DO, OR DO NOT. THERE IS NO TRY.
(Yoda*: The Empire Strikes Back*, 1980)

In this Quarterly Outlook I'll offer some thoughts on a collection of data and worries. The data glass isn't half full or half empty; it's the wrong sized glass. The Federal Reserve continues to distort most measurements of the economy so we look elsewhere for direction. Our goal is to minimize regret in that environment – elimination is impossible. The issues are complex, but as long-term investors we must stay as correctly informed as practicable.

Things that go bump in the night include:

- Are stocks expensive, cheap or "just right?"
- If bonds are expensive, why do they keep becoming more so?
- Is the drop in gas prices at all relevant? Will it last?
- Do we again blame the weather when the First Quarter GDP is poor?
- Can or will interest rates rise without the Federal Reserve first starting the process?
- Is this up 300 one day, down 300 the next a message to go to cash?
- Dollar strength is good? Bad? Important?
- Oil? Now what?
- Is housing ever going to be normal or simply remain abnormally volatile?

STOCKS

The traditional valuation method for stocks is the price to earnings ratio (P/E) – the current dollar price of a stock divided by the current year's earnings. A $35 stock earning $2 per share in the current year carries a P/E of 17.5. Variations, such as the P/E over some prior or future period, are also used.

Two other often unmentioned influences are these:

1) The earnings growth rate of a firm is often used to justify higher (or lower) P/E ratios. A firm with a 20% earnings growth rate is worthy of a higher P/E than a firm growing at 3%. A "normal" P/E is probably around 15 and

WWW.SANSGROUPLLC.COM
4900 WILLIAMS ROAD • SAN JOSE, CA 95129
408 253 3568 • FAX 408 253 3568

higher or lower is based on analysis, guidance from the firm, comparative estimates, inflation, industry trends, experience . . . a litany of variables.

2) Higher interest rates often arrive with higher inflation, which can make dividends from stocks less attractive. With very high interest rates bond yields look better and vice versa for low rates. That also can influence P/E.

3) One byproduct of a climate marked by high inflation is the time-value-of-money issue – the discount investors apply to those future earnings and dividends. Simply put, cash for some future period has less attraction in a period of high inflation. Those future earnings are worth less and a discount is applied to the P/E to reflect it. Firms with solid growth rates of 10% or more back in the high inflation of the 1970s sold at 6 or 8 times earnings.

When inflation cooled, P/E ratios for those same firms rose sharply into the mid-teens. Currently no "inflation discount" is in the majority of stock P/E ratios.

When we speak of the "market P/E" we are usually referring to the S&P 500. All 500 stocks for example, may have aggregated earnings of $100. If the S&P is at 2,000, the market P/E is 20. Buried in there are both fast growing and slow growing companies that are being collectively labeled with a market P/E or, in street parlance, a "market multiple." This is the most frequently referred to number by market commentators.

Many investors rely on the market P/E or market multiple as an indicator of whether the market is overall expensive or cheap. They do this based on historic periods – often selected to prove a personal thesis. The data that follows is courtesy of Gluskin Sheff, the interpretations are mine to help my personal thesis.

There are three arithmetic parts to moving stock prices up or down: 1) earnings growth, 2) dividend growth and 3) the P/E. In the last 100 years, the combined return of these three elements averaged 9.6% pretax. Of that, the dividend contributed 4.1%, the growth in earnings contributed 5.3% and P/E changes contributed 0.2%. In a few words, fundamental factors are far more important than the P/E. Dividends were assumed to be re-invested in this data and again, no taxes. Without dividends and their re-investment the total return is primarily the 5.3% aggregate earnings growth.

In further analysis, that 100-year block of data was broken into 10-year segments and this was found:

WWW.SANSGROUPLLC.COM
4900 WILLIAMS ROAD • SAN JOSE, CA 95129
408 253 3568 • FAX 408 253 3568

1) Except for the Great Depression (earnings declined 6% average annually 1925-1934), earnings growth has been positive, on average, in each 10-year period.
2) Earnings were strongest in the decade following WWII (11.5% annually) and during the 1995-2004 Tech boom – up an average of 7.8% annually.

