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In Pursuit of Value

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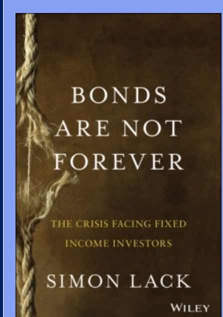


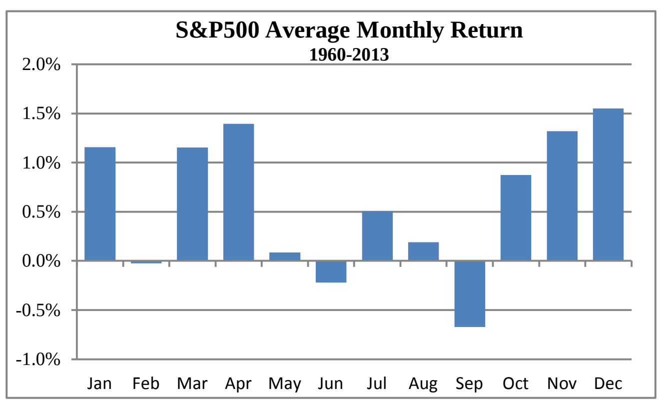
September's Pattern

There's something very appealing, very human, about pattern recognition. We inhabit a world that is full of unpredictability and chaos. The notion that certain events repeat, that "history rhymes" (as Mark Twain said) is short of a monotheistic explanation for how the world works and is still appealing all the same. It's as if accepting the randomness of life is to reject the very essence of being alive, and is instead to process information as if made of silicon. We expend much energy improving upon the disorder around us. Why, there's even a Pattern Recognition Society whose mission is to help researchers working on such things.

Investing produces all kinds of patterns. The entire field of technical analysis rests of the belief that past performance ***IS*** an indicator of future returns (quite contrary to the warnings on every investment offering you've probably ever seen). And in case you think you detect some skepticism leaking into these words, let me note that I have friends whom I greatly respect that make a very good living out of practicing just that. It's not what drives us at SL Advisors, but it works well enough to retain its adherents.

Seasonal patterns are fascinating, because there are often plausible explanations for them. A pattern that works without a clear reason why runs the risk familiar to statisticians of exhibiting a correlation without causation. Ronald Coase, an economist, has been quoted as saying that, "If you torture the data long enough, it will always confess." Identifying a statistical relationship can often fall frustratingly short of finding a predictive one. I've always felt that if you don't know why it works, you may find that when it stops working you won't know why that happened either.

Seasonal patterns may exist in part because humans are creatures of habit. For example, Mondays are believed by some to be a bad time to sell. Perhaps it's because investors use the earliest opportunity to exit what they spent the weekend worrying about. Or maybe it's because some traders go home with smaller than average long positions on Fridays given the two days' of possible geopolitical events with no available liquidity. In his 1987 book *Don't sell stocks on Monday* Yale Hirsch made the case. I don't know if it's worked since.



The Financial Analysts Journal (FAJ) recently published an article titled "Sell in May and Go Away". It's in the July/August edition so unfortunately too late to be useful for this Summer. However, it caught my interest because the authors found that it's a good rule to follow. Observant readers of this newsletter may recall that a year ago we wrote on this topic and reached the opposite conclusion. The contrasting opinions of SL Advisors and the FAJ probably bother me more than them. So I looked at the data a little more closely.

It turns out that most of the difference depends on when you repurchase what you sold (the other difference is that the time period analyzed by the FAJ article begins in 1970 whereas we went back to 1960). We thought of the rule as implying a Summer free of investment worries and calculated a "Sell Before Memorial Day and Buy Back By Labor Day" rule. It turns out that holding stocks in September can be one of the poorest times of the year to be invested. A Dollar conventionally invested in the S&P 500 on January 1, 1960 would have grown to $28.18 (with the Utopian assumptions of reinvested dividends and no taxes). Nimbly skipping September would have resulted in $42.53 (and that's without factoring in the interest income from holding cash one month each year).

