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In Pursuit of Value

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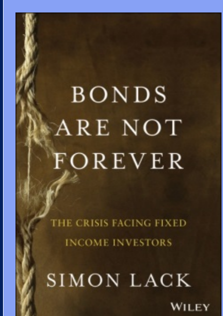

Spot the Bubble

Recently there has been growing chatter among the talking heads and others about whether stocks are in a bubble. Clearly following a 29% rise so far in 2013 (and the year's not yet over) the market's not as cheap as it was. David Einhorn, president of hedge fund Greenlight Capital, hedged his bets by stating that, "…certain stocks…are behaving in a bubble-like fashion." Jesse Columbo was more forthright, asserting recently in Forbes that stocks, "…are undoubtedly experiencing a massive bubble." Around the same time Robert Lenzner explained (also in Forbes) that there was no bubble. Forbes obviously intends to get it right.

Bubbles need not be confined to equities though. The biggest bubble might well be in bonds. Over the past five years, from November 2008 shortly after the collapse of Lehman through October 2013, $983 billion has flowed into bond mutual funds according to the ICI website (although in 2013 flows have been modestly negative). This $1 trillion of private money has been supplemented by the Federal Reserve, whose balance sheet has grown by $2.5 trillion over the same period. What could be more indicative of a bubble than when the public and private sectors are competing with one another to invest in the same asset class? Paying up for fixed income is less justifiable than overpaying for equities where one at least has the hope for appreciation. In the best case scenario for bonds you get your principal returned along with the coupons. While fixed income savers may lament today's paltry interest rates, collectively they have been engaged in their own form of Quantitative Easing, aiding the Fed in its repression of fixed income yields.

Analyzing Social Media Stocks

Don't assume that all the expressed concern about the Fed "tapering" its $85 billion monthly buying program means that investors are well positioned for rising rates. Even with a positive yield curve, it doesn't take much of a hike in bond yields to wipe out what little interest income is on offer. A mere 0.40% jump in ten year government bond yields is enough to drive the one year holding period down to 0%. For high grade corporate bonds, whose slightly higher yields provide somewhat more protection, a 0.50% rise eliminates any return. There's reason to believe that many investors are ill-prepared for a weaker bond market. In a recent Wall Street Journal survey, 72% of respondents were worried about a big drop in stocks while only 28% were concerned about bond prices falling *when rates rise* (i.e. many people don't get that price versus yield thing).

Current pricing offers scant return for the risks involved. But in addition, if ten year treasuries are to provide a 2% positive real return (i.e. after inflation), the current yield of 2.7% implies inflation over the next ten years of less than 1%. The kind of anemic GDP growth necessary to maintain such low inflation is unlikely to bring unemployment down and will be politically increasingly unacceptable. 2.7% almost challenges the buyer to bet on a quiescent country willingly accepting slow growth without complaint. An increasing tolerance for fiscal risks in order to boost both inflation and GDP growth would likely gather political support under such circumstances. Accepting a future of reduced ambition is not a vote-winner. Americans are rarely so patient.

The bond market is not the only likely bubble. Hedge funds are closing in on their eleventh consecutive year of failing to beat a simple 60/40 stocks/bonds allocation. There are no doubt some truly talented hedge fund managers, but the diversified portfolio of big, established hedge funds long ago ceased to be additive to the typical institutional portfolio. Today's $2.5 trillion in hedge fund assets hoping for the consensus 7% annual return is assuming $175 billion in annual profit after fees, or about $270 billion before fees, almost exactly the GDP of Chile. Financial markets are big to be sure, but probably not so inefficient as to allow Chile-sized arbitrage and relative value returns year after year. The collective assumption by hedge fund investors to the contrary must represent a bubble of its own.

A year ago Newsweek wrote about, "…the Coming Burst of the College Bubble." No doubt college tuition and student debt have been increasing at unsustainable rates. Total student loans outstanding recently hit $1 trillion. The Federal Reserve didn't even measure the figure separately until 2004 when it was around $350 billion. The ready access to credit afforded students certainly represents an appealing public policy but has also allowed many colleges to operate with substantially reduced financial discipline as eye-watering annual price hikes have been readily accepted by young customers able to spread repayments over most of their working lives.

Iowa farmland has had a good decade or so as well, rising fourfold since 2000 and 20% this year according to the U.S. Department of Agriculture. Low interest rates don't only help financial assets, and combined with rising output they've caused a repricing in America's heartland.

