The Phoenician Model

Alfred Winslow Jones, the inventor of the investment vehicle now commonly referred to as a hedge fund, was well versed in maritime history. When he explained the basis of his fee structure, which mirrored the 20% share in profits often seen today, he would invoke the approach of ancient Phoenician traders. Like these captains, he would demand 20% of the value of any cargo successfully delivered to its destination.

His story was a savvy one. I imagine he also mentioned the rare predatory sea snails that produced the dye that made the royal purple sails that graced those Phoenician ships. Born in 1900 to a GE executive, raised in Schenectady New York, and an alumnus of Harvard University, Jones had a range of advantages. After college, while working in Germany as a diplomat he clandestinely married a wealthy leftist socialite named Anna Block and joined her in the Leninist

Organization. His marriage quickly unraveled and he promptly rejected his Marxist ways, realizing he needed to make a living for himself. Naturally, he returned to the United States and got a degree in Sociology. Luckily, his thesis, "Life, Liberty, and Property" was good enough to earn him a job writing for Fortune magazine. There his interests quickly turned to stock market psychology. It wouldn't be long before he found some loopholes in the regulatory environment and started the first "hedged fund" with $40,000 of his own savings and $60,000 belonging to outside investors.

Sarcasm doesn't come off well in written form, but you can probably sense some in this story. You can't help but laugh at this seemingly hapless route to a storied career in finance. However, like many great investors inexplicably linked by their non-traditional approaches, Jones went on to do well for his clients. So why poke fun at Jones while simultaneously tipping my hat to him? Well, like many hedge fund managers he did well for his clients, but great for himself. That brings us back to his Phoenician fee model, which remains a great sales tactic, but in practice often proves destructive for hedge fund clients over the long term.

The issue is that while a Phoenician captain is interested in making 20% of whatever he can deliver, his fear of sinking the ship and drowning in cold seas tempers his greed and forces a realistic look at the dangers of the route. Hedge fund managers, on the other hand, will tend to want to sail no matter the conditions because their "ship" is actually a fungible set of documents and their lives are most certainly not in jeopardy. Often times their careers are not even in danger. As an old hedge fund acquaintance said, "It's a mulligan industry." He was referring specifically to John Paulson's gold fund that lost nearly 50% of its value in 6 months in 2013, yet amazingly didn't put his firm out of business. (A mulligan, for non-golfers in the crowd, is essentially a playground "do-over.")

This Phoenician model is problematic from the point of view of thoughtful investors because there is little incentive for the manager to say "**You can't get there from here. It's simply too dangerous**." While those words are never fun to hear, they are the difference between succeeding for 5 years and succeeding over a lifetime. Being paid on a flat-fee basis, I'm incentivized to grow my client's accounts more steadily, and not make any particularly risky voyages. My duty is more harbormaster than swashbuckler—and I'd really like to do this work until I'm 75.

In fact, last week I was inspired by Bill Gross, the former manager of the world's largest bond fund. He announced at age 70 that he is leaving the helm of his $230 billion fund, and $1.97 trillion firm, to start a new fund from ground zero with Janus Capital, based in Denver. Gross, who is known for practicing yoga daily, signaled his interest remains in the intellectual pursuit of investing rather than running a sprawling financial services firm. The only real surprise is that he didn't stop investing entirely to focus strictly on his *drishti*. He clearly loves his work.

With that I need to turn your attention away from the stories that keep finance interesting, and place it on S&P 500 internals, which I understand often causes people to hit the close button on my PDFs. I hope you don't, because what follows is the real crux of our business together.

S&P 500 - Income Statement
Source: Standard & Poor's Financial Services LLC
USD, per share

	2013	2014 est.	% Change
Sales	$1,117	$1,170	4.7%
Operating Earnings	$107	$119	11.2%
As-Reported Earnings	$100	$110	10.0%
Operating Margin	9.6%	10.0%	4.1%

Since last year's Q4 letter, sales growth has improved a bit to an estimated 4.7% annual rate, higher than last year's estimated rate of 3.6%. Operating margins have also ticked 40 basis points higher to 10%, which is very likely to be a new all-time high, above the current record 9.8% achieved in Q4 2013. Profits at large companies continue to come in beyond the limits that history previously suggested possible. Capital continues to benefit over labor in an outsized way. Betting on meaningfully higher margins from here would certainly take some significant swashbuckling. The harbormaster figures margins are likely near a peak for this business cycle, and perhaps longer term as well.