Of course, one month is bound to be the worst just as one will be the best. Critically though, is there a reason for it? Otherwise, it's just another of life's random events and may not persist. The January effect is well documented, although surprisingly over the past fifty years it's been only the fourth most profitable month (1, 2 and 3 are December, April and November). Its 1.2% return is still double the average for all months, and missing every January since 1960 would have caused the invested dollar to limp along to only $17.02. The January effect does have credible explanations. Many investors make allocation decisions on a calendar year basis, and that perhaps with a modest lift from year-end bonuses seems to provide a valid reason for the January effect.

September is harder to figure. Half the market's annual return is historically earned by April. Perhaps a Summer of complacency combined with imprudent decisions by those whose performance has lagged result in a little less cash than is needed to scoop up cheap securities? The Romans associated September with fire and volcanic eruptions, since its God was Vulcan, the God of Fire. Roman investors would undoubtedly have sold stocks in August. Over the last fifty years poor returns in September are fairly consistent though. During each decade from the 1960s to the 2000s September was lousy. The 1990s was the only decade when Septembers were even positive, and that was largely because from 1997-99 the market was up virtually every month as it rode the dot com bubble. The corollary of poor September returns is that it's therefore a bad time to sell. On average you'll do better by waiting.

SL Advisors, LLC focuses on identifying securities that are trading at a discount to intrinsic value.

We're about to find out if this pattern will be repeated, and unlike the FAJ analysis this one does at least arrive in time to be actionable. For our part, we have no opinion on whether this September will be typically bad, but remain curious for possible explanations. There's no shortage of reasons to be cautious, including Mid East turmoil, weakness in Emerging Markets and another imminent fight in Washington over the debt ceiling. But there are always things to worry about. Moreover, profitably exploiting seasonal patterns once you figure transactions costs and taxes can be mighty difficult. Going to cash every September would result in all of an investor's capital gains being taxed at the short term rate, a significant drag. Fortunately though, for the real investor who doesn't seek to profit from short term market moves and is sensitive to the tax liability caused by frequent buying and selling, September can be a good time to buy.

Website Upgrade

We recently overhauled our website so as to provide more information, navigate more logically and provide an improved "look and feel". We're very happy with the results and encourage you to check it out (www.sl-advisors.com). Notable additions include a more detailed description of each of our investment strategies, a link to our Investment Philosophy and a fully integrated blog. I post to the blog periodically, about twice a week as long as there's something useful to say. Anyone that's interested can sign up to receive e-mailed updates.

After much agonizing I also joined Twitter several months ago, once a journalist explained to me that it's really a personalized news feed. I've learned that Twitter isn't just for followers of Justin Bieber or Katy Perry (currently the most followed), and by "following" news sources (NY Times, FT, Economist etc.) it can become a personalized, scrolling newsfeed. Our embrace of social media has stopped short of using Facebook though. Gathering "Likes" and "FB Friends" seems too juvenile, or maybe I'm just too old for it.

Clients will also note that the website's home page has a Client Login link at the top which will take you easily to information on your own account(s). We think you'll like it, and welcome any feedback.

SL Advisors runs a variety of strategies focused on generating attractive risk-adjusted returns using public equities in long-only and long-short format. Contact us for more information, or go to our website: www.sl-advisors.com

Returns for each strategy shown at right are from a single continuously managed account. The Hedged Dividend Capture, Deep Value and MLP Strategies have all been independently verified and attested to by Marcum, LLP. Documentation available on request.

