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In Pursuit of Value

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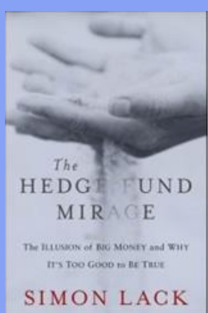
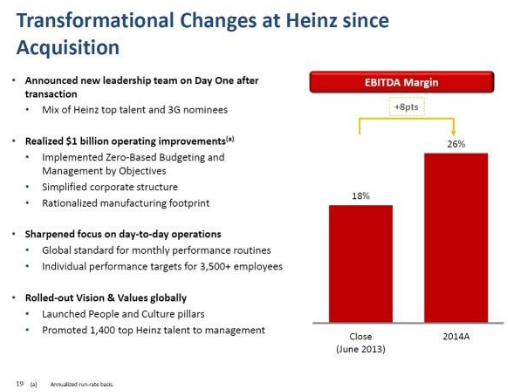


Quarterly Outlook

Individual risk appetites vary like most issues about which people hold opinions, and they can sometimes surprise you. A few weeks ago over dinner with another couple, one guest asked me about our riskiest strategy, because she wanted to make money in a hurry. I've written before about what Behavioral Finance teaches on male versus female approaches to investing, which includes that males are more typically risk-seekers (often irrationally so). Successful investing relationships depend in part on avoiding poor match-ups; clients with a bigger risk appetite than mine are likely to be disappointed, and an enjoyable dinner remained so by gently limiting our friendship to non-financial matters.

Our High Dividend/Low Beta ("HighDiv") and Hedged Dividend Capture ("DivCap") Strategies both hold diversified portfolios of large cap companies with understandable business models, a reliable history of growing dividends and strong balance sheets. Although these stocks can move like any other, they generally have more stable operating performance than the average S&P500 company. We believe that investing in a diversified portfolio of names that are hopefully boring on a daily basis can over the long run produce an attractive yet low risk return. Nonetheless, the persistent strength in the US$ in recent months has led many of these multinationals to report weaker than expected foreign sales because of this currency headwind. Rising rates in the U.S. compared with rounds of QE in Japan and the Eurozone offer little prospect of a respite. Then the merger of Kraft (KRFT) with Heinz revealed the potential for improved operating efficiencies in food companies with decades of operating history.



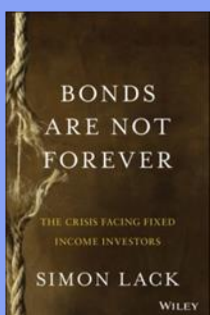
We used to be invested in Heinz, until it was taken private by Brazilian investment firm 3G and Berkshire Hathaway in 2013. Since then, their EBITDA margin has jumped from 18% to 26% as shown in the chart. As an operator, 3G is clearly raising the bar for competitors with their "zero based budgeting" (ZBB). The reaction of analysts on the conference call to discuss the transaction was one of audible amazement. The impact was most immediately visible in the stock price of KRFT as investors reassessed the potential to trim fat. But it was also felt farther afield, as the following day on Conagra Foods' (CAG) earnings call Citigroup's analyst asked why ZBB couldn't result in "…dramatically larger efforts…" at CAG to emulate what 3G achieved. CAG CEO Gary Rodkin responded with a brief and bland response, no doubt contemplating how CAG's non-3G-like 8.8% 2014 EBITDA margin must now appear to the activist hedge funds in the wings. While Samuel Johnson once said that, "When a man knows he is to be hanged…it concentrates the mind wonderfully," investors in CAG must similarly hope that the possible loss of (clearly ample) corporate perks will improve Gary Rodkin's focus. We are invested in KRFT and CAG.

The broader point though is that the revelation of 3G's operating success can be expected to cause many other low beta, consumer staples sector companies to revisit their operating models or face more hostile investor challenges to their failure to do so.

One thing we've learned from the Fed's greater openness about their deliberations in recent years is that they're not very good at forecasting. Back in January 2012 when they started providing detailed information on each FOMC member's forecasts for interest rates (dubbed the "dot plot" by the media because of the format of blue dots used to present the information), they believed that by now they'd have started raising rates already and were on average projecting a Fed Funds rate of over 2% for the end of this year. Last month when they released their current projections, the year-end 2015 rate forecast was 0.63% (median) or 0.77% (average). This is in spite of the fact that Unemployment has fallen faster than they expected; December 2014's Unemployment rate of 5.6% was fully 1.5% below their central expectation three years earlier. Many private forecasters and not just FOMC members have consistently erred on the side of expecting higher interest rates. Bonds continue to defy expectations in offering paltry yields. Lower inflation across the developed world is a good part of the reason. Lower for longer has been the most reliable posture for forecasting interest rates.