3) Dividend yields have been slowly declining over the last century (surprised me, too, but logical when you think about it).
4) P/E expansion contributed a tiny bit over the last 40 years and was mixed for the prior 60.

5) The most recent decade saw P/E expansion play no measurable role in the total return of stocks. Note: That's the last decade, not the last few years.

The last finding is this: A decline in interest rates tended to expand the P/E. Recall that the 10-year Treasury has declined from 11% in 1985 to 2% of late.

Conclusion? The "high" P/E rate of late is, in part, justified by the ongoing low level of interest rates in spite of weak to non-existent operating earnings growth. More importantly, as we enter a period of rising interest rates and a better economy, it is unlikely to cause an overall decline in stock total returns as we have the long history that the P/E contribution is minor in the expected long-term return of 9%+.

This, of course, is the point where the average investor says something like "I'm not seeing 9% per year from my stocks."

True, and it's because you aren't seeing anything like the kind of real earnings growth that makes for that 9%+ and you haven't since 2005. Think about that – since 2005. Only of late has dividend growth increased its influence – not back to the 4% of 1985 to 1995, but up modestly. It simply cannot replace the major contribution earnings growth makes, however.

Hopefully this helps explain 1) why I tended to focus on dividend-oriented stocks for the last 7 years or so; 2) why dividend-stock mutual funds did well, too; 3) why I am very concerned about companies with minimal earnings growth that (artificially) raise dividends with borrowed money, and 4) why I am concerned about firms that also create (artificial) earnings growth by shrinking the number of shares they have outstanding with borrowed money. This takes me to a place where most all of what I read about "historical" P/E and warnings based on P/E levels are viewed as misleading and often far too shallow in analysis, to say nothing of being too short-term focused.

WWW.SANSGROUPLLC.COM
4900 WILLIAMS ROAD • SAN JOSE, CA 95129
408 253 3568 • FAX 408 253 3568

BONDS

The last few comments lead nicely into the vast amount of corporate debt that's been created over the last 7 years and the impact that debt has had on pushing stock prices higher.
If, in fact, the thesis that earnings and dividend growth substantially drive the total return of stocks, then debt to artificially drive them further with stock buy backs and dividend hikes makes sense only in a mathematical way. Fundamental support for stock prices is lost in the fog of debt creation.

Record low interest rates also induced otherwise mediocre corporations to borrow and, what with corporate leverage, the tax deduction for interest and even a modest internal rate of return on a firm's deployed capital, why not? It's near effortless "earnings" and the typical armchair investor appears unaware.

But the question remains: Why higher bond prices when rates are near zero? I think it's two major factors among many: A flight to safety reflected in world demand for dollar assets – U. S. Treasuries – and now the European Central Bank stating they will buy the debt of their member nations even if the yield is negative. The belief that this will continue for some time is the driving force. Add in the higher yield of U. S. Treasuries and their quality and the demand becomes more obvious.

The convergence of these induced demands is driving bond prices up well beyond worth and so any numbers of firms are willing to issue debt into this demand. Investors, seeing this trend, are switching from stocks to bonds, clearly assuming the Fed will tighten only very slowly thus adding more demand. All is calm until rates rise. Much of the "soft" stock market of late reflects this asset shift to bonds.

To this point, I see bonds (maturities beyond 10 years or so) as a sell. Stocks are fair value if you assume an ongoing muddle recovery and an historical trend that earnings matter most. Add also that "timing" in and out of an upward bias begs failure. That hundred years of history is tough to ignore, however cyclical.

GAS

I find it very logical that certain consumers are using savings from lower gas prices to both build personal savings and to reduce debt. The gas price decline is relevant to the bottom 1/5 by income, perhaps the bottom 2/5, but near irrelevant to the top 1/5 and likely well into the middle class. It makes great headlines, inflames folks who are convinced it's an oil company trap and irritates seniors who remember $0.20/gallon and find themselves tight on disposable income, thanks to near zero return on their savings. To the working poor it's a great relief on many fronts.

