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In Pursuit of Value

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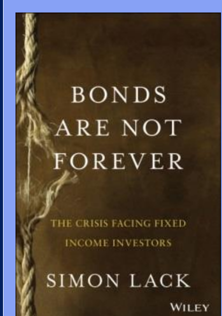
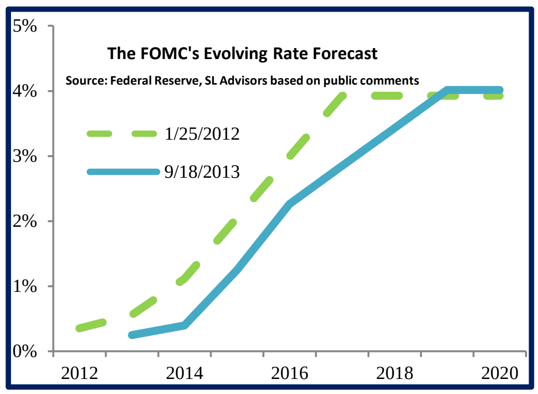


Quarterly Outlook

As is so often the case, the near term outlook for financial markets hinges on the two channels through which the government influences economic activity: monetary and fiscal policy. The Fed's decision to continue Quantitative Easing via its $85 billion a month buying program showed how difficult it is to communicate the subtle shifts in the precise level of monetary stimulus being provided. The subsequent drop in bond yields demonstrated a communication breakdown between the market, which had expected a reduction in the Fed's purchases, and the Fed, who thought they'd been clear all along. No wonder Larry Lindsay, a former Fed governor, commented that less openness might well be better.

Personally, I found $10 billion per month more or less of bond purchases not as striking as the answer Bernanke gave to a question about when the Fed might allow short term rates to "normalize" back to the 4% rate that their website posits as the equilibrium level. Bernanke noted what is already public, that the majority of FOMC members expect to begin tightening short term rates around 2016, but then suggested that it might be another two or three years after that before rates reach 4%. Of course Bernanke has only a few months left at the Fed, but his reflection of the FOMC's views suggests that one consequence of the 2008 financial crisis will be more than a decade of stimulative interest rate policies. So far such policies have worked better than many expected so there's limited tangible evidence that they're flawed. The FOMC's current forecast for short term rates, and that from early 2012, can be seen in the chart at right. On this basis, bond investors face many more years of unattractively low rates that will ever so slowly rise to the point of fair compensation. A ten year security bought at a 3% yield will approximately return zero if over the subsequent year its yield rises to 3.4%, since the drop in price will offset the interest income. Even after the "non-taper" bond rally, corporate bonds have returned -3%. Why, hedge funds have done better!



At the time of writing we are entering another period of brinkmanship in Washington over funding the government and raising the debt ceiling. It's not the sort of thing that alters our investment posture, though we despair at the dysfunction in D.C. just like everyone else. The sight of Texas Senator Ted Cruz reading from Dr. Seuss's *"Oh, the Places You'll Go!"* during his marathon monologue may not be the deliberative legislative process at its best, but then other countries' elected officials have even been known to get into fistfights (for example, Kiev, Ukraine on March 19, 2013). The competition for legislative comedy champion is fierce. Although government policies can affect almost any company, we focus on those that we believe are less sensitive to variables we can't predict.

MLPs

Master Limited Partnerships (MLPs) had quite a tumultuous month, buffeted both by moves in interest rates and also by critical research from a small firm in Connecticut called Hedgeye. MLPs are bought by yield-seeking investors, and although unlike bonds their distributions generally grow each year, monthly fund flows are sensitive to movements in other traditional income generating sectors. Over a three day period recently MLPs rallied more than 4%, driven both by the drop in bond yields following the Fed's "non-taper" and a reaction to the sell-off precipitated by Hedgeye (on which more below).

