New Realities.

Happy New Year – 2017.

On a personal level, I couldn't be more pleased with the outlook for the year. As many of you know, in December, Thomas Denkenberger joined the Sankala Group. Previously at Merrill Lynch where he served private clients, Thomas brings a background in science that complements my own strengths well. I'm delighted to be working with him, a partner I both enjoy and respect – and together we look forward to continuing to grow our business in 2017.

First and foremost, I'd like to warmly welcome all of Thomas's clients who are joining us. Many people newly introduced to this firm naturally ask about our name. *Sankala* is a word derived from Sanskrit that communicates the relationship between cause and effect. While I think it's particularly applicable to our work, the more important part of the name is actually the word "*group.*"

From the beginning I have always thought of myself simultaneously as the consultant and the consulted. Each and every client we serve has unique experiences and insights. Our job is to sit at the center of this circle of accomplished and interesting people, and bring ideas and experiences – both successful and unsuccessful – across the circle when helpful and expedient for others in the group.

We run this circle with discretion, always mindful of privacy, and we try to add our own analytical, technological, and operational skills to enhance the usefulness and monetary value of our varied conversations and projects.

For 2017, there is one critical topic we need to add some data and objective thinking on, and that is corporate taxation and the *Trump Tax Plan*:

> Fact 1: Donald Trump has been elected President of the United States.
> Fact 2: Republicans have won temporary control in Congress.
> Fact 3: The President and Congress now agree on something: lowering corporate taxes.

Regardless of any feelings we have about these realities, they are facts we need to consider closely as investors.

In the United States, we have a statutory Federal Tax rate of 35% for each dollar earned by a corporation above $335,000. We also then have a combined average state rate of 4.1% - bringing the final statutory tax rate on companies to 39.1%. Despite these posted rates, in practice, corporations pay far less. In Q2 2016 the weighted average tax rate for the S&P 500 was 26.7%. That is a difference between the posted and actually paid rate of 12.4%. That difference can be thought of as the current value of all the loopholes, congressional giveaways, and offshore tax sheltering currently going on.

To put this in better perspective, S&P 500 pre-tax earnings were just about ~$1 trillion in 2015 and will be similar this year. So 12.4% of that number is ~$124 billion. That is an amazing amount of money not being collected by the tax agencies. It also demonstrates how complicated and "lobbied out" the tax code has become over the years. Perhaps even more alarming is that the current rate of 35%, which was set in 1986, has consistently eroded away over the years with great predictability. In that year, the statutory rate and effective rate nearly matched as you might expect. The divergence has grown in most every year since then, culminating during the financial crisis when the difference between the headline rate and effective rate reached more than 25%. The government collected *less than half* what it appeared they should collect to the casual observer.

The Trump plan calls for two main adjustments. The first is an across the board reduction to the statutory rate to 15%, ostensibly to make our headline rate competitive with other headline rates around the world and to kill the attractiveness of offshoring earnings. The second is the elimination of loopholes and other complexities that lead to these differences between the headline and effective rates.

While I do believe the headline rate might come down to perhaps 20% after negotiations with key influencers, I'm very cynical about the second part, the elimination of loopholes. There is a simple litmus test here. It's called the *carried-interest* tax loophole – the loophole that allowed Mitt Romney to pay tax rates below his housekeepers on the vast majority of his earnings. The loophole is not only unfair, but it is also inherently dishonest in the way it allows certain people to claim another person's investment tax rates on what is obviously earned income, not investment income, to that individual.

President Obama understood this loophole is bad policy and is also bad symbolically. Yet he could not close it simply because too many related political donations had mired the Democrats. Donald Trump even once pointed out the injustice of the policy. He has since stopped mentioning carried interest. Why? He started looking outside his own bank account for political donations. Frankly, I will be overjoyed if this loophole is closed in the next four years. My faith in Washington would return in strong measure. It would essentially mean politicians had turned their backs on greed. But it's a very unlikely story, and one I'm not holding my breath on.

So let's be generous but realistic about Washington in our analysis. Let us imagine a few things. First that all S&P 500 earnings are taxed in the U.S. which they are not. Second, that they heroically remove 50% of the bad corporate tax code and the value of all loopholes drops to ~$62 billion from ~$124 billion in tax year 2018. We then figure we see a negotiated ~20% headline rate on ~1 trillion or ~$200 billion in Federal taxes. We then subtract $62 billion for the remaining loopholes, which comes to $138 billion. Then we add back state-level taxes of 4.1% or $41 billion. The total tax bill on the S&P 500 might then be roughly $179 billion, down from the ~$267 billion implied by the current actual effective rate. That would leave the IRS out of ~$88 billion, and the S&P 500 companies with that same amount now attributable to shareholders. That basically implies a ~9% increase in after-tax earnings.

All other things being equal, that means we need to revise our estimates for after-tax earnings on the S&P 500 upwards for 2017 and 2018. However, in close discussion with Thomas, we agree that this boost will likely not increase underlying operating earnings too materially. Thus we think we will see higher dividend growth, and perhaps share buybacks staying at current elevated levels. We've done this work in the table attached to this letter so you can see exactly what we are seeing, and what our models are telling us about fair pricing historically.

What we can say categorically is that no matter how we feel about the qualitative implications of such a policy, the numbers (even with a softened view of what Congress can actually accomplish) do underpin a so-called “Trump Bump” in the U.S. stock market.

Further, the possibility also exists for a repatriation window of offshore funds at concessionary rates which would also drive stock values higher on the same basis.

Like everyone else we were caught by surprise by this election. We now need to move our estimates higher based on these probabilities, despite all our remaining suspiciousness of historically high valuations in the stock market.

Of course there are many other important factors at play, but the tax element will have a significant influence on sentiment if such policy shifts build momentum. We are now left to wonder longer-term if these changes will stabilize or destabilize the economy, and how they might impact the prices of U.S. debt. Finally, if interest rates increase further, we also need to consider how that removes the analytical underpinning that justifies these high stock valuations. Retirees may start to take a renewed interest in bonds, and profits will be taken from stocks to do that.

We wish you all great health and happiness in New Year – and please don’t hesitate to call if you want to discuss any of this further.

Best,

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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	EBIT/10Y Yield 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%	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%	Still Bullish / Cautious
2015	$2,044	$100.44	$43.39	4.91%	2.12%	20	23	2.13%	2.8%	$2,195	$1,507	43%	Cautious
2016	$2,238	*$102.00*	$45.00	*4.56%*	*2.01%*	*22*	25	2.10%	*2.5%*	$2,379	*$1,530*	*44%*	Cautious
2017 *est.*	*$2,300*	*$104.00*	$48.00	*4.52%*	*2.09%*	*22*	25	2.50%	*2.0%*	$2,057	*$1,560*	*46%*	Bullish Only Due to Tax Outlook
2018 *est.*	*$2,400*	*$106.00*	$51.00	*4.42%*	*2.13%*	*23*	25	2.75%	*1.7%*	$1,894	*$1,590*	*48%*	
Averages	**57**	**Years:**		**6.68%**	**3.00%**	**17**	**21**	**6.19%**	**1%**			**45%**	

Source: Standard & Poor's Financial Services LLC

10Y Compound	5%	3%	7%
30Y Compound	8%	6%	6%