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In Pursuit of Value

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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.

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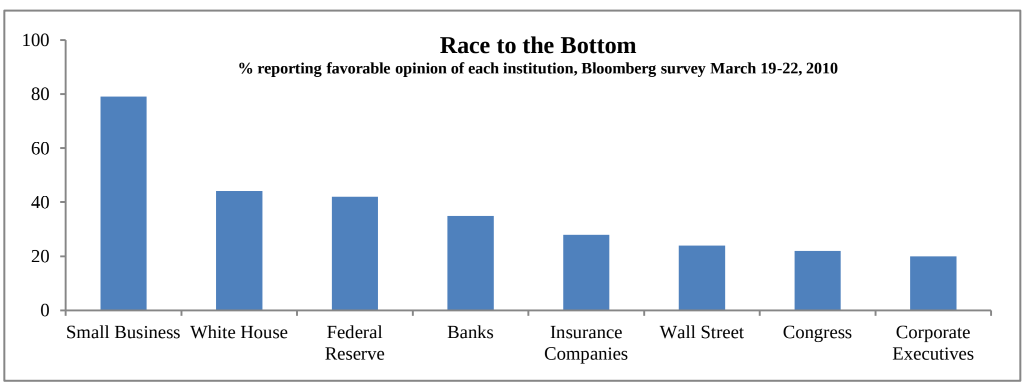
Many years ago when I was running fixed income derivatives, a salesman on Lehman Brothers' government bond desk approached me with a proposal (let's call him John). John would sell me a decent-sized block of treasury securities (I don't recall the precise amount) at today's market price, and tomorrow buy them back at a marginally higher price. Many readers will recognize this as a "repo", or repurchase agreement, an overnight collateralized loan that is utterly routine and is part of the normal financing of bond portfolios handled by dedicated trading desks. I was surprised that John was proposing a specific transaction, since such activity was handled elsewhere, and as I questioned him the unconventional nature of the trade became apparent. As his explanation made clear, I was to record today's trade today but tomorrow's trade could not be documented until tomorrow. This would create the appearance of two independent transactions, and so allow Lehman to report reduced holdings of securities at their quarter end.

Many questions occurred to me – in truth, my first thought was what if bonds fell and the proverbial truck removed John before the following day's trade could be documented, creating a large trading loss. But having assured myself of his good health, I pondered the culture at Lehman that could induce a salesman to propose a transaction that was clearly intended to mislead users of their financial statements. Although I couldn't know for certain, I doubted John was pursuing such unconventional business without clear direction from above. Most plausibly, Lehman was actively seeking ways to create a smaller-looking balance sheet through multiple avenues. Since the CFO wasn't going to personally execute and document such transactions, its implementation must have involved many people down the chain of command, and the passive knowledge of many more. The environment and leadership at Lehman must have been such that this activity was consistent with their objectives and values. The integrity of any enterprise is defined by the behavior of the people at the top.



This episode occurred at least fifteen years ago. As Anton R. Valukas found in his report on Lehman's bankruptcy, Lehman was mis-reporting their assets using a similar technique during 2007-08 and right up until their demise. While Wall Street has rarely been popular with Main Street, the Credit Crisis has exposed plenty of poor judgment and much dubious behavior; consequently banks are plumbing depths of disapproval normally reserved for the U.S. Congress. Polls can be both simple and imprecise measures of opinions. One of the things I loved about working at JPMorgan was the unwritten commitment to honesty regardless of its consequences (although there was and I'm sure still is a written Code of Conduct). Whatever the topic, whether it related to a client transaction, profitability, risk, market share, performance or financial results, a suggestion to distort the situation would have drawn the same wide-eyed response as showing up to a meeting in a clown's outfit, complete with baggy pants, oversized shoes and a red nose. Senior executives impact many meetings without being there, if their values and likely response are predictable. Reputations are easily lost; cultures are developed over many years. While I'm sure JPMorgan isn't unique, I worked there a long time and it's the only firm with which I have first-hand knowledge. Their values and culture were developed over decades. Evidently, so were Lehman's.

Closed End Fund Discounts

Closed end fund discounts are what often attract retail investors to this asset class. Discounts have been narrowing since last Spring, and recently reached 0.8% according to Morningstar, so add this to the growing evidence of the reach for yield. Discounts were last this tight in March 2007, and the asset class was briefly at a premium to NAV in early 2004. There are currently 620 funds listed in the U.S. with a market cap of $193BN, and there are wide variations in discount by sector. Funds that invest in high dividend stocks are particularly popular – perhaps most notable is Alpine Total Dynamic Dividend (AOD), which trades at a whopping 33% premium to its NAV. Regrettably it's rarely possible to short such funds, but satisfactory returns for its holders over the next twelve months are unlikely. Strong differences of opinion over value are what make this asset class interesting. By contrast, emerging market, biotechnology, real estate and certain municipal bond funds all offer discounts of 10% or more to NAV, providing many opportunities for additional research.

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

What We Own

Blackrock Defined Opportunity Credit Trust (BHL) is a diversified credit fund that holds below investment grade fixed and floating rate debt. Their most recent report listed 82% in bank debt, although under their mandate they do have the ability to switch to longer duration bonds. Leveraged loans have continued to benefit from the economic recovery and low rates as investors have sought yield. Some of these managers have told us that when the inevitable Fed tightening begins their sector will continue to do well since their holdings are often pegged to Libor rates. Whether or not that turns out to be the case, many closed end funds in this sector have outperformed their underlying assets, and consequently now trade at premium to NAV. We recently reduced exposure to certain names but BHL remains more attractive than its peer group. BHL is a holding in our Fixed Income strategy.

Source Capital (NYSE:SOR) is an equity-oriented closed end fund managed by First Pacific Advisors in Los Angeles. Since 1996 Eric Ende has managed the portfolio. SOR focuses on small and mid cap equities with a reliable history of earnings growth offered at attractive prices (known as GARP – growth at a reasonable price). Their portfolio turnover is quite low at 15% p.a.; a typical holding is O'Reilly Automotive (ORLY) which they've held as a full position continuously since 2000. Eric recalled that in the 70s Berkshire Hathaway bought 20% of SOR at a 50% discount to NAV, and used their board seat to promote a changed investment strategy. While Berkshire is no longer an investor, Eric's description of ORLY and his search for world-class managers evokes the influence of Source Capital's one-time investor. In our Discount Arbitrage strategy we trade more actively than our other strategies, but this is a current holding.