MARTIN
CAPITAL MANAGEMENT, LLC
Registered Investment Advisor

QUARTERLY
CAPITAL MARKETS REVIEW

July 2015

The Forest *and* the Trees

Since the current and second-longest ever largely uninterrupted upswing in the S&P 500—dating all the way back to March 9, 2009—turned north with a vengeance in November 2012, it did not dip below the 200-day moving average line (the average price for the preceding 12 months) for almost two years. From trough to its September 2014 peak the index gained another 50%, bringing the grand total percentage gain from inception to 300%. Although largely unnoticed because of the headline distractions in Greece and, more recently, China, the S&P apparently has met a wall of resistance, barely eking out a 1.5% gain in the last eight months. Such bulls as Dave Rosenberg, whose economic analysis we respect and to whom we often refer, see such breathers as the pause that refreshes. It quite possibly is.

In like vein, technical indicators (e.g., "market breath") are signaling that the Shanghai Stock Exchange Composite is poised for a rebound—a reprieve from the recent spate of incessant selling. It has not escaped most observers that the 30% decline is that market's worst five-week nosedive since 2008. But what is really at issue in China, metaphorically the forest, is whether the politically engineered bull market can be saved by those same authorities as euphoria gives way to its opposite, and the speculative igniter of greed is displaced by the paralysis of fear. While valuation carries little weight in the short run, it is somewhat alarming to note that the median price-to-earnings in China is 57, by far the highest among the world's major markets, with the S&P and Hong Kong coming in second and third at 19 and 13, respectively.

And so it is with Greece. At least that's what today's headlines say. But the trees of compromise might well obscure the view of a forest of a troubled past that could cast a pall on the future. Since regaining its independence in 1830, Greece's dire political record has been marked by three top-level assassinations, two uprisings, the deposition of three kings, three *coups d'état*, five military conflicts, occupation by the Nazis and subsequent civil war. Despite the multi-day celebrations in stock markets around the world, the leap of faith across that chasm to durable stability stretches the limits of credulity.

Regarding the U.S. markets, our primary concern is that, in all of our poring over periodicals in recent months, researching a subject about which you will read more in a forthcoming publication, not a single source opined on the probability—near-term or long-term—of a secular bear market in U.S., or even global equities, for that matter. A number made vague allusions to a possible future decline in stock prices, but their vacant references removed any sense of impending danger. Such indifference is indigenous to the kind of rationalization that gives rise to the great market cycles. Keynes called it *convention*:

> In practice we have tacitly agreed, as a rule, to fall back on what is, in truth, a convention. The essence of this convention—though it does not, of course, work out quite so simply—lies in assuming that the existing state of affairs will continue indefinitely … This does not mean that we really believe that the existing state of affairs will continue indefinitely. We know from extensive experience that this is most unlikely.[1]

For Bob Shiller, an admirer of Keynes, it is *psychological ambience*:

> During bubbles, it seems that the psychological ambience is rather one of public inattention to the thought that prices could fall, rather than firm belief that they can never fall. The new era stories are not new strongly held convictions—they are merely ideas foremost in people's minds that serve as justification both for the actions of others and of themselves.[2]

Another force acting on us as individuals is the power of *social pressure*, often manifesting itself as anxiety or distress originating with the apprehension about being seen as different or foolish before the group. Such pressure can sway our individual judgment. On a less emotional plane, investors often conclude that the many simply cannot be wrong. They react more to the information that a significantly large group has reached a judgment different from theirs, than merely the fear of expressing a contrary opinion. Whatever the reason, it seems people are ready to believe the majority view or believe authorities even when they plainly contradict the individual's matter-of-fact judgment.

