Sankala Group

Symptoms vs. Causes

As of the writing of this letter, the S&P 500 is just above its 2001 highs, and just below its 2007 highs. From a technical chart-based standpoint, we are at the top of a 15-year trading range, in an established area of resistance. It's a price where the market has switched directions and broken down before. Of course, the question naturally arises, "Should we be concerned?"

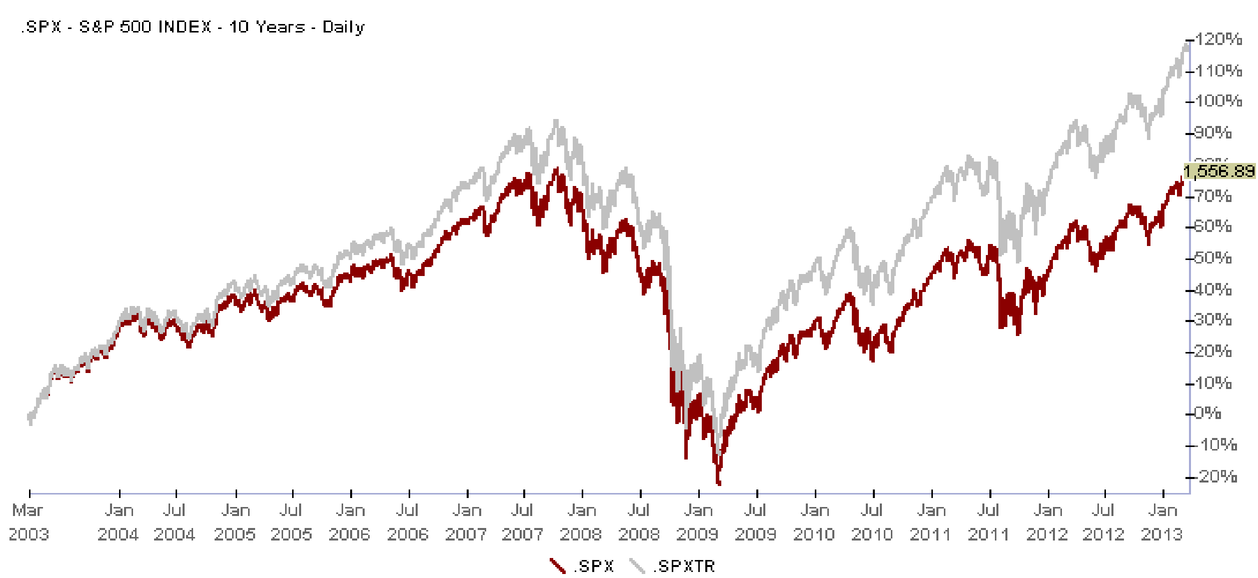
The answer is yes, but not for those reasons. In this quarter's letter I want to explain why long-term charts can be misleading, and why sticking with our primary methods of value analysis will help us make better decisions in the coming quarters.

As fundamental investors, we place more emphasis on our view of inherent value than on the psychological implications that price movements have on other investors. In fact, we try to locate assets where we think their true worth is at least 20% higher than their current selling price. Unfortunately, moments where disjunctures of this magnitude arise are somewhat rare, and when we do find them, we can never know for certain if they will get more disjointed or less in the near term. Despite these drawbacks, the approach is proactive and helps us avoid overpriced assets.

Many other investors base their decisions primarily on price, and how they think other investors will react to it. That approach is reactive and often steers them towards momentum driven and potentially richly valued assets. The attraction of these types of strategies is their tangibility, short-term feedback, and how they fulfill a desire to work in black and white rather than shades of grey. My personal experience is that is pays to work on the spectrum, and that the search for black and white is quixotic.

Let me illustrate. Why is the price of the S&P 500 misleading? The first reason is straightforward—due to the corrosive effects of inflation, a share of the S&P 500 today at $1550 is not anywhere near as valuable as the same share was the last times it hit that price. Actually, according the Bureau of Labor, a share would need to sell for $1758 today to buy what one share would have bought in 2007, and fully $2058 to buy what it did in 2001. So the fact this price has reappeared has essentially zero relevance to what it's worth to us. In fact, by celebrating this price you're really just letting Wall Street get you worked up about being worse off.