WWW.SANSGROUPLLC.COM
4900 WILLIAMS ROAD • SAN JOSE, CA 95129
408 253 3568 • FAX 408 253 3568

A few years back, I did a Quarterly that touched on the number of hours (or minutes) of work the average guy has to put in to buy a gallon of gas. That downward trend in "time needed" continues. I suspect the real issue is the volatility and that lies behind saving the savings and not spending it. A wiser consumer. One current surprise is that in January, U. S. drivers consumed the most gas for the month of January in seven years. The figures are startling: 8.7 million barrels a day and about 9% of the world liquid fuel consumption for the month.

I had observed a few months back that savings from lower gas prices were being spent on more gas. It seems that has been confirmed. The drop in prices seems to be relevant to a specific segment of the population, not impacted directly by crude oil prices, which are headed back up. The gas drop itself will likely persist until fall. The middle class will save the money, the upper 1/5 will be unaware and the bottom 1/5 will be grateful.

WEATHER AND GDP

It should be only a few weeks after this Quarterly goes out that GDP for the first quarter is reported. I have written I thought it would be weak and I still think that.

Weather has been a factor for some time, but in a muddle-along economy it is now becoming only a convenient whipping boy. My view is that it is increasingly less so as greater amounts of retail transactions are internet based and the logistical issues of package delivery are in the hands of FedEx and the like. Consumer shopping trips can be delayed by weather but consumption can proceed in spite of it. It will remain a good excuse for economists, though. May I point out we always have "weather?"

Consumers being the driving force of the economy, their spending is carefully watched. Of late, it seems weak – very weak. I have noted that reported sales data is in dollars, not units. This makes me think that the observed significant deflation in many big-ticket goods (flat screens, phones, clothes, furniture, etc.) is in aggregate greater than the inflation in smaller ticket – services, entertainment, restaurants, etc. – and therefore unit sales of goods are higher than the sluggish rate implied by sales dollar reporting. Note also that the service sector is not subject to much global competition so price increases are fairly easy. It can pretty much remain free of concerted domestic competition also. It's coming, though – one small example is the rising number of surgeries in foreign countries. All in all, the consumer is not as weak as measured and is absorbing inflation in small ticket items.

That said, my vote is still that GDP will be weak and not only because of the port strike or weather. More likely the consumer is simply continuing to save and worry. The second quarter is (early guess) likely to be very good – over 3%.

WWW.SANSGROUPLLC.COM
4900 WILLIAMS ROAD • SAN JOSE, CA 95129
408 253 3568 • FAX 408 253 3568

INTEREST RATES

Yes, I think interest rates can (and are) rising ahead of any Federal Reserve rate hike. Look no further than car loans, mortgages, credit card rates and bank consumer loans.
As son Mark puts it, we keep forgetting this is not just a weak, normal business cycle with its peaks and valleys. Rather, it is also a balance sheet cycle, a U. S. Government balance sheet recession and recovery superimposed on a weak business cycle.

We are left to isolate each component and, sadly, because of ongoing Fed behavior, the predictive value of the yield curve and other measures are failing us under the weight of the Fed managing rates.

When the Fed bumps the short rate up a quarter point next year (?), I suspect that other Fed influences will limit the ability of our favorite indicator, the 10-year Treasury, to initially move up in concert. The odds for that move up are slim – to my mind, 10%. The most likely bet is that it's ignored and the 10-year continues to trade up and down around Fed action, not market forces. The open market cost of money, outside of the Fed channel, is rising and will very likely continue to do so. Here again, the overlay of a weak business cycle and the Fed's struggle to deal with a balance sheet recession are in conflict.

VOLATILITY

I repeat: There is a difference between vulnerability and sensitivity. Stock (and bond) volatility reflects their respective sensitivity to events – Fed and otherwise. Stock and bond vulnerability is a function of their inherent credit or financial quality to weather these events. Pay less attention to price movements of "up 300, down 300" and focus on your asset quality. Go to cash if you are a trader seeking to "time" a correction in stocks so you can re-buy them. We investors will be cheering for you as we wait out yet another correction and move into summer with our quite nice long-term holdings.

THE DOLLAR

It's important. It's the safe haven for all the citizens of tottering economies world-wide. It's the currency needed for emerging nations to pay their dollar-denominated debt. Its strength is hurting every multinational company. The cure for those companies is found in hedging and pricing and that takes more than a quarter or two for any company to set in place.

