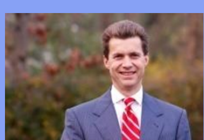
Published by SL Advisors, LLC

In Pursuit of Value

March, 2011

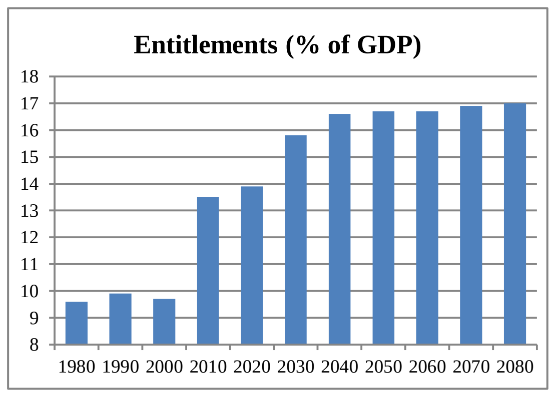
SL Advisors, LLC is a registered investment advisor offering separately managed accounts to individuals, family offices and institutions.



Fiscal Prudence Delayed (Again)

The sound of melting snow trickling away was a welcome sound in New Jersey during a run on a recent Spring-like day. There is still grass in suburbia, although it's been invisible for way too long. It's sorely missed, like leadership to solve America's developing debt problem before our financial future drains away.

Behind the rhetoric that passes for debate nowadays in Washington DC are some cold political calculations. The President's recently published 2012 Budget does not make a serious attempt to alter the long term outlook. Yet his Deficit Commission presented a path back to sensible fiscal balance, by going where the money is. Later retirement, higher taxes for the wealthy, reduced mortgage tax deduction, lower defense spending. It's really not that complicated. Entitlements are the problem and controlling them will eventually be the solution. The President's budget illustrates the growing share of GDP that Social Security, Medicare and Medicaid will consume. Rather than produce a plan to avoid the train wreck, the document weakly submits that "The Administration intends to work with Congress…(to) assure fiscal sustainability…". Obama's political calculation is analogous to the Presidential candidate who delays announcing his intentions until media interest builds to a climax, positioning the inevitable announcement as a response to overwhelming demand. He has decided to follow not lead the budget debate concluding there is little political benefit to the latter. Of course the Republicans are no better. House speaker Boehner recently commented that entitlements were not being considered as a source for the $100 billion in spending cuts that the now fiscally prudent Republicans are demanding. This is apparently because Americans don't yet fully understand the size of the problem. As implausible as that sounds, the political calculation behind it is that there's little popular appetite for the personal sacrifices necessary to restore fiscal balance. For an investor in U.S. bonds, it's becoming increasingly likely that the solution will be preceded by a crisis.



Some voter skepticism is understandable. Just as this winter's weekly blizzards in the northeast U.S. render global warming a theoretical challenge, 3.5% ten year treasury yields hardly seem a harbinger of trouble. While the budget analysis seems unrelenting, driven largely by demographics, it's becoming increasingly clear that a consensus around the necessary belt-tightening will require some evidence of the cost of inaction in the form of rising bond yields. Confiscatory short term rates will no doubt be with us for a good while longer, steadily transferring wealth from the thrifty to the profligate. Consequently, fixed income investments outside the U.S. continue to be an attractive source of income. The unfolding turmoil in the Middle East, while highly complicated to assess, is also unlikely to be supportive of GDP growth and therefore higher short term interest rates. However, it does highlight the ludicrous dependence on an unstable region of autocrats our heavy use of crude oil perpetuates. To an investor in natural gas E&P names, almost every news development appears to support the bullish case. Low natural gas prices are stable and should attract greater demand from power stations; high prices enhance the profits from drilling. High crude oil prices emphasize the energy-equivalent cheapness of natural gas; low crude oil prices are positive for economic growth. So it won't surprise regular readers to learn that BHP's $4.75 billion purchase of U.S. shale gas assets from Chesapeake Energy, rising gasoline prices or UPS's announcement that they'll add another 48 liquid natural gas powered tractor trucks to their fleet of 1,100 such vehicles all sound bullish, and natural gas E&P stock prices are beginning to respond accordingly.

What We Own

Kraft Foods (KFT) is an investment that we think is hiding in plain sight. While obviously widely followed, its performance has been disappointing for the past several months. The acquisition of Cadbury was roundly criticized by investors including Warren Buffet himself who remains a substantial holder. So the stock price remained under pressure, and as a result it recently dipped to a P/E of around 14. Many of Kraft's traditional businesses (such as snacks, beverages and cheese) are growing at only single digit rates, but Cadbury's has much higher growth prospects as well as likely synergies with the rest of Kraft in areas such as distribution. Although food inflation has pressured Kraft's operating margins as higher input costs for coffee, sugar and other commodities have hurt, these costs can generally be passed on to consumers through higher prices. Meanwhile, when raw food inflation eventually moderates as farmers respond to the higher prices by increasing supply, companies like Kraft will likely maintain prices and see margins expand. Consensus per share earnings estimates are for $2.25 this year and $2.50 next. We think expanding margins and faster growth in emerging markets create the potential for upside surprise, while the downside should be limited by its relatively attractive valuation. We also think that should food inflation persist as a multi-year phenomenon Kraft's strong brands should allow them to continue pushing price increases through. We like its low risk profile (it has around 50% of the risk of the overall market) as an appealing complement to some of the higher risk investments we have. KFT is a holding in our Deep Value Strategy.

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

Coeur d'Alene (CDE) is a silver mining company with a checkered past. Although we don't have large exposure to precious metals we do respect the bullish case of those that do. Warren Buffet recently commented that all the gold in the world was approximately equal in value to half the housing stock in the U.S. That may be what they're both worth, but there's little doubt which should generate more reliable income over the long run. So while we understand and respect the bullish case of those who maintain large exposure to bullion, it's not been a sector to which we've had much exposure. Nonetheless, CDE and silver have some interesting features. The supply/demand dynamics of silver are far more interesting than gold. Around half of silver consumption is for industrial use, so it's less sensitive to speculative flows. It's a highly efficient conductor so is used in IT and home electronics, and possesses anti-bacterial qualities which make it useful in medicine. Since silver is largely produced as a by-product of other minerals (such as nickel) supply isn't that sensitive to price. Nickel prices are more important in determining silver output than silver prices themselves. On the demand side, while silver has unique qualities it is usually a relatively minor component in most commercial processes, so demand is similarly price insensitive. The result is a commodity with highly inelastic supply and demand, which explains its volatile price. CDE caught our attention more than a year ago because it was trading at a substantial discount to the NAV of its proved reserves. The stock was disliked by many for its high priced acquisition of the Palmarejo mine in Mexico, but production has exceeded expectations both there and at their recently opened Kensington mine in Alaska. Meanwhile, the long time CEO Dennis Wheeler is retiring, and it seemed likely he was preparing to leave the company is good shape so as to maximize his legacy and his stock options. The stock still trades at a discount to the NAV of its reserves (which continue to grow in quantity as well as value) and provides leveraged upside exposure to precious metals (through expanded operating margins since its costs are largely fixed) at a discount to intrinsic value. Although not one of our larger positions (approximately 3% of capital) we continue to think it's an attractive investment. CDE is a holding in our Deep Value Strategy.