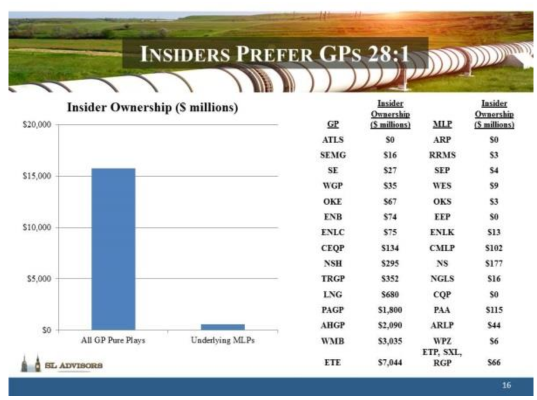
Of additional interest is that the FOMC has steadily, if at times imperceptibly, lowered their estimated "equilibrium" rate, which we might interpret as the level which they ultimately expect short term rates to reach. Perhaps acknowledging the reduced risks of inflation, they've knocked 0.5% off their long term forecast since 2012. On March 18 when subtle but widely expected parsing of the language in their press release signaled tightening was ever more proximate, bond yields nonetheless fell. The reason was a quite dramatic (at least by the dull standards of Fed press releases) drop in their current forecasts of as much as 0.70% for year-end 2016.

SL Advisors, LLC focuses on investment strategies that provide income without relying on fixed income securities.



The bond market has consistently expressed little respect for its biggest sponsor (the Fed currently owns $4.2 trillion in bonds between treasuries and mortgage backed securities) by offering yields that are incongruous with the FOMC's forecast path of short term rates. Or put another way, the Fed itself has for years (until Quantitative Easing officially stopped last year) been committing capital at yields that contradict their own forecasts. The world's biggest buyer was and remains price-insensitive, non-value seeking.

While all these machinations are fascinating to some, more relevant to many is that short term interest rates are likely to move higher this year, and induce clients to enquire of their investment manager, "What do you plan to do about it?" Master Limited Partnerships (MLPs) are one choice for yield-seeking investors and are therefore conventionally believed to be vulnerable to rising rates along with other related asset classes such as utilities and REITs. Distribution yields on MLPs are frequently compared with the ten year treasury, and at a spread of 4.3%, today's 6.3% yield on the benchmark Alerian Index is 1% wider with respect to treasuries than the long term average. However, MLP returns are completely uncorrelated with returns on AAA bonds. Their strongest statistical relationship is with high yield bonds, and rising rates can reflect stronger growth which is good for non-investment grade borrowers or can cause a re-pricing lower of all forms of debt.



GP	Insider Ownership ($ millions)	MLP	Insider Ownership ($ millions)
ATLS	$0	ARP	$0
SEMG	$16	RRMS	$3
SE	$27	SEP	$4
WGP	$35	WES	$9
OKE	$67	OKS	$3
ENB	$74	EEP	$0
ENLC	$75	ENLK	$13
CEQP	$134	CMLP	$102
NSH	$295	NS	$177
TRGP	$352	NGLS	$16
LNG	$680	CQP	$0
PAGP	$1,800	PAA	$115
AHGP	$2,090	ARLP	$44
WMB	$3,035	WPZ	$6
ETE	$7,044	ETP, SXL, RGP	$66

In our MLP Strategy our focus on the General Partners (GPs) of MLPs means we own securities with lower yields but higher growth prospects than the MLP market overall. An example is Plains All America (PAA), and its GP, Plains GP Holdings (PAGP). PAA currently yields 5.9% (based on its expected 2015 distribution) and management is forecasting 7% growth. By contrast, PAGP yields around 3% on the same basis with 21% targeted growth. Either may be a sound investment, although we strongly favor PAGP. While investing in the MLP sector through securities that often yield far less than the benchmark may appear to be an ill-advised way to operate in a sector regarded as sought for yield, we believe the faster growth prospects and superior economics and governance rights enjoyed by GPs easily compensates for the lower yields. Moreover, we think that securities whose return relies less on their yields should be less vulnerable to rising yields elsewhere. This is part of our answer to the client question posed above.

Another striking case for favoring the GPs comes from the actions of the managements. As the chart above shows (first used in a recent blog post), insiders favor GPs over the underlying MLPs by a factor of 28:1. In the case of PAGP/PAA the ratio is over 15:1. We are invested in PAGP.

To Our Clients

At SL Advisors it's important to us that your investments with us are aligned with your financial situation and objectives. If there have been any relevant changes from your perspective or any reasonable restrictions you wish to impose, please let us know and we'll be happy to discuss appropriate modifications. Of course, anytime you have any questions or concerns don't hesitate to contact us.