



In Pursuit of Value

July, 2014

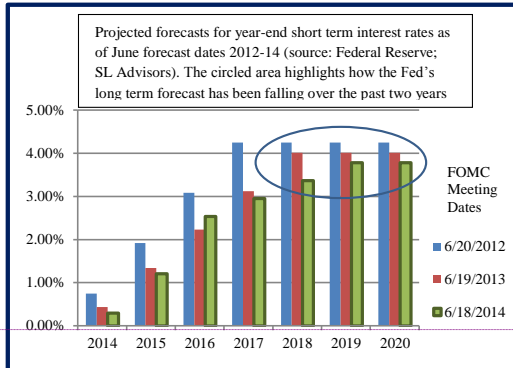
Quarterly Outlook

During the second quarter SL Advisors and our clients enjoyed strong absolute performance that was the best in our five year history in terms of outperforming respective benchmarks. Our MLP Strategy and related versions of this (not all included on the Performance page) were particularly strong. Positive surprises handily outnumbered negative ones among our individual holdings, and thematically the ideas reflected across our strategies were in favor. Most notable was a growing recognition that MLP General Partners represent a compelling way to invest in the development of America's shale energy resources and the attendant need for substantial new energy infrastructure. It provided a pleasant underscore to the five year anniversary of the founding of SL Advisors.

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

The outlook appears broadly unchanged; interest rates remain low and equities continue to look far more attractive than bonds while the 5.2% 2Q return on the S&P500 pushed valuations slightly higher. The market's P/E rose somewhat while interest rates fell a little so the Equity Risk Premium (defined here as the earnings yield, which is the reciprocal of the P/E, minus the yield on ten year treasury notes) hardly changed during the quarter.

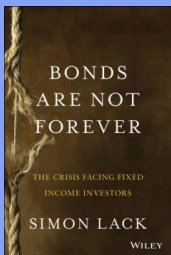
An unheralded but nonetheless very interesting revelation from the recent Federal Open Market Committee (FOMC) meeting concerned their long term interest rate outlook. We've noted before how the Federal Reserve has been moving towards a more open communication strategy. Long gone are the interminable monologues of Alan Greenspan that left his Congressional interlocutors dumbfounded and the public no wiser about monetary policy. The Fed provides fairly clear guidance on their thinking across all plausible investment horizons, and while their forecasts can change like anybody else's, we're better off for knowing their perspective.



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The long term equilibrium level for short term rates is a reasonable guide to what bond yields should be when the current period of temporary and extraordinary (although it no longer seems like either) low interest rates comes to a close. The Fed's most recent set of projections brought that long term rate lower, to 3.75% from 4%. Since they've been making such public forecasts their equilibrium rate has been between 4% and 4.25% but this is the first time it's dipped this low. The chart above shows the median forecast of voting FOMC members as of their most recent meeting in June and compares it with June meetings over the past two years.

Each voting member provides their own estimate, and as Chairwoman Janet Yellen noted, changes in the committee's composition can also affect this median forecast. But the participants don't change that much and so for a long term investor considering their strategic allocation to investment grade fixed income (as opposed to a short term trader figuring out the next move in bonds, or a high yield investor whose returns are linked to equity markets) this information is pretty important.



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

Many considerations play a role in assessing an equilibrium rate, including long-run inflation, the economy's sustainable growth rate, returns on other assets and no doubt many more. It probably reflects a more modest view of how fast the economy can grow, and indeed their long-run forecast for GDP is 0.2%-0.3% lower than it was last Summer. What this says to us is that although short term rates will most likely start rising next year (as the Fed has indicated) there need not be much urgency to raise them quickly. While that might sound like good news for today's bond investors who apparently find pigmy rates acceptable, for the more discriminating bond buyer holding out for a fairer return, that day is farther out than before. While few investors are hoping for a crash in bonds, something a lot like that is required before yields are can provide a positive after-tax, real return.

The current policy of maintaining artificially low interest rates to steadily reduce the burden of public and private sector debt at the expense of fixed income investors looks set to continue. It's almost six years since short term rates reached near-zero (December 2008, three months after Lehman's failure). Whether you think the Fed's \$3.5 trillion balance sheet will be unwound elegantly or will provoke another crisis, it seems unarguably true that as public policy it has been highly successful. While the stimulus will be unwound, it's unlikely to be done urgently. If the Fed was forced to retrace their steps following a too hasty removal of the monetary accommodation, it would represent a substantial setback.

The point of this interest rate assessment that is familiar to regular readers is to support our still constructive view on equities. Rates are the basic building block for valuing any cash generating asset, since future cashflows have to be discounted to today using something. Therefore, an assessment of equities that doesn't consider bond yields is missing a critical input. The Equity Risk Premium is roughly unchanged over the past three months. Although the market's P/E rose modestly (thereby driving down its reciprocal, the earnings yield), long term interest rates similarly fell slightly, so the relative pricing of one asset class to another barely moved. While we don't try to time the market, it still seems to us that achieving acceptable returns ahead of inflation and taxes is only possible with various forms of equities, in combination with holding cash to mitigate risk and provide some optionality should other attractive opportunities present themselves.

Are MLP's Hedge Funds?

This is the pointed question that's now part of my *Hedge Fund Mirage* presentation (amazingly still in demand more than two years since publication). It remains thematically our biggest bet, reflected to varying degrees across all our strategies and of course fully in our MLP strategy. To recap: MLPs *are* like hedge funds, in that investors have limited rights and their investment is controlled by a manager for whom asset growth is invariably profitable. In this regard, MLP managers (known as General Partners, or GPs) *are* like hedge fund managers and their Incentive Distribution Rights (IDRs) are the hedge fund's 2% management fee and 20% incentive fee. Consequently, if you like the idea of investing in hedge fund *managers* (which you really can't unless you run one or seed one) you'll like investing in MLP GPs (which has become possible in recent years as more of them have gone public). For someone who wrote a book noting that substantially all the profits generated by hedge funds have gone to the managers, the analogy has proved irresistible.

I won't repeat the entire case here (available in our January 2014 newsletter) but in June Williams Companies (WMB), the owner of one and a half MLP GPs, bought the half it didn't own at an attractive price and thereby showed where some of the best alignment of interests can be found in investing. We think there will be ongoing M&A activity in this sector spurred by the shale-induced development of infrastructure, low interest rates, consolidation, large commodity price discrepancies, and strong cashflow growth at many firms. Kinder Morgan (KMI) remains one of our largest holdings, as we agree with founder Rich Kinder that the stock price does not adequately reflect the cash generating power of his company.

Meanwhile, we'll regard our recent investment results as we would a successful forty foot putt; undoubtedly the result of work on the putting green, but also incorporating a measure of luck; always strived for and occasionally, unexpectedly, achieved.