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In Pursuit of Value

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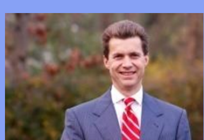
SL Advisors, LLC specializes in publicly listed closed end funds.



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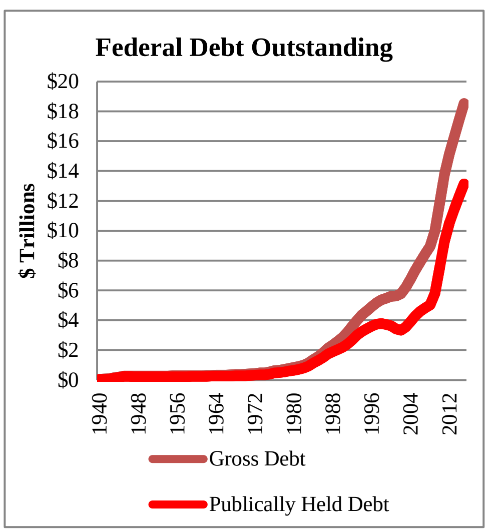
The Bond Market's Forecast

Studying America's long term budget outlook, as depressingly laid out in the Administration's 2011 Budget, is hopefully not how readers spend their free time. The unsustainable fiscal path it dryly describes is supported with numerous very similar charts showing debt levels reaching escape velocity from what is prudent and possible. The thrust and direction of the Federal finances are familiar to everyone; further details are not necessary. Ronald Reagan once quipped that the budget deficit was big enough to take care of itself, and it's grown up enough for this writer.

Reconciling spiraling budget deficits with a 4.0% 30 year bond yield isn't easy. Anybody who invests in long term U.S. treasuries after contemplating America's fiscal future is unlikely to be planning a long stay. And yet, the dire U.S. fiscal outlook combined with the ongoing low cost of continued fiscal deterioration is perhaps the biggest conundrum facing investors today. Research has shown that the average estimate of an outcome is often more accurate than the vast majority of individual guesses. Barton Biggs in his 2008 book "Wealth, War and Wisdom" develops this idea and points to key turning points during World War II when stock markets (representing the collective assessment of future economic prospects) identified military turning points not recognized by contemporary commentators. UK equities bottoming prior to the Battle of Britain in 1940, and German equities peaking just as German troops viewed the Kremlin in 1941 are two examples. By this yardstick, the bond market's collective wisdom looks beyond a fiscal crisis and anticipates a solution. Today's fiscal worriers might as well preach about global warming while temperatures are falling. However, dramatic Congressional action requires a crisis, in this case presumably a bond buyers' strike, and bond yields are silent on how exactly we will get from here to there.

Although much discourse with little action is applied to America's finances, what's largely unspoken is the staggering moral failure of one generation in its obligation to the next. Whatever your political beliefs and voting history, what we have witnessed and perpetrated together is a fiscal cognitive dissonance with consequences shifted to the next generation. As voters, we have in aggregate almost always rejected spending cuts and tax hikes, because the people who would ultimately close the fiscal gap were too young to vote or not yet born. Demographics assure that tomorrow's taxpayers are destined to pay more than today's would ever accept, to pay for the great heist. What is true at the Federal level is also often true at the state level, and applies in varying degrees to most developed countries.

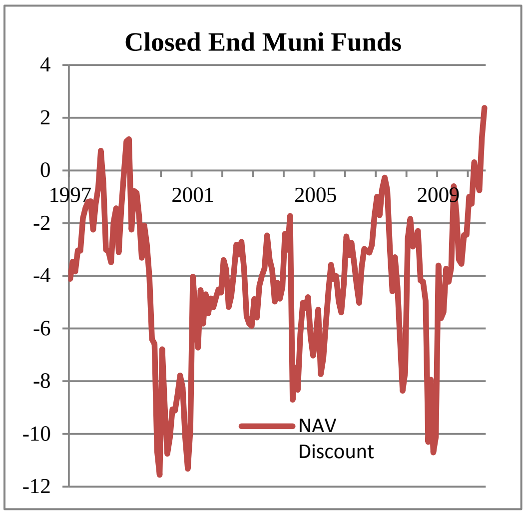


While there is no bright delineation from one cohort to another, the stage is inevitably set for an epic inter-generational struggle between Baby Boomers who promised themselves senior benefits without saving for them, and the next generation. This is likely to represent an inconveniently loud crosscurrent in the politics of achieving fiscal balance as the bill comes due. In a reversal of roles, the taxpaying generation will remind the older but not wiser boomers that chores come before the X-box.

Two of my children are already voters, and for many years I have been educating them about the trap we Baby Boomers have laid. While both higher taxes and entitlement reform will be part of our future, our collective, abject moral failure is surely deserving of much more of the latter. "Smaller, later pensions for most, and for some none at all," should be a soundbite in future elections. The old versus young struggle over who pays the bill has not yet begun, and like most family fights over money it will not be pretty. But it is the only plausible outcome, and perhaps sanguine Asian investors in U.S. treasury bonds reached the same conclusion a long time ago.

Municipal Closed End Funds

Certain closed end fund sectors are beginning to reflect expectations of tax changes. Although Congress hasn't yet decided how to treat the expiring "Bush" tax cuts, consensus appears to be building around maintaining current income tax rates (other than the top rate which is the one that matters to many investors) and modestly increasing taxes on dividends (from 15-20%). National municipal closed end funds, of which there are 104 with a market capitalization of $38BN are trading at a record premium to NAV of 2.4% (according to Morningstar). This sector has only closed the month at a premium six times since 1997 (as far back as Morningstar's records go). Three of those months were in 2010, and the others were in 1998 (following which they plunged to a record wide discount of 11.5% by the end of 1999).



By contrast, the 14 funds in Morningstar's Real Estate sector are at an average discount of 14.9%, having widened by 5% since March reflecting refined tax expectations and perhaps nervousness about the sector itself.

What's fascinating is that changes in the tax code should properly only affect the prices of the underlying securities owned by closed end funds, not the funds themselves. Closed end funds don't pay tax, so generally changes in the tax code should be fully reflected through NAV movements rather than changes in discounts (although to the extent that a fund has unrealized gains and capital gains tax rates change, the discount to NAV may adjust to reflect that).

What We Own

Corrections Corp of America (CXW) runs prisons for Federal agencies and states. It is the largest private operator of prisons in the U.S. Roughly 1% of America's population is in prison as a result of tougher sentences over the past thirty years, and regardless of whether this is good public policy, the cost of doing so is claiming a growing percentage of state budgets. State prison systems are at 97% of capacity (and California is at 170%) while the Federal system is at 137%. In addition, the private sector can build and operate prisons at significantly cheaper inmate per diem rates than the States and Federal agencies. Recently the 2nd and 3rd largest private operators merged, resulting in a duopoly (Corrections Corp and The Geo Group). CXW, the market leader, has excess capacity where there is growing demand at a lower cost, earns around 14% return on capital, and has low debt. CXW is a holding in our Deep Value strategy.