As far as valuations go, the S&P 500 remains somewhere in the range of 11% to 16% overvalued based on our *15x Operating Earnings Fair Price* model, and *Graham Dodd Modified Value* model respectively. Additionally, the value model is based on a very low 2.6% average yield on the 10 year Treasury for 2014, with quite a bit of room to the downside should bond yields rise and show investors any safe avenue to more portfolio income. Details can be seen on the next page.

My attitude on the upside remains bound up in the possibility that sales will sustainably break out of the lull they have been in and thus drive bottom lines higher. While fully plausible, I find that bet swashbuckling because wages remain stagnated, and companies are more interested in doing share buybacks than investing in new capacity. Could this change? No doubt, but as we compare the various probabilities for these outcomes, this would equate to the current Goldilocks situation for big companies going full-fledged Repunzel. It's just not the harbormaster trade.

Year	S&P 500 Price	(EBIT) Operating Earnings	(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)	Notes:
1974	$69	$9.35	13.64%	5.43%	7	11	7.56%	6.1%	$44	$140	Historic Opportunity
1975	$90	$7.71	8.55%	4.14%	12	14	7.99%	0.6%	$43	$116	
1976	$107	$9.75	9.07%	3.93%	11	16	7.61%	1.5%	$49	$146	
1977	$95	$10.87	11.43%	5.11%	9	13	7.42%	4.0%	$55	$163	
1978	$96	$11.64	12.11%	5.39%	8	12	8.41%	3.7%	$54	$175	
1979	$108	$14.55	13.48%	5.53%	7	12	9.43%	4.1%	$54	$218	
1980	$136	$14.99	11.04%	4.74%	9	14	11.43%	-0.4%	$49	$225	
1981	$123	$15.18	12.39%	5.57%	8	11	13.92%	-1.5%	$43	$228	
1982	$141	$13.82	9.83%	4.93%	10	12	13.01%	-3.2%	$50	$207	
1983	$165	$13.29	8.06%	4.32%	12	14	11.10%	-3.0%	$61	$199	
1984	$167	$16.84	10.07%	4.68%	10	13	12.46%	-2.4%	$58	$253	
1985	$211	$15.68	7.42%	3.88%	13	15	10.62%	-3.2%	$70	$235	
1986	$242	$14.43	5.96%	3.38%	17	17	7.67%	-1.7%	$97	$216	
1987	$247	$16.04	6.49%	3.71%	15	17	8.39%	-1.9%	$90	$241	
1988	$278	$24.12	8.69%	3.68%	12	17	8.85%	-0.2%	$92	$362	
1989	$353	$24.32	6.88%	3.32%	15	21	8.49%	-1.6%	$105	$365	
1990	$330	$22.65	6.86%	3.74%	15	19	8.55%	-1.7%	$112	$340	
1991	$417	$19.30	4.63%	3.11%	22	23	7.86%	-3.2%	$124	$290	
1992	$436	$20.87	4.79%	2.90%	21	23	7.01%	-2.2%	$144	$313	
1993	$466	$26.90	5.77%	2.72%	17	23	5.87%	-0.1%	$188	$404	
1994	$459	$31.75	6.91%	2.91%	14	21	7.09%	-0.2%	$171	$476	
1995	$616	$37.70	6.12%	2.30%	16	26	6.57%	-0.5%	$199	$566	
1996	$741	$40.63	5.49%	2.01%	18	28	6.44%	-1.0%	$222	$609	
1997	$970	$44.09	4.54%	1.60%	22	33	6.35%	-1.8%	$249	$661	
1998	$1,229	$44.27	3.60%	1.32%	28	39	5.26%	-1.7%	$334	$664	
1999	$1,469	$51.68	3.52%	1.14%	28	43	5.65%	-2.1%	$350	$775	
2000	$1,320	$56.13	4.25%	1.23%	24	35	6.03%	-1.8%	$363	$842	
2001	$1,148	$38.85	3.38%	1.37%	30	29	5.02%	-1.6%	$446	$583	
2002	$880	$46.04	5.23%	1.83%	19	21	4.61%	0.6%	$498	$691	
2003	$1,112	$54.69	4.92%	1.61%	20	25	4.01%	0.9%	$598	$820	
2004	$1,212	$67.68	5.58%	1.60%	18	25	4.27%	1.3%	$601	$1,015	
2005	$1,248	$76.45	6.12%	1.79%	16	24	4.29%	1.8%	$652	$1,147	
2006	$1,418	$87.72	6.18%	1.77%	16	25	4.80%	1.4%	$636	$1,316	
2007	$1,468	$82.54	5.62%	1.89%	18	24	4.63%	1.0%	$700	$1,238	
2008	$903	$49.51	7.24%	3.11%	18	15	3.66%	3.6%	$907	$743	
2009	$1,115	$56.86	5.45%	2.00%	20	18	3.26%	2.2%	$1,042	$853	
2010	$1,258	$83.77	6.65%	1.84%	15	20	3.22%	3.4%	$1,119	$1,257	Sankala Group Founded
2011	$1,258	$96.44	7.67%	2.10%	13	18	2.79%	4.9%	$1,365	$1,447	Bullish
2012	$1,426	$96.83	6.79%	2.19%	15	19	1.76%	5.0%	$2,247	$1,452	Still Bullish
2013	$1,848	$107.07	5.79%	3.02%	17	23	2.34%	3.5%	$1,749	$1,606	Still Bullish / Cautious
2014 est.	*$2,000*	*$119.00*	*5.95%*	*2.60%*	*17*	*23*	*2.60%*	*3.4%*	*$1,674*	*$1,785*	*Cautious*
Averages	54	Years:	**6.86%**	**3.11%**	**16**	**21**	**6.56%**	**0%**			

