Martin Capital Partners

Quarterly Point of View

October 11, 2010

If we were transported back to March of 2000, and given mutual fund 'flow' information indicating where investors were (and weren't) putting their capital, what would it have told us? Would it have offered up valuable insight to enable investors to discern a wise course of action? Could this information have helped us make decisions that would have been beneficial over the next three, five or ten years? We believe the answer is yes. Obviously there are many influences on the markets, but getting a sense of where the crowd is going, or more importantly where they have been, can assist us in important allocations of capital.

Between April of 1998 and March of 2000, money poured into stock funds at a pace 21 times greater than that of bond funds[1]. Most of that capital found its way into 'new economy' funds focused on stocks that were the apparent engines of the technology and internet revolution, while no one noticed a 10 year US treasury note could be purchased with a coupon of 6.5%. Of course we now know how this story ends, the NASDAQ Composite, which houses many of those companies (or used to before many failed), still sits 50% below its peak of 10 years ago.

What are we seeing take place today? Bond mutual funds took in an estimated $87 billion in the third quarter of 2010, bringing the total new investments in these funds to an astonishing $620 billion since the start of 2009, according to the Investment Company Institute (ICI). Additionally the ICI reported that money market fund balances reached $2.8 trillion in July, or the equivalent of almost two full years of Canadian GDP, in cash on the sidelines. Meanwhile, investors pulled out of U.S. stock funds to the tune of $43 billion in the past three months, bringing total withdrawals to $100 billion since the beginning of 2009. What are these investors seeing in the bond market that continues to look so attractive? Evidently a 10 year US Treasury note that ended September with a 2.51% yield, or the opportunity to get a coupon of 3.68% by loaning their money to the U.S. government for 30 years. More likely this is the same rear-view-mirror investing which has the masses putting money to work based on what has already happened, similar to behavior witnessed 10 years ago.

The purpose of this illustration is not to make a judgment on the short term direction of bond yields and interest rates. We know from past experience that

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these trends can last a lot longer than anyone tends to think – so rates could continue lower for some time. But with bond yields at generational lows and approaching zero for short maturities, it's probably fair to say the trend is in its late stages.

We think these facts do demonstrate something very important though – the investing public's apparent distaste for stocks. This sentiment is understandable as the market averages returned, from start to finish, nothing in the past decade. Yet within that dark cloud there is a silver lining for those who choose to look.

It's a market truism that the best investments are those that have previously performed the worst, where prospects appear uncertain and expectations are low, yet hidden beneath the surface are sustainable characteristics. All we need to do is analyze the seeds of the bond bull market decades ago to find these factors – factors we believe are prevalent in the environment currently surrounding high quality US stocks.

Let's take a quick glance at some valuations of what we would term quality, durable, dividend growers.

Company	Dividend Yield	5 Yr. Dividend Growth	Dividend Paid Since	Fwd Price to Earnings (PE)	Current Discount to S&P 500 (PE)
Johnson & Johnson	3.50%	12.0%	1944	12.2	-12%
Wal-Mart	2.27%	16.0%	1973	12.1	-13%
Intel	3.27%	28.5%	1992	10.1	-27%
Abbott Labs	3.35%	9.0%	1926	11.3	-19%
Chevron	3.52%	11.7%	1970	8.4	-40%
ConocoPhillips	3.80%	16.4%	1982	8.5	-39%
Raytheon	3.30%	9.2%	1964	8.6	-38%
Texas Instruments	1.91%	38.3%	1962	10.6	-24%
Medtronic	2.68%	19.3%	1972	9.2	-34%

What we see in the above table is a sampling of the unique valuation environment for quality assets. Imagine having the opportunity to purchase some of the largest, most well constructed homes in town – in the best neighborhoods – for less than you could buy a home of average quality in any neighborhood. To a great degree that is the landscape in global stock markets today as the most financially sound, durable franchises that consistently reward shareholders with growing cash dividends can be purchased cheaper than the average run of the mill company. Many of these dividend yields are significantly higher than fixed income rates. At quarter's end a 5 year US treasury note yielded 1.26% and that income has no chance of growing, whereas the above companies produce significantly higher rates of current income – and in many cases that income gets larger each and every year. Though equity and bond ownership are not an apples to apples comparison, this kind of discrepancy may ultimately sway many income investors who have the ability to weather the added volatility of stocks in search of enhanced income production.

There is no doubt that the US economy faces a challenging set of circumstances for which there are no quick or easy solutions. But 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. In a market dominated by high frequency trading, flash crashes, 24 hour cable news and the blogosphere that shouts 'buy and hold is dead', it may seem quaint or old fashioned to focus on a long term strategy. But history shows that 'durable' companies that pay growing dividends are exactly what feed long term returns. We would refer to it as 'buy and earn', and that is what we will focus on doing.

It is our belief that the core of every portfolio should maintain exposure to quality, durable, dividend growers at all times, but given what history tells us from observing the 'flow' of funds, and the valuation levels described above, we feel now is a uniquely opportune time to be invested in this area.

Equity Strategy Performance

Though our team has combined experience of over 55 years in the industry, our firm Martin Capital Partners, LLC was just formed this June, marking the quarter that recently ended our first full quarter as a new entity. For the three month period ending September 30th, 2010 our Core Dividend strategy's composite return was +11.83%[2]. The Core Flex strategy returned +10.83%[2]. We always advise investors to take a long cycle view in analyzing performance, but for reference the S&P 500 returned +11.29% in the same time period.

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,

Martin Capital Partners, LLC

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[1] JP Morgan Asset Management

[2] The Core Dividend and Core Flex Composites: Individual portfolio performance may vary, as accounts may include differing weights of the elements of the strategy. Additionally, many portfolios have varying percentages of income producing securities in their portfolios, which are not included in the Core Dividend composite or the Core Flex composite.

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.

Statistical and analytical data provided by Bloomberg Professional and the Investment Company Institute

The market views and opinions expressed above reflect the opinions of Martin Capital Partners, LLC and are not intended to predict or forecast the performance of any security, market, or index mentioned.

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