Quarterly Point of View
Motion Sickness

October 10, 2011

It goes without saying that we are currently in very volatile times for the financial markets. Professor of finance Andrew Lo at the M.I.T. Sloan School of Management says "The last few years have been the most volatile for all recorded history"[1] and for evidence he cites 11 of the 20 biggest daily drops and 10 of the 20 biggest upswings occurring in the last 31 years have taken place in just the last three. Closing price moves of 4% or greater in the S&P500 Index, or 'extreme volatility' as Lo defines it, have occurred at 7 times the average pace displayed in the 40 years between 1960 and 2000.

This volatility can be extremely unnerving and the motion sickness appears to be having an effect on many investors. During the three months ending August, investors world-wide pulled $92 billion from developed market stock funds[2] – this figure exceeded the total amount of money that had been invested in the 26 months following the market lows of early 2009 and matched the worst three month period during the depths of the financial crisis. Through the first 3 weeks of September an additional $25 billion had been withdrawn. Each investor pulled this money based on their own circumstances, but collectively it is important to remember a key point from these fund flows – most people get it wrong. Redemptions traditionally happen in and around the time markets make their lows. For evidence, we look to a Dalbar Inc. study examining mutual fund flow data that measures investor behavior to determine how the 'average' person faired. For the trailing 20 years through the end of last year the average investor produced a return of just 2.6%, while the S&P500 returned 7.7% annually, a wide spread and very likely due to easily susceptible traits of selling on fear and buying on greed.

Additionally, Fidelity studied the performance of over 7 million 401(k) accounts, comparing returns for investors who made changes during the 2008-2009 crisis up through June of 2011. Participants who changed their equity allocation to zero between October of 2008 and March of 2009 and stayed out of the market saw an average account balance increase of only 2%, while those that stayed with a continuous allocation that included stocks had an average increase of 50%. The S&P500 itself returned 105% from the lows of March 2009 through June of this year. Clearly those who exhibited patience through a very difficult and fearful period were rewarded.

At times of extreme volatility we think it's wise to view the stock market in a different context. The comments below are pulled from Warren Buffett's Berkshire Hathaway annual report in 1987. He refers to Benjamin Graham, considered by many to be the father of value investing, and his story on how to view the market. We think it is helpful in framing investment decisions:

"Ben Graham, my friend and teacher, long ago described the mental attitude toward market fluctuations that I believe to be most conducive to investment success. He said that you should imagine market quotations as coming from a remarkable accommodating fellow named Mr. Market who is your partner in private business. Without fail, Mr. Market appears daily and names a price at which he will either buy your interest or sell you his. Even though the business that the two of you own may have economic characteristics that are stable, Mr. Market's quotations will be anything but. For, sad to say, the poor

fellow has incurable emotional problems. At times he feels euphoric and can see only the favorable factors affecting the business. When in that mood, he names a very high buy-sell price because he fears that you will snap up his interest and rob him of imminent gains. At other times he is depressed and can see nothing but trouble ahead for both the business and the world. On these occasions he will name a very low price, since he is terrified that you will unload your interest on him.

Mr. Market has another endearing characteristic: He doesn't mind being ignored. If his quotation is uninteresting to you today, he will be back with a new one tomorrow. Transactions are strictly at your option. Under these conditions, the more manic-depressive his behavior, the better for you. But, like Cinderella at the ball, you must heed one warning or everything will turn into pumpkins and mice: Mr. Market is there to serve you, not to guide you. It is his pocketbook, not his wisdom, that you will find useful. If he shows up someday in a particularly foolish mood, you are free to either ignore him or take advantage of him, but it will be disastrous if you fall under his influence. Indeed, if you aren't certain that you understand and can value your business far better than Mr. Market, you don't belong in the game. As they say in poker, 'If you've been in the game 30 minutes and you don't know who the patsy is, you're the patsy.'"
– Warren Buffett

With these thoughts in mind and given the statistics cited above we strive 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. During these times we think it's worth repeating the characteristics we seek in the companies we want our clients to own, terming it *QDG: Quality, Durability and Growth.* Generally businesses fail or are at risk due to some combination of intense competition, low returns on capital and unmanageable debt levels. Additionally complacency and/or arrogance manifest's itself in insufficient attention to the balance sheet when times are good – in turn putting the enterprise at risk when times aren't so good. As these are the characteristics often associated with failure, we look to turn that around and focus on *Quality* franchises with very strong competitive positions (often global leaders in their industries), with consistently high returns on capital, favorable gearing ratios (debt to capital levels) and other important marks of balance sheet attention. Identifying the *Durability* and *Growth* of dividend income are key steps in finding those companies that not only survive the turbulent times but thrive in the next phase. We look for a history of dividend payment through market cycles, an identifiable, established and committed dividend culture or one that is making a rapid and decisive conversion to an attractive dividend payer. Strong cash flow and prospects for earnings growth to support payout growth is crucial. We would rather accept a lower yield that consistently grows, than stretch for a higher yield we believe may not be sustainable. Ultimately we believe a portfolio of quality companies with durable and growing dividend payments - where we're treated as an owner, sharing in the profits consistently on a cash basis – has the opportunity to produce attractive risk-adjusted returns. We are pleased to say this is playing out so far in 2011, as our Core Dividend strategy has significantly outperformed the market averages. Investors appear to be seeking companies with fortress balance sheets, producing current and growing income that is hard to find in other areas.

Many issues confront investors today and we've attempted to address some of them in previous letters, but a quote we've heard in the past is timely and accurate – "Investing in an uncertain world is the only certainty". This rings true – as from almost every juncture in history we can pull a litany of items from the time that seemed destined to alter the investing landscape. Very few do however when viewed in the context of someone's long term needs

and goals for their money. Since 1980 despite average intra year drops of 14.3% for the S&P 500 Index, annual returns have been positive 77% of the time. From our viewpoint it is vitally important for investors to focus on the kinds of qualities and characteristics discussed above. Believing we understand and can value our businesses better than 'Mr. Market', we need to remember not to succumb to the fear volatility breeds.

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.

We are humbled and excited to wake up each morning and serve those that have entrusted us with their capital. It is a sincere privilege.

Respectfully,

Cameron K Martin
Chief Investment Officer
Martin Capital Partners, LLC

1: New York Times 9/11/11
2: EPFR Global

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

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