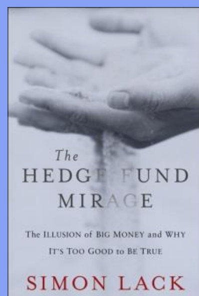
Published by SL Advisors, LLC

In Pursuit of Value

April, 2013

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

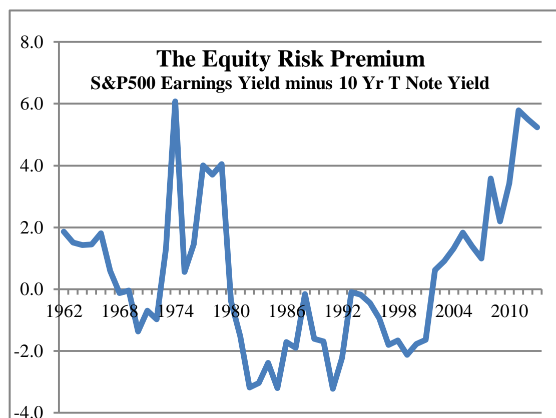


Quarterly Outlook

"Financial Repression" is the term used to describe an interest rate regime that functions to the benefit of borrowers and at the expense of lenders (i.e bond investors). It is characterized by yields on government securities that are set by the authorities to provide a return below inflation – and worse after taxes are figured in. Since most high quality, investment grade corporate debt is priced with reference to government yields the ability to borrow at negative real rates is not confined to the sovereign but extends to blue chip corporations as well. During such a regime, fixed income investors willingly shun more risky assets that provide the possibility of fairer returns and instead accept the relentless guarantee of lost purchasing power.

Reinhart and Rogoff, in their highly readable book, *"This Time Is Different – Eight Centuries of Financial Folly"* equate Financial Repression with "default through debasement", the almost imperceptible loss of value caused by negative real rates. Inflation in the U.S. remains low to be sure, at 2% or so. A government that created the conditions for much higher inflation so as to impose far more negative interest rates would be a more obvious "debaser". Referring to current interest rate policy as a form of default by the U.S. government will sound like an overstatement. The semantics are for others; investors need simply figure out how to respond.

Following a strong quarter, aided in part by investors responding to financial repression, U.S. equities and other risky assets probably offer somewhat less return with somewhat higher risk than was the case late last year. Prices have moved more than fundamentals, since the good news largely consists of what has not happened: the fiscal cliff was averted; sequestration does not appear to have hurt consumer spending that much; the Euro-zone avoided disaster but didn't grow; Israel hasn't bombed Iran and other potential areas of conflict in Asia are quiet.



Equity valuations have become somewhat less attractive following the 10.6% 1Q13 return on the S&P500. Consensus 2013 EPS on Bloomberg is $110, so the 7.0% earnings yield ($110 divided by S&P 500 level of 1,569) at the end of March is still 5.2% above the yield on ten year treasuries. While the Math comfortably favors a combination of stocks and cash instead of fixed income as we've written here before, the current 5.2% Equity Risk Premium is less attractive than the 5.8% level of 2011. Earnings have grown, but stock prices have risen somewhat faster. Given the available alternatives, we continue to believe that completely shunning the return-less risk of bonds is right. Holding some cash provides the "risk capacity" to hold assets with the potential to beat inflation. It's just not as good an opportunity as it was, but from where things are today still the right approach.

Low beta names had a very good quarter. Much of what we do involves investing in companies with low debt, predictable earnings and therefore less volatility than the overall equity market. It's not a popular strategy because it doesn't provide much excitement. Heinz (HNZ) was rarely mentioned by CNBC's Fast Money crowd as a great trading opportunity. So much of what is said and written nowadays focuses on hot

stocks and near term market direction. We tend to avoid the former and don't spend much time on the latter. HNZ was a holding in several of our strategies until Berkshire and 3G announced their acquisition. The Consumer Staples sector was consequently quite strong in the first quarter. We continue to like a number of names that similarly provide reasonably good long term prospects with low debt. Sometimes boring can be exciting in its own way. Our Hedged Dividend Capture, High Dividend Low Beta and Low Beta Long-Short strategies are all built around investing in stocks that, while widely held are not the focus of many active managers. Our Deep Value Equity strategy combines this concept with other names that are out of favor but similarly have low debt.

Master Limited Partnerships (MLPs) had a great year in just three months. Following a fairly mediocre 2012 (our MLP strategy was +7.4% versus the Alerian Index +4.8%) so far in 2013 MLPs have delivered +22% (the index is +19.7%). This represents the strongest quarter in the history of the Alerian MLP Index, which extends back to 1995. Its previous best was when markets bottomed in early 2009 following the Credit Crisis; in 2Q09 the index returned 19.4%. The search for income has clearly caused some cash to flow into MLPs. The Alerian Index currently offers a distribution yield of 5.3%. Our objective in this strategy is to closely track the index return with better performance in a low cost, tax-efficient way. There are many ETFs, closed-end funds and exchange-traded notes which are designed to track the index but they are all far less tax efficient and more expensive (in many cases, investors in these vehicles earn a return only after 35% corporate tax has been deducted, which is not the case for direct investors in MLPs). These co-mingled vehicles continue to draw smaller retail investors who are indifferent to, or unaware of, the substantial inefficiencies they face. Receiving a 1099 rather than K-1s is preferable to them, so direct investors in MLPs benefit from the fund flows into the sector. In addition, because ETFs and the related vehicles pay corporate income tax their growth reduces the foregone tax revenue that occasionally draws attention to the sector. Bigger MLP ETFs are in everybody's interests.

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

5% yields combined with distribution growth of 4-6% still offers the prospect of a 9-11% total return. MLPs remain a good investment, but if they are flat for the rest of the year few could complain.

JCPenney (JCP)

JCPenney is a holding that attracted more questions from clients than anything else we own, out of all proportion to its size in our Deep Value Equity strategy. Anyway, we were wrong about management's ability to retain their old customers and overly optimistic on their strategy to attract new ones. My inability to identify a single friend of my wife as a JCPenney shopper was a further piece of due diligence that deserved greater importance. Fortunately, it wasn't that big a position so the stock's miserable performance hasn't affected our results visibly. We've also re-categorized it to the "speculative" bucket, as a consequence trimming its size to reflect its uncertain prospects but valuation below tangible asset value.

The Hedge Fund Mirage

I can readily attest that holding a controversial view can be great fun if your arsenal (the miserable Math of investor returns) is more powerful than the weapons used by the naysayers. Critics occasionally pop up to find fault with my analysis – meanwhile, they face a moving target because hedge fund returns continue to be mediocre. It's worse than in my book. For another quarter, the simple 60/40 stocks/bonds allocation beat hedge funds, continuing a pattern that has prevailed every year for the past ten.

I was on CNBC TV's *Halftime Report* last month offering the view that pension fund investors in hedge funds will largely find returns to be disappointing. Hedge funds are overcapitalized. You can find the spot here. Three CNBC regulars were lined up to argue the case *For*. I'm usually outnumbered, but rarely outgunned. Off camera, one of my protagonists noted that he had met me at JPMorgan when he was seeking seed capital for his start-up hedge fund. We had turned him down. I had to confess that I didn't recall the meeting – we had turned down so many. He seemed happy with his new career in front of a camera.