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In Pursuit of Value

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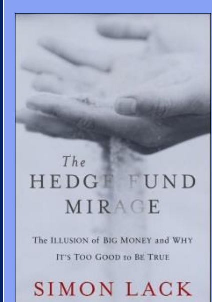
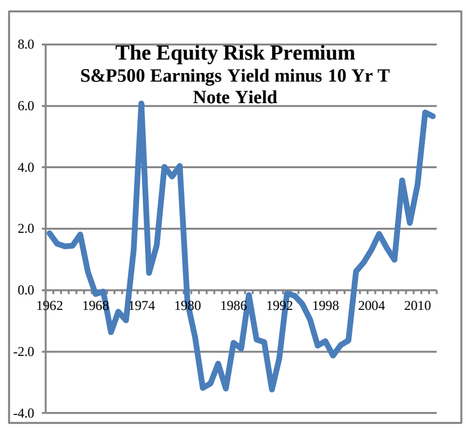


Quarterly Outlook

Fiscal issues dominated the last few weeks of 2012 and are likely to provide headlines during the next several months as well. Therefore, it's worth contemplating what it means for investors. Following this most recent skirting of disaster with the Fiscal Cliff, it's possible to draw some inferences about how the ongoing budgetary debate will unfold. Both parties believe they won an electoral mandate for their policies. President Obama won re-election, but the House of Representatives remained Republican. Moreover, there is less reason to expect this form of divided government to lead to grand compromise. The partisan split in Congress with fewer tight electoral contests is increasing the importance of the primaries in selecting candidates. Less turnover in Congressional seats gives the dominant party's core voters greater influence. This is most obvious in the House Republicans' rejection of compromise recently, revealing a greater fear of Tea Party challengers in 18 months than a general election loss. Similar dynamics exist for Democrats. The New York Times recently noted that Americans are showing a greater tendency to cluster in neighborhoods of like-minded people, a development that will exacerbate the current trend towards argumentative government by further reducing the competitiveness of elections for the House of Representatives.

Given the absence of much long term budget repair in the latest brinkmanship combined with the polarizing dynamic described above, it seems that the most realistic expectation is for quite modest fiscal improvements albeit achieved under the threat of government-induced catastrophe. The debt ceiling will no doubt provide another flashpoint for differing philosophies fairly soon. The fact that the recent compromise relied mostly on taxes with no meaningful spending cuts probably means the Republicans will look to this next manufactured crisis as an opportunity to advance that aspect of their agenda. It won't be long.

Moreover, for all the hand-wringing over the long term outlook, it's not clear that there is much coherent political support for fixing it. Raising taxes and cutting entitlements are intensely unpopular. The near term benefits of prudence are hard to identify. The Federal Reserve is quite possibly shielding the economy from unhindered bond market feedback on the fiscal outlook through quantitative easing, so low interest rates don't portend much actual trouble. It's like predicting global warming during a blizzard – hard to get much serious attention.



For an investor, there is probably a little more certainty over public policy than was the case a month ago. Our government is not bold in confronting problems, but there is a certain predictable logic driving decisions. As a result, there is far more certainty about fiscal policy than was the case last month. Incremental improvements punctuated by a crisis with a dramatic conclusion are beginning to look like a pattern. It's not exactly what the Bowles-Simpson Commission recommended, but it appears to be what the next couple of years at least have in store.

The increased certainty and the absence of any significant fiscal drag should allow corporations to make more confident long term decisions and be positive for growth, albeit punctuated with a political crisis from time to time. Equities continue to be attractive relative to fixed income. The Equity Risk Premium remains historically very wide, and with interest rates likely to remain below inflation (more so after taxes are included) government and high grade corporate bond markets remain a safe way to steadily lose purchasing power. It remains the case that 23 cents invested in equities will, with 4% dividend growth, deliver the same ten year return as $1 invested in ten year treasuries. After taxes with the new rates on income, dividends and capital gains the Math requires only 19 cents. High grade corporate bonds alter the comparison only modestly.

Income generating securities came under pressure late in 2012. As it turned out the increase in investment tax rates wasn't as punitive as might have been feared. The Low Beta anomaly persists, so our Hedged Dividend Capture Strategy ("DivCap") consisting of a long/short portfolio of $100 in stable, dividend paying stocks hedged with $50 short the S&P 500 provides a good way to pick up dividend income with minimal equity volatility. I'm currently adding to that strategy myself.

Master Limited Partnerships (MLPs) also gave up some ground in recent weeks. But the tax treatment of MLPs did not change and with higher ordinary income tax rates the tax-deferred nature of the distributions is now relatively more attractive compared with other income generating sectors on an after tax basis. If Congress decides to tackle tax reform this year MLPs will probably be vulnerable. However, their tax treatment has existed for over a quarter century (since the 1986 Tax Reform Act under Reagan) and improved energy infrastructure is an easily defended policy goal. Moreover, overhauling the nation's tax code will require a grand compromise between both parties so far removed from recent discourse that it barely justifies consideration.

Low Beta Long-Short

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

We have incubated this strategy for two years now, and the returns are on page 3. Although we generally strive to avoid excitement and make investments in companies where reliably increasing profitability can be found, this strategy offers a little more return and risk. Developed out of our focus on low beta stocks as a source of return, Low Beta Long-Short is more concentrated than 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. The results have been good as you can see. For those clients interested in this type of risk-return profile we'd be happy to discuss it in more detail.

Blog

I've been writing a blog now for about 18 months. It was recently highlighted by MarketWatch.com as one of "ten new, must-read investing blogs". They said, "The former JPMorgan banker and current hedge fund mythbuster weighs in on macro issues and major investing themes." Their attention is very kind. I aim to write only when there seems to be something worth saying – about twice a week, which will surprise friends of mine who find me far more verbose in person. Brevity benefits the writer as well as the reader. You can find it at www.blog.sl-advisors.com. Further reflecting my stubbornly slow use of new technology, I have finally started to use Twitter. I've found it to be a useful customized newsfeed, but I occasionally "tweet" as well @SimonLack.

Hedge Fund Mirage

The book has passed its one year anniversary. I won't repeat here the many items of news and controversy it has created (you can find them on my blog, and book reviews on www.hedgefundmirage.com). A Google search will reveal ample further commentary, and in spite of the objections of a small handful in the industry, hedge fund performance continues to drive home the relentless truth behind my analysis that clients have, in aggregate, done rather poorly.

Most recently it made the Wall Street Journal's list of Best Business Books of 2012. AllAboutAlpha.com, a hedge fund website, listed it as one of their top five stories of 2012. Hedge fund people are largely a pretty intelligent bunch, and consequently most of them have agreed with much of what I've pointed out. I'm quite sure they'll continue earning a good living.