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In Pursuit of Value

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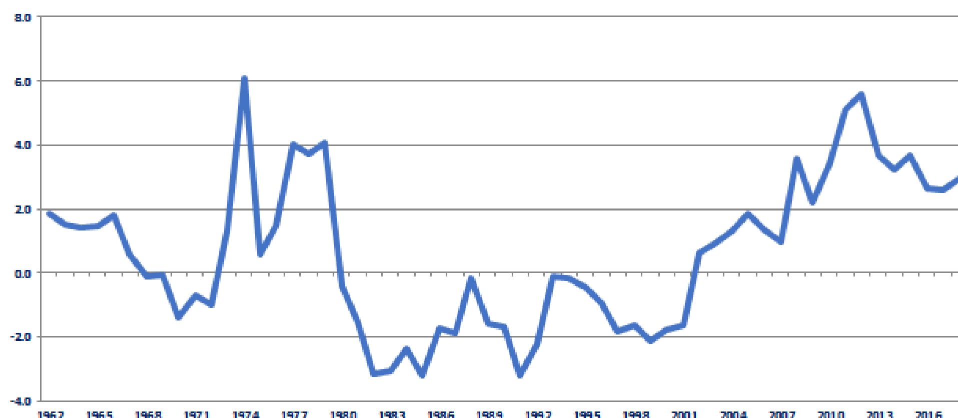
2017 Year-end Review and Outlook

The Equity Risk Premium (ERP) measures the difference between the earnings yield on the S&P500 and the yield on the ten year treasury. It represents a measure of relative value – valuing stocks in isolation, without considering the risk-free alternative, isn't very useful. Any investment decision is a function of the choices available at that time.

We've been using the ERP for many years in writing about stocks. It's consistently shown equities to be cheap versus their alternative (bonds), and they've duly risen. Even after the 22% return in 2017, stocks still look cheap relative to bonds. Earnings growth has almost kept pace with returns, and interest rates have remained low. Based on 2018 EPS forecasts, stocks continue to be relatively attractive.

Since the valuation case relies on current interest rates, a surprising spike in bond yields could quickly undermine it. A 2% increase in rates would eliminate much of the valuation advantage currently enjoyed by equities. Although not probable, it's possible that a tightening labor market could put upward pressure on inflation and cause the Fed to lift rates more rapidly. Higher rates have been forecast incorrectly for years – few now expect it.

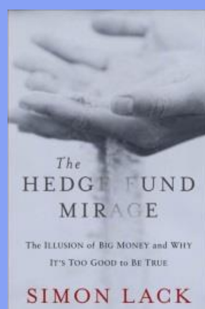


The Low Beta Anomaly, which underpins our Low Vol strategies, typically does worst in a very strong, growth-oriented equity market similar to what we saw in 2017. It relies on companies with reliable, stable growth outperforming those with faster, less certain growth (think tortoise versus hare). When investors chase excitement (i.e. the hare), the Low Beta Anomaly doesn't work so well. Put another way, in a market led by FANG (Facebook, Amazon, Netflix and Google), few prognosticators go on CNBC to recommend boringly safe P&G for the next leg up in stocks. Consequently, our Low Vol strategies lagged, although not by as much as we might have feared. With approximately half the volatility of the S&P500, Low Vol Long Only's 10% return was just a little shy of being commensurate with the risk. The flat 2017 performance of Low Vol Hedged following a strong 2016 nonetheless maintained its 6% p.a. long term return. Our Low Vol strategies continue to provide "low-octane" exposure to equities and, in the hedged format, uncorrelated mid-single digit returns.

Energy infrastructure, which comprises most of our assets, was a miserable place for much of the year. Persistent weakness contrasted sharply with the buoyant overall market, and investors were increasingly frustrated. Blog readership was highest when subscribers were most confused, which was typically following another bad week. MLPs and Tax Reform was the first in several that considered how changes in the tax code would affect MLPs, and this topic generated the most views. As it turned out, MLPs were beneficiaries of the final legislation. Barrons noted this in late December.

The Tumult in MLPs was published mid-week in late October, rather than as usual on a Sunday. We were fielding so many calls from perplexed investors that it was obvious people were looking for answers. It received a lot of views. Regular readers will be familiar with our opinion that the shift from growing distributions to financing growth has alienated an entire class of traditional MLP investors who simply wanted regular payouts with no excitement. The Changing MLP Investor and More on the Changing MLP Investor articulated this view and continued to draw readers well after they were published. Part of the frustration probably related to Alerian confusingly showing MLP distributions growing (see MLP Distributions Through the Looking Glass) while Alerian-linked investment products were cutting payouts.

We also field regular questions on the impact of renewables and electric cars (separate but related topics) on traditional energy demand. We think change will come more slowly than many would like, but we monitor developments carefully, because we recognize change is coming. A Futurist's Vision of Energy reflects our current thinking and drew a healthy response.



Much of our writing in 2017 sought to explain recent returns, as highlighted above. It was a very difficult year for those seeking near term confirmation of their investment thesis via rising prices. One of the hardest questions asked of an investment manager is to explain why the chosen sector fell last week when it should have risen, especially with little change in fundamentals. Naturally, that's the most common question. The answer most often lies with understanding investor sentiment rather than shifting fundamentals. The former fluctuates far more rapidly.

2017 returns for energy infrastructure were down 8-14% (depending on strategy); not nearly as bad as looked likely in mid-November before the year-end seasonals kicked in and brought a strong rally into year-end. But it felt far worse, and given the 22% return in the S&P500, an allocation to the energy sector still resulted in a substantial drag on performance.

2018 will see the U.S. achieving record output in crude oil, natural gas liquids and natural gas, as the Shale Revolution continues the drive to American Energy Independence. Perhaps unsurprisingly given the 2017 performance divergence, relative valuations in energy infrastructure are highly attractive (see Falling Taxes and Valuations Boost Energy Infrastructure Outlook). Consensus 2018 earnings growth for the Energy sector is 37% according to FactSet, three times the 11% growth forecast for S&P500 earnings. According to analysts' target prices, energy stocks have the most upside.

We think all these factors will combine to generate attractive returns, and December's 6.5% return in the American Energy Independence Index is hopefully a step in that direction.

As always, we value the support of, and interaction with, our growing number of clients and friends. A substantial portion of the partners' net worth is invested alongside you. We wouldn't have it any other way.

To Our Clients

At SL Advisors it's important to us that your investments with us are aligned with your financial situation and objectives. If there have been any relevant changes from your perspective or any reasonable restrictions you wish to impose, please let us know and we'll be happy to discuss appropriate modifications. Of course, anytime you have any questions or concerns don't hesitate to contact us. We value your business, and never forget the faith you have placed in us as stewards of your capital.