Quarterly Point of View
FANG Fad

January 19, 2016

Later this year will mark my twentieth in the investment business. It's been an interesting couple of decades to say the least, with two of the stock market's worst bear markets of the last century crammed into a nine year span in the 2000's, preceded and followed by massive bull markets (here's hoping the next twenty years contain more 'boring'). Without a doubt the trailing 20 years has reinforced the way in which our firm manages clients' assets – by focusing on high quality companies that stand the test of time and that pay us durable and growing dividend income in the process. This philosophy has proven successful over the years, and I have little doubt it will continue to produce attractive risk-adjusted returns over the long term, but at times it will not be the 'popular' way to do it. Last year felt like one of those times.

Several factors have played an influential role in shaping the capital markets' environment of the last handful of years, and one of those we've discussed often in prior letters. The Federal Reserve's extended zero interest rate policy (ZIRP) has had the effect of drowning out fundamentals, in our view, and inspiring risk taking in parts of the market not seen since the late 1990's. Yes, the Fed did officially 'end' ZIRP in December by raising its benchmark interest rate (albeit just 25 basis points, or ¼ of 1%) and outlining a plan to lift it gradually over the next several years. Given though, that the Fed had this policy in place for seven years, six of those while Leading Economic Indicators were trending positive, it's easy to see how 'free' money during an economic expansion may have distorted some allocation decisions. In fact, it appears to have reached a point that the concept of valuation has been out-right ditched in certain segments of the market.

Though the major U.S. stock indices finished the year hovered around the 'flat line', that innocuous result belies a highly bifurcated backdrop. To the right is a table illustrating a diverse set of annual returns for major asset classes across the globe last year.

Index / Asset	2015 Performance
S&P500	1.38%
Russell 1000 Value	-3.83%
Oil	-45.97%
Dow Jones Dividend	-1.64%
Value Line Composite	-11.24%
NASDAQ Composite	6.96%
Energy MLP	-32.59%
Emerging Markets	-14.60%
FANG Stocks	83.20%
US Long Bond	-1.17%
Russell 2000	-4.41%
Russell 1000 Growth	5.67%
Gold	-10.67%
S&P International Dividend	-15.67%
Berkshire (Buffett)	-12.48%
International Stocks	-5.66%

Probably the most garish example of the bifurcated nature of this market is the performance of what has been termed the FANG stocks, and the impact they had on the indices we all watch and the media reports on every minute. FANG is an acronym for Facebook, Amazon, Netflix and Google (Google re-named itself Alphabet in 2015). These four stocks collectively produced an average return of 83.2% last year. What's important to understand is that these four stocks

940 Willamette Street ▲ The Woolworth Building, Suite 350 ▲ Eugene, OR 97401
tel 541.636.4170 ▲ fax 541.636.4815 ▲ www.martincp.com

affected the returns of some major indices in a dramatic fashion, as they account for a significant weighting of the S&P500, NASDAQ and Russell1000 Growth Indices. Most Indices, including these three, are capitalization weighted groups, meaning the larger the company's total value, the larger the portion of the index. The combined market capitalization of these four companies was $1.18 Trillion at year end – yes, *trillion*. To put that size in perspective we can think of it this way; those four stocks are valued more than all publicly traded companies in Italy, Ireland, Norway, Portugal, Argentina and New Zealand – combined. Or, from a slightly different angle, their value is equal in size to almost twice the entire S&P Small Cap 600 Index, or ¾ of the entire German stock market, one of the world's largest!

Examining the S&P500, FANG accounted for a weighting over 5% by year end, the NASDAQ a 14.43% weight, and the Russell1000 Growth at 9.93%. Looking at average weightings through the course of 2015, it can be calculated that FANG accounted for almost a 3% return contribution to the S&P500, approaching 8% for the NASDAQ, and nearly 5% for the Russell1000 Growth. In other words, dropping just those *four* stocks, returns for even the most 'popular' groups would have made them 'unpopular'.

The stocks that make up FANG may very well be good companies, but that doesn't mean they are good investments, and one thing they are not is reasonably valued. Giving them the benefit of the doubt by looking at forward price to earnings ratios; Facebook trades at a P/E of 39x, Amazon 143x, Netflix 618x and Google/Alphabet 24x. The cheapest of these is a 46% premium to the market average, while the most expensive is 38 times the average level. Though investors are focused on the 'return' side of 'risk/return' right now given their exuberant price action, there is more risk imbedded there than many probably realize.

