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In Pursuit of Value

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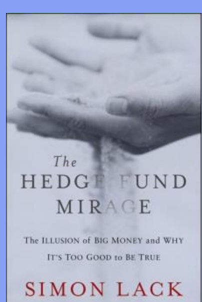


Less Macro and More Micro

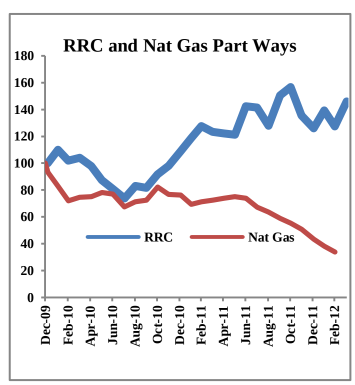
The major themes driving markets somehow seem less urgent of late. European austerity may be softening in the face of growing popular revolt as more Euro-zone countries (now seven) descend into recession. The threat of a crisis is being replaced by the monotony of continued lost output, and the growing chorus of politicians calling for pro-growth policies may well blunt the Teutonic demand for cuts everywhere. While the likely election of a Socialist president in France is hardly auspicious, it could alter the trade-off between fiscal discipline and current economic pain.

In the U.S. I continue to be fascinated by the Federal Reserve's detailed forecasts of interest rate policy. While Chairman Bernanke provided assurances of further monetary support (QE 3) if needed, the FOMC collectively became modestly more hawkish and now forecasts a 0.75% increase in short term rates during 2014. This is in sharp contrast to the yield curve which, by pricing in expectations for less than half this is expressing an unflattering view of the Fed's forecasting acumen.

China may be about to demonstrate the limits to its growth. Thoughtful analysis in support of a sharp Chinese slowdown (by Hugh Hendry from Eclectica for example) is compelling, and yet this is not a new warning. Correctly assessing the near term macro picture, rarely easy, appears especially hard right now.

Descending from 30,000 feet to look at industries is often far more interesting. I did a call with Park Shaper, President of Kinder Morgan (KMP), recently. KMP is a holding in our MLP strategy and at $28 BN in market cap is the bellwether for the sector. KMP's strategy through their acquisition of El Paso (EP) late last year (expected to close this quarter) is to be ready to move growing volumes of natural gas around the U.S. as they expect steady increases in demand from electricity generation, commercial transportation and industrial manufacturing that relies on cheap methane. They are going where the puck is going (as Wayne Gretzky always said) and the trend they're following looks inevitable to us. KMP is also investing money in coal export facilities, reasoning that coal's incremental replacement by natural gas will free up more for export. It's a logical strategy, and one that isn't highly sensitive to natural gas prices. In fact, they're betting on a continued abundance of the cheap fuel which would result in higher volumes, benefitting the toll-model so characteristic of MLPs.

We recently added the C-corp., Kinder Morgan Inc. (KMI) to our Hedged Dividend Capture Strategy since its low debt, stable dividend and solid growth prospects make it an attractive investment for income generation.



I also had the opportunity recently to attend an investor dinner with Range Resources' (RRC) senior management. RRC is a holding in our Deep Value Equity strategy. CEO Jeff Ventura has surrounded himself with a solid team that is focused on growing per-share value of the company without taking undue risk. RRC boasts that they have 60 TCFE (trillion cubic feet) of potential low cost natural gas, worth far more than its $13 BN enterprise value. Jeff Ventura is confident they have that much – time will tell if he's right. While RRC waits for higher natural gas prices, they continue to derive value from "wet" gas, producing natural gas liquids into a much more robust market than exists for natural gas itself.

Macro issues will often dominate in the short term, but understanding the fundamentals of individual companies and investing in good businesses with strong balance sheets is our preferred way to withstand the inevitable "tail-events" that hang over almost every investment decision.

The Hedge Fund Lobby Responds

The Hedge Fund Mirage has upset some people, but far fewer than many might expect. The Financial Times recently described me as, "…one of the industry's most vocal critics." Financial News has called me, "The industry's fiercest scourge…" All because I asked how hedge fund investors had done in aggregate, and published the analysis showing they hadn't made any money while the managers and their service providers had made a great deal of money. And yet in some respects the controversy has been less than I expected. Many hedge fund managers and others in the industry have contacted me to say how they loved my book and that they weren't at all surprised at the result.

Happily though, the Alternative Investment Managers Association (AIMA) in London has been moved to respond. After all, one of their objectives is to "promote the industry's global development." I have been told by more than one journalist that my book has hit a nerve with them, casting doubt as it does on the very utility of their mission. That they are defensive is wholly appropriate for a group advocating investments in an area whose most significant result has been an enormous transfer of wealth from clients to managers. Let me repeat what I frequently point out: there are great hedge funds as well as happy clients and most probably always will be. In the 90s through 2002 hedge funds did a fantastic job for their investors, preserving capital and adding value. There just weren't that many clients back then, and as they became more numerous the results inevitably deteriorated. The Absolute Return Industry's IRR is less than treasury bills.

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

AIMA responded by commissioning a marketing brochure from KPMG showing that a hypothetical investment allocated equally to all hedge funds from 1994 did rather well. This is their basis for advocating hedge funds to investors; they don't address how all investors did, because they well understand the Math isn't supportive. Surely the experience of all investors is the most meaningful measure of results when rising AUM so reliably coincides with falling returns. Consequently I quickly took the opportunity to critique their marketing brochure on our blog as well as discuss the weakness of their conclusions on Bloomberg TV. Those interested in more detail can follow along on our blog (URL on Pg. 4). Journalists, and more importantly hedge fund clients, are starting to challenge the case for hedge funds and their fees, lack of transparency and illiquidity.

Business Update

I founded SL Advisors in 2009 following my retirement from JPMorgan. Shortly afterwards I was joined by Henry Hoffman who researches our investments and whose insights add immeasurably every day to our results. Henry without doubt raised the average IQ here and has become a good friend as well. The capital we manage was initially just mine and that of immediate family. We have not done any formal marketing beyond publishing this newsletter, and so asset growth to this point has been very largely "Friends of Simon" (more numerous than I had any right to expect) asking to open accounts, a vote of confidence which we acknowledge every day. Larry Hirshik, who became a friend when he was trading derivatives in 1984, joined soon after and ably executes our trades.

The passage of time has lengthened our track record and my book has drawn more exposure than I had envisaged. We think we have compelling investment strategies delivered with clarity and see the opportunity to discuss these with people who are (at least not yet!) Friends of Simon. Therefore I am very happy that another old friend of mine from my days trading derivatives in the 80s has joined us to lead business development. Ty Tessitore has broad financial markets' experience covering high net worth and institutional clients in interest rate and commodity derivatives, structured products and other capital markets products. But even more importantly Ty shares our values, and is someone I first met over 25 years ago. We are excited to have Ty join SL Advisors.