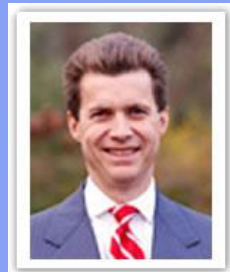




In Pursuit of Value

January, 2012

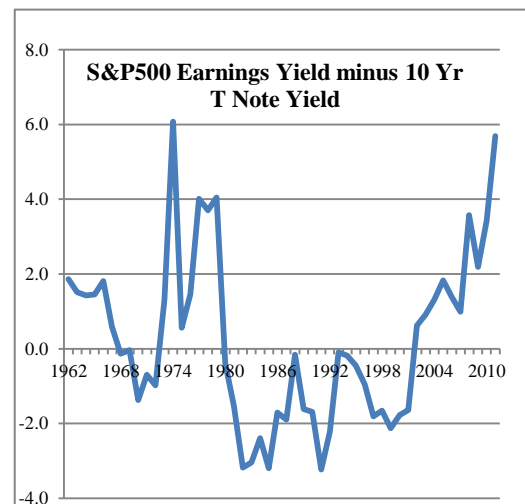
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Quarterly Outlook

That the world's a risky place has not escaped the recent attention of investors. The potential demise of the European single currency and perhaps with it European banks and the European project itself looms large over every investment decision, and has for many months. Economic slowdown in China, the uncertain consequences of the Arab Spring and more recently Iran's nuclear ambitions all add to the global uncertainty. Within the U.S. a highly partisan Congress has led to legislative gridlock and no certainty about long term fiscal policy. It makes you wonder how investors get out of bed in the morning. And when they do, they are confronted with a choice of risky assets (such as equities) which may lose value immediately, or less risky assets (such as bonds) which will lose real value with certainty. That investors are choosing the certainty of lost purchasing power over the available alternatives reflects the seemingly poor choices on offer. Thus is the equity risk premium, the difference between the earnings yield (inverse of the P/E ratio) on the S&P500 and the ten year U.S. treasury yield, at its widest since 1974, a year that closed with the Dow Jones Industrial Average having dropped 45% from its peak only eighteen months earlier, and inflation at 12.3%.

Start with bonds. Today's ten year treasury yield of around 2% assures even the tax-exempt hold-to-maturity investor of a loss in purchasing power if inflation over ten years exceeds 2%. The taxable investor of course will fare even worse. Even a portfolio of blue chip corporate bonds yielding around 4% will struggle to overcome the twin headwinds of taxes and inflation. But bonds have a big thing going for them, which is momentum. For those who draw comfort from investing with a tailwind, bonds are a warm and cozy place. The Dow Jones Corporate Bond Index has returned 10% per annum for the past three years including 8.5% in the most recent one. Who's to say that this won't continue? And of course it may, although such forecasts will



struggle mightily to overcome the Math; for bonds to return more than their current yield, their yields need to fall causing prices to rise. Corporate bond yields could drop from 4% to 3%, although such would presumably require a similar drop in treasury yields, to 1%. The world in which 1% ten year treasuries draws buyers is unlikely to be a friendly one for corporate credit, and at such a time credit spreads might be substantially wider, depressing the prices of corporate bonds. So, much as bonds investors might draw comfort from looking backwards, their best plausible outcome is that they'll earn the current yield and suffer a steady depreciation in the real value of their assets.

In fact, relative pricing between stocks and bonds is such that \$20 invested in the S&P500 yielding 2% will, assuming 4% dividend growth (and the 50 year average is 5%) generate the same increase in after-tax wealth as \$100 in ten year treasuries. This assumes the \$80 not invested in stocks earns 0% by sitting in cash, although holding cash provides the option to do something with it that might well earn a return later on. The Math works for corporate bonds as well (just change the \$20 in stocks to \$40).

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

So bonds have been good, but past performance is highly unlikely to be repeated. In fact, we believe there's a strong case to be made for all investors to reduce their asset allocation to fixed income. Government policy is to maintain ruinously low interest rates while debtors rebuild their balance sheets. The Federal government is effecting a transfer of real wealth from investors to borrowers. This policy is likely to continue for quite a long time, not least because it's popular (with those voters who contemplate such things). There are many more debtors than creditors, and regardless of how independent you think the Federal Reserve is, monetary policy is unambiguously populist, designed for the masses. The appropriate response is to allow the government's voracious appetite free rein. If Chairman Bernanke likes bonds that much he can have the lot.

As a result, identifying alternative sources of investment income is a task that consumes much energy on a daily basis at SL Advisors.

The stock market offers a risk to suit every taste. For those who like to wake without first worrying whether their holdings are solvent, many reasonably priced large cap companies with low levels of debt and a history of steady earnings growth are available. Kraft (KFT), Microsoft (MSFT) and Berkshire Hathaway (BRK-A) are all examples in our Deep Value Equity Strategy, along with less well-known names such as Corrections Corp (CXW) and Republic Services Group (RSG). Domestic energy exposure adds volatility and return potential through Devon Energy (DVN) and Comstock Resources (CRK). The former bond investor can allocate his new funds to a combination of stocks and cash (depending on risk appetite), or to other income generating strategies.

There are even examples of stocks whose dividend yield exceeds that on their own bonds – not because their fortunes have suffered and a high dividend yield reflects expectations of a cut, but because price-insensitive bond investors have driven bond yields low in their flight from equities. Johnson and Johnson (JNJ) is one such example. Our Dividend Capture Strategy consists of a diversified portfolio of such names combined with a hedge to eliminate most of the daily market moves. The result is a portfolio exposed to dividend paying stocks and dividend growth that is hedged against excessive moves in stocks.

Master Limited Partnerships (MLPs) are another attractive asset class for taxable investors tolerant of K-1s. I won't repeat here the well-worn arguments that are familiar to regular readers, except to note that the sector's unique structure renders it worth having in many income-seeking portfolios. MLPs offer tax-deferred distribution yields of 5-6% combined with growth expectations of 4-6% (suggesting a total return potential of 9-12% with no change in earnings multiples).

The Hedge Fund Mirage

John Wiley exceeded expectations and was able to begin distribution before Christmas. The publicity has steadily mounted, with TV appearances in London followed by New York and with reviews expected shortly in the mainstream financial press (most recently the Financial Times). So far my friends in the hedge fund industry have remained so (or at least that's what they tell me) which is hopefully in part because the book is intended to help investors gain more from their hedge fund investments through selectivity and more informed negotiating. There are many great hedge fund managers – there ought to be more successful clients.

Early feedback is encouraging (or perhaps my friends are too well-mannered to call and complain). But the thought that others are taking the time to read my work is humbling enough – that they like it is a bonus. Of course, I do think I have something useful to say, but it is nevertheless heartening to not hold that view alone.

