Quarterly Point of View
10 Years

July 13, 2020

Where are we now? That question could reference many diverse issues at this stage of 2020, but for purposes of this letter let's ask it of the capital markets. It was not all that long ago, February 19th to be exact, that the U.S. stock market reached an all-time high with the S&P500 closing at 3,386. Then the reality of the new Coronavirus began to rapidly unfold and with it came the fastest ever trip into a bear market – a five week decline of 34% culminating on March 23rd with a 2,237 close. After reaching that low, the market mercifully rallied the last week of the 1st quarter and then launched a breathtaking ascent through the 2nd, closing the quarter on June 30th at 3,100 – almost 40% higher than its very recent nadir.

Considering the world is engaging in a struggle with the most extreme pandemic in a century, and as a result potentially the worst economic contraction in roughly eight decades, this monstrous move in share prices seems to defy logic. At the moment, the market seems to be taking a sanguine view of these items:

- The Fed and Treasury are throwing every solution they can think of at this problem, and broad consensus seems to be that they will work.
- Covid-19 cases are declining in previously hard-hit areas such as New York, while in other locations the goal of 'flattening the curve' seems achievable.
- Optimism is rising with regards to a potential vaccine, and other treatments showing promise are adding to confidence.
- Investors likely acknowledge there will be a significant economic hit – in terms of job losses, GDP contraction and corporate earnings declines – but now seem comfortable looking through this as a "one-off" event limited only to this year, and maybe next.

There appears to be more economic unknowns currently, however, than at most points in history. GDP estimate dispersion is at its highest level (by far) in half a century[1], and 90% of S&P500 companies have either guided lower or withdrawn any attempt to forecast their own business for the rest of 2020[2]. In that kind of environment, it's fair to look at the flip side of the above points:

- What if measures taken by the Fed and Treasury create more problems down the line than they solve now?

- Though some hard-hit areas have achieved curve flattening, others have seen dramatic spikes in new cases, specifically Arizona, Florida, Texas and California – together representing nearly 30% of the U.S. population.
- What if hopes for a vaccine are not realized for another 12-18 months, or longer?
- Isn't it possible the economic contraction could be deeper and last longer than current market robust sentiment seems to discount?

We accept the adage that investing in an uncertain world is the only certainty, as a case can be made at some level for both sides of the bullet points outlined above. Famed investor Charlie Munger has stated in the past "A lot of people are trying to be brilliant, and we are just trying to stay rational." This, we believe, is a wise default position if there ever was one, and certainly no exception now. It is our conviction that certain time-tested concepts can help investors produce successful long-term outcomes despite a very uncertain future, and now may be as good a time as any to re-visit a few.

Martin Capital Partners' 10th Anniversary

This past month marked Martin Capital Partners' 10th anniversary, and this is our 40th Point of View quarterly letter. Our first, written in October 2010, was titled *Uniquely Opportune Time*, in which we posited that stocks, particularly those with 'quality' characteristics, represented an attractive reward for risk opportunity. In it we said:

> *…from our perspective stocks in general and specifically those with 'quality' characteristics look less expensive than they have in many, many years. Investors have become keenly focused on what can go wrong with stocks and their potential for decline, versus their potential to produce gains through dividends and appreciation. We believe this environment has created meaningful opportunity for investors committed to equity ownership.*

The past decade certainly produced meaningful opportunity for those that were committed to equity ownership, as illustrated by the greater than 250% total return for the S&P500 for the 10 years ending in June. This next decade presents opportunity as well, though in our view it will take more discernment and discipline by investors to find and capitalize on it. Even with those attributes, returns are likely to be more muted in the next ten years, particularly given current valuations and other structural factors less conducive to expanding market valuations.

We'll address those challenging factors in future letters but considering this is our "10-year anniversary," we've culled a few topics, lessons, and concepts previously examined that we believe will be vital to success over the coming years.