Hedged Dividend Capture Strategy (%)							Since Inception			13%	*Index*		*-4%*
	Jan	**Feb**	**Mar**	**April**	**May**	**June**	**July**	**Aug**	**Sept**	**Oct**	**Nov**	**Dec**	**YTD**
2011										**0.4**	**0.2**	**3.5**	**4.2**
Index										*0.6*	*-0.2*	*0.2*	*0.6*
2012	**-3.5**	**-2.1**	**1.1**	**1.6**	**1.2**	**2.1**	**1.1**	**-1.3**	**0.4**	**0.8**	**0.5**	**-0.7**	**1.0**
Index	*0.4*	*-0.8*	*-1.2*	*-1.5*	*-0.4*	*-1.5*	*-0.1*	*-0.1*	*-0.3*	*0.2*	*0.5*	*0.1*	*-4.7*
2013	**2.8**	**3.4**	**4.1**	**0.9**	**-2.8**	**1.1**	**1.4**	**-3.2**					**7.8**
Index	*0.4*	*0.2*	*0.0*	*0.5*	*0.2*	*-0.6*	*0.6*	*-1.4*					*-0.2*

The Index is the HFRX Equity Market Neutral Index. Returns are net of fees. Past performance is not indicative of future returns.

High Dividend Low Beta Strategy (%)							Since Inception			40%	*Index*		*51%*
	Jan	**Feb**	**Mar**	**April**	**May**	**June**	**July**	**Aug**	**Sept**	**Oct**	**Nov**	**Dec**	**YTD**
2011										**5.9**	**0.1**	**4.0**	**10.3**
Index										*10.9*	*-0.2*	*1.0*	*11.8*
2012	**-1.3**	**0.1**	**2.8**	**1.3**	**-1.8**	**4.2**	**1.8**	**-0.2**	**1.7**	**-0.1**	**0.8**	**-0.2**	**9.1**
Index	*4.5*	*4.3*	*3.3*	*-0.6*	*-6.0*	*4.1*	*1.4*	*2.3*	*2.6*	*-1.8*	*0.6*	*0.9*	*16.0*
2013	**5.4**	**4.1**	**6.0**	**1.9**	**-1.6**	**-0.4**	**4.0**	**-4.6**					**16.0**
Index	*5.2*	*1.4*	*3.8*	*1.9*	*2.3*	*-1.3*	*5.1*	*-2.9*					*16.2*

The Index is the S&P 500 including dividends. Returns are net of fees. Past performance is not indicative of future returns

Deep Value Strategy Monthly Returns (%)							Since Inception			134%	*Index*		*94%*
	Jan	**Feb**	**Mar**	**April**	**May**	**June**	**July**	**Aug**	**Sept**	**Oct**	**Nov**	**Dec**	**YTD**
2009							**8.5**	**1.0**	**11.3**	**0.4**	**3.5**	**9.8**	**39.3**
Index							*7.6*	*3.6*	*3.7*	*-1.9*	*6.0*	*1.9*	*22.6*
2010	**-1.1**	**3.8**	**6.6**	**3.5**	**-5.6**	**-4.5**	**5.2**	**7.0**	**7.8**	**1.2**	**1.0**	**2.7**	**30.2**
Index	*-3.6*	*3.1*	*6.0*	*1.6*	*-8.0*	*-5.2*	*7.0*	*-4.5*	*8.9*	*3.8*	*0.0*	*6.7*	*15.1*
2011	**0.2**	**2.2**	**1.9**	**2.5**	**-2.3**	**-2.9**	**0.6**	**-5.2**	**-9.2**	**12.3**	**-0.5**	**-0.6**	**-2.3**
Index	*2.4*	*3.4*	*0.0*	*3.0*	*-1.1*	*-1.7*	*-2.0*	*-5.4*	*-7.0*	*10.9*	*-0.2*	*1.0*	*2.1*
2012	**4.4**	**5.2**	**0.9**	**2.0**	**-8.8**	**3.8**	**0.7**	**3.6**	**3.3**	**-0.9**	**-2.6**	**1.0**	**12.4**
Index	*4.5*	*4.3*	*3.3*	*-0.6*	*-6.0*	*4.1*	*1.4*	*2.3*	*2.6*	*-1.8*	*0.6*	*0.9*	*16.0*
2013	**6.4**	**0.6**	**4.3**	**1.6**	**2.1**	**-1.6**	**4.3**	**-1.2**					**17.4**
Index	*5.2*	*1.4*	*3.8*	*1.9*	*2.3*	*-1.3*	*5.1*	*-2.9*					*16.2*

Returns do not include cash balances prior to November 2009. YTD returns are unannualized compounded returns. The Index is the S&P 500 including dividends. Returns are net of fees. Past performance is not indicative of future returns.

