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In Pursuit of Value

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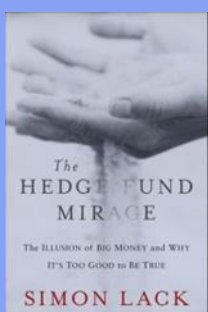
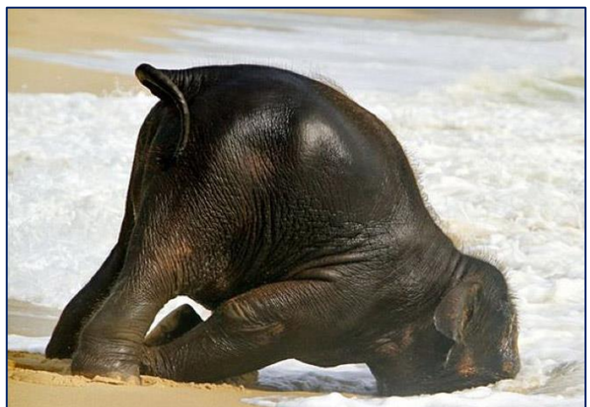


Quarterly Outlook

Equity investors can always find something to worry about. The absence of a source of concern can itself be worrying, in an oddly circular sort of way. Looking out over the next few months, the two visible areas of concern (a Greek default and rising interest rates) both appear to be heading towards some type of resolution.

However events unfold in Greece, it ought not to be a major issue for the U.S. economy. Greece's GDP is $242BN[1], roughly mid-way between Missouri ($258BN[2]) and Connecticut ($234BN) and no doubt heading rapidly towards Louisiana ($222BN). It's hard to imagine the consequences of any of those three U.S. states leaving the US$ and defaulting on their debt. Had such an event been preceded by the perpetual rolling crisis that has defined Greece's relations with their Eurozone partners ever since they gained admittance through mis-representing their finances, both sides might welcome a break.

For some reason, bond investors tend to be a forgiving lot. Arion Bank, an Icelandic state-owned creation following the $85BN default of that country's major banks in 2008, issued a Eurobond just three years later, in 2011. Argentina's 2001 default was followed in 2005 by an agreement with creditors to accept 35 cents on the dollar in new bonds while relinquishing their prior claims. This allowed Argentina to return to the capital markets so it could set the stage for its 2014 default. Puerto Rico's governor recently announced that the island's $72BN in debt is "not payable." It seems that to be a bond investor today, one must either accept insultingly low interest rates from borrowers who will more than likely honor their commitments, or insults to your intelligence from riskier borrowers whose higher yielding debt warns that repayment is by no means assured. The moral obligation to repay what's borrowed is weakening at the same time that the returns to lending are poor. Borrowers increasingly regard their creditors as having few choices, and indeed just by being a bond investor one broadcasts the suspension of any need for reasonable value in your investments. In effect, when interest rates led by public policy ought to guide lenders elsewhere, borrowers are invited to say, "You get what you get and you can't get upset."


Another Yield-Hungry Investor Stumbles in Uncharted Waters

Greece's current 180% Debt/GDP ratio is well beyond the sustainable threshold defined by Reinhart and Rogoff in *This Time Is Different*. Indeed, they noted that Greece has been in a state of default for roughly half its life as a country since winning independence from Turkey in 1822. You'd think by now its creditors would possess a well-worn playbook. Meanwhile, the citizens of Greece may have exceeded their tolerance for income transfers to lenders who ought to have known better. Such views are not only Hellenic. Lee Siegel recently announced in the New York Times that, "I chose life. That

[1] Source for Greece GDP: World Bank
[2] Source for state data: U.S. Bureau of Economic Analysis

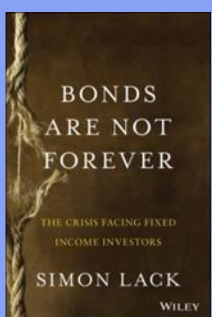
is, I defaulted on my student loans." Lenders increasingly must adjust to shifting attitudes towards repayment obligations along with pygmy interest rates.

While one can't help but feel sympathy for the Greek population as it contemplates only unattractive options, we don't expect any significant effect on the U.S. economy or capital markets. If this turns out to be wrong, then the other visible challenge for markets (see below) should recede.

Rising interest rates is the second major area of concern facing investors. We are told to prepare for a hike possibly by September (as New York Fed President William Dudley recently warned) but certainly by year's end. Although in recent years the Federal Reserve has been no better at forecasting interest rates than most Wall Street economists, eventually they will be right and it might as well be in 2015.

Financial crises usually show up where they're unexpected, which is why it's somewhat heartening to note recent warnings about bond illiquidity. JPMorgan's Jamie Dimon used his 2014 chairman's letter to highlight the relatively limited supply of U.S. government debt available to investors during a flight to quality. Actual debt is of course more than ample, but with so much of it held by central banks unlikely to part with it, what remains may prove inadequate to meet demand in the next crisis. Added to this is the curious capital treatment now applied to large bank deposits, in that cash held by a bank draws a capital charge. Conventionally, capital is held against assets to reflect the possibility of their value impairment (such as a defaulted loan), not against liabilities. However, large bank deposits placed by institutions such as hedge funds can quickly flee, and charging capital against them assures banks will limit their use of "hot" money even at 0%. These two issues, combined with a greatly reduced desire of banks to hold bond inventory, are rightly drawing attention. Dimon described the process as one of making each individual bank safer at the cost of increased systemic risk. Blackrock's Larry Fink has voiced similar concerns.

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



Increasingly, the managers of large bond funds are setting up credit lines in order to meet anticipated withdrawals should such occur at a pace beyond their ability to immediately meet them through asset sales. This applies to mutual funds as well as exchange traded funds. There are certainly examples of a mismatch between the daily liquidity offered by such funds and, at the other extreme, the seven day settlement process that's standard in the senior loan, or bank debt market. If anticipating a crisis is the surest way to avoid one, we may draw comfort from such moves although a Greek crisis has been widely expected but has seemingly arrived too.

The Alerian Index, the most commonly used benchmark for Master Limited Partnerships (MLPs), is down a surprising 11% for the year (surprising to us anyway), and 17% over the past twelve months. It's tempting to blame it all on indiscriminate selling by investors fleeing anything related to the energy sector following last year's collapse in oil with only a modest recovery. The yield on the Alerian Index has duly risen as prices have fallen, since distributions have remained robust. It now yields 6.5%, a level that would look attractive as a fixed payout on a bond but should be doubly so on an asset class whose distributions can be expected to grow over time.

The growth story for MLPs and their General Partners is predicated on increased output from shale oil and gas plays. Although production costs continue to fall sharply in the U.S., uniquely among global fossil fuel producers, at the margin the lower price of oil does reduce the potential for new output and new infrastructure. There is also widespread reporting of deflation among energy sector service providers as E&P companies seek economies wherever they can. Against this backdrop, one must concede that the outlook is not as unambiguously positive as was the case a year ago; nonetheless, we see many businesses that sport a very positive outlook combined with attractive valuation. Opting to not try and time entry and exit to the sector is to concede the obvious, which is that it's too hard as well as incredibly tax-inefficient. Consequently, few will be surprised that being more or less permanently invested in MLP General Partners because of their very positive long term return outlook, we find their current prospects appealing. If there's anything less attractive than talking one's book, it must be offering opinions that aren't backed up with one's own money. We are most definitely guilty of the former.

To Our Clients

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