Second, when the media mentions the S&P 500 they strictly quote the "price index." However, when Sankala Group clients look at their performance benchmarking, they see a modified version of the index called the S&P 500 Total Return. This modified index takes the price level of the S&P, then adds back the effects of dividend reinvestment. As you can see below, the difference is enormous over time:



This chart shows how an investor who held an S&P 500 position and reinvested the dividends over the last 10 years actually surpassed their old high-water mark more than a year ago. That is why many investors with established equity positions are now holding significantly more dollars than they had in 2007, despite the fact that the S&P 500 hasn't yet reached a new price high.

Clearly, using the total return index for your benchmark sets the bar high. The index itself doesn't have any drag created by the unavoidable fees we need to pay to make and maintain an S&P 500 investment, and it assumes an investor doesn't need to remove any dividend income from the portfolio. Perhaps most importantly, it also assumes they can tolerate the even higher volatility of the TR index over the price index. All that aside, the salient point is that just because the S&P has returned to its old price level, it doesn't mean that either the economy or the market are in any better or worse shape. The recurrence of the price level has only psychological meaning.

That is not to say psychology is irrelevant. It isn't. But when investors are paying more attention to psychology than corporate earnings, it may present fundamental investors with some disjuncture to work with. The best way I've found to think about the issue is to look at price as a symptom, and value as a cause. Most traders focus their models exclusively on price and its derivatives – like volatility. They are treating symptoms, not causes.[i]

Below is our table of real S&P 500 causes. By reviewing it regularly, we get a line on the patient's underlying health, rather than looking at its latest ache or pain:

Year	S&P 500 Price	Operating Earnings (EBIT)	Dividend	Operating Earnings Yield	Dividend Yield	Current P/E Ratio	10 Year Cyclical P/E Ratio	10Y Treasury Yield
1999	$1,469.25	$51.68	$16.71	3.52%	1.14%	28	43	5.65%
2000	$1,320.28	$56.13	$16.27	4.25%	1.23%	24	35	6.03%
2001	$1,148.09	$38.85	$15.74	3.38%	1.37%	30	29	5.02%
2002	$879.82	$46.04	$16.08	5.23%	1.83%	19	21	4.61%
2003	$1,111.91	$54.69	$17.88	4.92%	1.61%	20	25	4.01%
2004	$1,211.92	$67.68	$19.41	5.58%	1.60%	18	25	4.27%
2005	$1,248.29	$76.45	$22.38	6.12%	1.79%	16	24	4.29%
2006	$1,418.30	$87.72	$25.05	6.18%	1.77%	16	25	4.80%
2007	$1,468.36	$82.54	$27.73	5.62%	1.89%	18	24	4.63%
2008	$903.25	$49.51	$28.05	7.24%	3.11%	18	15	3.66%
2009	$1,115.10	$56.86	$22.31	5.45%	2.00%	20	18	3.26%
2010	$1,257.64	$83.77	$23.12	6.65%	1.84%	15	20	3.22%
2011	$1,258.00	$96.44	$26.43	7.67%	2.10%	13	18	2.79%
2012	$1,426.00	$96.83	$31.25	6.79%	2.19%	15	19	1.76%
2013 est.	*$1,560.00*	*$97.00*	*$33.00*	*6.22%*	*2.12%*	*16*	*20*	*2.20%*
Averages – Since 1962				**6.87%**	**3.09%**	**16**	**21**	**6.56%**

Source: Standard & Poor's Financial Services LLC

Before I get into the critical information, I want to briefly discuss the table itself. It's easy enough to find this data pre-packaged on the internet. However, in my opinion, this on-demand approach undermines craftsmanship. This is the most critical information we use, and we balance all other assets against it, so it deserves special attention. One of my market innovations is keeping an expanded version of this table by hand, in a particular format I designed, so I can touch each number as it comes in and evolves. I do the same for my client's high-level quarterly reviews. It would be easy enough to automate all this, but the lion's share of the meaning and awareness created by the process would be lost. While that limits scalability a bit, the time I spend is recaptured in the fact that I don't offer clients auto-filled three-ring binders speculating on the future, nor show them back-tested models of what could have been. My feeling is encapsulated in this John Wesley Powell quotation:

"You can't see the Grand Canyon in one view, as if it were a changeless spectacle from which a curtain might be lifted, but to see it you have to toil from month to month through its labyrinths."

