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In Pursuit of Value

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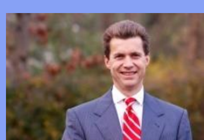
SL Advisors, LLC specializes in publicly listed closed end funds.

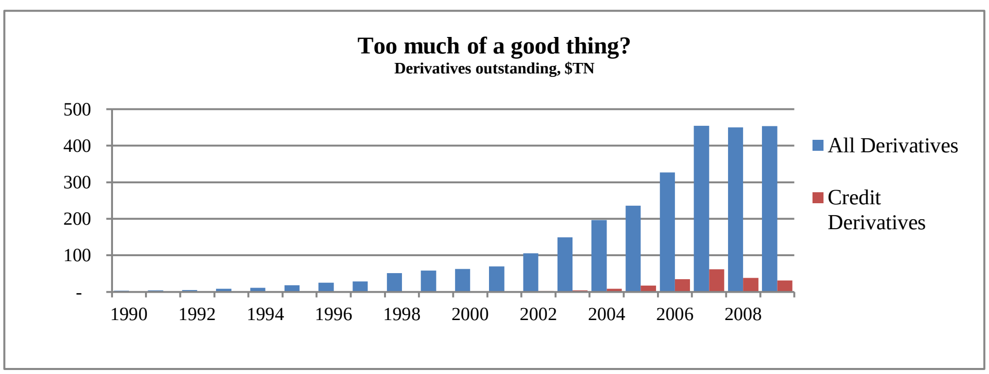


SL Advisors, LLC is a registered investment advisor offering separately managed accounts to individuals, family offices and institutions.

Abacus

Sometimes it can be helpful to step back from what you're doing and recall precisely why you're doing it. For example, a Finance professional working on Wall Street in 2007 might have recalled that the capital markets exist to channel savings to where they can be invested most productively, and that when done reasonably well economic growth generally follows. Beneath that simple description lie innumerable jobs, securities and activities, but in its simplest form this is the fundamental justification for Wall Street. I spent many years trading interest rate derivatives, and while this raison d'etre was not nearly as important to me every day as making a profit, in my more contemplative moments I did understand why we were there.

The SEC's complaint against Goldman Sachs reveals just how far some activities on Wall Street have strayed from their core purpose. Whether or not Goldman committed fraud is not important here – the unfolding legal battle will no doubt provide an absorbing spectacle. However, the transaction that is the basis of the SEC's complaint provides a fascinating glimpse of today's capital markets. The underlying deal Goldman arranged between the counterparties was not unusual, and Goldman was certainly not the only investment bank to engage in such trades. By way of background: individual mortgages are assembled into pools of mortgage-backed securities and then sliced up into different ranked tranches to suit investors' tastes. CDOs (collateralized debt obligations) are in some cases used to reassemble the slices of different MBS pools into yet more securities. Synthetic CDOs are theoretical CDOs, in that they refer to other pools of MBS or corporate securities that could be assembled together but haven't been, or are unavailable. In a sense they don't even exist except as reference points for a trade.



Source: ISDA (2009 data is as of June 30)

The SEC's complaint describes how Goldman Sachs, John Paulson and ACA spent their time constructing a very elaborate bet on housing prices through the construction of a synthetic CDO, an activity so completely divorced from facillitating the efficient movement of capital through the economy that it more appropriately belongs under the purview of the Nevada Gaming Commission than the SEC. Free markets allocate resources impartially based on supply and demand communicated through prices (whether of traders' compensation or the cost of capital), and synthetic CDO trading was evidently worth some of Wall Street's labor and capital. What a curious perversion of a free market economy when such businesses are worthwhile.

Throughout the 80s and 90s as the derivatives market grew, many observers predicted ultimate disaster caused by all this new financial activity. I spent fifteen years in interest rate derivatives and found most of the criticism wrong. The products were very largely used by banks for whom managing interest rate risk is a core activity. Many significant events including the 1987 stock market crash, 1990 invasion of Kuwait, the '90-'91 recession and the S&L crisis of the early 90s all occurred without derivatives receiving the blame for exacerbating financial losses. When Warren Buffet (whose insights are almost always right) famously described derivatives as "financial weapons of mass destruction", following his acquisition of General Reinsurance and its large derivatives portfolio, I attributed it to weak due diligence and buyer's remorse. But during the last decade developments moved seriously off track with the enormous growth in all derivatives including credit default swaps. Structured as insurance, with relatively small premiums compared with their potential payoffs (as spectacularly demonstrated by John Paulson's hedge fund), they combine asymmetry with availability even to those without any need for insurance. They have taken financial innovation in a direction wholly removed from the fundamental purpose of the capital markets, and maybe Warren Buffet was right on this point as well. The pendulum has swung too far, and through regulation, litigation, taxes and market forces it is assuredly swinging back.

Closed End Fund Conference

Capital Link recently held their 9th Annual Closed-End Funds and Global ETFs Forum in New York. They reported 950 attendees, a record, and a wide variety of topics was covered. The mood was upbeat while cautious given strong recent performance. A panel of lawyers was surprisingly interesting, during which former SEC head Harvey Pitt described the SEC's lawsuit against Goldman as a "bet the farm" move to salvage their enforcement reputation following failure to uncover several high-profile frauds including Madoff and Stanford.

SL Advisors runs three separate strategies: Fixed income, Deep Value and Discount Arbitrage. Contact us for more information, or go to our website: www.sl-advisors.com

What We Own

Boulder Growth and Income Fund (BIF) is an equity fund with several unusual features. It has 24% of its assets in Berkshire Hathaway (BRK-A), in which PM Stewart R. Horeijsi says he has been a consistent investor since BIF's inception in 1990. It has 16% of its assets in U.S. treasury bills. The PM and affiliates collectively own over one third of BIF's shares, having been buying steadily for almost two years. It pays no dividend and is not currently buying back shares, although its large cash holdings and 16% discount to NAV provide ample justification. Over the years BIF has outperformed the S&P500, no doubt helped by its largest holding. By most measures it is cheap. It is a holding in our Discount Arbitrage strategy.

Southwestern Energy Company (SWN) and Petrohawk (HK) are natural gas exploration and production (E&P) companies. Natural gas is an area where we've been steadily building exposure. The bullish case for natural gas is well known – it burns more cleanly than other fossil fuels, is not subject to Middle East geopolitical risk (since the U.S. possesses enough to meet its own needs for decades) and on an energy-equivalent basis is now much cheaper than crude oil. All these features provide potential upside with uncertain timing. Technological advances in horizontal drilling have increased supply and so for some time prices have been depressed. As a result, stocks of natural gas E&P companies are in some cases trading at substantial discounts to the value of their assets, and many of them fail to earn a return equal to their cost of capital. While timing is never easy, current industry returns are unsustainable and if natural gas prices don't rise we expect to see production cuts that will reduce supply as companies exit uneconomic activity. We've focused on E&P companies with low debt, a heavy natural gas focus, relatively unhedged future production and low production costs. SWN and HK are holdings in our Deep Value strategy.