



# In Pursuit of Value

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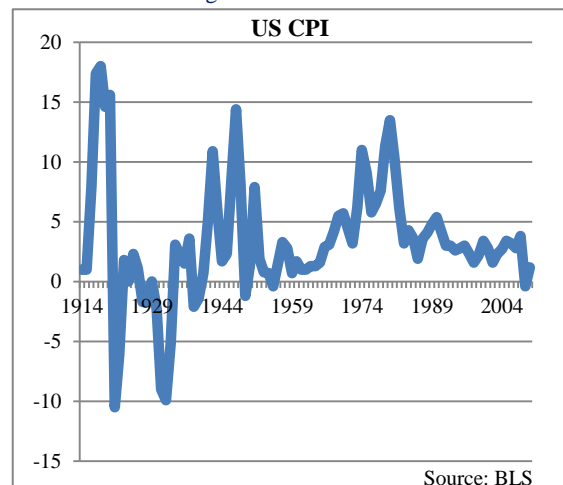
## Inflation

The future inflation rate is one of today's great investing imponderables. It's never been as important as it is now to forecast it accurately, and opinion has never been so divided. At one extreme sit those who believe that huge fiscal deficits and the Federal Reserve's reckless monetization of debt will lead to currency debasement and rampant inflation. The bull market in gold is one manifestation of such fears. At the other extreme are those who note persistently high unemployment as evidence that ample spare capacity exists in the economy. Today's very low bond yields suggest that inflation fears are not dominating investors' decisions.

While future inflation will affect investors' returns, less attention is paid to how inflation is calculated. Correct measurement is of no small concern to just about everybody. Savers ultimately need returns net of inflation, and many commercial contracts as well as substantial payouts from Federal and state governments (including Social Security) are indexed to inflation. The Bureau of Labor Statistics (BLS) calculates multiple inflation measures to reflect different spending patterns and to smooth out volatile items (such as food and energy). The most widely used measure is the CPI-U, U.S. City Average, All Items (CPI for short). Over the past twelve months it has risen at 1.2%. In 2009 it was -0.4%

Individuals routinely complain that prices are rising faster than the BLS calculates. Education (3.7%), Medical Care (3.4%) and Fuel (13.4%) are all causes of this opinion. The statisticians have an answer, which is that frequent, small purchases (school books, prescription medicine, gas) affect perceptions disproportionately compared to infrequent, large ones (new cars, housing, computers).

Few people outside government statisticians and obsessive fixed income investors spend the time to analyze the construction of the CPI. It's built by statisticians and while the subject of criticism the BLS maintains that it does its job. However, the BLS notes that it's not a cost of living index and it excludes most taxes which obviously have an impact. But most crucially, the CPI measures a basket of goods and services of constant utility (a theoretical concept related to how much use an individual gets from each purchase). Measuring the cost of maintaining a constant standard of living would be much more useful, but the CPI isn't designed to do that. Because of this and other quirks, the CPI does what statisticians want but fails to fully measure what's important to most people. One of the most bizarre components of CPI is Owners' Equivalent Rent (OER), which is intended to capture the cost of shelter. Rather than measure actual rents, or the costs of owning a home (mortgage, taxes, maintenance), OER is derived from a homeowners survey that asks what rental income owners think they could earn on their home. This is currently 24% of the entire index. How many people stay current on what they could rent their home for? And given the high incidence of home ownership in the U.S., how relevant is OER to the actual cost of owning a home experienced by most people? The statisticians respond that houses are an asset, like stocks and bonds, while they're trying to measure the cost of shelter, a service. But surely a more meaningful statistic would be to survey data on the direct costs of housing which would include (for owners)



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

mortgage rates, taxes and maintenance.

Another feature that only a statistician could love is the BLS's treatment of quality improvements. Companies improve their products all the time, but in CPI-land, if a product improves in quality with no price increase, that is the same as a price decrease. This works for a box of breakfast cereal increased in size from 12 oz to 15 oz sold at the same price. But how should this be applied to computers, whose speeds and capacity are increasing regularly? If a laptop cost \$500 last year and this year's current version with Microsoft's latest operating system costs \$500, the BLS will register a price decrease because of the quality improvement. This is known as a "hedonic quality adjustment", and uses statistic modeling to estimate the value of the quality improvement. However, the laptop hasn't really fallen in price (and even if you could buy last year's model for \$400, who would?). The BLS's aim for constant utility turns unchanged prices into deflation and in the case of computers drives down the overall CPI. The same applies to cars which now carry airbags. Since an airbag adds utility, the price of a car with an airbag is adjusted down so as to compare with the old price of a car without an airbag. But you can't buy a new car without an airbag, just as you don't want to buy an old computer. The result is that the inflation statistics are not presenting information that reflects how most people experience price changes. While it works for the BLS, this may explain why many individuals believe they experience higher inflation. It's the difference between constant utility and a constant standard of living. If the CPI wasn't so widely used as a price index its quirky construction would relegate it to obscurity.

Conspiracy theorists have speculated that the government deliberately understates inflation to reduce its expenditure since substantial transfer payments are indexed to the CPI. However, that would presume implausible statistical sophistication on the part of our elected leaders. Nobody watching the legislative process of the past few years could seriously believe this same group is secretly poring over subtleties in how inflation is calculated.

#### **What We Own**

**Overseas Shipholding Group (OSG)** is one of the largest bulk shipping companies in the world. They have leading positions in the transportation of crude oil, liquid natural gas and related fuels. Their major routes include the Arabian Gulf to Asia/Europe, and West Africa/Caribbean to the U.S. Gulf of Mexico and East Coast. Thematically, we like shipping because of the tangible assets (ships) combined with exposure to global growth. OSG owns and operates 112 ships (11.5 million deadweight tons) with another 13 on order. Shipping rates are highly sensitive to shifts in economic activity, and shipping rates across most markets are currently depressed with additional capacity ordered prior to the Credit Crisis likely to come online over the next several years. As a result, some shipping companies are valued at substantial discounts to the secondary market value of their fleets. OSG is better run than most; having managed a conservative balance sheet through the downturn, they have Debt:Equity of 0.8, and their assets are almost all ships and cash. Over the past five years they've earned a 15.7% return on equity, ahead of the industry's 12.7%. Because of the weak pricing environment, OSG trades at 0.6 of tangible book value although they are still generating positive cashflow from operations. At its current valuation OSG's fleet of ships can be acquired at one third off carrying value, even though they have one of the youngest fleets in the industry. As recently as 2008 they earned \$305MM, around 28% of today's market cap. OSG also has an attractive dividend yield of 4.7%, which management was able to maintain through the downturn due to their conservative financial management. We believe current pricing provides a margin of safety to invest at less than intrinsic value, and provides substantial operating leverage to a firming of shipping rates, which are showing some signs of firming, as well as increased Chinese refining capacity. OSG expects overall time charter equivalent rates to be 4% higher than a year ago on a ton/mile basis (although 3Q10 pricing was down on the prior quarter). 75% of their revenues come from the spot market, where prices are most sensitive to shifts in supply/demand. Their strong balance sheet allows them the flexibility to avoid locking in too much of their fleet at today's still depressed long term rates. OSG is a holding in both our Deep Value and Discount Arbitrage Strategies.