



In Pursuit of Value

November, 2011

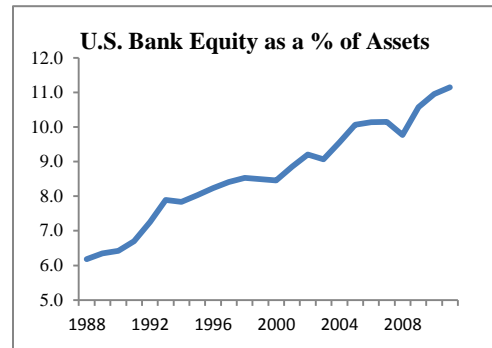
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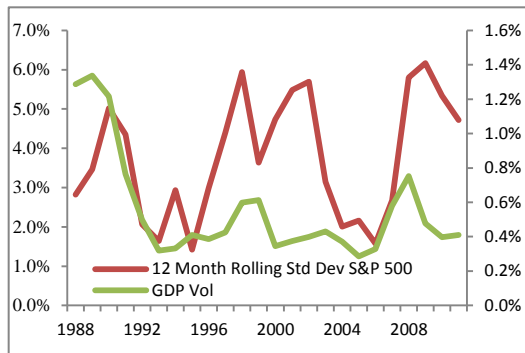
Banks and Leverage

Another near death experience in equity markets avoided – at least for now. Kevin KAL Kallaugher’s cartoon in last month’s missive could scarcely have been better timed (if you missed it October’s letter is available on our [website](#)). Stepping back to examine levels of risk seems a reasonable place to start this month.

There is perhaps no more fundamental a question for bank regulators than knowing how much systemic risk exists, and its trajectory. Although it’s hard to believe looking back over the past few years, there is a well-established trend in the U.S. to increase the amount of equity capital supporting banks. The chart below from the [St. Louis Federal Reserve](#) shows that banks have reached 11% equity to assets with only a modest drop during the financial crisis. The numbers exclude companies such as Lehman Brothers (which was not a commercial bank) whose equity: assets was reported to be as low as 3% (i.e. balance sheet leverage of around 30:1) when they filed for bankruptcy in 2008. When Goldman Sachs and Morgan Stanley quickly converted to banks in the aftermath an immediate consequence was that they reduce leverage. But looking at the system as a whole and measuring common equity divided by total assets there is a clearly improving trend upwards. This analysis does not include any risk-weighting of assets, nor does it include any off-balance sheet instruments such as derivatives that might be altering, perhaps substantially, the apparent reduction in risk displayed here.



Systemic banking risk may be lower by one measure, but it’s obviously an imperfect yardstick based on recent history. The chart at the left shows the standard deviation of GDP (from the U.S. Bureau of



Economic Analysis) and the S&P 500. Economic swings have been fairly consistent for most of the past couple of decades while equity market volatility has been at times breathtaking. So is systemic risk really coming down or not?

The now soggy and cold Occupy Wall Street crowd may not yet articulate a coherent set of views, but one might speculate that the financially literate amongst them would favor still less risk rather than more. Measuring

equity as a percentage of bank assets is a crude and obviously out-dated tool, in addition to which some of the biggest losses occurred outside the banking system (such as AIG and the Federal housing agencies FNMA and FHMC). The broader socialization of credit risk and a recognition that some banks are too big to fail have been necessary precisely because the banking system is (or at least was found to be in 2008) undercapitalized. And even with 11% equity: assets, there can be little doubt that banks are in a class of their own when it comes to making their equity capital work hard. No other industry operates with anything like the leverage that banks employ. Companies with far more stable

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intrinsic value.*

earnings incur far less balance sheet risk. To select a few by way of illustration: Bristol-Myers Squibb (BMY) has 34% equity: assets and Johnson & Johnson (JNJ) 36%. These calculations exclude goodwill from assets and therefore use tangible common equity to be more conservative. As a result no adjustment is made to these and many other companies that own operating assets whose value has increased substantially since they were acquired but which have not been written up in value on their balance sheets. Financial services companies rarely own assets worth more than their stated value. Loans and bonds are hopefully worth their face amount, but doing much better than getting your money back is hard unless such assets were acquired in distress and while banks often hold distressed assets they rarely acquire them as such. Even within the financial services sector Travellers (TRV) gets by with almost 21% equity. Not coincidentally, these are all holdings in our **Hedged Dividend Capture Strategy**, which seeks to offer better returns than corporate bonds through a hedged portfolio of equities of steadily growing and prudently managed companies. As regular readers know, outperforming high grade bonds is not simply a reasonable objective it's most likely imperative in order to avoid a loss in after-tax real wealth.

