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In Pursuit of Value

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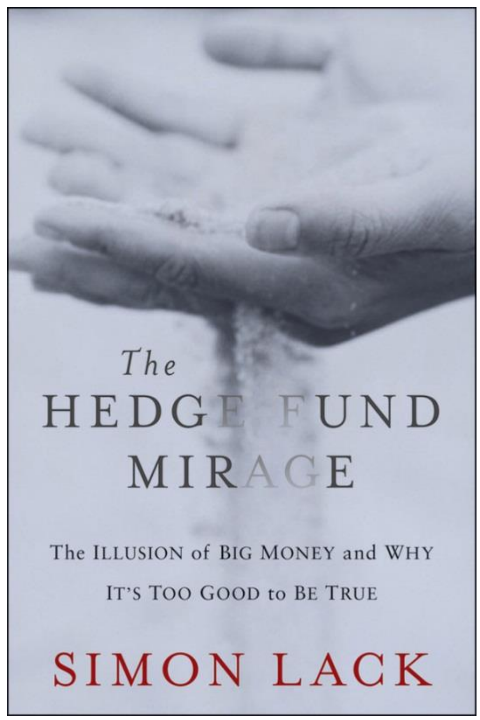
SL Advisors, LLC is a registered investment advisor offering separately managed accounts to individuals, family offices and institutions.

The Hedge Fund Mirage

Ernest Hemingway once said, "There's nothing to writing. All you do is sit down at a typewriter and bleed." Writing *The Hedge Fund Mirage* wasn't as intense and the writer's tools have evolved. But it still represents an act of faith that people will care what you have to say. Perhaps the most distressing reader response is indifference.

Until last year I never thought I'd write a book. Contemplating such a project and the daunting volume of output seemed absurd (how does one produce 60 *thousand* worthwhile words?), and the notion that I possessed an insight so far not articulated elsewhere somehow arrogant. However, I managed to overcome both obstacles with indecently little trouble and the result is a volume that I hope will be interesting, provocative and at times entertaining.



I learned that to write, you need to care passionately about your subject and be qualified to discuss it. Helping hedge fund investors achieve better outcomes turns out to be one of the few ideas, or perhaps the only one, for which I can check both boxes. While there is a great deal to admire in the investing insight possessed by some of today's most successful hedge fund managers, I never liked the role of supplicant required of those who would be their clients. The enduring supply/demand imbalance around talent has led investors to endure steadily worsening terms as their numbers have swollen. Recurring equity market shocks, miniscule interest rates and aging populations of future retirees are all adding urgency to the preservation of long term purchasing power. Hedge funds may be part of the solution but if so substantially more of their profits will have to wind up with clients than has been the case so far. The issue is far more than simply one of helping sophisticated, wealthy people stay wealthy. Public pension funds are increasingly relying on hedge funds to meet their retirees' needs, and as we discovered in 2008 private obligations can all too easily become public ones if assumed returns don't materialize. Done poorly, this will become a public policy issue and another drain on tomorrow's taxpayers.

Ask Amazon "How to Write a Book" and the website suggests 146 different titles. It turns out that the way to get a non-fiction book published is to write a book proposal, not a book. The most important part of the proposal is, of course, the Marketing Plan. While I naively assumed that the book is the point, for the publisher making money is really the point. How could a creature of financial markets overlook the profit motive in others? Having gratefully found my way to John Wiley and the undoubtedly better book their partnership has helped create, I also understand why so many writers have two jobs. Many professionals (literary agent, lawyer, and publicist) offer their services along the way, but the meager pool of net income retained by the writer can be quickly exhausted by such help. The "negotiations" I pursued with John Wiley had much in common with an investor seeking access to a highly desirable hedge fund although Wiley's charming Acquisition Editor made it an enjoyable process. However, I'm not a complete pushover and so I did manage to retain the movie rights. Since I'm holding out for Brad Pitt to play the starring role the screenplay is not yet far advanced.

At some point you have to put down your pencil and stop writing. Working on weekends during the snowy winter of 2011, at times the words flowed in abundance. I surprised myself at how much I had to say. But the revising and editing is really never over. Every re-reading reveals opportunities for improvement, and while I fervently hope there are no factual errors in the final product the prose, however imperfect, is truly the result of my best efforts. It has already been an enjoyable journey, and the book's release in January will lead to a much more public phase. I hope you enjoy reading it and, as I've told many friends already, stop by my office in Westfield, NJ anytime and I'll be happy to sign your copy. You can even pick one up from the Town Book Store at 270 Broad Street in Westfield, and then walk two blocks to visit the author.

For those readers that are impulse buyers, here's the link:

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

Bond Math

You don't need a degree in Psychology to know that investors are nervous. Pick up any newspaper, or just take your own pulse. Macro issues dominate almost every investing decision, and it's therefore not surprising that the safety of bonds remains attractive.

No doubt fixed income has had a great run. The Dow Jones Corporate Bond Index, a benchmark of long duration investment grade debt, has returned 7.9% p.a. since the beginning of the millennium. The S&P500 has managed 0.5% p.a. over the same period. Investing by looking backwards can be reassuring – generally if something has happened before, it can happen again. Bonds look better than stocks in the rear-view mirror and they can appear pretty compelling looking forward too. If the Euro collapses then for stocks, so goes the conventional wisdom, down is a long way. And so it might be.

But here's the Math. High grade bonds (as defined by the relevant iShares ETF, LQD) yield 4.4%. That is what the hold-to-maturity investor in long term corporate debt can hope for. Factor in a 40% tax rate on interest payments with 2.5% inflation and it will be hard to maintain purchasing power. Stocks were roughly 2.5 times as volatile as bonds over the last decade – selling those bonds and putting 40% of the proceeds in large cap, dividend paying stocks that yield 3.5% (with the rest, for now, in cash) maintains the same overall portfolio volatility and only requires 3.8% dividend growth to beat bonds (compared with a fifty year growth rate of 5%). The 60% in cash provides a useful option to invest at a later date when prospects are clearer – and who knows, maybe one day interest rates with an integer could return to the money markets.

Ben Bernanke is steadily raising the stakes for those bond investors who wish to invest alongside him. The Fed's QE2 program has created a large and non-commercial buyer for debt that is not motivated by profit. Indeed, the Fed's objective is to create an environment in which bond investors wish they owned something else. Real returns on investment grade and government debt are likely to remain negative for an extended period of time. The Fed has the ability to ensure this state of affairs persists indefinitely should they so desire. "I promise you negative real returns for many years" may not be a catchy soundbite, but if Chairman Bernanke said those words they would not require any change in monetary policy. While it's usually good to follow the smart money, in this case it may be academic smarts rather than street smarts that are on display. The most significant long term challenge facing investors must surely be identifying alternatives to traditional fixed income.

Merry Christmas, Happy Holidays and All the Best for 2012!