



In Pursuit of Value

September, 2011

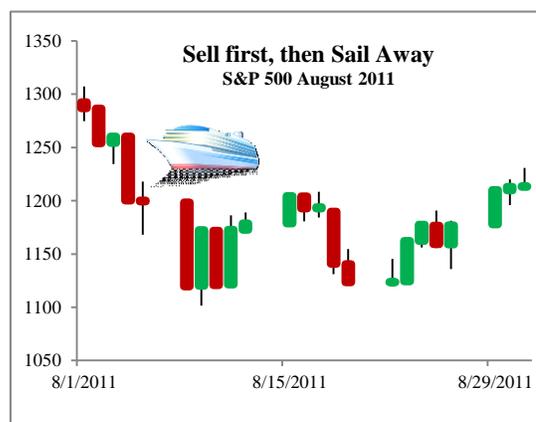
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Why Smart People Should Work in August

Four years ago in July 2007 I monitored that Summer's market swoon from the balcony of our cruiseship cabin. The calm waters of the Caribbean were a welcome distraction from the deleveraging that drove down asset prices. I did at least enjoy the view while like many others spending hours on conference calls discussing risk positions and necessary actions. Stocks were down only 3% that month, although far worse was in store over the next year or so. On cue, as we boarded for this year's cruise (a month later than usual, in August) the Summer deleveraging began, although as with many aspects of life it is faster this time. I am reminded of a hedge fund manager who always lost money in the Summer. Theirs was a quantitatively driven strategy that reduced human emotion to statistics and regarded equity market seasonality as a quaint but unsophisticated notion. Consequently we had a reliable conversation every Summer about the weak academic case for seasonal patterns in stock returns. Since this view became steadily more at odds with the empirical results that were their P&L, my high IQ friends finally asserted that their strategy relied on other intelligent investors buying the same things their quantitative approach already owned. In Summer, they lamented that most of the smart people are away on vacation.

Rare will be the investment commentary advocating panic right now. If you read many investment letters, settle in for endless variations of the benefits of rebalancing towards riskier assets (stocks) when falling prices reduce their allocation (like now), and the importance of pursuing a long run strategy. In an effort to avoid duplication, we'll express our general agreement with those views and will avoid repeating them here. That is how we invest, and consistent with that we have been modestly rebalancing towards equities and away from bonds while making a few new investments where appropriate.



Some things stand out and are worthy of note. The speed of the drop in equities has been shocking. It's true GDP forecasts have been falling quite sharply – consensus for the U.S. over the next four quarters is 1-1.5% lower than it was two months ago. But the odds of a recession still seem less than 50%, and the almost 15% monthly drop in the S&P 500 registered by August 8th looks excessive relative to the altered outlook. The U.S. economy suddenly lost altitude without any obvious external shock to the system (although the debt ceiling brinkmanship certainly didn't help confidence). It's as if the pressure of the economic headwinds was suddenly too much, and consumer confidence fell sharply along with consumption and other contemporaneous measures of activity. The economy just ran out of steam.

It's also curious that revised earnings' forecasts have been slow in coming. General Electric (GE) is as exposed to global GDP as probably any company, and consensus earnings for their 4Q11 have barely dropped a penny, from \$0.42 to \$0.41. Perhaps the CFOs who drive earnings guidance are also all away in August (along with the smart people my hedge fund friends rely on), but profits warnings would seem to be likely in September. Hedge funds are reported to be down 4% in August, apparently the 4th worst month on record, so no doubt a good chunk of the recent selling was from the overleveraged becoming less so. The

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value.*

timing of my upcoming book, *The Hedge Fund Mirage*, could not be more appropriate. It will be released in November by publisher John Wiley, and you'll hear more about it as we get closer to publication.

MLPs held up reasonably well in August, at least by the low standards set by most other risk assets. Distribution yields of around 6% combined with historic distribution growth of 4-6% offer potential returns of 10% p.a., making this an attractive time to be investing (though of course past performance is not indicative of future returns). MLPs joined the equity swoon in mid August as they often do, but by the end of the month the appeal of reasonably steady income brought the monthly result to -1.1% (as represented by the Alerian MLP Index).

Given my track record of observing collapsing equity markets while bobbing around on the high seas, one client helpfully suggested that next time I sell everything before going on vacation. I'm sure the cruiseline and my children would welcome the liquidity, and such sentiments are totally understandable. At a minimum, we will incorporate the SVI (Simon's Vacation Indicator) into our market timing.

Natural Gas and the Marcellus Shale

There always seems to be something to say on this topic. Although natural gas E&P companies typically represent 15-20% of our Deep Value Equity strategy, they provide disproportionate volatility but have also provided very good returns. The U.S. Geological Survey (USGS) is a Federal agency that gathers information and publishes research on the environment and natural resources. A week ago they published a report on the amount of natural gas in the Marcellus Shale, an enormous area which runs from New York State to Alabama. They estimated that the "mean undiscovered natural gas resource" in this region is 84 TCFE (trillion cubic feet equivalent). They use the mean because the science isn't certain and they have various forecasts with different levels of certainty. 84 TCFE is a lot of gas, roughly four times annual U.S. consumption. But this estimate is sharply lower than previous ones, and as a result the Energy Information Agency (EIA) whose job it is to forecast available energy resources, said it would slash its previous forecast of Marcellus availability by 80%. The EIA is deferring to the scientists at the USGS.

Range Resources (RRC) has long been a core holding of ours. The company is largely focused on extracting natural gas from the Marcellus Shale where it was one of the early movers. We like the company very much. It's run by smart people who understand their business and is focused on increasing shareholder value. RRC has among the most efficient operating structures of any of its peers, and perhaps the cheapest F&D (Finding and Development) costs in the Marcellus. Current President and COO Jeff Ventura will be taking over from John Pinkerton as CEO in January in what will probably be a seamless transition. Jeff has an engineering background and has led their successful activities in the Marcellus to this point.

RRC reports total resource potential of 40-56 TCFE, of which 22-32 TCFE is in the Marcellus (and mostly in Pennsylvania). When the EIA was forecasting around 400 TCFE in the entire Marcellus area, this seemed fine. However, the revised 84 TCFE figure probably can't be reconciled with RRC's forecast (which is an estimate of resource potential, not proved reserves). We wouldn't bet against RRC. They've been extracting increasing volumes of natural gas from this area for a long time and know the geology well. But Chesapeake Energy (CHK) estimates they have 93 TCFE of potential ("unrisked, unproved" is their definition). Something's going to have to give. An intriguing possibility is that if the Marcellus ultimately delivers less than expected, other shale plays could be substantially more valuable given the resultant drop in long term natural gas supply. For our part, while we continue to like RRC we recently shifted into Devon Energy (DVN), which provides more diversified natural gas exposure and is also a very well run company. DVN's market cap is approximately equal to its proved reserves (i.e. potential reserves are not reflected in the price). They have very little debt, are buying back stock and should earn \$6-7 per share next year which makes an attractive multiple given their \$67 price. DVN is in many different unconventional natural gas areas, but not in the Marcellus. The Marcellus Shale story no doubt has more chapters to come.