# Quarterly Point of View
## *Disciplined, Not Dogmatic*

October 11, 2018

When I started in this business in the mid-1990's most investors ignored, if not scorned, dividend centric investment strategies. Why would anyone "wait around" to collect cash dividends, produced predominantly by old stodgy value stocks when you could buy anything with a ".com" at the end of the company name and make a fortune within a few days? That was certainly the mentality anyway, at least until just after the clock turned into a new century and investors woke up to realize that cash flows matter in real life business. Since that time of course, we've suffered through the bursting of that technology bubble and the all-too-painful global financial crisis seven years later. These events, coupled with generationally low interest rates brought on by experimental monetary policy, helped draw attention back to fundamentally sound investment processes like dividend strategies (though there are again signs of a speculative drift as behavioral driven bubble pockets may be forming in the market, but that's a subject for another time).

Dividend investing has clear appeal reinforced by historical data, but there are hidden challenges that can undermine the potential dividend income production and total return potential of these types of strategies. With that in mind, we thought it might be helpful to review several broad characteristics of our strategies that seek to counter those challenges, helping increase the probability of long-term successful outcomes.

### Disciplined, Not Dogmatic

We like to refer to our process as disciplined, not dogmatic. In other words, we do not have hard and fast rules for metrics such as current yield, minimum years paying a dividend or number of sequential dividend increases. Those are all important factors, and part of our process, but in and of themselves do not tell the whole story. In fact, in many cases they can lead investors to missing good chunks of the story, limiting opportunities. A couple of examples within our portfolio may be helpful in illustrating this concept.

Cisco Systems (CSCO), the networking products and services company, started paying a dividend in April of 2011. We followed the company, liked the fundamentals and balance sheet strength, but waited for more evidence that a dividend culture was developing. After a year, they raised the dividend 33%, followed just two quarters later by another 75% increase. Though the company had only paid a dividend for roughly 1.5 years, we bought the stock as it met a host of other attractive criteria. From our point of initial purchase, the company has increased their dividend another 136% cumulatively, and produced a total return of 219%.

Another example would be Apple Inc. (AAPL), the technology and consumer products company. In the mid-1990's, as the company was going through a near-death experience, management cut their dividend to zero, where it sat for 17 years. In 2012, after years of reinvented success, they started to pay a dividend again, and in 2013 grew it an additional 15%. We purchased the stock in July of that year at an attractive relative yield,

and since that time Apple has grown their dividend an impressive 68%, producing a total return of 317%. At this juncture, Apple now stands as the single largest dividend payer in the world in absolute terms, and that all happened in just six years.

Most dividend strategies missed the opportunity to invest in these transformational dividend cultures early on. In fact, of the five largest dividend ETF's, not one is invested in Apple (AAPL), and only one of the five owns Cisco Systems (CSCO). Many rely on quantitative criteria, such as dividend payments for a minimum number of years, often 5 to 20, or systematic rebalancing based on trailing yield. Though those metrics as one component of an overall analysis of a company can be very helpful, we believe in some cases they can also be too limiting, particularly if they are one of only a few criteria. Dogmatic rules-based measures can hinder the ability to anticipate and react to changing dividend cultures, whether that means taking advantage of early positive signs, as highlighted above, or responding to perceived trouble before a dividend is cut.

Sector & Geographic Yield Diversification

There are 11 broad industry sectors as defined by the Global Industry Classification Standards (GICS), and only three of those – which include the recent addition of Real Estate Investment Trusts (REITs) – have aggregate dividend yields that exceed 3%. None exceed 4%. An overly mechanical or straightforward approach to seeking dividend yield stocks can then inadvertently lead to construction of portfolios that are unreasonably exposed to certain areas of the economy, creating unintended risks. As one of the oldest and most popular dividend indices, the Dow Jones U.S. Select Dividend Index is a good example of concentration that can enhance unintended risks because of a quantitative strategy that seeks highest relative yields. This index currently has almost 1/3rd of its entire portfolio in Utilities, one of the sectors yielding north of 3%. An investor may assume that by investing in this dividend index they are getting a diversified portfolio but would be surprised to learn they are making a fairly large bet in just one economic sector. Utilities are for the most part, lower volatility, conservative, regulated business models, but they are negatively impacted by rising interest rates to a greater extent than many other sectors. This exposure, though understandable on the surface for someone seeking dividend income, has the potential to erode the benefit of that income due to concentration of a specific, yet unintended risk. This kind of risk isn't just hypothetical, either. A decade ago (6/30/2008), this exact index had 44.6%[1] of it's assets invested in the Financials sector as it was one of the highest yielding groups at that time. As we now know, that was less than three months before Lehman Brothers declared bankruptcy and financial stocks led the entire market lower as the global financial crisis unfolded.