That attention to the present state of our markets is what led me to the fact that the S&P 500 companies earned only ~$97 per share last year. That's only ~0.40 cents more in operating earnings for 2012 over 2011. Their "as reported" earnings, which includes one-time items, actually somehow managed to fall ~0.40 cents. This is not what I or most other analysts had expected, nor has it been reported in the mainstream media. It was my view, as well as the financial community's view, that the S&P 500 would do more than $100 per share in earnings in 2012. Many thought upwards of $107. Estimates for 2013 remain in the $112 area.

The issue here should be clear. The price of the S&P 500 stands some ~24% higher than at the start of 2012, and yet the companies weren't able to generate any more earnings over that time. In physician's terms you might say the patient put on 24% new body mass, but none of it was muscle.

Looked at from a broad perspective, one could argue the patient was thin to start with so some extra weight is not too bad. That's actually very true. Valuations have been better than average for some time. Nevertheless, markets are governed by relativity just like the rest of the world, so it would be remiss not to point out the stall out in the earnings trend. It also follows that we should ask ourselves how the S&P 500 companies will meet expectations and earn $112, or ~15% more next year when they couldn't earn a single dollar more last year, a longer leap year, and the year *prior to sequestration*.

Looking back, in my Q4 2011 letter, I wrote, "we have sound quantitative reasons to believe current panics are likely providing some very good entry points, with less risk than usual. Investing new long-term capital into the market should therefore be celebrated." At that time, I saw a plethora of avenues by which stocks might rise, including new earnings by cost reductions, asset write-ups, new sales, and increases in valuations from low levels, etc.

Now I see less. I only see two viable ways the market can move up significantly from here:

1.] Surprisingly strong new sales numbers. (A very good reason…)
2.] Valuations keep rising just because the alternatives are less attractive. (A decent reason…)

Both are fine and reasonable ways for the market to keep moving. But from the perspective of probability, when you can only think of a couple reasons an outcome might occur, down from a bunch you had before, you know the probability of the event happening has decreased.

Further, since this market isn't significantly overvalued, we need to continue to be nuanced. You are still making about 5% more in operating earnings yield in the S&P 500 than you are in 10 year government bonds. That said, since interest rates choked up a bit in recent months, and earnings have stalled while equity prices rose, the alternatives are getting *less* less attractive, if that makes any sense. More technically, the earnings/interest rate yield spread came in a bit.

So what are the action items? If you have equity positions you are too concentrated in, or portfolio/account structuring changes you want to make, now is a great time to do that. Being out of the market here for a bit will be just fine. If your U.S. equity exposure has increased in percentage terms past your targets, well, it really should have been cut back to target already. At this point, you should consider moving underweight. If you have tax liability issues in your positions, consider short sales of the Russell 2000, or other lower dividend yielding indices to manage some risk without crystallizing gains. Finally, look to select international markets to find better earnings yields, liberalizing private sectors, and more physical plant and equipment/book value for your investment dollars.

People prefer to hear cut and dry answers like "sell it all," or "buy everything you can." But that expectation in unrealistic. We are much better off keeping our discipline. Managing a portfolio is like driving a big cruise ship. If the water starts looking skinny, you turn the boat slowly towards deeper water, you don't attempt to yank it off the Italian coastline at the very last minute. By following this approach, we stay proactive and flexible. That way, if we do start to see a pickup in corporate sales, we can always nudge the boat back a little closer to Giglio.

Other things I'm exploring with clients this quarter:

- Optimizing Social Security
- 529 plans for college savings
- Restructuring rolled 401(k)s
- Short Philippino equities
- Re-entering Vietnamese equities
- Seriously, is Ben Bernanke really over his job?
- Wood lathe turning, and other activities for mediocre investment environments

Best,

Harold A. Hallstein IV
Sankala Group LLC
T: (720) 310-0605
F: (866) 892-0819

Sankala Group

[i] George Soros has done some very interesting work exploring circumstances under which market symptoms can actually morph into causes, but the subject is beyond the scope of this letter. I'd enjoy discussing with anyone interested.