Published by SL Advisors, LLC

In Pursuit of Value

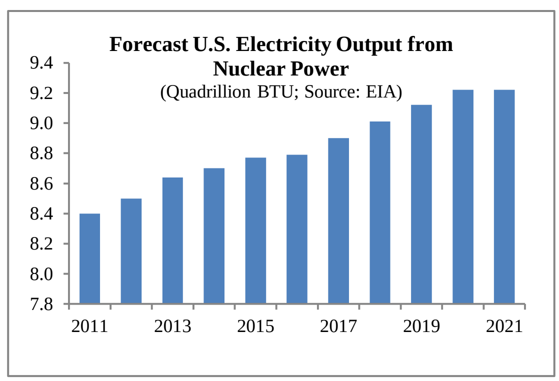
April, 2011

SL Advisors, LLC is a registered investment advisor offering separately managed accounts to individuals, family offices and institutions.

Quarterly Outlook

Looking back over the past three months and the major surprises that confronted investors, the relatively modest fall and subsequent rebound in markets illustrate just how hard it is to call highs and lows in equities. Unfolding political instability across the Middle East, the tragic combination of earthquake/tsunami/radiation release in Japan and ongoing European sovereign debt concerns are all part of the investment landscape and yet so far not that damaging. U.S. GDP forecasts are only modestly lower as a result, and a rise in short term interest rates still seems unlikely before next year. Meanwhile, some fiscal drag is expected as Congress tinkers with but doesn't fix the budget deficit.

In Fixed Income, the looming question is how the bond market will react to the apparently abrupt ending of QE2 in June. Yields fell steadily into last October in anticipation of its start; there is less uncertainty about its stop (until last October's announcement the size of new demand was uncertain; in June the size of removed demand is certain, about $105 BN per month). U.S. treasury bonds have been unattractive investments for some time, and yields still appear to have much greater potential to rise than fall in order to attract new investors. Bill Gross notes that historically the yield on ten year U.S. treasuries has varied around nominal GDP, which would suggest ultimately they belong at 5% rather than around today's level of 3.5%. Meanwhile, government policy to weaken the US$ continues to be executed flawlessly if without fanfare. Pygmy interest rates (so memorably says Jim Grant) and relentlessly energetic Federal spending are eloquent reminders to own foreign currencies. In our Fixed Income strategy 25% of our investments are now in non-US$ (versus 20% a month ago), mostly in short term diversified emerging market currencies where growth, inflation and interest rates are all higher than in the U.S. It's one of the few ways to earn any income. We continue to maintain our U.S. interest rate risk around the two year sector in diversified high grade corporate bonds, selecting a cautious compromise between yield and risk, generating some income and preserving capital while waiting for fairer yields.



Regular readers are familiar with our natural gas theme, which is currently 25% of our Deep Value Equity strategy through various natural gas E&P names. Articulating the case in new and interesting ways becomes increasingly challenging – to summarize, compared with other fossil fuels (such as crude oil) natural gas is cheaper, cleaner and here. Companies with low debt that are efficient (i.e. low cost) finders and producers create lots of upside optionality for their investors waiting for the thesis to play out. Our holdings include Range Resources (RRC), Comstock Resources (CRK), Southwestern Energy (SWN), Ultra Petroleum (UPL), Petrohawk (HK) and Westport Innovations (WPRT). Leaking radioactivity in Japan was hardly top of our list of potential catalysts, but it has probably reduced the role of U.S. nuclear power in meeting future energy needs. The chart is based on forecasts made prior to Fukushima – we think it will look different when the EIA updates it. The Financial Times recently noted that OPEC's oil revenues will reach $1 trillion this year, an annual transfer of wealth so breathtaking that it surely must provoke a policy reaction among their clients. President Obama's recent speech seeking to reduce oil imports by a third over ten years was welcome if light on specifics. We think this story has plenty of chapters left.

We continue to own a couple of shipping investments – many of these stocks trade at steep discounts to tangible asset value (i.e. their ships) but face continuing pressure on freight rates (driven by steady growth in global shipping fleets). We recently sold Euroseas after it moved closer to fair value but continue to own Overseas Shipholding Group (OSG) and Aegean Marine Petroleum (ANW), both of which are depressed and therefore offer an attractive risk/return. We have a residual investment in Coeur d'Alene (CDE), a silver mining company that has handily outperformed the rally in silver. We're also invested in a number of large cap, low P/E names including Kraft (KFT), Microsoft (MSFT), Johnson and Johnson (JNJ) and Procter and Gamble (PG). While we can scarcely claim a research edge into such widely followed companies, they each provide an attractive potential investment return with acceptable risk. We were intrigued by a recent article in the Financial Analysts Journal highlighting that in a world of relative performance with so much capital benchmarked to indices, low beta names (such as these four) tend to provide a higher return per unit of risk. This is because actively managed funds tend to overweight higher beta names that are expected to outperform a rising market. The article partially invalidates the Capital Asset Pricing Model, and while space doesn't allow a detailed description here it's always interesting to find inconsistencies in a widely followed academic theory. Interested readers can find a summary at http://www.cfapubs.org/doi/abs/10.2469/faj.v67.n1.4 though CFA membership is required to access the full article. We also published our own research on this idea at http://seekingalpha.com/article/257956-low-beta-stocks-look-particularly-compelling-today. Our natural gas and shipping investments (high beta but in our opinion modest risk) provide a complimentary fit to attractively priced broad market exposure through some of the low beta names such as those listed above.

What We Own

SL Advisors, LLC focuses on identifying securities that are trading at a discount to intrinsic value.

Microsoft (MSFT) currently trades at a P/E of 10 based on this year's earnings (they have a June year end) or 9 times next year's consensus EPS of $2.76. Their cash hoard net of long term debt is $31.6 BN or $3.69 per share, so the business excluding cash trades at only 7.9 times 2012 estimated earnings. Revenues will grow at 11% this year and probably 10% next year. The familiar criticism of MSFT is that they generate monopoly-like profits from their dominance of the PC business through Windows and Office only to sink it all into gaming and online services with precious little profit to show for it. Nonetheless they'll still generate around $4.12 per share of Free Cash Flow to Equity this year and revenues in their Entertainment and Devices division are growing at twice the company's overall rate. Eventually, and maybe sooner rather than later, gaming and online will stop using cash and start generating it. In fact JPMorgan produced some research earlier this year illustrating that even with fairly stagnant growth in cashflow the NPV of flows suggested there was still substantial upside in the stock. At current levels we think MSFT provides exposure to global GDP at a reasonable price with attractive potential. MSFT is a holding in our Deep Value Strategy.

Republic Services Group (RSG) is the second largest waste management company. They are sensitive to economic activity through their Commercial business (a stronger economy produces more garbage) while their Residential business tends to be more stable. They're in a competitive business, but through small price increases, efficiencies and volume increases they generate fairly reliable earnings growth. RSG is a consolidator in that they can acquire much smaller firms and squeeze efficiencies out of them. They can also benefit from cash-strapped municipalities looking to offload their own garbage services to a private operator. RSG's stock price is not depressed, currently trading at around the market P/E multiple, but we like the fairly reliable and inflation-resistant nature of their earnings (since many of their contracts reprice annually based on CPI). RSG is a holding in our Deep Value Strategy.