To help offset this kind of risk, we seek broader sector yield diversification. Our Core Dividend strategy currently has seven sectors with yields exceeding 3%, and four of those exceed 4%. Our heaviest weighting of the 11 GICS sectors is Healthcare, representing 15.8% of the portfolio[2]. We believe that diversification of yield production by sector is an important tool in managing portfolio risk.

In addition to sector diversification, geographic diversification of dividends can also be very beneficial. For one thing, the benefit of exposure to investments that do not correlate directly to U.S. assets is important in limiting volatility over a market cycle, thereby reducing certain kinds of risk. At times it can dilute performance, which international investments have recently (as well as buoy performance), but over the long-term the diversification and muted volatility benefits outweigh short term performance concerns and aid materially in meeting long term goals. From a tactical perspective, valuations for international stocks relative to domestic markets may indicate an opportunity exists currently, as well. Since the market lows of 2009, the S&P500 has produced a return almost three times greater than that of the MSCI All Country World ex-U.S. index. This staggering performance differential has resulted in international stocks trading at a 23% price to earnings discount to U.S. stocks, while offering a dividend yield 70% higher[3]. Finally, given that the majority of the world's dividends are paid outside of the United States, it seems a bit illogical to limit the universe of dividend investments only to domestic stocks. We mitigate certain challenges unique to companies residing outside our borders by making investments internationally only through American Depositary Receipts

(ADRs), which represent shares of foreign firms, traded on U.S. exchanges and denominated in dollars. From a structural perspective, opportunities and benefits of this expanded investment universe help us create portfolios with enhanced sector and geographic dividend yield diversification, important in meeting our strategic goals.

### Total Return Mindset

Though it may seem obvious that income focused investors would desire stocks with the highest yields, that 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 it, precluding business investment that ultimately guards the company's competitive position and therefore the dividend. For those familiar with our philosophy, we dub our investment process: Quality, Durability and Growth. We do not espouse 'high yield' but seek companies that pay durable dividends (those we believe are highly unlikely to be reduced or cut altogether) with the ability to sustainably grow them at a healthy clip, exceeding inflation. Approaching dividend strategies from a total return perspective – the combination of asset appreciation, dividends and dividend growth – has produced higher returns, with lower volatility. Historical returns support this contention. Looking at monthly return data since 1945[4], and segregating the market by dividend decile, from no dividends on one end as a 'zero' decile, and then the 10th decile being the highest dividend yielders, some distinctive conclusions can be drawn. Most interesting and applicable to us is that the best performance of all segments comes from the 8th decile, those that clearly have dividend cultures and attractive yields, but not the highest. In fact, the 8th decile of dividend yields outperformed the 10th decile by over 2% annually studying this vast time frame (note: both deciles outperformed the non-paying segment). Moreover, the attractive relative performance was produced with almost 17% less volatility as measured by rolling twelve-month standard deviation. Very high dividend yields may look enticing on the surface to the average income seeker, but durable dividends that grow are the winners through time.

We are ardent believers in the long-term value of dividend strategies, but as with all investment approaches there are certain caveats. By being disciplined but not dogmatic, keeping a keen eye on sector and geographic yield diversification, and while doing so with a total return mindset, we can increase the probabilities of successful absolute returns without undue risk.

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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Chief Investment Officer
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1. iShares.com, BlackRock, Inc.
2. MCP Core Dividend Strategy Representative Account, Martin Capital Partners – See additional disclaimers below.
3. *Guide to the Market*, JP Morgan Asset Management, September 2018.
4. Kenneth R. French Data Library, Tuck School of Business, Dartmouth College, 2018.

Core Dividend Strategy holding information provided from a representative account. Holdings and weightings may vary for each client in the strategy and are subject to change at any time. The representative account is the account in the composite that Martin Capital Partners believes most closely reflects the average client portfolio in the Core Dividend Strategy, and has not been chosen based on any performance metric. References to specific investments should not be construed as a recommendation by Martin Capital Partners to buy or sell the securities, as these are part of a broader, more diversified investment portfolio. Data presented as of the end of the third quarter, 2018. Accounts invested in the MCP Core Dividend Strategy generally concentrate their assets in fewer individual holdings than a diversified product, and therefore are more exposed to individual holding volatility than a diversified product or index. As always, past performance provides no indication of future results, further, loss of principal value is possible as the strategy invests in equities. Statistical and analytical data provided by Factset.

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