Sankala Group

Crossed Lines

The Sankala Group places a quasi-religious emphasis on knowing the fundamentals of the S&P 500. Each year, as the first quarter closes, we look back at finalized annual results and put deeper thought into the index's outlook for the next year.

As investors who live in the United States, the S&P 500 holds very special meaning for us. It is denominated in our own currency and is constituted by leading firms we buy products and services from every day. It is a superior index to the Dow Jones Industrial Average in its construction and breadth, and has $7.8 trillion benchmarked to it – the most of any equity index globally. If we don't understand it fully we have little basis from which to make judgments about any other investments. The S&P 500 has its own gravitational field – one our portfolios simply cannot escape.

2015 saw a few critical developments in the index. First, I no longer need to try to convince you that earnings for these 500 companies are set to shrink. Earnings fell over the full year period, by a significant amount:

S&P 500 Sales, Earnings & Dividends			
	2014	**2015***	**YoY % Change**
Sales	$1,163	$1,127	**-3.11%**
Operating Earnings	$113	$100	**-11.13%**
Reported Earnings	$102	$86	**-15.48%**
Dividends	$39	$43	**10.00%**

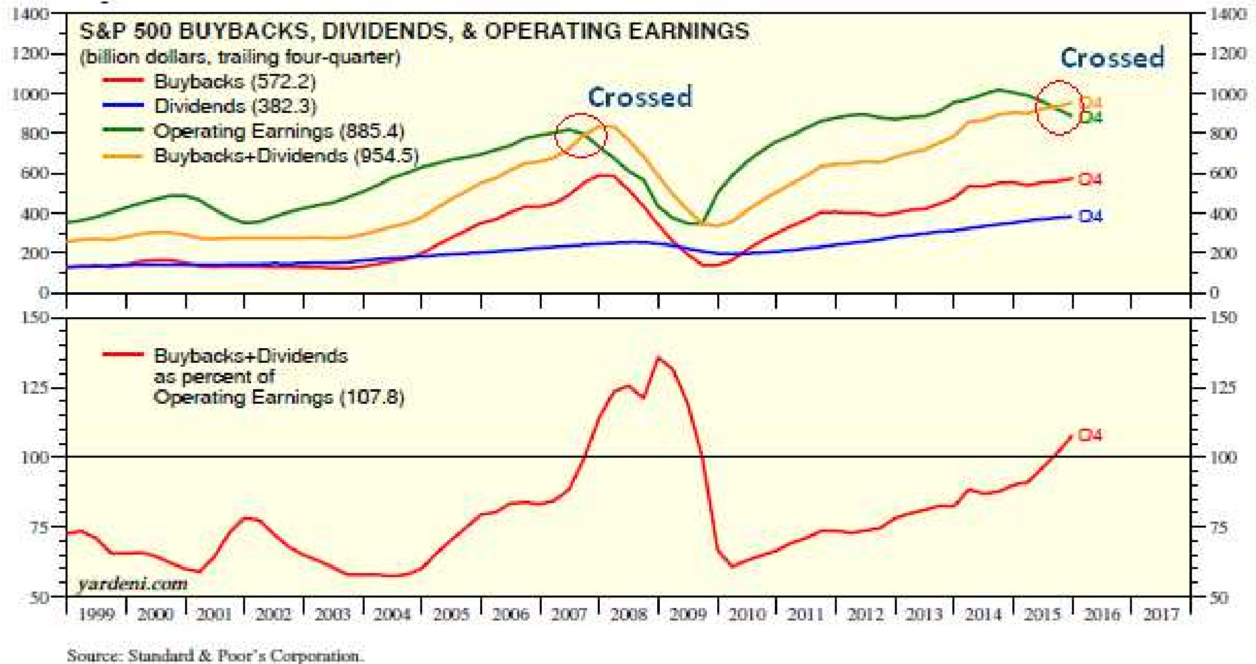
*Source: S&P Dow Jones Indices LLC (*495 of 500 Reported)*

I also included some details on the dividends paid by the index because it helps illustrate the second important development in 2015. While earnings shrank double digits, dividends continued to grow at an above average pace, rising 10% from 2014 levels.