Firing a shot across the bow of the proponents of market efficiency, Shiller contends:

> The popular notion that the level of market prices is the outcome of a sort of vote by all investors about the true value of the market is just plain wrong. Hardly anyone is really voting. Instead people are rationally choosing not to, as they see it, waste their time and effort in exercising their judgment about the market, and thus choosing not to exert any independent impact on the market. Ultimately, all such information cascade theories are theories of the failure of information about true fundamental value to be disseminated and evaluated.[3]

Our conclusion from studying the seven secular bull and bear markets since 1900 (see chart/table below) in the context of the above is that, on the eve of the change from one to the next, virtually everyone was clueless. Since the great market movements tend to go to extremes (lesser movements do not earn the right to be called great), those who call for a change in direction are invariably premature. Most eventually lose credibility and, with it, self-confidence. Those who were skeptical at first seemingly fall into ranks as the markets move relentlessly to prove their skepticism unwarranted time and again. As markets rise to extremes in valuation and investor psychology, focus increasingly turns to short-term performance at the very time—or so history would suggest—when the imperative logically should be the opposite.

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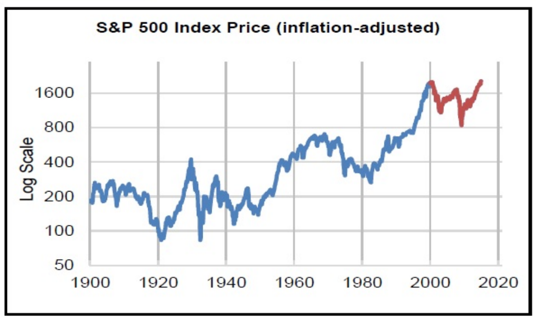
[1] Keynes, John Maynard (2007-10-11). *The General Theory of Employment, Interest and Money* (Kindle Location 2342).

[2] Shiller, Robert J. (2015-01-25). *Irrational Exuberance* (p. XIV). Princeton University Press.
Ibid., p. 178.

[3] 2014 MCM annual report; April 15, 2015 speech at the Ivey Value Investor Conference in Toronto

During downward extremes, the powerful emotion of fear trumps otherwise more or less rational thought. Perhaps the most egregious copout by the purveyors of investment advice is the contention that bear markets cannot be predicted as the principal reason for doing nothing. It should be remembered, however, that they are not "doing nothing" in isolation, but rather, together. The herding instinct is rooted in the primal urge for self-survival. As Keynes pragmatically observed: "It is better to fail conventionally than to succeed unconventionally."

2000-2014



Time Span	Shiller P/E Beginning	Shiller P/E End	Annualized Rate of Change in Shiller P/E	+	Annualized Rate of Change in Shiller EPS	=	S&P 500 Real Annualized Return Capital Appreciation	+	Dividend Return	=	Total Return
1900-1921	18.5	6.1	(4.9%)		2.4%		(2.6%)		5.3%		***2.6%***
1922-1929	6.1	32.6	24.1%		(2.8%)		20.6%		6.2%		***26.9%***
1930-1949	22.0	10.5	(3.6%)		0.8%		(2.8%)		5.6%		***2.7%***
1950-1965	10.5	23.7	5.2%		3.8%		9.2%		4.7%		***13.9%***
1966-1981	23.7	7.8	(6.7%)		2.0%		(4.8%)		3.8%		***(1.0%)***
1982-1999	7.8	44.2	10.1%		0.7%		10.9%		3.5%		***14.4%***
2000-2014*	**44.2**	**26.8**	**(3.3%)**		**3.6%**		**0.2%**		**1.9%**		**2.0%**

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**Not necessarily indicative of low tide, but simply the latest date for which data is available*

26

Chart/table from April 15, 2015 Ivey Value Investors Conference speech transcript

As is no surprise to our regular readers, our focus is on what really matters to the long-term investor: the metaphorical forest. As we find ourselves better equipped to hedge away that kind of risk, we can more freely venture among the trees in search of opportunity.

