MARTIN INVESTMENT MANAGEMENT, LLC
1560 SHERMAN AVENUE SUITE 1250
EVANSTON, ILLINOIS 60201

PATRICK A. MARTIN, CFA **(847) 424-9124**
SANDRA STASKON MARTIN **FAX (847) 424-9182**
MARY ELLEN MARTIN ZELLERBACH

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Taking a Long View of Intrinsically Valued Companies

Corporations are benefitting from top line growth and little wage cost pressure. Martin Investment Management, LLC expects that the positive earnings backdrop will continue to drive stock prices higher this year in absolute terms, even if Congress fails to enact any legislation. On a four-quarter moving total basis, the earnings-per-share (EPS) of the S&P 500 Index was up by more than 13% in the first quarter of 2017 with 84% of companies reporting. After three years of flat earnings for the S&P 500 Index, Strategas Research Partners, LLC is estimating earnings of $123.75 for 2017, up 4.7% year over year from 2016. In particular, large and mid-capitalization companies are exhibiting strong upward earnings revisions and attractive valuations relative to their companies' respective sector. U.S. EPS is above the Eurozone and Japan, but the projected acceleration in EPS growth is equally impressive in the Eurozone and Japan. With little help from fiscal or regulatory policy globally, corporate profit growth has accelerated in the world's major markets and is the reason for the gains in the equity markets. The S&P 500 Index increased 3.09% on a total return basis for the second quarter of 2017 and 9.34% on a total return basis for the first six months of 2017. The MSCI EAFE Index (USD Net) increased 6.12% for the second quarter of 2017, and 13.81% for the first six months of 2017.

The recent Federal Reserve Open Market Committee (FOMC) looked beyond the recent soft economic data and lower inflation (dropping from 2.2% in February to 1.9% in April) and raised interest rates by 25bps in June. The Federal Reserve remains committed to increasing rates and scaling back its reinvestment program of maturing Treasuries and mortgage back securities (MBS) portfolio by the end of 2017. While the Federal Reserve recently increased its U.S. growth forecast for 2017 to 2.2% from 2.1%, it pared down its core personal consumption expenditures (PCE) deflator forecast for 2017 by 0.3 percentage points to 1.6%. Judging inflation remains challenging and presents its own conundrum as price deflation such as in apparel costs varies greatly from the persistently stable to rising inflation dynamics in services.[1]

If unwinding the balance sheet leads to increased volatility and a tightening across financial markets, the Federal Reserve is expected to proceed more slowly on rate hikes. The U.S. housing bubble bursting in 2008 spread deflation risk globally, but also helped create a solution of widespread quantitative easing (QE). Although quantitative easing was considered "unconventional" monetary policy, this policy spread around the world. In a

world of QE, deflation should no longer occur. It may take a very large amount of QE for a very long time, but a limitless commitment to QE should stabilize the price levels. Japan has been a key test case for this thesis. Given that foreign central banks are adhering to a looser monetary policy than the gradual course change occurring in the U.S., the dollar may continue to rise across other currencies as the U.S. interest rates continue to climb.

Capital investment expenditures in business remain an important element for productivity growth. The U.S. has reached an inflection point where weak productivity growth is starting to push up both the neutral real rate and inflation. Productivity growth is largely a function of technological change. If productivity growth has slowed with waning gains from the internet revolution and still uncertainty surrounding virtual reality and artificial intelligence, it is likely that the pace of technological innovation has also diminished. Peter Berezin, Chief Global Strategist for BCA Global Investment Strategy Service, commented recently as much as Facebook and Instagram are revolutionary in connecting people, they do little to boost business productivity growth and may even detract from it as people spend increased time on social media. Recent technological innovations have tended to be more of the labor saving than capital saving variety, such as electrification.[2]

Companies such as Google, Apple, and Amazon have thrived from globalization without having to undertake massive amounts of capital spending leaving them with billions of dollars in cash on their balance sheets. Technological advances have facilitated the emergence of “winner take all” industries where scale and network effects allow just a few companies to rule the roost. Such market structures exacerbate income inequality by shifting wealth into the hands of a few successful entrepreneurs and business executives. The birth of new firms in the U.S. has fallen by half since the late 1970s and is now barely above the death rate of companies. Educational achievement of a secondary or higher degree is increasing at half the pace it did in the 1990s globally while the average level of global mathematical proficiency is now declining for the first time in modern history.[3]

