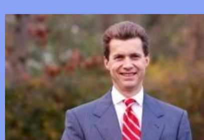
Published by SL Advisors, LLC

In Pursuit of Value

October, 2010

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



Stocks, Bonds and the US$

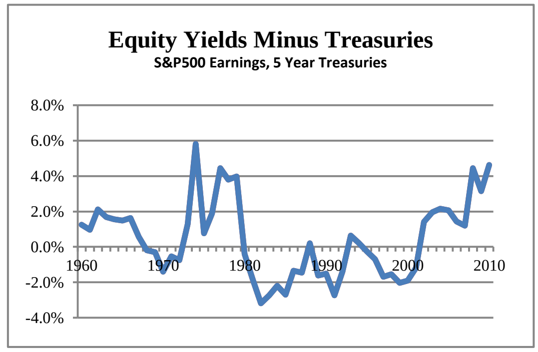
Amidst all the demand for instant gratification from shows such as CNBC's Mad Money (Jim Cramer's never boring) and Fast Money, websites, blogs and myriad other sources of the next quick profit to be made, it's worth pausing occasionally to contemplate the longer run prospects (let's say, five years) for equities and fixed income which make up the bulk of most investors' portfolios. Faced with bond yields that are derisory, surely the relatively attractive dividend yields (and therefore high earnings yields or low P/E ratios) on equities demand closer inspection. Many thoughtful commentators have said as much, and yet the opportunity persists (though modestly less so than during the Summer). Sentiment among individual equity investors remains cautious; typical of many surveys, the American Association of Individual Investors measure of bullish sentiment recently dropped 6% to 45%. Flows into equity mutual funds also indicate investor skepticism – the Investment Company Institute reports 2010 net outflows of around $2BN through July 2010, while taxable bond funds have attracted $163BN over that same period. In fact, the numbers compare with flows into equities during the 2000 TMT bubble – Morgan Stanley has noted that in the 12 months leading up to September 2000, US equity funds saw cumulative inflows of $340bn while in the equivalent period up to April 2010, US bond funds recorded net inflows of over $410bn. As is almost always true, the future provides plenty to worry about.

			5 Year return with…		
Ticker	**Div %**	**P/E**	**Flat Growth**	**5% Growth**	**Flat Growth, 20% lower P/E**
XOM	2.9%	9.8	2.9%	6.6%	-1.1%
INTC	3.3%	10.2	3.3%	6.9%	-0.7%
WMT	2.3%	12.3	2.3%	6.1%	-1.8%
MSFT	2.6%	9.4	2.6%	6.3%	-1.4%

The Math of equities is worth considering. Numerous members of the S&P 500 pay dividends (typically comfortably covered by earnings) in excess of the yield on five year treasuries, including Exxon Mobil (XOM, 2.9%), Intel (INTC, 3.3%), WalMart (WMT, 2.3%) and Microsoft (MSFT, 2.6%). If a diversified portfolio of stocks such as these experiences no profit growth at all over five years, investors will still have earned the dividend and book value will have grown by the earnings not paid out as dividends each year. Since 1960 the five year growth in S&P 500 earnings has been negative only once. While dividends provide current income and impose some discipline on management through returned earnings, earnings yields are a better measure of economic return. Since 1960 the average five year growth in S&P500 earnings is 5.9%. With 5% earnings growth and commensurate dividend increases these four companies will return 6-7% per annum; or put another way, their P/E ratios could all drop by a fifth and they'd still outperform treasuries.

From a top down perspective the bears can always make a strong case. Unconstrained fiscal policy, consumer indebtedness, the Fed's slow monetization of debt, the overhang of housing; the list is endless. None of these issues is new, nor will they be solved easily or soon. However, while there's no denying some severe economic headwinds the U.S. economy has never failed to adapt and thrive through countless challenges. Analyzing individual companies and their likely prospects from the bottom up, and calculating plausible ranges of return as above, leads to a more constructive outlook. As a result of viewing the world through this framework, our equity allocations for clients are fully invested.

Long term bonds are as expensive as equities are cheap. Treasury yields are low for widely understood reasons including fear of deflation and the probability of more Quantitative Easing (QE 2) from the Federal Reserve. Bond yields are unlikely to rise too far in the near term and may well continue lower. However, the political imperative in the U.S. will always be avoidance of another 1930's depression. The economic environment from which today's bond investors will profit is one whose very avoidance would demand increasing fiscal stimulus and other extraordinary intervention. We think it's likely that over five years there will be higher yields available than today's. Bonds may or may not be in a bubble, but they're worth avoiding. Consequently, our clients' fixed income exposure is in shorter duration (2-3 years), high grade corporate bonds that while providing lower yields than longer dated bonds are less exposed to capital loss on rising yields.



The spread between S&P500 earnings yields and treasuries (shown here) has been wider over the past fifty years, but rarely. As a predictor of relative performance, when it's this wide it's been more accurate at forecasting disappointing returns for bond investors than high equity returns. This may turn out to be the case today as well, and avoidance of equities may not turn out to have been an expensive decision. However, it's likely that embracing bonds will be.

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

We are supplementing the low yields on U.S. fixed income with some exposure to higher-yielding, emerging market currencies. The case for having some non-U.S. exposure just became a little bit stronger with proposed legislation aimed at China that would define their low currency as an unfair export subsidy. This will play out over several months but does raise the temperature around the US$/Renminbi exchange rate.

In a world of competitive currency devaluations in search of export-driven growth, the U.S. is playing a strong hand. The various arms of government are well coordinated, through legislative pressure as noted above quietly supported from Treasury (who will, "…carefully examine any proposals put forward") and the Fed about to further reduce the already low yields on long term bonds making the US$ even less attractive. So it seems that everybody's working from the same script. It's likely that a steadily eroding US$ would be quietly welcomed by this Administration as cheap means with which to combat frustratingly sluggish domestic demand and high unemployment. So as long as a US$ depreciation doesn't become disorderly, it's hard to see what's not to like. And there's the ever-present risk that foreign central bank buyers of long term debt may reject lower yields as insufficient for the risk, another reason to avoid that sector.

Of course with growth and inflation generally low in the developed world, it's hard to pick a currency to own instead of the US$. The Euro remains vulnerable to sovereign debt concerns around the Mediterranean and in Ireland; the Japanese are even more keen to weaken their own currency than is the U.S.; Sterling is rarely a good investment when the US$ is depreciating. The Canadian $ is worth considering, given their stronger fiscal situation, avoidance of the Credit Crisis and large energy reserves. And naturally emerging market currencies (faster growth, stronger finances), look most attractive. When it comes to a weaker US$, the U.S. has a well-coordinated policy combined with a very large external financing need. It's likely to prove the path of least resistance.

So we are fully invested in stocks, underinvested in bonds and selectively invested in short term foreign currencies. In some respects it barely seems contrarian – many thoughtful (at least, we think they are!) commentators express similar views to those presented here. And yet, valuations and flows persist in reflecting an alternative opinion. The experience of many investors during 2007-08 has created a strong desire to avoid a repeat, and as a result the certain return of capital is being paid for with a highly likely loss of purchasing power. The future is always uncertain, but looking out beyond the near term we are pursuing value where we see it.