24 Months in the Desert.

At one point in August the S&P 500 erased more than 12 months of gains in a mere 4 trading days. The Dow Jones Industrial Average lost nearly 24 month's progress in the same period. We walked for years in the desert and then came over the top of a dune to see our own footprints again. Equity investing—it's like the legend of *Zerzura*, and we need to brush up on finding an oasis.

At the Sankala Group we generally price our positions four times per year. Pricing positions is different than valuing them. The difference between the two is akin to a mirage versus a real oasis. When we price, we record a brief picture affected by the angle of the sun and the atmosphere. That picture might even be materially different by the time you open the email that contains it. When we value, we look at a map of where water actually is in the desert. We discount what people think they see on the horizon, and discuss the resources we know are there from past history. This map is enduring and practical, and I'm going to give you a copy after we talk about *Zerzura*, the mythical city in the sand.

Exactly 24 months ago, I wrote a letter titled *Lemonade Stand Logic*. That letter discussed weak sales growth in the S&P 500, and the fact that corporate share buybacks were leading to earnings-per-share growth without growth in the total dollars earned by those 500 companies. That phenomenon, which I called the "buyback mirage," is a trick of corporate finance that can make an enterprise look healthier than it actually is. You can think of total dollars earned like fresh water in an oasis. Buybacks, when executed at bad prices, are more like a Bedoiun pouring your remaining water into a sandy hole then asking how they look in a swimsuit. Many of the buybacks executed over the last 24 months are turning out to be this type of shimmera.

Our lead camel in the search for water is the S&P 500. As you know, its knees buckled about 7.5% recently, leaving us with two choices. We can either argue about the straw that broke the camel's back, or we can talk about the proximity of the closest water. The argument over the straw that broke the camel's back is called *technical analysis*, or chart reading. The discussion about the proximity of water is called *fundamental analysis*—it's what you do when you're thirsty and serious about finding water.

The prevailing rationale since 2012 has been that U.S. stocks are the least-ugly option among low-yielding bonds, zero-yielding cash, and outright falling commodity prices. That rationale is under pressure because the S&P 500 is expected to make $111.55 per share in operating earnings for 2015, **down** from $113.01 in 2014. Sales in the first half **declined** 3% from $572 last year to an estimated $555 this year.[i] For an oasis, the difference between rising water and falling water is critically important. The water is now falling.

We expect these things to ebb and flow naturally, but this time around we have more reason to be vigilant because the price of large U.S. companies remains high relative to history. For ease of arithmetic, let's look at *reported earnings*. Conveniently, it is right around ~$100 per share for the S&P over the last 12 months. When the S&P peaked at ~$2100 per share that means it was trading for 21 times reported earnings. When it hit the recent low in this correction at ~$1870 it was still trading at nearly 19 times earnings. The historical average going back to the 70's is ~16 times earnings. To put that in more usable terms, the current range implies between a 4.8% and 5.3% return on our equity dollars, pre-tax, with static earnings. That compares to 6.3% we should see at normal valuations. Of that, we now expect 2.1% to be paid directly to us in the form of dividends, versus 3.1% over the historical period.

In an environment where earnings are growing faster than normal, paying 19x or even 21x could make some sense. If people are finding water everywhere, it makes sense to push a bit further into the desert. Unfortunately, earnings are not growing faster than normal. They are not even growing at normal rates. They are shrinking. To reach a historical level of valuation based on average earnings growth, the market would need to fall another 18% from today's level of ~$1960 to ~$1600. If earnings weakness continues or accelerates, it would not be surprising to see levels below that.

The Interest Rate Mirage

Certain prominent investors, led by Bill Gross and Muhammad El-Erain, suggest we are seeing a "new normal" of slower growth. They say we should lower our return expectations accordingly. This view is driven by the belief that the economy won't grow fast enough for the Fed to raise interest rates, yet stocks, bonds and real estate will remain reasonably supported by cheap money. This will result in less-than-average but positive returns.

That is a unique twist for the Wall Street mirage factory. "Buy stocks and bonds! Their high prices are not an issue. It simply looks that way because you haven't lowered your expectations enough!"

Glimmer and shimmer. Not only has an argument been made to buy assets, they also set up a scenario for selling leverage too. Academically, if you believe an asset can provide low but consistent returns, you can always improve that model by buying more of the asset with borrowed money. Similar to the amorphous sunlight over hot desert sand, low interest rates create a haze in the banking system. In financial models, when both discount rates and financing rates are low, the numerical rays of Microsoft Excel literally bend and shift. Ideas that previously didn't deserve investment look more attractive. Prizmatically, water looks like it is everywhere.

