saw the benchmark 10-year U.S. Treasury yield plummeting near all-time lows under 1.50%, before rising a bit to settle out at 1.68% at month-end.

Even with rates in the United States collapsing, they remain some of the highest in the world. Nearly $15 trillion worth of government debt globally trades with a negative yield (down from $17 trillion a month earlier)[1], meaning investors, on an incredible scale, are paying to *lend* their money to sovereign borrowers. We will undoubtedly address this issue again in the future, but for now we are going to leave it at this - global interest rates are once again at, or near, all-time lows, and central bank policy is virtually unanimously dovish, worldwide.

The seemingly immutable secular decline in interest rates that began in 1981 presents a clear challenge for savers, in that 'real yields' are negative. This means that the current nominal yield on the 10-year treasury as cited above, is lower than the inflation rate. We can debate whether we should use current, trailing or future inflation expectations in this calculation - but what is clear to us is that savers will not be 'saving' much of anything, and likely losing future purchasing power of their dollars at these interest rate levels.

The above is a mathematical problem, but this interest rate regime also poses psychological challenges as well. Raymond DeVoe Jr., who authored a Wall Street newsletter for many years, is credited with saying, "More money has been lost reaching for yield than at the point of a gun." This statement applies clearly to bond investors - meaning if paltry yields force savers to take on more interest rate (maturity) or credit risk, simply to get a few extra basis points of income, they will inadvertently expose their principal to excessive risk when the cycle turns.

The concept of 'reaching for yield', in other words 'reaching for return', also applies to equity investors in a few important ways. Firstly, from a dividend perspective. As we wrote in our year ago letter, it may seem obvious that income focused investors would desire stocks with the highest yields, but that

940 Willamette Street ▲ The Woolworth Building, Suite 350 ▲ Eugene, OR 97401
tel 541.636.4170 ▲ fax 541.636.4815 ▲ www.martincp.com

philosophy comes with more risk than meets the eye. Dividend yields are often the highest immediately before they are reduced or eliminated altogether. Additionally, even if a company is able to preserve an extremely lofty yield for a period of time, it may have to 'sacrifice' too large a portion of its cash flows to maintain that yield, precluding business investment that ultimately guards the company's competitive position and the dividend in the first place. Our investment process spends a lot of time stewing over the durability of a company's dividend payment, looking to avoid the temptation to reach for the highest current yields. At this point in the market cycle we think this is a highly important consideration.

The second way 'reaching for yield' is dangerous, refers to the pushing of common sense boundaries in search of ever-higher returns, particularly in an environment where the cost of capital is basically free. Currently, this lack of common sense appears evident in the initial public offering (IPO) market. Note these statistics[2]:

- IPO activity is booming, with estimates for total value in 2019 on pace to surpass the 1999 record, which coincided with the peak of the dot-com bubble.
- The vast majority of offerings are unprofitable, as 81% of IPO's had negative earnings per share in 2018.
- Combined losses of IPO's with negative earnings per share totaled $8.4 billion in first quarter of 2019, surpassing the previous tech bubble record.
- The composite operating margin of IPO's has declined to *negative* 5.4%, essentially 10 percentage points lower than the average from 1991-2015.
- In the biotech industry, not a single IPO posted positive earnings within the last two years.

The above data is disconcerting enough on the surface, but it gets more uncomfortable when diving a bit deeper. Historically, companies that listed dual-class voting structures were not listed on the New York Stock Exchange, but this has changed dramatically. We wrote this a few years back in our letter, *Pendulum Plotting*:

Snap Inc. issued stock that does not vote. Shareholders have no voting rights. Only Evan Spiegel (CEO) 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…

Since that point, the absurdity of multi-class voting structures hasn't abated. To us this is a clear illustration of the problem with 'reaching for yield', as investors drop their guard, not demanding as they normally would that companies demonstrate responsible governance. In 2019 for instance, two of the most highly anticipated IPO's exhibited shareholder unfriendly structures in the extreme. Ride-share company Lyft (LYFT) went public in March, and within its corporate design the co-founders maintain close to a majority of its voting rights - yet own just 7% of the company's stock[3]. A more acute example was highlighted in the Pinterest offering. Pinterest (PINS), a "visual discovery engine" (as the company defines itself) went public less than a month after LYFT and peaked in August with a market capitalization of almost $20 billion. Founder Ben Silbermann had his legal team build in rights to the offering of a super-voting class of shares that stay in effect up to 540 days in the event of his death or "permanent incapacitation", giving his heirs control of the company for up to a year-and-a-half. This doesn't sound much like a 'public' company, and to us is an egregious example of rotten corporate governance.

Evidently the banks that brought Pinterest public, and the traders that gobbled up the shares, do not share our concern. They might at some future point.

Very recently, however, the market is showing glimpses that it may be reaching a tipping point in its ability to digest this type of junk, which is an encouraging sign. We (formerly WeWork), a real estate outfit that billed itself as an enlightened tech company, canceled its plan for an IPO last month after concerns about the company's corporate governance, it's finances and the behavior of its CEO Adam Neumann, who was forced out of his position. One significant cancelled IPO may not be enough evidence the market is becoming more discerning in its 'reach for yield', but we're hopeful it's at least a start.

Whether a saver seeking income in bonds in the current interest rate regime, or an investor in stocks that is affected by those rates from a psychological perspective, everyone would do themselves a big favor by reducing their expectations and foregoing additional risk in the attempt to 'juice' returns. In other words, 'reaching for yield' in this environment will likely only lead to pain in the next. In memory of investor John Bogle, who passed away earlier this year, we'll conclude with a quote that we think is apropos to this concept:

…You should invest with simplicity. Rely on ordinary virtues that intelligent human beings have relied on for centuries: common sense, thrift, realistic expectations, patience and perseverance. Call them 'character'. And in investing, over the long run, character will be rewarded.

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. Wall Street Journal – *Investors Scramble for Yield as Growth Outlook Darkens*. 9/30/2019.
2. JPMorgan, Bloomberg, Epoch Partners, Jay Ritter IPO Database. Epoch Investment Partners – *Blitzscale and Hope: Unicorns, IPOs and the Fear of Repeating the Late 1990s*. June 2019.
3. thestreet.com – *Tech IPOs with Dual Class Shares Start to Face Meaningful Pushback*. 4/8/2019.