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July 2015
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Second-Quarter 2015 Portfolio Review

	MCM Total Account Composite (net of fees)	S&P 500
2nd Qtr 2015	-0.3%	0.3%
YTD 2015	-2.3%	1.2%
Since Inception *	4.7%	4.2%

* Annualized, Inception Date 1/1/2000

Martin Capital Management's Total Account Composite declined 2.27% in the second quarter of 2015, while the S&P Index returned a flattish 1.23%. Overall, the equities in our portfolio declined 0.81%. The table below shows the portfolio's quarterly gainers and losers. While some of the companies we highlighted last quarter appreciated this quarter, their appreciation was more than offset by declines in some of large and longstanding holdings.

Company	Model† Position Size	Q2 Price Change††
Berkshire Hathaway Inc	4.9%	-5.7%
Gentex Corp	4.9%	-10.3%
Travelers Cos Inc	3.0%	-10.6%
Wal-Mart Stores Inc	2.9%	-13.8%
Garmin Ltd	2.8%	-7.6%
Amgen Inc	2.5%	-4.0%
Baker Hughes Inc	2.3%	-3.0%
Helmerich and Payne Inc	2.3%	3.5%
Rosetta Resources Inc	2.3%	36.0%
Stryker Corp	2.0%	3.6%
AbbVie Inc	1.6%	14.8%
Civeo Corp	1.5%	20.9%
Colfax Corp	1.0%	-3.3%
Rayonier Advanced Materials Inc	0.8%	9.1%

++ Price Change reflects only the market price difference from the beginning of the quarter to quarter end. It does not include dividends and interest.

• The MCM Total Account Composite consists of all portfolios (or consolidated portfolios) with assets greater than $1 Million held in fully discretionary fee-paying accounts whose owners have given MCM the authority to invest up to 100% of the account in equities. MCM notes that one of the accounts in the composite has a large portion of assets invested in a non-earning asset. Due to the relatively low yields currently earned on U.S. Treasuries, this asset has a negligible impact on overall composite performance.

• The MCM Total Account Composite is managed in accordance with our Model Portfolio. The Model Portfolio is a representation of fully discretionary accounts positioned to conform to our ideal investment process. The primary investment objective for both the Total Account Composite and Model Portfolio is above average long-term growth in capital through a combination of capital appreciation and income, at below-average risk of permanent capital loss.

• Performance is shown Net-of-Fees. Assets are shown in US Dollars. ***PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS.***

• The MCM Total Account Composite performance is compared to the S&P 500 Index. The S&P 500 Index consists of 500 stocks chosen for market size, liquidity and industry group representation. It is a market value weighted index with each stock's weight in the index proportionate to its market value. The reported returns reflect a total return for each year inclusive of dividends but exclusive of taxes and management fees.

Equity Updates

During the second quarter, there were developments at two of our portfolio companies worth mentioning. The first was Noble Energy's announcement of its intention to acquire Rosetta Resources. The second was Abbvie completing its acquisition of Pharmacyclics.

Rosetta Resources (ROSE) — Noble Energy (NBL)

On May 11, 2015, Rosetta Resources (ROSE) announced its acquisition by Noble Energy (NBL), valued upon announcement at $2.1 billion, plus the assumption of Rosetta's net debt of $1.8 billion. Noble expects the deal to be immediately accretive to its production, reserves, earnings, and cash flow. Rosetta shareholders will receive 0.542 shares of Noble for each share of Rosetta. Based on Noble's trading price at the close of trading May 8 ($49.12), the deal implied a value of $26.62 per share for Rosetta on that date, a nearly 30% premium to its average price in the 30 previous trading days. ROSE shareholders will own nearly 10% of Noble Energy. The acquisition of Rosetta Resources is expected to close in the third quarter. Noble Energy currently trades at 12x 2014 earnings. At approximately 4.5x cash flow, it is near 10-year trough valuations on that metric. It briefly reached 3x cash flow during the 2008-2009 financial crisis. Over the past 15 years (2000-2014) Noble Energy has compounded proved reserves at 9% per annum, production at 10%, and its market capitalization at 13%. We are still deepening our knowledge of Noble Energy and our current intent is to hold the shares of Noble Energy we will receive.