“Winner take all” presently applies to the investment industry as well. Since 2008, there has been a widening imbalance of money inflows ($3 trillion) into passive versus active investing. The ascent of passive indexing, particularly through exchange traded funds (ETFs), is having the side effect of altering the financial markets core economic function to allocate capital efficiently. Two firms, BlackRock and The Vanguard Group, have been the major recipients of inflows to their ETF strategies, increasing over $14 billion each in May of 2017 in new net asset flows.[4] Five stocks, Apple, Google, Microsoft, Amazon, and Facebook, represent 42% of the NASDAQ Index and 13% of the S&P 500 Index. This means that if one buys an index based on the NASDAQ, 42% of one’s money is invested in only five stocks, leaving 58% for the remaining 95 stocks. Passive market index investing creates an environment in which badly managed

companies' stock prices rise along with those of well managed companies. ETFs comprised of illiquid products may quickly begin trading below actual net asset values (NAV) when they sell.[5] Although the number, types, uses, and users of ETFs have grown substantially over the years, only approximately 6.7% of equity based ETFs are in actively managed strategies.[6]

Warren Buffet commented that when the "favorite holding period is forever," it is easier to take advantage of market inefficiencies, even if they are fleeting and less frequent.[7] Professor Jeremy Siegel of the Wharton School has studied the very long-term performance of U.S. equities. Since 1802, U.S. stocks have had real inflation adjusted returns of 6.7%, far more than bonds (3.5%), Treasury bills (2.6%), gold (0.5%), and the dollar (-1.4%). Siegel stated even a price earnings (P/E) ratio of 20 would predict 5% real returns and 7% nominal returns, which are well above those of bonds.[8] Historically, stocks have posted positive calendar year returns 74% of the time from 1926 through 2016. Several new publications support Buffet, Siegel, and Martin Investment Management LLC's philosophy of investing for the long-term in the equity markets. Our firm differentiates its philosophy by investing in a focused portfolio of quality businesses, which we believe are intrinsically valued for future stockholder returns.

Security Analysis, the classic value-investing text by Graham and Dodd (1934), advocates a comprehensive approach to buying stocks trading at a significant discount to intrinsic value, specifically avoiding a formulaic approach to choosing equities. Presently, the term "value investing" is often used differently based on simple ratios of accounting numbers to stock prices, such as low price earnings (P/E) ratios. Kok, Ribando, and Sloan found that mechanical formulaic strategies, unlike Graham's and Dodd's comprehensive approach, failed to produce meaningful outperformance from 1982 to 2015. They found that an approach involving a comprehensive study of a company's intrinsic value is more successful in identifying temporarily underpriced securities. Our firm uses a comprehensive approach, based on fundamentals, for valuing the equities in our portfolio.[9]

According to Willis Towers Watson's Thinking Ahead Institute, long-term investors may earn as much as 1.5% in additional returns annually. Among the return opportunities cited in the report was the well documented illiquidity premium, which is the compensation investors earn by locking up capital. A long-term approach also includes fewer trading and settlement costs, resulting in "significant savings" on transaction costs. The result of increased corporate engagement and ownership of long-term investors has led to higher returns. Long-term investors can profit at the expense of short term investors, who might sell assets below "fair value" in exchange for liquidity during times of market stress.[10]

Martijn Cremers, the co-developer of the concept of Active Share, believes that active management should be judged from the framework of a manager's skill, conviction, and opportunity. Cremers uses duration as a proxy for a manager's investment conviction on the basis that long holding period strategies require stronger conviction because they are riskier for the manager to pursue and harder to replicate. The increased risk is created by the possibility that a long-term profitable strategy may underperform in the short-term and cause investors to redeem their fund shares. Only active stock pickers with strong, long-term conviction are successful. To quantify this finding, the study found in portfolios where both Active Share and holding durations are in the top quartile, alpha (return above the benchmark) is 1.94% a year. By contrast, if holding duration is in the bottom quartile, alpha is -1.15%.[11] Martin Investment Management, LLC is committed to holding a focused portfolio of equities for a full market cycle, which increases the opportunity for long-term capital appreciation.

Wishing you a wonderful summer!

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11. "Active Share and the Three Pillars of Active Management: Skill, Conviction, and Opportunity," Martijn Cremers. in *Financial Analysts Journal*, Volume 73 Number 2, Second Quarter 2017 Page 61.

Note:

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