Without sounding too jaded, I simply don't think stocks, bonds and real estate can all hover along and equitably distribute the limited resource of return to American investors. I see the combination of low interest rates and high stock, bond, and real estate prices as a recipe for above-average volatility. Those factors will simply help investors make bigger mistakes faster than would be possible in a more normalized rate environment. Particular caution is warranted because the asset classes at the center of the issue are traditionally the highest allocations of retiree's portfolios, often 80% or more of total assets.

The worst decision we could make is to accept this "new normal" and adjust our return expectations downward. If anything, we should adjust our expectations higher because we see so many avenues for people to make mistakes. Mind you, keeping our expectations high simply means demanding a historically reasonable amount of water for each dollar we invest.

The glorious map I promised you earlier is on the next page. I've highlighted the mirage in red, and the actual depth of the water in blue. All the other numbers are basically indicators of how heated the quest for mythical cities is.

Year	S&P 500 Price	(EBIT) Operating Earnings	Dividends	(EBIT) Operating Earnings Yield	Dividend Yield	Current P/E Ratio	10 Year Cyclical P/E Ratio	Avg. 10 Year Treasury Yield	Earnings/10Y Spread	Graham Dodd Modified (Value)	15x Operating Earnings (Fair Price)	Dividend Payout Ratio	Notes:
1974	$69	$9.35	$3.72	13.64%	5.43%	7	11	7.56%	6.1%	$44	$140	40%	Historic Opportunity
1975	$90	$7.71	$3.73	8.55%	4.14%	12	14	7.99%	0.6%	$43	$116	48%	
1976	$107	$9.75	$4.22	9.07%	3.93%	11	16	7.61%	1.5%	$49	$146	43%	
1977	$95	$10.87	$4.86	11.43%	5.11%	9	13	7.42%	4.0%	$55	$163	45%	
1978	$96	$11.64	$5.18	12.11%	5.39%	8	12	8.41%	3.7%	$54	$175	45%	
1979	$108	$14.55	$5.97	13.48%	5.53%	7	12	9.43%	4.1%	$54	$218	41%	
1980	$136	$14.99	$6.44	11.04%	4.74%	9	14	11.43%	-0.4%	$49	$225	43%	
1981	$123	$15.18	$6.83	12.39%	5.57%	8	11	13.92%	-1.5%	$43	$228	45%	
1982	$141	$13.82	$6.93	9.83%	4.93%	10	12	13.01%	-3.2%	$50	$207	50%	
1983	$165	$13.29	$7.12	8.06%	4.32%	12	14	11.10%	-3.0%	$61	$199	54%	
1984	$167	$16.84	$7.83	10.07%	4.68%	10	13	12.46%	-2.4%	$58	$253	46%	
1985	$211	$15.68	$8.20	7.42%	3.88%	13	15	10.62%	-3.2%	$70	$235	52%	
1986	$242	$14.43	$8.19	5.96%	3.38%	17	17	7.67%	-1.7%	$97	$216	57%	
1987	$247	$16.04	$9.17	6.49%	3.71%	15	17	8.39%	-1.9%	$90	$241	57%	
1988	$278	$24.12	$10.22	8.69%	3.68%	12	17	8.85%	-0.2%	$92	$362	42%	
1989	$353	$24.32	$11.73	6.88%	3.32%	15	21	8.49%	-1.6%	$105	$365	48%	
1990	$330	$22.65	$12.35	6.86%	3.74%	15	19	8.55%	-1.7%	$112	$340	55%	
1991	$417	$19.30	$12.97	4.63%	3.11%	22	23	7.86%	-3.2%	$124	$290	67%	
1992	$436	$20.87	$12.64	4.79%	2.90%	21	23	7.01%	-2.2%	$144	$313	61%	
1993	$466	$26.90	$12.69	5.77%	2.72%	17	23	5.87%	-0.1%	$188	$404	47%	
1994	$459	$31.75	$13.36	6.91%	2.91%	14	21	7.09%	-0.2%	$171	$476	42%	
1995	$616	$37.70	$14.17	6.12%	2.30%	16	26	6.57%	-0.5%	$199	$566	38%	
1996	$741	$40.63	$14.89	5.49%	2.01%	18	28	6.44%	-1.0%	$222	$609	37%	
1997	$970	$44.09	$15.52	4.54%	1.60%	22	33	6.35%	-1.8%	$249	$661	35%	
1998	$1,229	$44.27	$16.20	3.60%	1.32%	28	39	5.26%	-1.7%	$334	$664	37%	
1999	$1,469	$51.68	$16.71	3.52%	1.14%	28	43	5.65%	-2.1%	$350	$775	32%	
2000	$1,320	$56.13	$16.27	4.25%	1.23%	24	35	6.03%	-1.8%	$363	$842	29%	
2001	$1,148	$38.85	$15.74	3.38%	1.37%	30	29	5.02%	-1.6%	$446	$583	41%	
2002	$880	$46.04	$16.08	5.23%	1.83%	19	21	4.61%	0.6%	$498	$691	35%	
2003	$1,112	$54.69	$17.88	4.92%	1.61%	20	25	4.01%	0.9%	$598	$820	33%	
2004	$1,212	$67.68	$19.41	5.58%	1.60%	18	25	4.27%	1.3%	$601	$1,015	29%	
2005	$1,248	$76.45	$22.38	6.12%	1.79%	16	24	4.29%	1.8%	$652	$1,147	29%	
2006	$1,418	$87.72	$25.05	6.18%	1.77%	16	25	4.80%	1.4%	$636	$1,316	29%	
2007	$1,468	$82.54	$27.73	5.62%	1.89%	18	24	4.63%	1.0%	$700	$1,238	34%	
2008	$903	$49.51	$28.05	7.24%	3.11%	18	15	3.66%	3.6%	$907	$743	57%	
2009	$1,115	$56.86	$22.31	5.45%	2.00%	20	18	3.26%	2.2%	$1,042	$853	39%	
2010	$1,258	$83.77	$23.12	6.65%	1.84%	15	20	3.22%	3.4%	$1,119	$1,257	28%	Sankala Group Founded
2011	$1,258	$96.44	$26.43	7.67%	2.10%	13	18	2.79%	4.9%	$1,365	$1,447	27%	Bullish
2012	$1,426	$96.83	$31.25	6.79%	2.19%	15	19	1.76%	5.0%	$2,247	$1,452	32%	Still Bullish
2013	$1,848	$107.07	$34.99	5.79%	1.89%	17	23	2.34%	3.5%	$1,749	$1,606	33%	Still Bullish / Cautious
2014	$2,091	$113.01	$39.44	5.40%	1.89%	19	25	2.52%	2.9%	$1,711	$1,695	35%	Cautious
2015 est.	*$1,960*	*$111.55*	*$41.00*	*5.69%*	*2.09%*	*18*	*22*	*2.11%*	*3.6%*	*$2,253*	*$1,673*	*37%*	*Cautious*
55 Year Averages				**6.81%**	**3.05%**	**16**	**21**	**6.40%**	**0%**			**45%**	

