Quarterly Point of View
What Have We Learned?

October 8, 2013

On September 15th, 2008 Lehman Brothers, the 158 year old investment bank, filed for bankruptcy. It is the largest bankruptcy in the history of the United States and is widely considered the anniversary date of the global financial crisis. In reality the beginning could have been considered several other previous dates, including a year earlier when the French bank BNP Paribas froze three funds that were invested in packages of sub-prime loans, indicating they had no way to value the complex assets known as Collateralized Debt Obligations (CDOs). But assuming we give the infamous Lehman event the nod, we just 'celebrated' the five year anniversary of the financial crisis that rocked global markets and economies.

For now we won't spend our energy on the 'whys' that precipitated the crisis, but instead on the 'whats' - as in - what did we learn that would help us as investors in the future? The crisis was undoubtedly grave; in fact it was the largest peak to trough market drop in the last century, outside of the stock market crash of 1929. But without question we will endure market drops that will feel as if we are heading for another legendary crisis. All 'pullbacks' approaching 10% or more feel as if they will eventually end that way, though as stated, most do not reach the magnitude of the event we are remembering. In order to be an effective investor over time we need to understand that timing our investments to miss these drops is a strategy unlikely to be executed successfully, even once or twice, and has proven impossible as a repeatable pattern. We therefore are better served understanding characteristics that allow us to endure the nerve-wracking declines and be appropriately positioned to participate with profits when markets rebound.

Before outlining the most important points we learned - or more precisely, what was resoundingly reinforced in the aftermath of the 5 year old financial crisis - here is a reminder of what happened in chart form.

For the S&P500, from the peak in October of 2007 to the nadir reached in March of 2009, the market descended an astonishing 55%, wiping out the previous 13 years' worth of gains.

Just when all seemed the darkest and most believed only bad news was possible, some green shoots of good news – or even 'less bad' news started to appear – and the markets stopped going down. The chart above continues the S&P500 performance from those lows in March of 2009, bringing it to date. The market has returned a quite staggering 181% to its recent peak - on a total return basis, meaning dividends included – which is now an all-time high.

With the perspective of time, or as one of our very valued clients likes to say, using the 'retrospectoscope' - what did we learn? There are many lessons for sure, but we take four as absolutely critical.

1- Focus on the tangible: Durable cash dividends

We call dividends the tangible and essential link between shareholders and the companies they own, furnishing investors with a steady and growing stream of income that dampens share price volatility and contributes meaningfully to long term returns. The importance of durable cash dividends, which tends to be de-emphasized during bull markets, is never more clear than during times of market instability. The concept of duration, which we've discussed in previous letters, is primarily used to analyze a bond's exposure to interest rate volatility. In short, the longer the duration, the higher the volatility - because an investor has to wait farther in to the future for the bulk of cash payments to be received. Though less precise, the same theory applies to equity investors. In a high-volatility environment where unrealized capital gains built on paper tend to erode as a crisis develops, possessing a shorter duration equity portfolio is critical. That is to say, if durable, high and rising cash dividend payments are produced, 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 an equivalent 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 tied to a final, correctly-timed asset sale.

2- Own Quality

High quality companies have enduring characteristics such as strong and established competitive positions, high returns on invested capital and wise management. They also maintain another extremely important characteristic - conservative levels of debt financing. Debt leverage can work wonders for a company when sailing is smooth, enhancing returns. Companies that play the leverage card however, needing to access capital at points of market stress, will find that raising funds will either be extremely expensive or simply not available. This is essentially what happened across the board five years ago. As an investor, the last place we want to find ourselves is owning a company that cannot refinance a large maturity, or one at risk of breaching debt covenants. In those situations, shares of over-leveraged firms will get destroyed, in many cases permanently. As Warren Buffett said in his annual letter to shareholders in 2008, "We never want to count on the kindness of strangers in order to meet tomorrow's obligations".

3- Keep it Simple

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. An investor in the following high-quality common stocks, who made a purchase commitment, not at the lows of the market but the day *before* Lehman Brothers went bankrupt, would still have produced the following gains through the end of this September: Johnson & Johnson 46%, Chevron 71%, McDonalds 76%, Pfizer 92% and Texas Instruments 103%. 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." We wholeheartedly agree.

4- Stay committed as an investor

In the information about our firm, including our website, we state that "Martin Capital Partners strives to employ a sensible investment philosophy that our clients understand and agree with, increasing the probability of long term success by minimizing complexity and confusion – which often leads to poor decision making, particularly at points of market stress". In order to achieve long term success we believe it is of immense importance for investors to think of themselves as exactly what they are - investors. Not market timers or speculators. Looking back to 1980[1], the average intra year drop for the S&P500 is a substantial 14.7%. In only two of those 33 years ending in 2012 did the market drop only 5% or less from its high, and in 19 of those years the drops were into double digits. Staying committed as an investor is vital, as the 181% return since the lows in March of 2009 would indicate. Many investors bailed on their stocks in the height of the crisis, with domestic mutual fund redemptions reaching almost a quarter of a trillion dollars in total between 2007 & 2009. The probability that investors who took their money out of stocks found an alternative to match the market's return is close to zero. More than likely based on the unprecedented flows into money market funds and government bond funds that yielded nothing or close to it, those investors meaningfully and permanently damaged their investment portfolios.

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. JPM Asset Management, Guide to the Markets – U.S., 2013.
Statistical and analytical data provided by Thomson Reuters

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. As always, past performance provides no indication of future results.

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2911 Tennyson Avenue, The Inkwell Building, Second Floor ▲ Eugene, OR 97408
tel 541.636.4170 ▲ fax 541.636.4815 ▲ www.martincp.com