



In Pursuit of Value

October, 2012

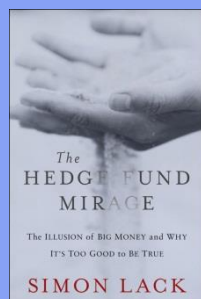
Quarterly Outlook

September 2012 might well be regarded as the moment when the Federal Reserve committed itself unambiguously to reflation, as they came down clearly on the side of improved U.S. employment as the more important element of their twin mandate. In achieving “maximum employment and price stability,” as the Fed describes its statutory responsibility, it is clearly coming up short on the former. Whether monetary policy can do any more now that we are into open-ended Quantitative Easing (“QE Infinity” as it’s been dubbed) is a legitimate question. A “substantial” improvement in the labor market is the Fed’s chosen yardstick, and it seems that yields below inflation will confront bond investors indefinitely. For us, we take the world as we find it not as it should be, and highly accommodative monetary policy for a very long time combined with either unhelpful or dysfunctional fiscal policy accurately describes the investment landscape.

To run the Math: \$100 invested in the ten year treasury note yielding 1.6% can, with interest reinvested expect to grow to \$117 in ten years. The same \$100 invested in the S&P 500 yielding 2.0%, assuming 4% annual dividend growth (the fifty year average is 5%), unchanged dividend yields in ten years and with dividends reinvested over this time would grow to \$179. This is all pre-tax -- the tax code currently makes stocks even more advantageous since dividends and capital gains are taxed more lightly than interest income, although that will probably change somewhat in 2013. The Math is similar though slightly less striking for corporate bonds since their yields are tethered to the U.S. government’s. However, the kind of deflationary, recession-prone environment that would result in today’s treasury bond yields turning out to be a good investment is unlikely to be kind to corporate credit risk. The Dow Jones Corporate Bond Index has returned 12% p.a. over the past five years, but absent a further drop in yields all you can expect to make is the current yield, around 3.5-4% for investment grade debt. Figure in taxes and inflation, and it’ll be hard to preserve purchasing power. It’s worth taking the long view, at least so as to avoid becoming the poor fellow in the cartoon.

Of course stocks can fall, which is why they are not considered a substitute for bonds. But you can make your own ten year treasury note at home with only \$22 of the \$100 noted above, because that’s how much you’d need to invest in stocks to achieve the same return as \$100 in treasuries, with the rest in cash. \$22 in stocks with \$78 in 0% yielding cash will, in the plausible scenario described above, return the same as the ten year treasury note. If the S&P fell 50%, this home-made bond would lose 11% of its value. A jump in interest rates from 1.6% to 2.8% would do around the same damage to the treasury bond investment. Although one seems far more possible than the other, the fact that investors are indifferent between the two reveals the continued risk aversion in the market. Some investors, as fear of complete disaster in Europe and the U.S. has moderated have clearly become more comfortable with equity exposure of late. But since the U.S. government is both the biggest issuer as well as the biggest buyer of bonds (the Fed now owns approximately 25% of the duration of the entire treasury market) the distortion of free market prices is virtually complete. If central banks want to own bonds so badly, leave them to it.

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Although “tail risk” has been reduced by central bank moves in the U.S. and Europe, corporate profit guidance continues to be very cautious. It’s becoming almost routine for companies to moderate their outlook; most recently Caterpillar reduced their 2015 guidance (orders for heavy earth moving equipment have a long lead time) and evidence of slowing demand is widespread. While the Math above continues to make equities an attractive investment, we have in recent months shifted away from stocks that we felt are highly sensitive to the economy. Our largest individual investment in our Deep Value Equity Strategy is Corrections Corp (CXW) which remains on track to become a REIT. We still like Berkshire Hathaway (BRK) with its diverse and attractively priced set of operating businesses combined with a well-run insurance unit, Microsoft (MSFT) with its twin highly cash-generative monopolies (Windows and Office) and Kraft (KFT) whose split into two companies should attract some new investors seeking more precise exposure to North American groceries (Kraft Foods Group, KRFT) or the global snacks business (Mondelez, MDLZ). A recent addition to the portfolio is Energizer (ENR) which sells batteries and razors, two products unlikely to go out of fashion. We also have a 10% position in the Gold Miners ETF (GDX) since many miners are cheap relative to the value of their holdings and we are inclined to bet with central bank efforts at either stimulating growth or raising inflation expectations (or indeed both).

Stable, dividend paying stocks with low beta (i.e. less volatile than the market) remain attractive both in a long-only format providing low-octane equity exposure or combined with a hedge to produce a more stable return stream. Turnover is light in this strategy, but we do own KFT here as well, (and therefore the two new components KRFT and MDLZ) so we will likely need a replacement for MDLZ which we expect to reinvest earnings for growth and pay a lower dividend than the rest of the names in this strategy. The Low Beta anomaly which is often an additional source of performance hasn’t generated any notable return this year as low beta names have provided about half the return of the S&P 500. A strong equity market with many active managers underperforming their benchmarks and reaching for beta doesn’t favor companies with stable earnings growth. Over time though, it’s been shown to be a reliable way to outperform.

MLP Update

MLPs have caught up lately, with the sector generating a year’s worth of performance in the last three months. The 8.6% third quarter return made up for a flat first half of the year. There have been some interesting recent IPOs, of businesses that have far more volatile earnings than is typical for an area characterized by yield-seeking investors where any deviation from steady distributions is quickly punished.

The Wall Street Journal recently highlighted some examples. Northern Tier Energy LP (NTI) runs a refinery in Minnesota whose profits are subject to fluctuations in refining margins. PetroLogistics LP (PDH), which produces propylene and is also subject to volatile earnings memorably warned in its registration statement that, “We may not have sufficient cash available to pay any quarterly distribution on our common units.” Both may be great investments, but they do highlight a recent trend in MLPs for private equity firms to IPO businesses that offer high current yields but not necessarily stable ones. Whether or not MLP investors will stay with these investments through a tough quarter or two remains to be seen; they are traditionally owned for their stable yields. We don’t currently own either of these names.

Midstream Business magazine noted that interstate liquid tariffs increased by 8.7% on July 1, that being the result of the 2.65% spread added to the annual change in the PPI lagged twelve months. Around half of the pipelines in publicly traded MLPs are governed by Federal Energy Regulatory Commission (FERC) pricing rules, and this illustrates the inflation protection that is built into many business models for the midstream MLPs (which is the MLP sector that we invest in). The IRS also expanded its definition of qualifying income (i.e. those businesses that can organize themselves as MLPs rather than corporations) to include (for example) the sale of hydrogen produced as a byproduct of fertilizer (since fertilizer is considered a natural resource, a requirement to qualify as an MLP).

It’s also worth noting that while taxes on most types of investment income are likely to rise in 2013, the deferred ordinary income that MLPs generate so far doesn’t look likely to receive altered treatment, although wholesale tax reform could plausibly change everything. The months following the election will presumably offer some clarity.