As a reminder, Rosetta holds premier acreage in the Eagle Ford Shale (South Texas), as well as recently acquired acreage in the Permian (West Texas). Unlike Rosetta, which operates two resource plays in Texas, Noble Energy operates internationally. Pro-forma, Noble Energy will have ~82% of production coming from four geographic areas. In order of greatest to least, those four regions are: DJ Basin (Colorado), West Africa, Marcellus (Pennsylvania), and the Eagle Ford (Texas). Noble will also receive production from the Eastern Mediterranean (coastal Israel), the Gulf of Mexico, the Permian (Texas), and others. The picture changes slightly when looking at pro-forma proved reserves. The potentially prolific discovery off Israel's coast is second in proved reserves at Noble, behind DJ Basin, and ahead of the Marcellus and Eagle Ford. Israel already receives half of its natural gas needs from the play off its coast. However, the size of the resource field being developed by Noble Energy and partners is believed to be far larger than Israel's own internal energy needs. The potential export of those excess natural gas reserves to others within the region is a matter of great interest to Israel. While international exploration adds risk to the shares, it may also arguably provide upside optionality.

In our early impression, the culture at Noble Energy strikes us as a positive as well. Noble Energy management seems committed to maintaining its investment-grade balance sheet, focused on value creation over the long-term, and a desire to only focus on the development of reserves that will be significant to the company. Over the past five years, they divested approximately $2.5 billion in non-core assets. Noble Energy also appears to have a focus on efficiency, continual improvement, and sharing operational knowledge across its resource plays.

Abbvie (ABBV)

Abbvie (ABBV), with a market capitalization of approximately $110 billion, closed on its ~$20 billion acquisition of Pharmacyclics (PCYC) on May 26. The deal which was announced in early March is expected to increase ABBV's presence in hematological oncology. But at what cost? PCYC earned $86M in profit or $1.10/share on $730M in sales in FY 2014. While the company and its markets are certainly growing, ABBV paid a rich price. The deal valued PCYC at over 25x sales and over 235x its 2014 earnings. Given the high price that was paid, management doesn't expect the purchase to payoff until 2019.

The medicinal markets are known for "blockbuster" drugs. The process of realizing breakthroughs in medicine is an uncertain one, and ultimately a race to patent the new product. Knowing which company will win or which drug will prove successful is a difficult task. Consequently acquisitions are often made in this space in an attempt to strengthen technological capabilities, and that reasoning is not unfounded. However, it is unreasonable if management is willing to pay whatever price necessary. The level of uncertainty should be reflected in the price one is willing to pay. Given the price ABBV was willing to pay for PCYC, our assessment of ABBV management in the time since they were spun-out of Abbott Laboratories is they don't fit the typical mold we look for in a management team: conservative, operationally-focused, and shareholder-friendly. Consequently, should the price of ABBV reach levels we deem to be too rich for a business with inherent uncertainty run by an aggressive management willing to pay high prices for acquisitions, we will look to exit our position in ABBV.

Website Information

www.mcmadvisors.com

- For additional periodic updates on both investment research and portfolio activity, visit the client section of our website at www.mcmadvisors.com.
- To log in, please enter either your email address (if on file at MCM) or your Fidelity account number into the Username box and MCM into the Password box.
- We recommend you change your password once you've accessed the client site. Passwords using combinations of upper-case and lower-case letters, as well as numbers, offer more security than simple names or numbers alone. Should you have any questions, or any suggestions as to how we can make the website more useful to you, please don't hesitate to contact us.
- If you would prefer to receive the MCM Quarterly Capital Markets Review in hardcopy format by regular mail, please call or email Kristen Smith-Myers (574-293-2077; kristen@mcmadvisors.com) and she will make the necessary arrangements.
- We'd love to hear your comments on this, or any other, communication from Martin Capital Management. Please call or email Frank Martin (574-293-2077; frank@mcmadvisors.com).
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