Published by SL Advisors, LLC

In Pursuit of Value

January, 2010

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

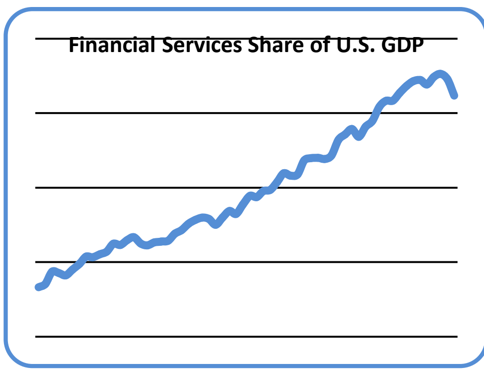
SL Advisors, LLC is a registered investment advisor offering separately managed accounts to individuals, family offices and institutions.

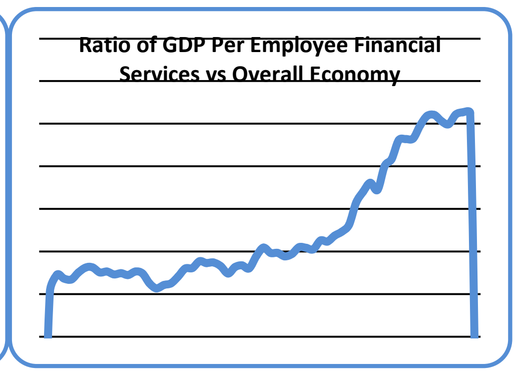
Spreading Populism

Populism is a developing theme driving political decision making, and it's likely to gain importance in the years ahead. The increasing gap between rich and poor; the disparity between the compensation of senior executives and rank-and-file employees; these are issues that are frequently covered in the popular press and while their causes are complicated they are certainly not uniquely American or even western concerns. The credit crisis has understandably channeled much of this anger at banks and their executives, whether in the form of the Administration's Pay Czar Ken Feinberg or the UK's recently announced 50% windfall bonus tax on bankers.

In contemplating these developments, it's interesting to drill a little deeper into the Financial Services industry. Since 1948, according to figures from the U.S. Department of Commerce, financial services has steadily increased its share of GDP, from 2.4% to a peak of 8.1% in 2006. This trend has been very consistent, generally unaffected by recessions, deregulation or war. Developed economies typically have bigger financial sectors than developing economies, and many economists link the two which is why financial liberalization is usually part of an emerging economy's growth strategy.

For much of the post-World War II period, GDP per employee in Financial Services remained between 100% and 120% of GDP per employee in the rest of the U.S. economy. In other words, while the financial services sector was growing, relative compensation levels (using GDP per employee as a proxy) between Finance and non-Finance industries were stable. In the early 90s, this relationship began to change. Deregulation, derivatives and globalization may all have played a role. Increasingly though, Finance jobs were the better-paying jobs and the Finance sector was still growing. While Goldman Sachs has been the lightning rod for recent criticism of bank pay practices, there's clearly been a bigger underlying story. The Credit Crisis of '07-'09 and the ensuing recession arrested 60 years of growth in financial services, and the charts below inform the search for at least one scapegoat, perhaps causing the pendulum to swing back towards government-orchestrated fairer wealth distribution (aka Populism). The likely consequences for investing will inevitably include higher taxes both to redistribute wealth and to pay for bigger government services, but could extend to greater government involvement in the economy, greater protection for borrowers and some years from now even a tacit acceptance of higher inflation to reduce the real value of debt.





Source: U.S. Department of Commerce

Closed End Fund IPOs

Most investors are initially attracted to closed end funds because they usually trade at a discount to NAV. The notion of buying $1 for 85 cents is behind many successful investment strategies. Therefore, given this history and common wisdom among closed end fund investors that “thou shalt not buy at a premium” it’s a wonder that any new issues are ever launched! In fact, every successful IPO of a closed end fund must represent the triumph of hope over experience, since underwriting fees generally deduct 4-6% from the proceeds as soon as the issue is freed to trade. And unlike an IPO of an operating company, it is possible to find an alternative way to access the underlying assets of a closed end fund since the securities it holds are available in the public markets. According to Thomas J. Herzfeld Advisors, 2009 saw 13 IPOs raising almost $2.5 billion, up sharply on 2008 although less than in prior years. A recent investment grade fund from Western Asset Management (IGI) confirmed the rule; issued in June at $20 (with an NAV of $19.06 after underwriters’ fees) price and NAV soon reliably crossed paths and by October it had joined its peer group at a 6-8% discount.

What We Own

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

Morgan Stanley Emerging Market Domestic Debt Fund (NYSE:EDD) invests in local currency sovereign debt in emerging markets. It’s one of the few closed end funds that doesn’t fully hedge its FX risk, so an investment in EDD will benefit from a weaker US$. Almost 40% of its assets are in Brazil and Mexico, its portfolio is largely investment grade and it uses only modest leverage. Co-PMs Eric J. Baurmeister, Federico L. Kaune and Abigail L. McKenna run $2.5BN in a similar strategy for instutional clients through separately managed accounts.

Earlier this year Morgan Stanley committed the cardinal sin for a closed end fund manager and cut EDD’s quarterly distribution, from $0.50 to $0.25. Management subsequently explained that this was necessary because investment returns were insufficient to cover the distribution; based on October’s conference call, while this may have been a sensible decision it still does not sit well with investors even several months later. However, the portfolio yields over 7% and they recently raised the distribution modestly (to $0.30) where it is still supported by investment income. EDD’s current 14% discount to NAV is several points wider than its peer group, and represents an attractive investment. EDD is a holding in our Fixed Income strategy.

Eagle Rock Energy Partners (Nasdaq:EROC) is a master limited partnership (MLP) which almost completely missed 2009’s enormous MLP rally and finished the year only marginally in positive territory. MLPs are a fascinating sector for U.S. taxable investors seeking steady yields with earnings growth. EROC slashed its distribution earlier in the year as a downturn in its natural gas business combined with too much leverage pressured cashflow. It’s in the process of restructuring its balance sheet through asset sales and debt reduction, and as a result some balance sheet analysis is required to arrive at the likely valuation of the company following the restructuring. MLPs are generally held by retail investors seeking yield with reliable earnings growth, and consequently EROC has lost its traditional investor base. Natural Gas Partners (a private equity firm) owns a preferred stake in EROC through two of its private equity funds, and made the original recapitalization proposal as a way to improve the return on its investment. Their initial proposal to buy some mineral rights assets from EROC was was regarded as low and this drew in more attractive, competing proposals. In the meantime EROC has been trading at 10-25% below tangible book value whereas MLPs as a group typically trade at much higher multiples.

The recapitalization is likely to be completed successfully, but even if it’s not EROC owns marketable energy and infrastructure assets which provide considerable downside protection with potentially attractive upside. EROC is a holding in our Deep Value strategy although it’s no longer a full position following late December’s sharp rally. If the opportunity to invest below $5.50 presents itself it would represent an attractive risk/reward.