MLP Strategy Monthly Returns (%)							Since Inception			131%	*Index*		*114%*
	Jan	**Feb**	**Mar**	**April**	**May**	**June**	**July**	**Aug**	**Sept**	**Oct**	**Nov**	**Dec**	**YTD**
2008	**-0.7**	**3.0**	**-0.8**	**1.9**	**4.2**	**-10.7**	**-2.0**	**0.6**	**-14.9**	**-1.1**	**-25.4**	**7.4**	**-36.1**
Index	*-0.6*	*-0.5*	*-6.3*	*7.3*	*1.0*	*-4.9*	*-1.7*	*1.7*	*-17.2*	*-0.1*	*-17.1*	*-3.7*	*-36.9*
2009	**15.4**	**-2.1**	**5.0**	**5.8**	**9.9**	**-1.1**	**10.1**	**0.1**	**1.0**	**2.3**	**6.2**	**5.0**	**73.3**
Index	*15.3*	*-4.2*	*0.7*	*11.0*	*9.3*	*-1.7*	*12.4*	*-3.2*	*4.8*	*2.9*	*6.4*	*6.6*	*76.4*
2010	**0.7**	**5.4**	**2.0**	**2.4**	**-0.5**	**5.1**	**5.8**	**-1.6**	**5.0**	**2.0**	**3.2**	**2.7**	**37.2**
Index	*0.6*	*4.6*	*2.9*	*3.4*	*-5.4*	*5.6*	*7.5*	*-2.5*	*6.1*	*5.4*	*1.9*	*1.7*	*35.9*
2011	**1.2**	**5.1**	**0.0**	**2.6**	**-4.3**	**1.8**	**-3.0**	**-0.3**	**-3.4**	**9.1**	**0.2**	**6.8**	**15.8**
Index	*3.0*	*3.5*	*-0.6*	*3.3*	*-5.0*	*1.1*	*-1.9*	*-1.1*	*-4.1*	*10.3*	*-0.2*	*5.8*	*13.9*
2012	**1.7**	**5.2**	**-3.7**	**0.9**	**-7.1**	**3.1**	**5.9**	**3.2**	**2.3**	**-0.7**	**0.4**	**-3.2**	**7.4**
Index	*1.9*	*4.2*	*-4.0*	*2.2*	*-7.5*	*3.3*	*5.1*	*1.6*	*2.0*	*0.5*	*-0.8*	*-3.1*	*4.8*
2013	**12.9**	**1.7**	**5.8**	**-0.5**	**-1.2**	**2.6**	**0.3**	**-0.4**					**22.5**
Index	*12.6*	*0.9*	*5.4*	*0.9*	*-2.0*	*3.1*	*-0.5*	*-2.5*					*18.4*

Returns do not include cash balances prior to May 2010. The Index is the Alerian MLP Index, AMZX. Returns are net of fees. Past performance is not indicative of future returns.

Low Beta Long-Short Monthly Returns (%)							Since Inception			107%	*Index*		*-4%*
	Jan	**Feb**	**Mar**	**April**	**May**	**June**	**July**	**Aug**	**Sept**	**Oct**	**Nov**	**Dec**	**YTD**
2011			**-3.5**	**19.4**	**6.5**	**4.5**	**0.0**	**9.1**	**-1.1**	**6.7**	**1.9**	**1.5**	**52.6**
Index			*-0.9*	*0.5*	*-1.4*	*-1.6*	*-0.1*	*-3.5*	*-3.0*	*0.8*	*-0.9*	*-0.4*	*-10.0*
2012	**-5.1**	**-1.6**	**5.7**	**3.3**	**1.1**	**2.4**	**3.2**	**-2.2**	**2.1**	**0.7**	**0.2**	**-1.3**	**8.6**
Index	*1.7*	*1.4*	*0.0*	*0.1*	*-1.7*	*-0.3*	*0.5*	*0.5*	*0.4*	*-0.5*	*0.4*	*0.9*	*3.5*
2013	**7.9**	**6.2**	**6.5**	**3.2**	**-2.1**	**-0.7**	**4.0**	**-2.1**					**24.7**
Index	*2.0*	*0.4*	*0.7*	*0.6*	*0.7*	*-1.3*	*1.0*	*-0.8*					*3.4*

The Index is the HFRX Global Hedge Fund Index. Returns are net of fees. Past performance is not indicative of future returns.

