Quarterly Point of View
The Point Is?

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> *The markets are not for individual professionals to make money in. They are really for corporations to raise capital so you can invest in this country and get a better standard of living. If we destroy the markets by too much volatility, too much professional trading, too much leverage, we ruin their credibility and we ruin the function for which they are supposed to exist.*

The description above of the stock market's purpose was given by John Phelan, who served as chairman and chief executive officer of the New York Stock Exchange during a period that included Black Monday – a single infamous day in 1987 when the market lost 22.6% of its value. Through his thorough understanding of the business, professional demeanor and steady calm in the months following the crash, Phelan helped preserve the credibility of the world's foremost market at a time when many doubted that credibility.

Approaching three decades later, doubts about the credibility of the markets linger. This fact is highlighted by the incredible buzz and debate brought on by the release of famed author Michael Lewis' newest book "Flash Boys", about high frequency traders. High frequency traders (HFT), using sophisticated proprietary computer algorithms and powerful technological tools move in and out of stocks in fractions of a second. Many credit the massive volume these traders produce as beneficial to market liquidity and trading costs, but many others including Lewis go so far as to claim that the market is 'rigged'. Critics argue that HFT firms cheat the system by having access to information about the flow of orders before others, locating their computer systems as close to the exchanges as possible shaving milliseconds off execution times, and then using these factors to determine where they can profit – by front running orders placed by other market participants. Reports vary, but many believe HFT may account for as much as 50-60% of total daily trading volume in the United States. Because of the massive amount of volume produced by this program trading, HFT has been accused of being the primary culprit in events such as the Flash Crash of May 2010 that saw the Dow Jones Industrial Average plunge 1,000 points, and then recover, all within a matter of minutes. Investigations into that event haven't produced definitive answers, but the finger continues to point in HFT's direction.

Recently, United States Attorney General Eric Holder announced that the Justice Department is investigating high frequency trading for possible violations of antitrust and insider trading laws. They join the Federal Bureau of Investigation, U.S. Securities and Exchange Commission, New York Attorney General and the Commodities Futures Trading Commission as having investigations in process or about to get underway.

It is welcome news that a discussion on the topic has reached this level. Investigations and the legal process will need to work their way out before we are able to determine whether this activity is by definition illegal, but either way it's unhealthy.

Speculation and short term trading have been and always will be part of the stock market. But defenders of the high frequency trading status quo – which include many of Wall Street's biggest firms with vested interests – claim that bountiful and unlimited liquidity is the name of the game. We believe they are missing the point entirely. As Mr. Phelan noted almost 30 years ago, markets are for corporations to raise capital and for individuals to better their standard of living through investment in these companies. Otherwise we stand to ruin the market's credibility, as well as their function.

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. Instead of stock price action and trading, we can look to the asset itself to produce the investment return. This distinction is vital, as it determines the separation between a speculator and an investor. The stock market is the vehicle by which we obtain ownership in great companies, and through that ownership we capitalize on durable and rising streams of distributed profits (dividends), that drive long term investment results.

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.

Due to the factors producing ever shortening time horizons, often the most sustainable of business enterprises rarely trade at the valuations they should. Some use the term 'time horizon arbitrage' to describe investing for the long term against the short term inclinations

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of most investors, crediting Warren Buffett with being the model practitioner of the strategy. In other words, determining that his advantage over the years has rested with his ability to buy assets with long term value that are underappreciated by the market, understanding that an investment's present value is often embodied in the cash flows many years out. This does require a higher than average aptitude for patience, but is the historical hallmark of the greatest investors.

As Wall Street focuses ever more intently on short term price movements, we have the choice to maintain a view in the opposite direction - to our advantage. We can instead focus on which businesses are deserving of our funding and which are not. We can make reasoned judgments, allocating our capital to those enterprises with sustainable competitive advantages, long-run earnings power and the lasting value of large and growing streams of dividend income. We believe this is the kind of objective that Mr. Phelan referred to, ultimately helping improve the individual's and the nation's standard of living, and functioning in the purpose for which the markets were intended.

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
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