Banking leverage is definitely good for banks and is necessary at some safe level in order to allow credit creation and economic growth. While leverage has come down, financial risk has not and there may be a link between increasing compensation and higher levels of risk since the two have grown together. Reducing bankers' bonuses shouldn't be an objective of public policy, but further increases in capital would result in a greater share of profits to the providers of capital rather than labor and a safer system too. I've long felt banks were much better places to provide labor than capital, which is why I worked for a bank for a long time but have never invested in one beyond the requisite restricted stock employees receive. But since society bears much of the downside of banking catastrophes, it's reasonable to ask whether society is receiving commensurate benefit. The financial system is measurably riskier over the past twenty years. Who else has this helped beyond the financiers?

It's a complex question. The global economy has become more linked, and of course there's only ever one version of history to evaluate. We can't know how things would have turned out with even lower bank leverage but an otherwise unchanged script. There is no "control experiment" with which to compare, so it's probably a question that will never have a satisfactory answer. There may be many problems with the Basle III capital guidelines, but directionally the shift towards even greater capitalization seems uncontroversial. If Greek sovereign debt hadn't been assigned a risk weighting of zero under previous rules, French and German banks who suspended critical thought wouldn't now hold so much of it. We wouldn't have a semi-annual Euro crisis. As banks strenuously debate every increase in regulation, their attitude to systemic risk should be part of their response.

Website Update

For those readers who are interested in more regular thoughts from SL Advisors (and you know who you are) we now publish a blog named after this newsletter which you can find here: <http://inpursuitofvalue.wordpress.com>. The familiar themes of ruinously low interest rates, too much debt and pursuing value are the prism through which we interpret the world. We have also updated our website to incorporate information on the investment strategies we run – conversations with clients and prospects increasingly focus on finding alternatives to fixed income that provide equivalent levels of risk with potentially greater return. Our **Hedged Dividend Capture Strategy** is an example of this.

In preparation for the publication of *The Hedge Fund Mirage*, we now have a website that provides news leading up to its release including public endorsements gratefully received and upcoming speaking opportunities where I'll be presenting the ideas in the book. It is a project very much aimed at hedge fund investors and its goal is helping achieve a more equitable share of the fantastic profits hedge funds generate for the investors who finance them.

SL Advisors runs a variety of separate strategies in Fixed Income, Equities and Absolute Return. Contact us for more information, or go to our website: www.sl-advisors.com

Hedged Dividend Capture Strategy (%)

	Jan	Feb	Mar	April	May	June	July	Aug	Sept	Oct	Nov	Dec	YTD
2006	0.7	0.7	-1.3	1.4	1.7	1.2	3.6	2.0	0.9	2.3	0.9	1.2	16.2
<i>Index</i>	-0.1	0.7	-1.7	-0.5	-0.4	-0.4	1.6	2.1	1.2	1.1	1.4	-1.1	3.8
2007	0.4	1.3	2.7	1.8	-0.5	-2.2	-2.4	1.9	1.9	2.9	1.9	-0.3	9.9
<i>Index</i>	0.2	2.2	-0.7	0.9	-1.2	-0.4	0.2	1.1	0.6	1.2	0.7	0.4	5.2
2008	-4.0	-0.1	1.7	0.8	1.8	-1.8	1.7	1.6	2.0	-0.1	3.2	-0.2	6.5
<i>Index</i>	1.7	-0.1	-0.7	0.8	-1.0	-0.5	-0.5	0.8	-5.9	-5.1	4.9	8.3	1.8
2009	2.4	-4.3	-1.1	-4.5	1.6	4.4	1.7	-0.2	-0.1	0.5	2.5	2.4	5.0
<i>Index</i>	0.8	-2.1	-0.6	3.1	4.1	2.8	4.6	1.4	1.7	0.7	1.6	-1.5	17.6
2010	-0.7	-1.1	0.6	-0.2	-1.3	3.2	2.1	3.9	-0.1	0.4	-2.4	-0.3	3.9
<i>Index</i>	1.5	0.4	0.2	1.8	-0.6	2.2	2.2	1.9	0.6	0.1	-0.8	-0.8	8.8
2011	-1.8	0.8	1.4	3.1	2.6	0.0	-0.7	4.0	1.7	-0.8			10.7
<i>Index</i>	-0.1	0.7	-0.2	1.8	1.6	-0.9	2.6	0.2	0.4	2.2			8.3

Returns are from a long portfolio of 58 equally weighted equities from which actual positions are selected, hedged to be beta neutral. This is not a return from an actual portfolio. The Index is the Dow Jones Corporate Bond Index, an equally weighted index of 96 investment grade bonds. Returns are gross 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	0.2	2.6	1.9	2.4	-2.2	-2.8	0.4	-5.1	-9.1	12.2			-0.9
<i>Index</i>	2.4	3.4	0.0	3.0	-1.1	-1.7	-2.0	-5.4	-7.0	10.9			1.3

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.

