Published by SL Advisors, LLC

In Pursuit of Value

December, 2015

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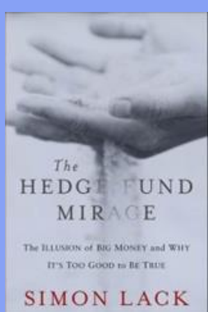


Cash is Not Quite Trash

For many years I've included treasury bills among my personal investments. While utterly devoid of excitement, these holdings have nonetheless brought me a measure of comfort during times of market stress. In 2008 as all my other security holdings slumped, I regarded my t-bills the way others might a security blanket; whatever else was going down, these would always be there for me. We've become great friends over the years. They are undemanding companions since they require no investment research – but then they give nothing back in return either. However, that last point is probably about to change. It'll be almost imperceptible, but in some small fashion I should soon start to feel just a little love coming back my way once the Fed tightens short term rates.

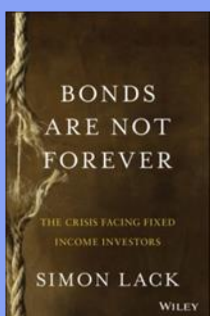
Of course, the reason for holding t-bills (basically, cash) is to create risk-taking capacity for the rest of my portfolio. As readers of my 2013 book *Bonds Are Not Forever; The Crisis Facing Fixed Income Investors* already know, bonds offer "returnless risk", which is to say there's little hope they'll preserve your purchasing power after taxes and inflation. Consequently, more equity-like assets and more cash are needed to fill the void left by shunning an asset class which government policy (via ultra-low interest rates) has rendered uneconomic.

Readers may recall we've illustrated this point in the past – for example, in our October newsletter we noted that the after-tax return expected from $100 held to maturity in ten year treasury notes then yielding 2.15% could be replicated with only $24 invested in the S&P500. There were various assumptions involved, such as unchanged tax rates, 5% dividend growth, an unchanged yield on the S&P500 and, lastly, that the $76 not invested in stocks would sit in cash, earning 0%.

It's an elegant way to show how poor are the prospects for bonds. If you can replicate their return with less than a quarter of the money, you're able to withstand a pretty severe equity bear market. For a 50% collapse in stocks would harm the 24/76 portfolio by less than a quarter of that, or 12%. A 1.5% jump in ten year yields would inflict greater damage on the bond investor.

This structure requires holding $76 in cash at a 0% return for ten years, a fairly draconian assumption. Since the Fed is likely to raise rates for the first time since 2006, it's a good opportunity to see how this stocks/cash barbell looks with different assumptions.

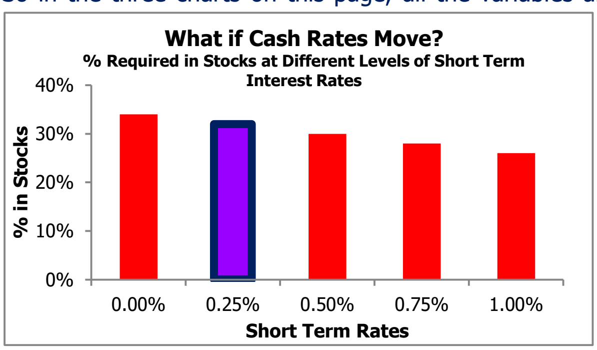
SL Advisors, LLC focuses on investment strategies that provide income without relying on fixed income securities.