A Bird in the Hand is Worth Two in the Bush (April 2012)

> *There is a concept discussed predominantly in bond markets called duration. Duration, which is used to analyze a bond's exposure to interest rate volatility, considers the present value of all coupon and principal payments to be received in the future. Expressed in years, it is the weighted average time until cash flows are received. The longer the duration, the greater the interest rate risk for the security. Because equities do not share the fixed payment schedules and principal maturities of bonds, measuring equity duration is less precise. The concept however, is important and timely. In a high-volatility environment where unrealized capital gains built on paper have a tendency to erode as the next crisis develops, possessing a shorter duration equity portfolio is critical. That is to say, if durable, high and rising cash dividend payments by quality companies are produced in an equity portfolio, more of the investment return is realized by the investor 'up-front', and less is required at the back end (as sales for capital gains) to produce the same total*

return. By virtue of focusing on the cash payments of corporations with well-established dividend cultures, we can eliminate some level of risk through the consistent and incremental capture of return; in this way, we need not attempt to leave all of our return to a final 'maturity date' sale. From an investment positioning standpoint, this shorter duration-- which can be referred to as a bird in the hand is worth two in the bush attribute-- will be important for a portfolio to exhibit during the continuing environment in which a volatile, unpredictable path will mark the road from A to B.

Key point: Through incremental capture of return via periodic cash dividend payments, we do not have to wait for someone to pay us a higher price at a future unknown date to get all of our expected return. All investors ultimately invest for a return of cash, and dividend investors are simply seeking to shorten their equity portfolio duration, or in other words, the time they must wait to receive a cash portion of return.

What Have We Learned? (October 2013)

Famed investor Peter Lynch once said "never invest in any idea you can't illustrate with a crayon." So how did the fancy products created by investment banks leading into the financial crisis (that couldn't be illustrated with a crayon) work out? Generally, most all could be classified as epic failures. Credit default swaps, option adjustable rate sub-prime mortgages, collateralized debt obligations, opaque hedge funds with terms like 'gates' and 'side pockets', are products and strategies extremely difficult to understand even generally, let alone how they would perform under stress. Investors are way too often fooled by smart people pitching esoteric and complex strategies, believing they must be able to perform better than the simple and straightforward. Rarely is that the case. …John Bogle expressed in a 1999 speech as the internet bubble was in full swing, "To earn the highest returns that are realistically possible, 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."

Key point: Many market participants currently look to be forgetting some important lessons of the past, as we've seen a significant rise in esoteric, derivative market-related products, which often epitomize pockets of euphoric conditions. Simple, "ordinary virtues" are once again likely to survive and ultimately prevail in the future.

The Point Is? (April 2014)

In today's investment world, everything is couched in terms of 'positioning' or 'trading', not 'investment'. Even when the term 'investment' is used, it isn't used properly. The mentality therefore that corresponds with frequent trading establishes a poor structure for disciplined investing. Years ago, Warren Buffett gave a lecture to the faculty of the Notre Dame Business School on the detrimental aspect of unlimited liquidity being present for investors, saying in part: "The very fact that you have, in effect, an unlimited punch card, because that's the way the system works, you can change your mind every hour or every minute in this business, and it's kind of cheap and easy to do because we have markets with a lot of liquidity – you can't do that if you own farms or real estate – and that very availability, that huge liquidity which people prize so much is, for most people, a curse…" As investors, we can choose how we handle our capital, and that's good news. We don't have to be short term traders or speculators, let alone the high frequency type. We can choose to think and act like investors looking to make long term commitments, as real owners in a business would... The prevalence of high frequency, quantitative, program trading - very sophisticated systems whatever we call them - may appear *to be another case where Wall Street resources and intelligence are extending the odds against the average investor. In very short time frames this may even be true, but as we've written before, this evolution is actually a valuable gift in disguise for investors with a timeframe stretching beyond today's trading hours, or the next quarter's earnings report.*

Key point: It's important not to overreact to short-term news, either positive or negative, that very often turns out to be noise. In fact, those traders and speculators who do react to noise often create opportunities within certain sectors, industries and companies for true investors that maintain a long-term perspective.

