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In Pursuit of Value

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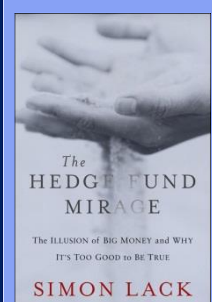

Hotel California

Summer has finally arrived in the north east United States. Cycling to work provides a pleasant reminder that commuting can be enjoyable, accompanied for now by the curious background chorus of billions of buzzing cicadas emerging from their 17 year subterranean slumber. It certainly beats getting on a train.

The question of the day is, when a company tells you how badly you might expect to be treated as an investor, does that absolve them of any responsibility when they subsequently do what they promised? Well, at least in the Commonwealth of Massachusetts, it turns out that a company's disclosure doesn't eliminate the obligation of a financial advisor to steer their clients away from really bad deals no matter how much the advisor may earn in additional fees.

Inland American Realty is a registered, unlisted REIT (Real Estate Investment Trust). Registered securities are available to the general public (unlike, say, hedge funds which are generally not registered and are therefore limited to investors with income and investable assets above a certain threshold). Registered securities must conform to more onerous reporting and disclosure requirements, but have a far larger pool of potential investors as a result. Unlisted securities cannot be bought and sold on an exchange (which is true of hedge funds as well as many other private, unregistered securities). Inland American is therefore a curious hybrid – available to anyone who wishes to invest, but with no obvious means of getting your money out. Being unlisted eliminates the interest of Wall Street research analysts to cover such a company, which given management's operating history is just as well.

Inland American's 2014 annual report?

To start with, Inland American's original prospectus in 2005 disclosed that, of $5 billion in estimated proceeds from their initial offering, $550 million was going to be used to pay "Selling Commissions", a "Marketing Contribution" and "due diligence expense allowance". Unashamed of this immediate 10.5% payout of their investors' money, the company further disclosed that "actual organization and offering expenses may total 15% of the gross offering proceeds." So your $10,000 initial investment was instantly worth $8,950 and possibly less (assuming, that is, that you could sell it, which you could not).

No doubt on the basis that, if a 15% fee hasn't put you off many other highly unfavorable features are unlikely to, management went on to disclose additional gems including the complete absence of any prior operating history, conflicts of interest between management and a key service provider, the expected payment of big fees to affiliates of management and the fact that no market would exist in the securities. Full disclosure of anticipated investor-unfriendly acts was evidently an important part of their business model. The 5% dividend has seduced many investors in search of steady income. However, since the company isn't profitable, paying any dividend simply amounts to giving you back some of your own money (i.e. a return OF capital rather than a return ON capital). Among their real estate assets are, appropriately, hotels in California. The Eagles warned investors how hard it could be to leave.

Perhaps not surprisingly, the investments chosen by this management team didn't turn out that well either.

Evidently skill at fleecing the buyers of your stock in broad daylight doesn't correlate that well with real estate acumen. The company's NAV (Net Asset Value) per share duly sank from its IPO price of $10 and was at $4.84 based on their most recent regulatory filing. Of course you can't sell it there because no public market exists. The company will buy shares back from investors, but only under fairly onerous circumstances such as death. Most would no doubt prefer somewhat better liquidity.

Since 2005 real estate investors have endured some gyrations to say the least. However, the Vanguard REIT Index ETF (VNQ) has risen 35% during this time, so holders of Inland have reason to feel that there were better places to put their money.

In 2012 the company disclosed that the SEC was investigating several issues including fees paid to affiliates, dividends paid to investors, and valuations. Inland American maintained a mysteriously stable NAV through the 2008 financial crisis which possibly helped them sell additional shares at too high a level. This is, in sum, not a story that reflects well on anybody involved in recommending the investment.

Which brings us back to Massachusetts, whose securities regulator recently reached a financial settlement with five brokerage firms who had been improperly selling Inland American and other non-traded REITS to investors in that state. The regulator found, "…a pattern of impropriety on the sales of these popular but risky investments." The complaint cited high commissions, conflicts of interest, sporadic valuation and the absence of a public market as sources of additional risk for investors. Evidently a few firms in Massachusetts were not overly burdened by the inconvenience of considering client suitability for their recommendations. One of the firms claimed in its defense that its compliance manuals and training materials included appropriate safeguards throughout the time they were inappropriately selling the securities. They obviously have bigger problems.

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

One would think that the features listed above would render Inland American and other similar securities (apparently unlisted REITS are a $10 billion per year industry) unsuitable for the clients of any brokerage firm whose intentions were to promote sound investments. A brief internet search reveals many more unhappy investors outside of Massachusetts who were guided into supposedly "safe" investments by their broker only to find that they were anything but. Several class action lawsuits have already been initiated. Perhaps the SEC and other state regulators will follow up with further sanctions.

This episode highlights the need for investors to truly understand how their financial adviser or brokerage firm is being paid. Firms recommending securities that result in a hefty share of proceeds to the broker selling them ought to be a clear warning. For a security that takes the public in but doesn't let them out, the time has surely passed.

Crude By Rail (CBR)

Among the many unexpected developments related to the enormous reserves of oil and natural gas in North Dakota has been a jump in shipments of crude oil by rail. Traditionally, oil and refined petroleum products have been moved long distances by pipeline because it's most economical. Our MLP strategy is largely invested in these midstream assets that rely on steady volumes to support their toll-type business models. However, moving oil in tanker railcars is proving to be an attractive alternative for producers in the Bakken Shale. Whereas pipelines require long term contracts given their large fixed investments, trains provide the flexibility to move shipments to where refining margins are most attractive. The large persistent pricing differential between two benchmarks (WTI and Brent) illustrates the specialized input needs of different refineries. More viscous grades of crude can also be more easily handled in railcars which reduce the need for mixing with the expensive diluent required for pipeline transportation.

Recent analysis by Raymond James reveals that CBR carloads in 4Q12 were 134K, 3.7X the year ago figure. 53% of the industry's 4Q12 revenues were earned by Burlington Northern, a subsidiary of Berkshire Hathaway (BRK), one of our larger investments. BRK bought the 77% of Burlington Northern it did not already own back in 2009. Increasing CBR was no doubt one of the reasons.