The dollar strength is also a good learning experience for investors as it exemplifies how an exogenous event can disrupt an otherwise good company and, importantly, provide the investor an insight to how good firms march on

WWW.SANSGROUPLLC.COM
4900 WILLIAMS ROAD • SAN JOSE, CA 95129
408 253 3568 • FAX 408 253 3568

through such events. We are watching how our stocks handle this but aren't overly concerned.

Yes, I know many sold their internationally exposed holdings. To each his own. I have no particular talent for knowing when to buy them back. I like our holdings and will accept the work – through. So, short-term bad for all international firms, long-term bad for poorly managed companies. Price swings in excess of the facts are disconcerting to short-term traders, but they seem to need the pain.

All in all, the dollar strength helps the consumer buy non-U. S. goods, hurts corporations at the onset and, as we are a near-closed economy, has little (or no) impact on consumer prices. As energy prices, like oil, are priced in dollars, there is no currency effect there, either. Important, yes, but on balance it's good for the American consumer, not good elsewhere.

OIL

The significant impact of lower world oil prices is the growing localization, if I may call it that, of the Middle East conflicts.

As we grow increasingly energy independent (and could be 100% in very short order if we wish), our dependency on Saudi oil or Yemen pinching the supply routes for that oil grows less and less relevant. We are fast approaching a time when Civilization Clash in the Middle East can proceed substantially without us, without our troops, without our oil dependency funding it. In fairness, all new Clashes are set to rise in the South China Sea, on the Korean Peninsula and, of course, with Eastern Europe and Russia.

To my way of thinking though, oil moves up in price, as I've said previously, primarily reflecting world discord, not sizeable new world demand.

That rise (likely to $65-$70/barrel) puts many smaller fracking operators here back in the game, but is not enough to bail out the high-production-cost producers like Russia or Venezuela. Ironically, Saudi oil is among the cheapest to produce in the world. Delivery is another issue. Look at where Yemen is on a map – you'll get the drift around their new commitment of planes and troops to the trouble spots on their border. All in all, higher oil prices, gasoline in a range, increased fracking, low natural gas prices and less Middle East involvement. By the way, other commodities should also bottom in price and start up, again based on conflict, not just demand.

HOUSING (data courtesy of D. Rosenberg)

In all the negative data sits housing with good February new home sales, a shortage of used homes and overall rising prices.

WWW.SANSGROUPLLC.COM
4900 WILLIAMS ROAD • SAN JOSE, CA 95129
408 253 3568 • FAX 408 253 3568

It seems that decent job numbers and decent, if still scattered, wage gains are both housing and savings bound.

Weather did hit housing, but “starts” fell 39% (annualized) over the 3 months ending February – weather doesn’t explain all of that.

I suspect “starts” fell by virtue of management caution – there is still a tone of uncertainty to any businessman’s view of the future and rate hike threats and rising material costs didn’t help.

February existing home sales (closings) looked poor, but I suspect were entered into in December? January? Here I’ll give weather a legitimate nod. The jump in new-home sales (8-year high) is more likely explained by that shortage of used homes.

Entry-level buyers are back, per Zillow surveys – likely reflecting a better job market for them. About 330,000 “thirty somethings” found jobs in December. This is the new driver to starts and should continue as the rest of us muddle along.

Last, note also that new household formation from that 25 to 34 age group – is twice (2 million) the rate of new housing starts. With but 4½ months of used home inventory, the root desire to get out of apartments (with their accelerating rents) is the one clear bright spot. One pending negative is the potential too many apartments have been built. I suspect apartment builders over-discounted the American dream of their own home.

In a past series of Quarterly Outlooks, I’ve lightly explored the behavioral side of economics.

In Quarterlies like *Snap*, I took a look at fear and ensuing stress, how we learn and how our lizard brain – our very root autonomic process, protects us with subconscious, gene-based learnings.

I’ve touched on game theory also, trying to understand how and why we make decisions and then act as we do. I’ve written of the power of the group and its ability to function together without formal awareness or coordination.

The broad decline in real investment decision-making – fundamental investment work, reflects, I think, both wariness and weariness of the investment management profession with this market. As a group they have come to act

WWW.SANSGROUPLLC.COM
4900 WILLIAMS ROAD • SAN JOSE, CA 95129
408 253 3568 • FAX 408 253 3568

collectively to the same end decision . . . wary and weary. Look only to the rise of Index Funds for one example.