This dividend growth is interesting when viewed in conjunction with corporate share buybacks, which is the other main avenue these companies use to return money to shareholders. In 2015 the 500 companies gave shareholders a total of $954 billion in dividends and share buybacks. How much did they earn in 2015? Only $885 billion.

Where does that extra $69 billion come from that they didn't earn but gave away? That is a tremendous question. In the strictest sense, that money came off corporate balance sheets, and created a net loss of equity. That is, the companies we are left with are now worth less, and since some of these payouts were financed with debt, our companies are also more leveraged as well. This saddles them with liabilities in the future that are not backing productive business activities, but are rather simply lining the pockets of current shareholders.

One of my favorite analysts, Ed Yardini, has done a great job illustrating this reality and showing how it compares to previous market tops. In the chart below we are concerned with the green line (earnings) and orange line (payouts) on the upper plot. I've gone ahead and circled the areas of particular interest in red, noting when these two lines crossed. *These "crossings" are indicators of extreme greed.* They are moments when companies give away money they aren't making:



Source: Standard & Poor's Corporation.

A healthy corporate environment is an environment where companies earn money (green line) and give some portion of it back to owners (orange line) while also saving some to invest and grow the business. It is no different than how a healthy household looks. Earning, saving, and investing. When this is happening correctly the green line should be above the orange line – as it is in most years. When extreme greed prevails something different takes place. The amount being given to owners exceeds what the company earns, and the lines cross. You can see the last crossing happened in 2007, just prior to crisis.

Critics of this analysis are likely to point out that there aren't too many good things to do with money right now, so giving it back to shareholders makes sense. Let shareholders invest it poorly rather than giving management the responsibility for investing it poorly. There is certainly logic to that – it serves executives well, and shareholders also believe they are doing well because they don't yet perceive the harm being accrued in the future by the early payouts and underinvestment.

Other critics might suggest that I've been warning on this topic for more than two years – starting well before the lines even crossed. Where has that gotten us? To that, I'd point to the fact that measured from the beginning of March the S&P 500 was essentially flat over the last 24 months. Not much has been lost in opportunity over the last two years through circumspection and conservatism.

The recent rebound in March certainly called this stance into question. My view is that this rally is a temporary snap-back that will not last. Trading volumes are fading. We also know the S&P 500 traded around the same level we have today (2050) at the end of 2014. If earnings have fallen by double digits since 2014, why should we pay the same amount for materially less earnings today?

Some people say it makes sense to pay up because interest rates are so low. That popular view doesn't resonate for me because the facts actually suggest otherwise. The average yield on the 10 year Treasury was 1.89% in 2014. It climbed 13% to 2.12% in 2015. Rates have not fallen, they have risen. The Fed now seems intent on ushering them higher still. This should make those shrunken earnings even less attractive, not more attractive.

I always worry when the numbers simply don't add up. If you look at a project's revenues and expenses and they just don't jive, you should skip the project until they do.

On the next page you will find our core long-term analysis. Each year I offer a new estimate for the price level of the S&P 500. This year, even if I assume some earnings lost from the energy sector come back, I simply cannot make the numbers add up until I drop the price on the S&P 500 to **1850** or below. Staying patient is difficult, but the math continues to prescribe it for us.

Fortunately, the more extreme these imbalances become, the more likely we will be looking at another good cycle for making investments soon. Our work now it trying to make sure we are in a strong position when the numbers add up again.

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%	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	$2,044	$100.44	$43.39	4.91%	2.12%	20	23	2.13%	2.8%	$2,195	$1,507	43%	Cautious
2016 *est.*	*$1,850*	*$105.00*	$45.00	*5.68%*	*2.43%*	*18*	21	2.25%	*3.4%*	$2,230	*$1,575*	*43%*	Cautious
Averages	56 Years:			6.78%	3.04%	16	21	6.33%	1%			45%	

Source: Standard & Poor's Financial Services LLC

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