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In Pursuit of Value

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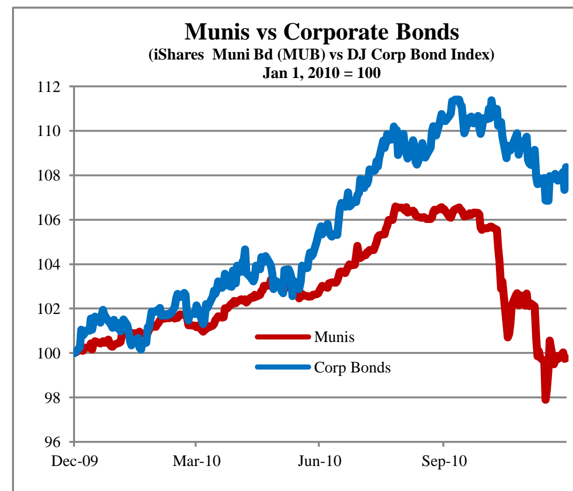
SL Advisors, LLC is a registered investment advisor offering separately managed accounts to individuals, family offices and institutions.

Quarterly Outlook

Back in September when I wrote our fourth quarter outlook, the likely direction for stocks and bonds was unusually clear. The difference between the earnings yield on stocks and punitively low bond yields had rarely been wider, strongly suggesting that bonds would be a poor investment and that stocks would outperform. Ten year treasury yields duly rose from 2.5% to 3.3% generating a loss of 5.5%, while the S&P 500 rallied from 1,141 to 1,258 returning 10.8% with dividends. Investing would be so simple if everything was so reliably obvious – of course it rarely is, otherwise it would be everyone's hobby.

Economic growth remains solid and the recent tax deal combined with QE II have pushed most GDP forecasts closer to 4% than 3% for 2011. The President's Deficit Commission produced a serious roadmap to balance the budget. Alan Greenspan commented wryly that something like it would surely be adopted, the only question being whether it would happen before or after a crash in treasury bonds. However, after several days of somber comments from the Senate about burden sharing and tough choices ahead, gridlock was discarded and common ground quickly found in the form of lower taxes all around. The U.S. will always avoid another Depression no matter what the long term cost; the budget deficit will only receive serious attention when bond investors decide it's time. Those two principles never fail to explain events in Washington, and are consequently never far from our thoughts.

The case for higher bond yields is well known, and I won't repeat it here. Treasury yields have seemed too low for years, but reported inflation has remained low as well. Having risen around 1% from their QE II inspired lows, the recently established trend towards higher yields makes it very comfortable to expect further increases. It's rarely that easy, and profiting from being in the consensus often requires being nimble. We remain underweight bonds in our fixed income accounts, but by no means out of the market. We have securities to sell if yields head back down towards 3%, and if yields drift higher our goal is that coupon income should compensate for capital losses. We continue to maintain 20% non-US$ exposure to emerging market currencies (where growth, inflation and yields are higher) and Canada (much better fiscal management and large supplies of energy). Fixed income investors have to look outside the U.S. for part of their return. Government policy (very low interest rates, quantitative easing, continued large fiscal deficits) continues to favor a weaker currency.



An interesting but little noted feature of the markets is the weakening relationship between treasuries and equities. For several quarters stocks zigged when bonds zagged as the "risk on/risk off" trade played out. When falling equities were forecasting a "double-dip" recession the relationship made sense. The high negative correlation between the two made inclusion of treasuries a smart risk reducing addition to most portfolios, and therefore pushed down their yield. Finance theory can show that an asset that's highly negatively correlated with a portfolio doesn't need to generate much return for its inclusion to be worthwhile

through reduced overall risk. While the mathematical proof is complex, the simple explanation is that as equities and bonds become less synchronized and move independently of one another, bonds are becoming less valuable to portfolio managers, and their yields should rise.

In Equities we like exposure to global growth, energy, transportation and commodities. We continue to focus on companies with strong balance sheets, tangible assets and a shortage of enthusiastic buyers. The natural gas exploration and production (E&P) sector offers all of these features. Shale gas extraction technology has created an abundance of cheap domestic natural gas in the U.S., depressing the prices of many stocks in the sector while creating a clear opportunity to reduce our dependence on Middle East oil. Natural gas burns cleaner than crude oil (and much cleaner than coal), is one third the price of oil on an energy equivalent basis, and is here rather than over there. What's needed is for the U.S. to adopt a self-interested energy policy that uses taxes and subsidies to guide energy consumption towards a more domestic mix of sources. As I found on a recent trip to Texas to meet many of these companies, the status quo has many well financed proponents in Washington. Big Oil writes big campaign checks, and the Coal industry is old and heavily unionized. The American Natural Gas Association is barely two years old and has yet to find an effective voice for the industry in Washington. However, energy policy may be one area where a newly-centrist President can find common ground with victorious Republicans; meanwhile, we're invested in natural gas E&P companies that have strong balance sheets, low costs of production and potential reserves worth substantially more than their current market value. Range Resources (RRC), Comstock Resources (CRK), Southwestern Energy (SWN) and Petrohawk Energy (HK) are all either current holdings or could be at modestly lower prices.

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

Shipping is another sector we like, with its exposure to global growth and tangible assets. Some of the stocks trade below the secondary market value of their ships – supply of new ships over the next several years is weighing on long term charter rates as well as stock prices. However, well run companies with conservative balance sheets can be found. We like Overseas Shipholding Group (OSG), Genko Shipping (GNK) and Euroseas (ESEA). An interesting complement to this strategy is our recent investment in Aegean Marine Petroleum (ANW) which provides fuel to the shipping industry. In a variation of selling pick axes to gold miners, should the supply of new ships surprise on the upside this will at least create more demand for ANW's services.

I've never been attracted to municipal bonds. Opaque pricing makes it an unnecessarily profitable product for brokers, and many people focus too much on reducing taxes rather than maximizing their real after tax investment returns. Munis are looking like a bet on (i) the economic recovery being sufficient to drive up tax revenues and close budget gaps, and (ii) the willingness of states and the Federal government to engage in bailouts as needed. Most muni investors suffered negative returns in 2010 and substantially lagged high grade corporate bonds. The market still faces many headwinds: no more Build America Bonds; outflows from bond funds; no tax increase and the disdain of Meredith Whitney (who is reprising her early negative calls on bank stocks four years ago with dire warnings of municipal default). Ms. Whitney's forecasts may or may not be accurate – her critics highlight low historical default rates which is the same backward-looking analysis that preceded the mortgage collapse. In any case it's difficult to profit directly from lower municipal bond prices although there's little doubt that state and local governments face pressure to spend less. To that end we're invested in companies that do what they do more efficiently than the public sector. Corrections Corp of America (CXW) is the largest private operator of prisons in the U.S. Public sector prisons suffer from chronic overcrowding as well as an expensive unionized workforce (who naturally oppose privatization and its use of non-union prison guards). CXW has the cost structure and capacity to help relieve budget pressures in many states, and has a business less correlated with GDP than most others. Another investment in that theme is Republic Services Group (RSG), the second biggest waste management company in the U.S. While their fortunes are tied to economic growth (since a stronger economy produces more trash) they're also in a position to grow through acquiring inefficient municipal and other local governmental waste operations whose fragmented structure allows RSG to run them more efficiently. Finding ways to profit from the depressing picture presented by state budgets is in some respects a personal hedge – Ms. Whitney lists New Jersey (where we live) among her five states with the worst fiscal outlook.