SL Advisors offers separately managed accounts for individuals, family offices and institutions across various investment strategies. Client assets are held with Charles Schwab, the largest provider of custody services in the U.S. with client assets of $1.89 trillion (as of September 30, 2012). Client portfolios are completely transparent via Schwab's extensive website which provides real-time access to accounts and all supporting information. Detailed monthly statements are mailed directly to clients from Schwab.

SL Advisors Hedged Dividend Capture Strategy

An alternative to bonds, this strategy utilizes stocks of stable companies with high dividend yields to generate income with capital appreciation by investing in a diverse, unleveraged, hedged portfolio of U.S. equities. Companies are selected that possess a history of steady earnings growth, attractive dividend yields and are less volatile than the overall market. The long positions are hedged with a short S&P500 position with the objective of making the portfolio beta neutral while still maintaining a net long equity exposure. Historically this strategy has exhibited monthly swings comparable to corporate bonds, and given the relative attractiveness of equities compared with investment grade bonds it has a more attractive return outlook. This strategy may be considered as a substitute for a portion of an investor's fixed income allocation.

SL Advisors High Dividend Low Beta Strategy

This is the long-only version of our Hedged Dividend Capture Strategy (Long/Short), which has been actively managed and deployed since October 2011. Academic research has shown the Capital Asset Pricing Model (CAPM) fails to explain risk-adjusted returns. Over long periods of time, high beta stocks tend to under-perform and low beta stocks tend to out-perform, on a risk-adjusted basis, which is inconsistent with predicted performance by the CAPM. This strategy allows investors to take advantage of this persistent anomaly.

SL Advisors Deep Value Equity Strategy

A portfolio of undervalued stocks of high quality businesses that aims to outperform the S&P500. Investments are in listed U.S. equities trading significantly below the intrinsic value of the underlying enterprise. Potential investments are identified both qualitatively and quantitatively following which detailed research is performed to assess fundamental value. Desired characteristics of businesses include pricing power, low leverage, low costs of production, and attractive valuation. Valuation is defined to us foremost as the net present value of cash one can extract from proportional ownership of the business, then relatively using peer multiples and finally liquidation value. The portfolio is reassessed constantly and all holdings are rated for return potential and risk against their peer group to rebalance into the most attractive opportunities. This strategy is part of the equity allocation for balanced accounts for individuals, and is also appropriate as an alpha seeking equity strategy for institutional accounts.

SL Advisors MLP Strategy

This portfolio consists of 10-15 investments in Master Limited Partnerships (MLPs) to receive a healthy and growing tax deferred income stream. MLPs are publicly traded interests in energy infrastructure and related assets. They represent direct proportional ownership stakes in the underlying assets rather than securities in a corporation. Historically they have paid regular distributions which have grown with the U.S. economy, and as such they can be suitable for investors seeking income generating investments with a tolerance for equity market exposure. The strategy engages in low turnover so as to minimize transaction costs and benefit from the income tax deferral features of the asset class. MLPs are appropriate for high net worth investors comfortable with receiving a K-1 for each investment rather than a 1099. SL Advisors does not provide tax advice.

SL Advisors Low Beta Long-Short Strategy

Low Beta Long-Short is more concentrated than Hedged Dividend Capture ("DivCap") with added leverage and is not restricted to dividend paying stocks. It includes our best ideas from DivCap weighted according to conviction rather than diversified, equal weight allocations. It is managed to be beta neutral and returns are driven very largely by individual stock selection. Assets for this strategy only are custodied at Interactive Brokers.

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