



In Pursuit of Value

June, 2011

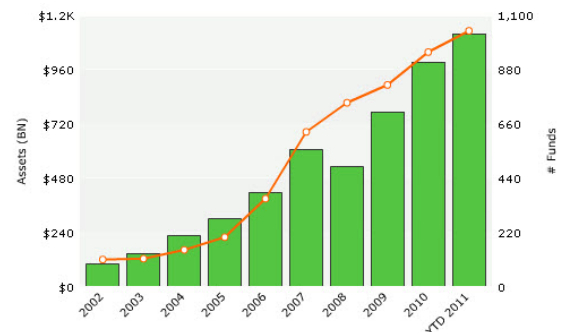
SL Advisors, LLC is a registered investment advisor offering separately managed accounts to individuals, family offices and institutions.



ETFs and the Bond Market

Recently I was asked to speak at a conference about the impact of ETFs on the broader market. Growth in ETFs is probably the most significant development in investing in recent years. Total U.S. outstandings reached \$1 trillion at the end of 2010, and Barclays iShares dominates the market with a 40% share. The growth of ETFs is global though, with European funds representing \$315BN (according to State Street), and there's no sign of it slowing down. By taking the familiar mutual fund structure and modifying it to allow intra-day trading activity the ETF industry has clearly tapped in to a new vein of demand. I was struck at the conference by how much focus there was on short term trading questions. High frequency trading (HFT) by hedge funds arbitraging the underlying components against the ETFs is a significant source of liquidity, and no doubt they generate healthy returns. But ETFs should be first and foremost an investment product, and while they do provide trading opportunities we generally have holding periods of many months and longer for the investments we make.

A little noticed but compelling feature of ETFs is the improved access to fixed income that they provide for investors too small to regularly trade "round lots" of \$1 million or more in corporate bonds. Wall Street banks make enormous profits from markets being less than fully transparent. Bonds, Foreign Exchange and commodities are all markets where substantial volumes are executed in the OTC ("over the counter") market and away from the immediate public price disclosure of an exchange. Transaction costs faced by clients in equities are quite low; commissions are \$9 per trade or less, and there's no pricing premium for smaller size. Making money as an equities broker is tough, as technology has brought electronic access and cheap transactions to the masses. In bonds by



Source: State Street Global Advisors

contrast, it's often hard to be sure you're obtaining wholesale pricing because of the vast number of different issues and less stringent SEC requirements on the reporting of trades. Bonds are also much more homogeneous than equities – substitution should in theory be much easier than in stocks because bonds are more highly correlated within a given sector than equities. If you want to buy GE stock you're unlikely to think AT&T is a good substitute, but if you're buying GE bonds it may well be that AT&T bonds are an acceptable substitute if pricing is slightly better. Few investors take this approach, and for the retail investor buying individual bonds can be one of the easiest ways to make your broker richer.

For evidence on how well banks do out of making markets in Fixed Income, Currencies and Commodities ("FICC" in industry parlance) go no further than the annual reports of the largest among them. Everybody's favorite whipping boy Goldman Sachs typically generates at least a third of its operating income here; in 2009 when markets bottomed and rebounded creating all manner of urgent activity in opaque markets they made \$23 billion, two thirds of their net revenue. No doubt recognizing the unfortunate optics of such success in knowing better than their clients where prices were, Goldman sensibly stopped breaking out their results in this way in 2010.

An academic paper (Corporate Bond Market Transparency and Transaction Costs, Edwards, Harris and

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

Piwowar, 2004) sought to identify the transaction costs incurred in corporate bonds by different types of investors. Although it's somewhat dated there's little reason to think the world has changed much. Contemporaneous pricing information on bonds is still much harder to access than for stocks, and since most bonds are not priced on screens obtaining the information requires talking to another person (usually pleasant but rarely fast). The paper found that for trades of \$1 million in size the average cost was 0.11% which is comparable to the all-in costs of trading similar size in large cap equities. However, the average cost rose quickly as size fell; \$100,000 orders cost 0.38% and \$20,000 orders were 0.69% (I can't imagine why it would make sense for an investor to transact in such a small individual bond, but apparently many people do). Transaction costs for equities don't change much for lower size. By contrast, the iShares Barclays Aggregate Bond ETF (AGG) has tracked its eponymous benchmark over the past five years with only 0.29% of tracking error which is not bad considering that, (a) this includes their fees, and (b) investing even in an index can't be done without incurring transaction costs.