There are a lot of moving parts here (the dividend yield on stocks, interest rate on cash, tax rates etc.) and the possible combinations are limitless. To make it manageable, we're going to examine one thing at a time. When contemplating the stocks/cash combination as a substitute for bonds, reasonable questions include: (1) what if cash rates move, (2) what if stocks move, and (3) what if tax rates move. We've also adopted the more realistic target of beating a 3% corporate bond yield rather than the ten year treasury, since that better reflects the choice of commercially driven bond buyers. Central banks and sovereign wealth funds are major holders of government bonds nowadays. So let's take a look at our initial assumptions:

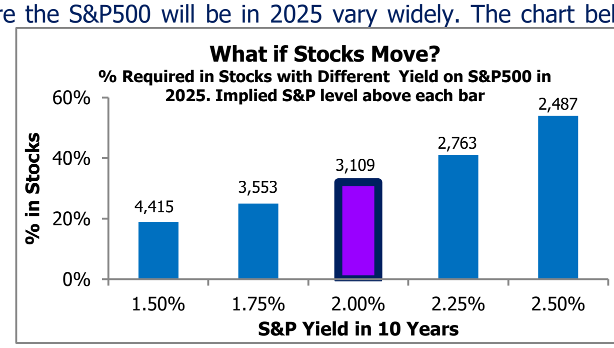
Variable	Value
Starting S&P Yield	2.0% (equivalent to S&P500 2,100)
Dividend Growth	4%
Ending S&P Yield in Ten Years	2.0% (equivalent to S&P500 3,109, assuming 4% dividend growth)
Cash Return over Ten Years	0.25%
Ten Year Bond Yield	3%
Dividend/Capital Gains Tax Rate (for stocks)	20%
Income Tax Rate (for interest income)	35%

Dividend growth has averaged 5% over 50 years even while companies have roughly halved the portion of profits paid out in dividends in favor of stock buybacks (because it's a more tax-efficient way to return money to stockholders). Stocks in ten years have a range of outcomes and we'll see how that affects the result for the stocks/cash substitute for bonds. So in the three charts on this page, all the variables are as in the table except for the one whose sensitivity we're measuring. The purple bar in all three charts reflects the starting assumptions in the table above.



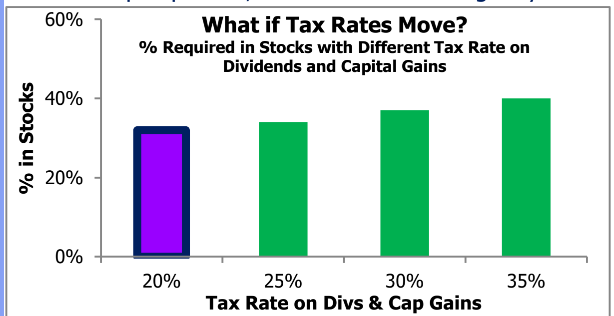
The first chart shows that as cash rates rise, the stocks/cash barbell requires less in stocks to equal the 3% bond yield we're trying to emulate. Personally, I think a 0.25% cash rate for ten years is a pretty low assumption. Cash will continue to be regarded as a drag on returns, although it provides you optionality because you can always decide to use it down the road when something's cheap. At least soon it'll be earning something, however modest.

The most obvious question for the barbell is, where will stocks be in ten years? At least with the 3% bond you know you'll get your original money back at maturity assuming no credit defaults. But estimates for where the S&P500 will be in 2025 vary widely. The chart below shows how much you'd need in equities based on liquidating at wherever the market is in ten years. If stocks still yield 2% in 2025 as they do today, the S&P500 will be at 3,109 (shown in the chart) since dividends will be 48% higher at that point (assuming 4% annual growth).



Finally, returns on stocks benefit from favorable tax treatment, since dividends and capital gains are taxed at 20% (Federal) versus 35% for interest income. Everybody's tax situation is its own adventure given the abominable tax code, but the point is you can see the sensitivity of this approach if tax rates on dividends and capital gains rise to those on ordinary income. We haven't included any outcomes with lower tax rates – that would be fantasy.

From our perspective, bonds are still a long way from where their yields would render them attractive. And rising rates on cash improve the stocks/cash outcome, requiring slightly less in stocks as the Fed tightens. As cash begins to earn a return again it makes bonds even less competitive with the stocks/cash barbell unless their yields rise.



Owning treasury bills will never be exciting, but I for one am looking forward to my affection for them being returned, albeit modestly. They're always there for me, but soon they'll be there with interest too.

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