This level of overvaluation is not extreme, and is not a signal to rush for the exits, but it is a signal to continue trimming in a tax sensitive manner, and to avoid putting new capital to work when possible. Moreover, our decision to cut smaller capitalization positions has come home to roost. The Russell 2000 has lost ~5% YTD, while the S&P 500 has gained about 6% for an 11% spread. As we had hoped, it looks like we will be able to put our old Russell 2000 funds back to work on better terms and permanently trap some value.

Our Vietnam index has also been a major bright spot for the year, having gained ~18% YTD, and at one point was up 27.5%. I remain very optimistic about these investments as valuations are almost half that in the S&P 500. We are being paid better on the dividends as well. Other Asian positions like large capitalization Hong Kong shares, and China Mobile specifically, have also done well on the back of money appearing to flow out of real estate speculation and back into China stock markets. While this was a turn I anticipated and discussed in previous letters, it has occurred 2 long years later than I imagined. I'm glad to finally see some of it occurring, as well as progress on the "through train" allowing Mainland investors access to Hong Kong listed shares. The final piece of liberalization I expect, which will bring the Hong Kong Dollar (HKD) under the wing of the Renminbi (RMB) remains outstanding and distant, but I continue to feel that it is inevitable and worth sticking around for.

Many risks obviously remain in China. We are perpetually on edge related to the Chinese banking system and wider economy. The Party has been intervening very aggressively in the telecoms space in particular recently. These interventions, by luck, have benefited us on net in China Mobile (CHL) over the year, but I don't understand their general thrust. Doing well by luck is great, but is also quite nerve racking. So we sold some CHL this quarter after seeing a 75 billion USD equivalent increase in capitalization in less than 6 months. I think we will be able to buy it back on better terms, but my view that China Mobile has a chance to surpass both Apple and Exxon-Mobile to be the world's largest corporation remains in place. Monthly phone service rates remain strikingly low in China, and when you multiply a potential doubling of revenue over the next decade by its 800 million customer base, you start to see how it would be possible to get there from here, without outrageous swashbuckling.

Weak spots in our work this year include our German index positions. The Eurozone appears to be weakening again and equities have been sold somewhat indiscriminately, including German shares. I have done nothing on this account, and I'm not too worried about it because I know we are in the best possible economy in Europe with dividends being paid a nearly twice the rate of U.S. inflation. We can sit back and enjoy our exposure to a range of world-class firms like Bayer AG, Siemens AG, BASF SE, SAP, and BMW. They aren't going away, and some principle value swings are to be expected in order to collect the benefits ownership.