The municipal bond market is even more egregious, with large numbers of retail investors overpaying their brokers. A similar study on transaction costs (Municipal Bond Liquidity, Harris and Piwowar 2004) found that retail investors paid on average 2% in transaction costs on municipal bonds. Even institutions were found to incur a 1% cost. Munis are particularly expensive to access given the large number of outstanding issues that trade infrequently and the many (financially) unsophisticated clients. The iShares S&P National AMT-Free Muni Bond Fund (MUB), one of the larger such ETFs, lags its index by around 0.83% according to Morningstar. Not great, but still much better than the costs incurred by retail investors buying individual issues.

The point is that fixed income ETFs achieve wholesale pricing for retail investors. They have democratized access to liquidity by making it possible to cut out the middle guy. Unless one has a large enough portfolio to justify individual trades of \$500,000 or more, there seems to be little point in owning individual bonds. Returns on investment grade and municipal bonds are generally much more sensitive to systematic variables such as interest rates and credit spreads. Unless there is a real risk of default, similar looking bonds tend to travel in groups, so returns don't vary nearly as much as for stocks. So next time your broker suggests a portfolio of handpicked individual bonds, tell him you'd like to go with an ETF instead. Since he can't mark the price up it won't be that profitable (for him) but it'll help your returns over the long run.

What We Own

iShares Barclays 1-3 Year Credit Bond (CSJ) holds investment grade U.S. corporate bonds. Its duration is 1.88, so the average maturity of its portfolio is around two years. The average credit quality is single-A. They own a diverse collection of familiar names such as Citigroup, General Electric and Verizon. No position is greater than 1% of the fund.

We use CSJ to access diversified investment grade debt without having to buy individual names. Barclays can buy large amounts of individual bonds at wholesale prices since CSJ has a market cap of \$8 BN. The annual expenses are 0.20%.

The yield is 2.3%, which is hardly going to excite anybody but reflects a compromise between earning some return greater than that offered by two year treasuries (a paltry 0.50%) and minimizing exposure to the possibility of rising interest rates. The combination of Round 2 of Quantitative Easing (QE 2), a non-existent Federal Funds rate and continued enormous Federal borrowing render long term bonds ever less attractive. Whether or not yields rise following the end of QE 2 in June, central banks (led by the Fed) are currently the only buyers of long term government debt and high grade bond yields are anchored to these artificially low levels. While you don't fight the government, you don't have to invest with them either. Consequently, although around one third of our Fixed Income Strategy is invested in non-US\$ denominated debt our biggest domestic currency holdings are in CSJ and its intermediate maturity cousin CIU.

SL Advisors runs three separate strategies: Fixed Income, Deep Value and Discount Arbitrage. Contact us for more information, or go to our website: www.sl-advisors.com

Fixed Income Strategy Monthly Returns (%)

	Jan	Feb	Mar	April	May	June	July	Aug	Sept	Oct	Nov	Dec	YTD
2009							9.6	4.3	6.3	-1.2	1.8	1.4	24.0
<i>Index</i>							7.0	1.5	2.2	1.5	1.6	-1.5	12.7
2010	2.7	1.5	2.7	1.8	-2.1	0.3	0.8	0.8	1.0	0.3	-1.0	0.0	9.0
<i>Index</i>	1.5	0.4	0.3	1.8	-0.6	2.2	2.2	1.9	0.6	0.1	-0.8	-0.8	8.8
2011	0.4	0.2	0.2	1.2	-0.3								1.7
<i>Index</i>	-0.1	0.7	-0.2	1.8	1.6								3.8

Returns do not include cash balances prior to November 2009. YTD returns are unannualized compounded returns. The Index is the Dow Jones Corporate Bond Index, an equally weighted index of 96 investment grade bonds. Returns are net of fees. Past performance is not indicative of future returns.

