Martin Capital Partners

Quarterly Point of View
Bridging Rough Water

January 12, 2012

Concerns about the spreading euro zone debt crisis, the downgrade of the USA's credit rating by Standard and Poor's and the partisan divide in Congress that took the country to the brink of default led the distressing headlines in 2011. As if that weren't enough, throw in a devastating earthquake that triggered a tsunami and ultimately a nuclear crisis in Japan, couple it with worries of a U.S. recession and then add a $41 billion bankruptcy of a wall street firm led by a former governor and US Senator and it made for one of the most volatile years for the stock market on record. Illustrating this volatility, the S&P closed up or down 2% or more on 35 days in 2011, 59% more than 2010. In contrast the market had zero days in 2005 with moves that size and only two in 2006. Further, the volatile movements were in mass – there were 69 days in the year in which 90% of SP500 stocks moved in the same direction – more than the combined totals from the ultra-volatile years of 2008 and 2009[1]. Despite all of this exercise the SP500 ended the year flat on price and up just over 2% with dividends included.

In light of the market's chicanery, rarely has it been more reassuring to have a long term, income producing and income growing strategy in place. In the midst of these tumultuous times – as always, dividends transmit corporate profits directly into our wallets, circumventing the daily unpredictability of stock prices to provide the tangible foundation of total return. Capital appreciation with stocks is inconsistent when viewed in short and intermediate time frames, but dividends paid in cash at regular intervals by firms that have the ability to grow those dividends help bridge this inconsistency, thereby assisting investors in meeting real world needs and goals.

Martin Capital Partners Core Dividend Strategy - where we focus on identifying financially strong enterprises with durable and growing dividend income - was a beneficiary of investor's desire for quality and income amidst the volatility last year. The composite return for our strategy was +11.53% in 2011, propelled by an average strategy dividend yield near 4% and annualized portfolio income growth that exceeded 10%. It is our belief that durable dividends - those highly likely to be sustained by corporations even during difficult economic times – with the ability to grow, ultimately act as the long term engine of investment returns. Analyzing the current landscape gives us a level of optimism that a constructive environment for high quality dividend growth shares is still in its early phases when viewed tactically. In other words, it's our opinion that these kinds of companies consistently provide a strategic foundation to any investment plan, but appear to exhibit tailwinds that may offer relative support versus other investment strategies in the intermediate term as well.

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First, dividend payments have been growing and this growth looks to continue. Companies within the SP500 paid dividends of $245 billion in 2011, a 16% increase from the $211 billion paid in 2010, yet still down from the all time peak of $255 billion in 2008[2]. It is remarkable that total dividends are only 4% from all time highs given the sector most responsible for overall dividend contributions last decade, the Financials sector, still pays 64% less than its apex - and that's after bumping payments up 38% in 2011. Despite rapid growth of payments year over year, payout ratios (the percentage of earnings paid to shareholders in dividends) remain near all time lows. In the third quarter companies paid out just 26% of their earnings in the form of dividends as they have undoubtedly been slow to part with cash reserves due to global economic uncertainty. Given the absurdly low levels of interest on already high levels of cash holdings, corporate management will likely come under increasing pressure to distribute a greater share of profits to shareowners rather than bank them. Additionally, a moderate economic recovery should allow for gradual profit growth, and when paired with low payout ratios, it is likely that dividends will grow faster than profits. These factors may help maintain emphasis on companies that diligently share their profits with investors through cash dividends.

Second, investors are searching for diversified sources of income. Uncertainties over economic growth and Federal Reserve actions have assisted in pushing interest rates to generational lows. Short term bonds pay almost nothing – forcing investors to extend maturities farther out on the yield curve in search of relatively higher coupons. But there is risk with this strategy if interest rates rise. Higher interest rates reduce the value of existing bonds and the longer the bond's maturity, the greater the damage. For example, from the start of 2012, a one percentage point increase in yield this quarter on a current 30 year Treasury would reduce its value by 17.3%. In addition many high quality stocks with long and reliable histories presently sport dividend yields higher than their own corporate bond yields, a very exceptional situation. A few examples include Johnson & Johnson with a dividend yield of 3.5% and a 10 year bond yield of just 2.23%, Intel 3.3% on the dividend versus 2.66% on its bond of the same length and Verizon with a current dividend yield of 5.21% - almost 70% higher - than its ten year note of 3.1%. Typically the reverse is true because the most a bond held to maturity will ever give an investor is its fixed return; it should offer a higher immediate yield than a stock, which can also offer the promise of rising dividend payments and capital appreciation. The market producing this condition speaks to the extreme lows in sentiment for stocks, presenting an opportunity for equity investors in general and specifically for those looking for sources of income outside of the corporate and government bond markets.

Finally, despite strong relative performance in recent years the market still may not fully appreciate that demographic forces are likely to remain highly supportive for durable dividend producers over an extended time frame, particularly in light of uneven economic growth and very low interest rates. As we cited in our letter one year ago, there are 10,000 people per day celebrating their 65th birthday in this country, and that will continue for nearly 20 years. According to a study by Kohlberg Kravis Roberts &

Co. entitled a *Brave New World*, the average retired investor has an equity portfolio with a dividend yield of 2.8%, or almost 90% higher than that of a pre-retiree's 1.5% yielding equity investment portfolio. This group will continue to become an ever increasing percentage of our population and as they retire and subsequently seek more income, there will be a tremendous secular force offering support for this particular investment theme.

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: Wall Street Journal 1/3/12
2: Bloomberg Professional

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.

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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