Another area that has been difficult is our entry into the Brazilian market. The volatility in the IBovespa index during the election cycle has been incredible. Often times new value investments keep moving against you before they turn higher, and we are still legging into our positions—but the market sure has gotten weak all of a sudden after being extremely strong to start the year.

My thesis here is built on picturing the world like a Brazilian middle-class saver. Brazilian investors can get paid about 12.4% per annum buying Real denominated 10 year government bonds. That is an attractive investment when compared to the ~10-11% operating earnings yield available by owning the riskier IBovespa index. That understood, a 10% current earnings yield with no growth expectations being figure in is an attractive long-term level to buy stocks. If Brazilian bond rates were to fall, investors would soon find these types of earnings yields far more attractive. I don't want to hazard any prediction on where Brazilian government rates are headed, but given how much higher Brazilian rates are than the global norm, there is certainly scope for inflation to moderate, rates to fall towards 2012 levels, and for the Real to rally.

You can see in the plot above a very recent sharp move higher in these rates. It's largely being blamed on polling data that suggested Dilma Rousseff is the favorite to retake the Presidency. This follows on the August 17th plane crash that killed candidate Eduardo Campos, whose economics background and views were supported by Worker's Party. While he had only 10% popularity, his crest-fallen voters seem to have tipped the scales back in Rousseff's favor and away from Marina Silva. Rousseff is a well known quantity. The issue is that her quantity has become synonymous with stagnation, most likely through no major fault of her own.

I think this is a short-term concern and that the Real will find some support near these 10 year lows. A rallying Real will almost certainly cause rates to fall, and thus for stocks to gain relative attractiveness to local investors. Perhaps this will lead us closer to the end of the 6 year bear market in Brazilian equities. At least we are quite positive we are not buying a top, and that our dividends will again be far superior to the S&P 500's in the meantime.

I'd like to close with a telling development in Vietnam.

Pictured above is Intel's half-million square foot production facility in Ho Chi Minh City, District #9, also referred to as the *Saigon Hi-Tech Park*. This facility, which is twice as large as Intel's next largest plant, is more than just the flagship in Intel's line of factories. The investment Intel has made here is so significant that a staggering 80% of Intel's computer chips are slated to be made in Vietnam by the end of 2015. Moreover, Intel plants in Malaysia and the Philippines were both shuttered recently as the Vietnamese facilities have been consistently producing more efficiently and at higher quality levels. These trends extend across industries. Take a look at any new technical garment or luggage from respected brands. You are more likely to see the words "Made in Vietnam," than "Made in China."

Vietnam continues to demonstrate that it can conduct business across a big part of the value chain. The types of jobs being created are driving demand in many sectors of the Vietnamese economy. We can buy shares in the companies that serve this demand to yield earnings of ~11% or more on our investment—much higher than ~6% the S&P is slated to earn for us. The harbormaster and the swashbuckler agree "you can get there from here," in Vietnam.

Best,

Harold A. Hallstein IV
Sankala Group LLC
T: (720) 310-0605

Sankala Group LLC's communications should not be considered by any client or prospective client as a solicitation or recommendation to affect any transactions in securities. Any direct communication by Sankala Group LLC with a client or prospective client will be carried out by a representative that is either registered with or qualifies for an exemption or exclusion from registration in the state where the prospective client resides. Sankala Group LLC does not make any representations or warranties as to the accuracy, timeliness, suitability, completeness, or relevance of any information presented in this communication, or by any unaffiliated third party. All such information is provided solely for illustrative purposes.

Different types of investments involve various degrees of risk, and there can be no assurance that the performance of any specific investment or investment strategy, including those undertaken or recommended by Sankala Group LLC, will be profitable or equal any historical performance level. All investments carry some risk of partial or complete capital loss. No client or prospective client should assume that this communication serves as a substitute for personalized advice from Sankala Group LLC, or from another investment professional. Sankala Group LLC is neither an attorney nor an accountant, and no portion of the communication should be interpreted as legal, accounting or tax advice.

As a condition of receiving this communication, each client and prospective client agrees to release and holds harmless Sankala Group LLC and its employees and agents from any and all adverse outcomes resulting from any of his/her/its actions which are independent of receipt of personalized individual advice from Sankala Group LLC.