Deep Value Strategy Monthly Returns (%)

	Jan	Feb	Mar	April	May	June	July	Aug	Sept	Oct	Nov	Dec	YTD
2009							8.9	0.6	9.3	1.6	1.4	9.7	35.4
<i>Index</i>							7.6	3.6	3.7	-1.9	6.0	1.9	22.6
2010	-1.3	4.3	3.9	3.1	-3.9	-4.6	4.9	7.2	7.8	1.2	1.0	2.7	28.8
<i>Index</i>	-3.6	3.1	6.0	1.6	-8.0	-5.2	7.0	-4.5	8.9	3.8	0.0	6.7	15.1
2011	0.1	2.4	1.9	2.4	-2.2								4.9
<i>Index</i>	2.4	3.4	0.0	3.0	-1.1								7.8

Returns do not include cash balances prior to November 2009. YTD returns are unannualized compounded returns. The Index is the S&P 500 including dividends. Returns are net of fees. Past performance is not indicative of future returns.

Discount Arbitrage Strategy Monthly Returns (%)

	Jan	Feb	Mar	April	May	June	July	Aug	Sep	Oct	Nov	Dec	YTD
2009											-0.2	0.9	0.7
2010	0.8	0.0	-0.7	-0.8	-0.6	1.3	0.1	1.6	1.4	-0.1	0.1	0.8	4.0
2011	-0.7	0.0	1.6	-0.7	0.5								0.6

YTD returns are unannualized compounded returns. Past performance is not indicative of future returns.

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SL Advisors offers separately managed accounts for individuals, family offices and institutions across three different investment strategies. Client assets are held with Charles Schwab, the largest provider of custody services in the U.S. with assets of \$1.36 trillion and 7.9 million individual accounts (as of June 30, 2010). Client portfolios are completely transparent via Schwab's extensive website which provides real-time access to accounts and all supporting information. Detailed monthly statements are mailed directly to clients from Schwab.

SL Advisors Fixed Income Strategy

A diverse portfolio of U.S. government debt, investment grade corporate credit, bank debt, and sovereign emerging market debt. The objective is preservation of capital combined with income generation. The portfolio's exposure to interest rates and credit spreads changes depending on the manager's outlook and assessment of relative value opportunities in each sector. Income generating investments with appropriate risk are favored when interest rates are stable or rising, while longer duration investments are selected when interest rates are falling. Investments are through ETFs, listed closed end funds and U.S. government securities. This strategy represents the fixed income allocation for balanced accounts, and is most appropriate for individuals, family offices and smaller institutional accounts.

SL Advisors Deep Value Equity Strategy

A portfolio of 10-20 names that are deeply undervalued. Investments are in listed U.S. equities trading significantly below the value of their tangible assets. In addition, they must have a strong balance sheet with relatively low debt and are likely to be underperforming similar securities in the recent past. Industries include energy, mining, shipping, infrastructure and others with hard assets where tangible value can be assessed. Potential investments are identified through a proprietary screen following which detailed research is performed to assess underlying value. The likely holding period is generally at least several months but can extend to one or two years until value realization occurs. The portfolio is reassessed regularly and all holdings are rated for return potential and risk against their peer group, which often results in rebalancings to upgrade into more attractive opportunities. This strategy is part of the equity allocation for balanced accounts for individuals, and is also appropriate as a deep value equity strategy for institutional accounts.

SL Advisors Discount Arbitrage Strategy

This portfolio consists of several sub-strategies that seek to extract value from pricing inefficiencies while minimizing market risk. One sub-strategy holds the same positions as the SL Advisors Deep Value Equity Strategy combined with a market hedge. Another sub-strategy takes long positions in closed end funds that are underpriced and hedges out the market risk. A third sub-strategy invests in special situations where a pricing inefficiency can be identified and isolated from overall market risk. Occasionally other sub-strategies will be employed when opportunities appear. Securities used include equities, listed closed end funds and ETFs. Broad equity market exposure is hedged away so this strategy is managed on a market-neutral basis to generate steady returns that are uncorrelated with other major asset classes, and is appropriate for institutional accounts.



SL Advisors regularly publishes investment research on Seeking Alpha's website. Click on the image to read more, or go to <http://seekingalpha.com/author/sl-advisors>.

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