Why does this matter? Investors, both institutional and private – all of us – have a tendency to fall into a 'benchmark trap'. A benchmark trap involves comparing ourselves to a basket of stocks (an index) that, in many cases, is arbitrary and may contain a higher level of risk than we would be comfortable taking, particularly if the structural facts were understood. The benchmark trap can also tempt investors away from time-tested strategies by the lure of better recent results, inadvertently leading to the acceptance of more risk. History has been very clear; buying over-valued securities can cause deep and irreparable harm, and unlike losses related to near term issues that face all companies periodically, purchasing stocks at grossly inflated prices can lead to permanent impairment of investor capital.

To understand the risk, it may be helpful to look at an illustration using Amazon, courtesy of Patrick O'Shaughnessy, CFA of O'Shaughnessy Asset Management[1]. As of October 31st, 2015, Amazon had a market capitalization of $293 billion and its one year earnings were $328 million. If we assumed they were to double their market cap in 10 years, in other words 7% annual growth (which is probably well beneath most of their investors' expectations), it would have nearly a $600 billion market value. If we were then to assume that the company ended that 10 years with a P/E of 22x (still a substantial premium to the average stock historically), it would mean that Amazon would have to grow its earnings at 55% - *PER YEAR* - for the next decade. Based on market data to 1973, only 0.28% of companies have ever been able to do that, and most, if not all, had the benefit of starting from a much smaller base. Could Amazon be the next company to pull off that growth feat? It's possible. Based on historical data however, the odds of it happening are about 9 times worse than hitting a random number in roulette. Either way, it's a sobering thought for those investing in high multiple stocks like the FANGs, or for those over-obsessing about their 'success or failure' in the market by comparing returns with baskets of stocks containing heavy doses of juiced up securities.

History Lesson

Company	Symbol	P/E Ratio March, 2000	Return from March 31, 2000 through 2015
Yahoo	YHOO	623	-64%
Oracle	ORCL	153	-9%
EMC	EMC	115	-62%
AOL Time Warner	TWX	217	-51%
Cisco Systems	CSCO	148	-65%
		251	**-50%**

Gazing back at the turn of the century, we can revisit some stocks and see a bit of a history lesson on how hard it is to produce good returns from elevated valuations. Please keep in mind the list to the left is a

940 Willamette Street ▲ The Woolworth Building, Suite 350 ▲ Eugene, OR 97401
tel 541.636.4170 ▲ fax 541.636.4815 ▲ www.martincp.com

sample of some of the 'survivors', as this letter does not have enough room to list all of the 100% capital impairments. i.e. all those companies that bit the dust. Sixteen years is a long time to be given an opportunity to 'earn' a way out of a high valuation, and it's still nearly impossible.

The point here is not to disparage the FANG stocks, or any other highly prized company. In fact, it isn't their fault investors have bid up valuations to unsustainable levels, it's merely a reflection of the success they've had to date in some way or another. The point is, due to the math of compounding, large losses have a disproportionate effect on long term cumulative returns. Part of our job is, and should be, trying to avoid this math by de-emphasizing near-term results, which can lead to inadvertently accepting additional risk in attempts to keep up with near term index results. I'll finish with one of my favorite comments on this subject, one that I have referenced in the past and will no doubt reference again. It's from Howard Marks, the billionaire co-founder of Oaktree Capital who sums it up clearly (emphasis mine):

> *The road to long-term investment success runs through risk control more than through aggressiveness, over a full career, most* ***investors results will be determined more by how many losers they have, and how bad they are, than by the greatness of their winners****. Skillful risk control is the mark of the superior investor…. Rather than just trying to do the right thing, the defensive investor places a heavy emphasis on not doing the wrong thing. Because* ***ensuring the ability to survive under adverse circumstances is incompatible with maximizing returns in good times****, investors must decide what balance to strike between the two.*[2]

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. Patrick O'Shaughnessy, CFA, O'Shaughnessy Asset Management: The Investor's Field Guide, November 2015.
2. Howard Marks, Oaktree Capital Management: The Most Important Thing, 2011.

Statistical and analytical data provided by Thomson Reuters Datastream, Eikon & Baseline.

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.

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.

940 Willamette Street ▲ The Woolworth Building, Suite 350 ▲ Eugene, OR 97401
tel 541.636.4170 ▲ fax 541.636.4815 ▲ www.martincp.com