.
"Diversify" is also the glib answer given by some less-informed managers to their clients; "diversify" if you're worried, weary or simply feeling a need to do something.

But investors aren't asking for diversification. They never do in a bull market. This is a bull market. When it ends, then they will ask for it.

What they are asking for now is less risk. Investors don't trust this market, the most mistrusted in history. Why? Because they know it's not entirely real. The Fed caused it. The Fed can, deliberately or not, end it. It's now Common Knowledge.

If investors are only thinking of some level of reward for some acceptable level of risk then greater diversification is the recommendation.

More likely is that investors are now very much **regret minimizers** and that is a whole new ballgame.

The psychological value associated with both realized and foregone reward is well captured in evolutionary biology and was touched on in various Quarterlies. These lessons are genetically branded on us. Diversification by constant shuffling of asset ratios or market sectors simply does not address the client's needs to minimize regret. Frankly it only soothes the manager's compulsion to "do something." This is a poor response to the "fight or flight" instinct.

Diversification does nothing to minimize regret. Regret for opportunities missed, regret for losses seen, regret for not being one of the "lucky ones." The multiplying factor is the growing awareness of manipulation of both fundamental stock pricing (flash trading, data mining, insider trading, fraud, etc.) and the economic variables. Lacking clean data, decision-making is far harder, regret more likely.

Look at it this way . . . in a Bear market regret minimization is driven by existential concerns. In this, a Bull market, regret minimization is driven by peer comparisons. In a Bear market, we try to avoid ruin and we sell to some "sleep level." Everybody is on board doing the same; we are calmer. In a Bull market your primary regret is ending up looking stupid and that produces one hell of a conflicted reaction.

Your goal is to de-risk – you don't get this market – but equally afraid of being labeled as scared, of missing an opportunity. I think of ancient man, hunting in the jungle. A snap of a twig. Food? Tiger? Run? Stay? He could not just

WWW.SANSGROUPLLC.COM
4900 WILLIAMS ROAD • SAN JOSE, CA 95129
408 253 3568 • FAX 408 253 3568

freeze; his life was on the line. We, in turn, can freeze, wait, and blame later. It's the "freeze" choice that causes the most damage, I think.

Regret minimization in an active portfolio can be approached in a few ways:

- focus on companies and industries sensitive to economic events, but hopefully minimally vulnerable to them;

- create as much of the reward for owning them as practicable by seeking reliable high dividend payers and reinvest those dividends;

- try, if you will forgive the sports analogy, to hit singles and doubles and never, ever, swing for the fences. Home runs come when you least expect them and hitting for them every time at bat guarantees regrets.

The task is to increase the reward and reduce extreme volatility. Part and parcel is to lose less money in corrections so that full value is back sooner.

Some other strategies periodically used include short positions via funds created by others for that purpose, counter intuitive assets and even trend following.

I have traditionally managed money to minimize regret. I have found that clients seek what I've outlined – core investments that, if they go wrong, create minimal regret. They prefer this to potentially larger volatility and much larger regret when something – the market, a stock, goes wrong. (. . . and always keep a little bit of "fun" risk in the portfolio . . .)

I credit Ben Hunt for some thoughts in this last section. His thought line crystallized what I have written about so many times.

Two last quotes from Ben's work:

> " . . . Regrets, I've had a few, but then again, too few to mention . . . "
>
> (Paul Anka, Frank Sinatra)

> "I see it all perfectly. There are two possible situations – one can either do this or do that. My honest opinion and my friendly advice is this: Do it or do not do it – you will regret both."
>
> (Soren Kierkegaard, 1843)

The last word, then, is from Yoda.

This material is for your personal use and is neither an offer to sell or buy securities nor is it a solicitation of your business. It should not be redistributed in any manner without approval. We believe our sources to be reliable, but cannot warrant the information herein as complete or accurate – and it should not be treated or relied upon as such. An ADV Part II is available upon request.

WWW.SANSGROUPLLC.COM
4900 WILLIAMS ROAD • SAN JOSE, CA 95129
408 253 3568 • FAX 408 253 3568