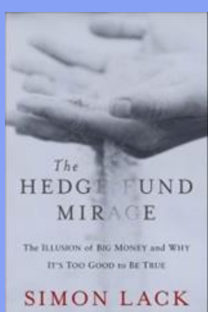
Published by SL Advisors, LLC

In Pursuit of Value

October, 2015

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



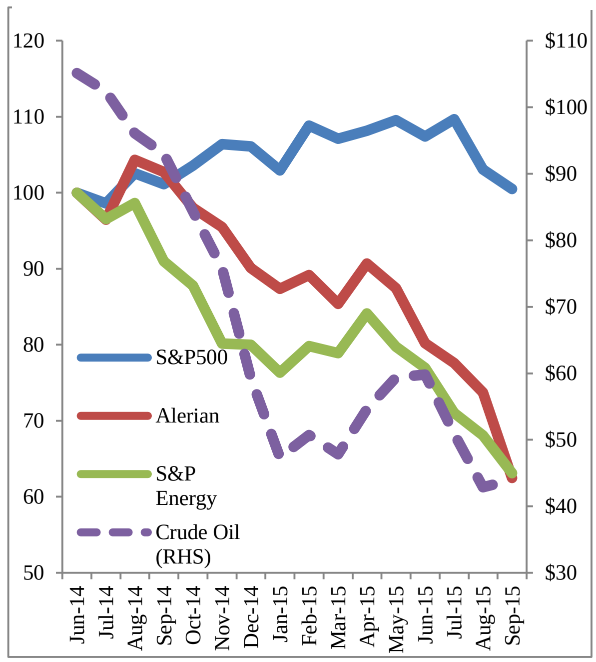
Quarterly Outlook

The third quarter saw the continued weakness in the Energy sector joined by the wider market. The S&P500 fell -6.4%. The Energy sector (as defined by the sector ETF, XLE) was down -18.0% and the Alerian Index, the benchmark for Master Limited Partnerships was -22.1%. Superlatives are in order; September was the worst month in the history of MLPs until a strong rally on the last day of the month but was still -15.3%. So far, 2015's -30.7% performance on the Alerian Index is alarmingly close to 2008's -36.9%. What is going on?

Fed policy remains accommodative. If news of tightening was to be brought by Godot, his friends would have long since left the area. If Janet Yellen was running the Fed at a different time, the bond vigilantes would be castigating her for a complete absence of the "inflation-fighting credentials" routinely required of her predecessors. While the Fed chair's job is "to take away the punchbowl just as the party gets going" you know that Ms Yellen would offer repeated unfulfilled warnings of such before finally doing so with an abject apology.

But inflation is clearly not today's problem, and so "dovish" is not a relevant epithet to toss in the direction of the FOMC. Fed projections continue to indicate that rates will rise slowly and won't need to be raised that far. As I noted in a recent blog (Bonds Are Dead Money), the steady fall in FOMC long term expectations of interest rates has accelerated quite dramatically over the past 18 months. All indications are that bond yields are unlikely to reach levels to justify a commercially driven investment anytime soon.

The S&P500 Finally Notices a Bear Market



U.S. GDP looks set to continue growing at 2.5% or so. The labor force is approaching full employment with the headline unemployment rate at 5.1%. One of the Fed's twin goals (maximizing employment consistent with stable prices) is close to being achieved.

S&P500 consensus earnings for 2016 are at $131 according to Factset, down by around 3.5% compared with six months earlier. Nonetheless, this still represents 10% expected earnings growth. Current valuations are a P/E of around 14.7X on 2016 EPS. Put another way, given the relative pricing of stocks and bonds, it remains the case that the after-tax return on $100 invested in ten year U.S. treasuries can be achieved with only $24 invested in equities[1]. The dividend growth of stocks and the modestly better tax treatment of their returns combine to create this outcome. So a ten year note can be replaced with a 24/76 barbell divided between stocks and cash. While stocks can fall, a 50% drop would reduce this barbell's value by close to 12.5%, about the same loss as would occur with a 1.5% jump in bond yields. These outcomes are not equally likely.

---

[1] The assumptions are: 2.16% dividend yield on S&P500; 2.15% yield on ten year treasury notes; 5% annual dividend growth on equities; current tax rates prevail for ten years; 0% return on cash portion for ten years; yield on S&P 500 in ten years is unchanged.