Voting and Weighing (October 2015)

As time is condensed, factors that matter most to the value of a business do not have time to demonstrate their worth, leaving a vacuum often filled by sentiment and emotion, driven by noise disguised as news. Within that space, stock prices are influenced by an extreme number of factors, and behave much more like a popularity contest than an arbiter of real value. As time frames lengthen, critical fundamental factors trump short term voting patterns. What ultimately matters are durable cash flows produced by competitively strong businesses that have a propensity to share that cash in a consistent and growing fashion with their shareholders. An important factor we evaluate, that most certainly gets weighed over time, is the 'yield on cost' of the purchases we make in our portfolios for clients. Yield on cost is calculated by taking the current annual dividend payment of a company and dividing it by original cost basis. This way we can analyze the impact of dividend growth - expressed as a yield - on the original cash outlay to purchase a stock… As former British Prime Minister Benjamin Disraeli (1804-1881) once said, "Patience is a necessary ingredient of genius." Now is not the time to be swayed by how the market is voting, but instead, to focus on the things that are weighed in time.

Key point: Dividends are the tangible and essential link between shareholders and the companies they own. By virtue of focusing on cash flows and their distribution through prudent levels of cash dividends, emphasis is placed on what the market will weigh over time, not how it will vote in the short term.

Invest Like an Owner (January 2019)

When we contemplate what the next cycle might look like we want to remind investors it will be critically important to analyze and treat investments in publicly traded companies as if they were private. We mean this from both a psychological, as well as an economic perspective. First, an owner of a private enterprise does not look to continually trade in an out of their business based on what someone might pay for it at any given moment. Instead a business owner looks to grow and run it sustainably, generating profits it can distribute. An owner of a private business takes a long-term view and makes decisions believed to be prudent considering the potential value they will create, not in the next quarter or next year, but instead many years into the future. The average public market investor, unfortunately and to their detriment, does not look at it this way. Studies reviewing investor return data consistently illustrate self-destructive investor 'timing' behavior. According to Morningstar, for the 10 years ending in 2013, which is a good sample that included both bull and bear markets, the average investor return was 4.81%, yet the funds themselves investors danced in and out of, produced a return of 7.30%[3]. This performance gap of 2.49% per annum is referred to as the 'behavior penalty' and illustrates the perils of trying to time the market. Successful long-term investors need to avoid this trap.

Key point: Timing the market is an extraordinarily difficult, if not an impossible task. It is also very dangerous. Though we own proportional shares of an enterprise through public stock, it is wise behaving as if we owned the entire business.

The quote below is a good place to conclude. It is one of our all-time favorites that we've used in prior writings and is as apropos now as ever – summing up the perspective with which investors should view the current environment.

Howard Marks, co-founder of Oaktree Capital:

> *The road to long-term investment success runs through risk control more than through aggressiveness, over a full career, most investors results will be determined more by how many losers they have, and how bad they are, than by the greatness of their winners… Because ensuring the ability to survive under adverse circumstances is incompatible with maximizing returns in good times, investors must decide what balance to strike between the two.*

We are extremely thankful to those that have entrusted us with their capital over Martin Capital Partners' first 10 years. It remains a sincere privilege serving you, and we look forward to the next decade of fruitful partnership.

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.

Respectfully,

Cameron K Martin
Chief Investment Officer
Martin Capital Partners, LLC

1. BofA Merrill Lynch, 4/4/2020
2. *Markets Follow the Fed Into Risk Assets*, TCW Insight, 5/8/2020
3. Morningstar, 2014

Statistical and analytical data provided by Factset.

If you would like additional information on how Martin Capital Partners, LLC conducts business, we can provide a copy of our SEC Form ADV part II, firm brochure.