MLP Strategy Monthly Returns (%)

	Jan	Feb	Mar	April	May	June	July	Aug	Sept	Oct	Nov	Dec	YTD
2008	4.5	3.0	-0.8	1.9	4.2	-6.4	-2.0	0.6	-14.9	-1.1	-25.4	7.4	-29.5
<i>Index</i>	-0.6	-0.5	-6.3	7.3	1.0	-4.9	-1.7	1.7	17.2	-0.1	17.1	-3.7	-36.9
2009	15.2	-2.1	5.0	5.2	9.0	-1.1	10.1	0.1	1.0	2.3	6.2	5.0	70.7
<i>Index</i>	15.3	-4.2	0.7	11.0	9.3	-1.7	12.4	-3.2	4.8	2.9	6.4	6.6	76.4
2010	0.7	5.4	2.0	2.4	-4.5	5.1	5.8	-1.6	5.0	2.0	3.2	2.7	31.7
<i>Index</i>	0.6	4.6	2.9	3.4	-5.4	5.6	7.5	-2.5	6.1	5.4	1.9	1.7	35.9
2011	1.2	5.1	0.0	2.6	-4.3	1.8	-2.4	-0.4	-3.3	9.1			8.9
<i>Index</i>	3.0	3.5	-0.6	3.3	-5.0	1.1	-1.9	-1.1	-4.1	10.3			7.9

Returns do not include cash balances prior to May 2010. The Index is the Alerian MLP Index, AMZX. Returns are net of fees. Past performance is not indicative of future returns.

SL Advisors offers separately managed accounts for individuals, family offices and institutions across various 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 Hedged Dividend Capture Strategy

An alternative to bonds, this strategy utilizes stocks of stable companies with high dividend yields to generate income with capital appreciation by investing in a diverse, unleveraged, hedged portfolio of U.S. equities. Companies are selected that possess a history of steady earnings growth, attractive dividend yields and are less volatile than the overall market. The long positions are hedged with a short S&P500 position with the objective of making the portfolio beta neutral while still maintaining a net long equity exposure. Historically this strategy has exhibited monthly swings comparable to corporate bonds, and given the relative attractiveness of equities compared with investment grade bonds it has a more attractive return outlook. This strategy may be considered as a substitute for a portion of an investor's fixed income allocation.

SL Advisors Deep Value Equity Strategy

A portfolio of undervalued stocks of high quality businesses that aims to outperform the S&P500. Investments are in listed U.S. equities trading significantly below the intrinsic value of the underlying enterprise. Potential investments are identified both qualitatively and quantitatively following which detailed research is performed to assess fundamental value. Desired characteristics of businesses include pricing power, low leverage, low costs of production, and attractive valuation. Valuation is defined to us foremost as the net present value of cash one can extract from proportional ownership of the business, then relatively using peer multiples and finally liquidation value. The portfolio is reassessed constantly and all holdings are rated for return potential and risk against their peer group to rebalance into the most attractive opportunities. This strategy is part of the equity allocation for balanced accounts for individuals, and is also appropriate as an alpha seeking equity strategy for institutional accounts.

SL Advisors MLP Strategy

This portfolio consists of 10-15 investments in Master Limited Partnerships (MLPs) to receive a healthy and growing tax deferred income stream. MLPs are publicly traded interests in energy infrastructure and related assets. They represent direct proportional ownership stakes in the underlying assets rather than securities in a corporation. Historically they have paid regular distributions which have grown with the U.S. economy, and as such they can be suitable for investors seeking income generating investments with a tolerance for equity market exposure. The strategy engages in low turnover so as to minimize transaction costs and benefit from the income tax deferral features of the asset class. MLPs are appropriate for high net worth investors comfortable with receiving a K-1 for each investment rather than a 1099. SL Advisors does not provide tax advice.



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>.

The Hedge Fund Mirage, my new book, will be out later this year. Go to:

<http://www.hedgefundmirage.com>

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