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

On September 18th Rich Kinder, founder of eponymous Kinder Morgan (referred to hereafter as KM since there are multiple entities), sounded every bit the angry billionaire as he defended his company on a conference call to investors. Hedgeye's research analyst Kevin Kaiser had issued a research report suggesting inadequate upkeep of KM's infrastructure and questioning their non-GAAP accounting for "maintenance capex" ("capex" is shorthand for capital expenditure). Before releasing the report Kevin Kaiser referred to Kinder Morgan as "…a house of cards on the verge of collapse." Apparently, Hedgeye's marketing strategy is to announce an impending report so as to attract new subscribers drawn by the stock's sell off in anticipation. They evidently have too few paid up subscribers to justify providing them the report in time to act on it (i.e. before the stock has fallen). This need not reflect on the quality of their research, but is nonetheless worth noting.

KM consists of four publicly listed entities: Kinder Morgan Partners (KMP), Kinder Morgan Management (KMR), Kinder Morgan Inc (KMI) and El Paso Pipeline Partners (EPB) with a combined enterprise value of $105 billion. It is the largest MLP, and although we doubt Hedgeye's Kevin Kaiser has spent much time with Rich Kinder, the former certainly got the attention of the latter.

The crux of Hedgeye's report concerned Kinder Morgan's definition of "maintenance capex". An MLPs Distributable Cash Flow (DCF), the money available to pay distributions to investors, is calculated after the cost of maintaining their assets. A pipeline that costs less to repair means more money paid out to LPs. Hedgeye's report argued that KM spends too little on maintenance, artificially boosting its returns, and subsequently makes up for it by replacing a pipeline and counting all of the cost as a capital investment.

Following price weakness induced in part by Hedgeye's report, Rich Kinder's initial response was to buy 500,000 shares of KMI to add to the 230 million he already owns (worth $8.3 billion). This was followed up a few days later with the September 18th conference call during which the company provided some detail around its maintenance capex to show the weakness in Hedgeye's analysis and conclusions. As they noted, energy infrastructure is a highly regulated business and operators have limited ability to skimp on maintenance. Accounting treatments vary, particularly for non-GAAP measures like DCF, and where one company may attribute maintenance expense to operating costs another may allocate it to recurring capex making a more comprehensive analysis of the financials prudent before sounding the alarms. A quick look a KM's record of spills and other accidents, the kind of thing that might point to such under spending, is at least comparable to the industry average. Furthermore, KM's distributions have been growing reliably for 17 years. So although KM doesn't quite rise to the "death and taxes" level of certainty, it still looks to us like a pretty good investment.

Although we didn't find Kaiser's analysis compelling, he did correctly note the substantial power General Partners (GPs) have over the Limited Partners (LPs) in many MLPs. The traditional MLP structure consists of a GP that owns 2% of the equity and is entitled to an increasing share of the Distributable Cashflows in the form of Incentive Distribution Rights (IDRs) before the LPs are paid. The GP's "cut" of these can reach 50%, as it has in the case of KMP. GPs also exercise substantial operating control over MLPs, far more than is the case with businesses organized as corporations. GPs benefit whenever an MLP issues equity through a secondary offering, since the cash raised is typically invested in a new project that increases the funds to pay IDRs without enduring the dilution suffered by the LPs. In fact an MLP GP's position is analogous to that of a hedge fund manager. KMI (which owns the GPs of KMP and EPB) owns a 2% GP interest in KMP and receives an almost 50% incentive fee on distributions paid rendering the ubiquitous "2 & 20" of the hedge fund industry almost frugal by comparison.

Just as the business of managing a hedge fund beats being a client, so it is with MLPs as well. Not all GPs can be bought on the public markets, but not all MLPs have a GP in their structure either. We have long recognized the similarity between hedge fund managers and the MLP GPs, and so around 60% of our MLP strategy is invested in MLPs with no GP, or in GPs themselves. We hold KMI in our MLP strategy and raised it to large position in our Deep Value strategy. We also run a variation of our MLP strategy for those investors who dislike K-1s. It is invested in C-corps that own GPs, and is designed to provide similar returns to the MLP benchmarks but with 1099s for tax reporting. As such it also represents a way for non-U.S. investors to access the underlying asset class.