Martin Capital Partners

Quarterly Point of View
Invest Like an Owner

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Stock market volatility returned in large-scale fashion during the fourth quarter of 2018. After having risen more than 11% for the year at one point in September, the S&P 500 ended the year down almost 4.5% - its worst annual decline since 2008. Both the S&P 500 and the Dow Jones Industrial Average endured their worst December since 1931[1]. On an Intra-day basis, amidst the ugliest Christmas Eve day of trading ever, the S&P 500 had dropped more than 20% from those third quarter highs, the threshold often defined as reaching a bear market.

We'll be more informed investors if we understand the possible sources of recent volatility, but even more importantly we stand to be successful investors over the long pull if we recognize how to navigate it prudently. This letter will address a principal characteristic, from our vantage point, of how successful investors through time behave amid volatility, but first let's consider some of the culprits of the disquieting price action of late.

Long Bull Market
Let's start with the simplest reasoning for the volatility, the fact that the near decade in length bull market was simply long in the tooth and seeking any legitimate excuse to trade down. Since the lows in March of 2009, the market had advanced almost 300%, without even one official bear market. Just the length alone is highly unusual. Since 1900, the Dow Jones Industrial Average has historically seen a 20% or greater decline about once every 3.75 years, a 15% decline every two years, and a 10% decline every year[2]. This decade we have not seen market drawdowns with nearly the frequency history would suggest. In fact, in 2017, the market had *zero* 7-day periods where stocks fell more than 2%[3]! This astonishing statistic had not been matched in the U.S. markets for at least 45 years. Based on simple reversion to the mean thinking alone, the current volatile price action was bound to happen, as we know both the economy and the psychology surrounding it are cyclical in nature.

Trade War
As a reminder, a tariff is a tax levied at a national border and raises the cost of imports, reducing the standard of living of consumers, and increasing costs to businesses who buy foreign inputs to make finished products. We wrote about the risk of employing tariffs twice in 2018 letters; *Tariffs & Trade* in April and *Trump, Smoot and Hawley* in July. Seeking not to bore those who've read the letters, I'll summarize briefly (and for those who would like to read them for the first time, or again, please visit www.martincp.com, and under the resources tab, click 'point of view'): Though we acknowledge there are legitimate concerns regarding open and fair trade with China, we believe the U.S. would be better

off dealing with these issues through other means, such as the rules-based global trading entities our country participated greatly in creating. This was not tried to any material extent. In fact, the President withdrew the U.S. in 2017 from the Trans-Pacific Partnership (TPP), a trade agreement with a group of 12 countries from Asia and the Americas, that was established in part to reduce the participating nations' dependence on Chinese trade and bring them in closer alliance with the United Sates. The TPP, which took over a decade to develop, contained measures to lower barriers for trade, including tariffs, and established a dispute mechanism to settle grievances. Instead, tariffs on hundreds of billions in Chinese goods have been put into effect, attempting to force the country to change its trade practices (the tariff rates stand currently at 10% and are set to rise to 25% this spring). Utilizing tariffs as a weapon to force change has simultaneously upended the post-World War II trading order, resulting in a dangerous game of chicken. The market's mood swings are now more fully beginning to reflect this. It may not be coincidence that the market suffered through its worst December since 1931, given that on just the 2nd trading day of the month President Trump declared, in a tweet to an already nervous market, "I'm a Tariff Man."[4]

QE to QT

Quantitative Easing (QE), which flooded the market with a cascade of liquidity as the policy response to the Global Financial Crisis, is in transition. No one should think this will be a smooth process. First, it's never been done before, so there is no road map. Second, even if it had been done before, the fact of the matter is that policy makers are now in the process of gradually removing liquidity, as the unprecedented size of central bank balance sheets is unwound. This process has been dubbed Quantitative Tightening (QT). If QE brought investors higher multiples on most assets they owned, and did it with low volatility, we should expect QT to do the opposite. In the five years from 2012 to 2017 for example, almost 2/3rds of the return from stocks was attributable to rising P/E multiples[5]. It will, therefore, be unwise to assume continued multiple expansion on assets in the new environment. Instead, the market's direction will rely predominantly on fundamental factors such as the direction of dividends and earnings. Investors should be best prepared for the next cycle by understanding it will likely contain many more fits and starts (i.e. market volatility) as central banks grapple with unwinding a decade of experimental monetary policy.

Given the factors cited above, 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%[6]. 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.

Secondly, from an economic perspective, the more the investment world unabashedly focuses on stock 'price' action and 'trading' as the mechanism to create returns, the more we look instead to the asset itself to produce the return. The stock market is the vehicle by which we obtain ownership in great businesses with strong competitive positions, and through that ownership we capitalize on durable and rising streams of distributed profits (dividends), not unlike a private business owner. As Warren Buffett has stated; "There are two types of assets to buy. One is where the asset itself delivers a return to you… then there are assets that you buy where you hope somebody else pays you more later on, but the asset itself doesn't produce anything, and those are two different games. I regard the second game as speculation."[7]

The added benefit of looking to the asset itself to deliver the return - in this case, durable, high and rising cash dividend payments by quality companies - is more of the investment return is realized 'up–front', and less is required at the back end to produce hoped-for capital gains. By virtue of focusing on the cash payments in the form of dividends, we can eliminate some level of risk through the consistent and incremental capture of return. In an environment displaying enhanced volatility and the absence of large-scale P/E multiple expansion, this should remain a critically important objective for investors.

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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