Of course holders of treasury securities are not concerned with an attractive return, as they are mostly central banks. Commercially driven bond investors are more likely to be considering investment grade corporate bonds. The Math is similar when comparing a 3.5% yielding corporate bond with the barbell above relying on the same assumptions, using a 40% equity allocation as opposed to 24%. Since investing is about relative choices, favoring stocks over bonds still looks to offer the best chance of achieving positive after-tax real returns for the long term investor.

Regular readers know we spend a good amount of our time researching investments in energy infrastructure. The Alerian Index doesn't cover the whole universe but a good portion of it. It finished 3Q15 down -30.7% for the year, challenging your writer to find ever more creative ways to say the same thing, which is that the sector is cheap. In fact, we think it's very cheap and if current trends persist we'll confront an inadequacy of adjectives with which to articulate this view.

The Alerian Index yields over 8.5%, and midstream MLPs where we focus continue to pay their distributions and generally forecast consistent growth. To acknowledge the bear case first, since it's clearly been the more profitable side: lower crude oil will moderate the need for some new energy infrastructure because of reduced U.S. oil production. Accordingly, MLPs with substantial crude oil businesses such as Plains All America (PAA) and large Natural Gas Liquids (NGLs) exposure like Oneok Partners (OKS) are now expected to see little or no distribution growth over the next couple of years. However, crude pipelines comprise only 8% of midstream pipelines with the majority focused on natural gas whose domestic supply and demand prospects remain bright. Year-on-year distribution growth rates through 3Q15 were 7-8%, demonstrating that the operating performance of the businesses tends to be substantially less dramatic than their stock price movements. Moreover, MLPs are structured like hedge funds and therefore MLP General Partners (where we invest) look like hedge fund managers, which as everyone knows is where most hedge fund profits wind up. The yield on our MLP Strategy, which is GP focused, is 6.6% and has grown distributions at 16.5% year-on-year. This is the best investment theme we know.

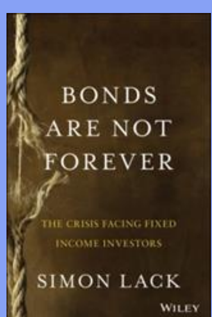
At the risk of sounding presumptuous, the problem with MLPs isn't so much the underlying businesses but the behavior of the investors. A sector still largely supported by retail investors incorporates some dramatically inefficient behavior, and outflows from mutual funds, ETFs and the like have represented a significant source of selling. Data on fund flows shows steady liquidations for the first half of 2015 with a notable increase in July and August. September is sure to show even greater outflows. Moreover, many of the funds are poorly structured, the result of attempting to meet the desire of investors to access the sector while avoiding the K-1s that can complicate tax reporting. Consequently, $60BN of funds in various forms exist, more than 10% of the sector's market cap, and many of them deliver the alchemy of MLP exposure with a 1099 through the decidedly unmagical embrace of a corporate tax liability which eats up 35% of the returns.

I have written on this topic before (see The Sky High Expenses of MLP Funds) so I won't bore regular readers by repeating the detail. Suffice it to say however, that investors who willingly hold funds with expense ratios of over 9% (as with the MainStay Cushing MLP Premier Fund) are probably not the most discerning. The taxes paid by the fund (the primary source of the expense ratio) are deducted from the fund's NAV so as to not disturb the 8%+ yield.

Furthermore, while the taxes act as a drag on upside performance they similarly cushion downside results (since a falling market reduces the taxable gains). It's an odd sort of reduction in volatility, but an extended bear market such as we're currently experiencing can also lead to the decidedly unpleasant outcome whereby taxable gains are wiped out and the holder is now exposed to the full force of a market fall while still being constrained to only 65% of the upside. Such is the fate of many MLP funds, since the Alerian index has wiped out three years of returns and taken prices back to levels that preceded the launch of many of these vehicles.

The owners of such investments are poorly advised and/or hasty in their research. Falling prices for the sector are most of the fundamental analysis they need, although the additional realization of the return asymmetry they face through the tax structure described may provide further impetus to sell.

We are therefore in a period of converting to better informed MLP investors, although I should note that at SL Advisors our investors have been without exception steadfast, and there are many cases of new clients as well as additions to existing accounts. I myself added to my MLP exposure on September 30th. The sector's valuation clearly deserves an overweight, but the process of upgrading the investor base is certainly no fun for those who understand what they own and plan to stick around. It's the best explanation we can offer for a market that is otherwise inexplicable.



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.