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In Pursuit of Value

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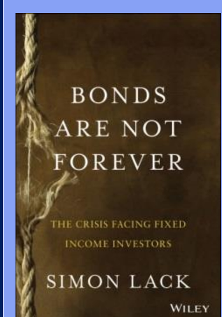
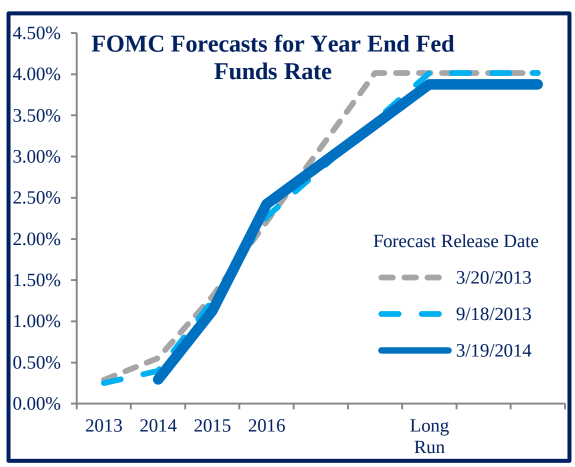


Quarterly Outlook

The evaluation of any investment relies on an interest rate with which to discount the future expected cashflows. Janet Yellen is now the primary source for this most basic building block of finance. Consequently, her recent press conference was of greater than typical interest. Her prior speeches as well as her six years (2004-10) heading up the Federal Reserve Bank of San Francisco (presumed to be as liberal as its neighborhood) have cast her as ever so slightly more willing than her predecessor to tolerate higher inflation in search of higher employment; such differences as may exist are probably far too subtle to be measured, and in any case the Fed routinely notes that there is no long term trade-off between their twin mandates (maximum employment with stable inflation).

It's been amusing to see talking heads (too forgettable to quote) on cable TV solemnly note that changes in leadership at the Fed "usually" cause an economic slowdown. My own career in Finance had until last month encompassed only two such changes and three Fed chairman (Paul Volcker, Alan Greenspan and Ben Bernanke). We've had more frequent changes at the White House, so opining on TV about any type of pattern simply confirms that TV producers occasionally need warm bodies to fill the gaps between commercials (a suspicion sometimes reinforced when I'm invited on TV myself).

A careful reading of the transcript from Janet Yellen's recent press conference and a review of the FOMC projections released suggests that very little has changed about the interest rate outlook notwithstanding the market's initial conclusion that rates will rise faster than anticipated. The chart of "blue dots" which reflect individual FOMC-member expectations for short term rates barely changed. The median forecast for the Fed Funds overnight rate at the end of next year is 0.75%, the same as it was in December. The average forecast rose from 1.06% to 1.13%, hardly substantial and in any case caused largely by the two highest forecasts moving even higher. Low rates for a long time remains the most likely outcome. The probable interval between the end of the Fed's bond buying and the beginning of higher rates (estimated at six months by Chair Yellen) seems dictated by the rhythm of eight FOMC meetings per year and their strong preference to announce policy changes ($10 BN less bond buying; 0.25% increases in Fed Funds) following each meeting. It's also highly doubtful that her objective in her first press conference leading the Fed was to cause a shift in interest rate expectations. The forecast path for short term rates defined by the FOMC remains the most likely way forward. It signals a Fed Funds rate of 1.13% by the end of next year and 2.42% by the end of 2016, as has been approximately the case for quite a while. The Fed's inflation forecast doesn't exceed 2% for almost three more years (through 2016) so they evidently see plenty of excess capacity in the economy. Surprises will assuredly occur, but for now it looks like a very long time until interest rates will rise to levels that make bonds once again an attractive proposition.



An important thematic element in our investment approach is the selection of stable companies with a high likelihood of growing their earnings year after year without the use of excessive leverage. The stock prices of such companies tend to have low betas (meaning they're less volatile than the overall market). Investing styles move in and out of fashion just like colors; although the low beta tortoise usually beats the momentum-driven hare, the short run race is unpredictable. By our measure the hare has been winning for the past three quarters, although there are recent signs that the pendulum is swinging back. While there are regrettably no reliable signposts to indicate when the "in" style is about to shift, qualitatively there seems to be less media attention on the urgency to get in to stocks. To paraphrase Ben Graham, perhaps the in-vogue investing style is switching from that of a voting machine in which fund flows drive popular stocks higher to that of a weighing machine in which earnings drive returns.

MLPs

MLPs had a great 2013 even by the standards of the asset class. So far this year the index returns have been unexciting (like equities) although we've managed to outperform the index by a decent margin. Kevin Kaiser of Hedgeye, a Connecticut-based research firm, may be the most notorious analyst following the sector. There's little doubt that Hedgeye punches above its weight in terms of press exposure, as one might expect given their contrary view. In recent months they've moved from recommending selective sales of certain MLPs to being broadly negative on the entire sector. This view was provided with a wider platform a few weeks ago when Barron's based an article largely on an interview with Kevin Kaiser.

An important differentiator within MLPs, one we think has been long overlooked, is whether there is a GP taking a share of the distributable cash flow (DCF) or not. As we've noted before, we have positioned our MLP strategy to be virtually free of the drag from GP Incentive Distribution Rights (IDRs). The GP is to an MLP as is the hedge fund manager to his hedge fund. GPs and hedge fund managers can both only win when the pool of assets they manage grows. This is the mantra we repeat whenever we discuss our MLP strategy. The ability for the GP to cause its MLP to issue equity allows the GP to benefit from increased cashflows without the need to put up additional capital, while the LP unitholders in the MLP always face the risk of possible dilution.

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

What this means in practice is that, while an MLP's unit price usually drops when it announces a secondary equity offering, the GP should increase in price for the same reason. There are indications more recently that the market is beginning to differentiate along these lines. For example, on the day in late March that Kinder Morgan announced it plans to invest $2BN in its CO2 business, Kinder Morgan Partners (KMP) was weak as investors anticipated the need for an additional equity raise by KMP to provide the funds. By contrast, Kinder Morgan Inc (KMI), which owns the GP of KMP, was firm because of the prospect of increased distributable cashflow as a result of the higher earning assets at KMP. Around the same time Regency Energy Partners (RGP) announced plans for a $400MM equity issuance which weakened its price while Energy Transfer Equity (ETE), which shares in the DCF of RGP through its GP ownership, was up. For these reasons, we are invested in KMI and ETE, but not in KMP or RGP.

Some investors have asked whether we think MLPs are due for a correction given the sector's recent strong performance. At such times, asserting up front that we don't try and time the market turns out to be a wonderful cop-out from having to answer a virtually impossible question. While we're definitely sellers of securities that we believe are expensive, such a view of an entire asset class (whether it is MLPs, low volatility dividend yielding equities or some other sector) could be arrived at only through an inability to identify attractively priced investments (i.e. bottom up) rather than a top-down assessment. The additional factor for MLP investors to consider is the tax consequence of selling. Creating realized taxable gains in addition to the recapture of previously deferred distribution income can create a substantial tax liability which requires the accurate forecast of a substantial fall in MLP prices to generate sufficient profit to offset the taxes. This has come about in part through strong performance and is to some degree a high class problem, but is nonetheless an important consideration for any MLP investor with a couple of years or more of history in the asset class.

Bonds Are Not Forever

If you have the time and inclination, you might want to read the generous review of my latest book by Laurence B. Siegel, Director of Research at the CFA Institute's Research Foundation.