10Y Compound	5%	4%	6%
30Y Compound	8%	7%	6%

Source: Standard & Poor's Financial Services LLC

Most of us know if the stock market is up or down recently. Some of us follow prices quite closely. Like the British explorers of the 1920's, we have *Zerzura* fever and act as though looking for a mythical city is a good way to spend our time. We would be far better off with a simple mantra: "When we go to the desert we think about water—only water."

You have now seen the state of the reservoir. Full year S&P operating earnings are ~$111.50 per share this year, down from ~$113 a share last year. Sales have gone from soft 24 months ago to negative today. If it wasn't for our companies giving us our own money back through buybacks and then asking for our congratulations we would have nothing to celebrate in jest! Remembering these fundamental figures is far more helpful than knowing how the mirage shifted yesterday.

After 8 letters and 24 months of describing the weak state of corporate earnings in the S&P 500, I wouldn't be surprised if people have started to think I'm just biased against U.S. stocks. Let me be extremely clear—*there are no companies on planet earth we would rather own than blue-chip U.S. firms.* Simultaneously, we are savvy enough to know we don't want to send resources out to look for a mythical city when there isn't enough water to sustain us.

Our approach is sound. We don't mythologize, we stay focused on where the water is, and we spread our business across a wide range of pools. Our decision to avoid new S&P 500 and Russell 2000 positions over the last 24 months has set us up well from here. Our next visit to the oasis will be much more satisfying. We waited patiently.

A closing note… For those more interested in the legend of *Zerzura* than corporate earnings, re-watch the film *The English Patient*, based on the book by Michael Ondaatje. It swept the Academy Awards, is better than you remember, and covers the essence of the myth.

Best,

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[i] S&P Dow Jones Indices LLC