David Einhorn may be prescient in noting that some stocks are in a bubble. We wrote about Amazon's valuation last month, but the entire social media sector looks very late 1990s. Facebook (FB), LinkedIn (LNKD), Twitter (TWTR) and others defy conventional analysis. FB has a forward P/E of 40, LNKD 96 and TWTR the ubiquitous "N/A" as sported by any self-respecting new paradigm. There may be an "E" in Twitter, but not in TWTR's P/E ratio. The bulls in these stocks will no doubt make money before the bears, but being sufficiently nimble to exit elegantly is not our calling.

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

Like most money managers, we prefer to identify bubbles around us while maintaining that what we own is very definitely not bubble-like. In fact, by contrast with some of the markets listed above we think we are invested in securities that are perhaps even cheap, or at least relatively attractively valued. Today's diminutive U.S. government interest rates, which are the foundation of all asset pricing, are intended to drive up the prices of other investments. Virtually every investor must by now have a plan for confronting the eventual rise in interest rates. This could include investing globally in search of business cycle diversification, holding short positions as a hedge or a determination to listen hard for that bell that's supposed to ring at the market's top (even though it never does).

Recently over a dinner conversation about investing (there's a shock) I recounted one of the many fascinating insights of Behavioral Finance, that women are on average better investors than men. Wives are rarely surprised to learn this, while the acceptance of the husband often depends on his investment results. It turns out that making overly confident predictions about many things (not just equities) is a masculine trait but not necessarily a financially rewarding one. Since women are apparently less certain of their own forecasts, they invest so as to be less exposed to their own forecasting error. It's in part why men never stop to ask for directions to the occasional frustration or amusement of their spouses, although the advent of GPS technology has helped with matrimonial harmony in the car.

Similarly, we think we have identified potential bubbles in the areas mentioned above and have therefore invested safely away from them. In looking for businesses with reliable earnings, good prospects and sensibly low leverage, we're incorporating some downside protection so that if we're wrong and things burst indiscriminately, what we own will maintain profitability and fare relatively better. It means foregoing stocks like LNKD (up 91% so far in 2013). Behavioral finance teaches less certainty about the future, especially over the near term. Being in touch with your feminine side means convictions are held more modestly. Over the long run though, equities (excluding a few names such as those mentioned above) must be the most promising investment to stay ahead of inflation and taxes.

Hedged Dividend Capture Strategy (%)							Since Inception			16%	*Index*		*-3%*
	Jan	**Feb**	**Mar**	**April**	**May**	**June**	**July**	**Aug**	**Sept**	**Oct**	**Nov**	**Dec**	**YTD**
2011										**0.4**	**0.2**	**3.5**	**4.2**
Index										*0.6*	*-0.2*	*0.2*	*0.6*
2012	**-3.5**	**-2.1**	**1.1**	**1.6**	**1.2**	**2.1**	**1.1**	**-1.3**	**0.4**	**0.8**	**0.5**	**-0.7**	**1.0**
Index	*0.4*	*-0.8*	*-1.2*	*-1.5*	*-0.4*	*-1.5*	*-0.1*	*-0.1*	*-0.3*	*0.2*	*0.5*	*0.1*	*-4.7*
2013	**2.8**	**3.4**	**4.1**	**0.9**	**-2.8**	**1.1**	**1.4**	**-3.2**	**-0.5**	**3.2**	**-0.8**		**9.8**
Index	*0.4*	*0.2*	*0.0*	*0.5*	*0.2*	*-0.6*	*0.6*	*-1.6*	*-0.1*	*1.1*	*0.7*		*1.6*

The Index is the HFRX Equity Market Neutral Index. Returns are net of fees. Past performance is not indicative of future returns.

High Dividend Low Beta Strategy (%)							Since Inception			50%	*Index*		*67%*
	Jan	**Feb**	**Mar**	**April**	**May**	**June**	**July**	**Aug**	**Sept**	**Oct**	**Nov**	**Dec**	**YTD**
2011										**5.9**	**0.1**	**4.0**	**10.3**
Index										*10.9*	*-0.2*	*1.0*	*11.8*
2012	**-1.3**	**0.1**	**2.8**	**1.3**	**-1.8**	**4.2**	**1.8**	**-0.2**	**1.7**	**-0.1**	**0.8**	**-0.2**	**9.1**
Index	*4.5*	*4.3*	*3.3*	*-0.6*	*-6.0*	*4.1*	*1.4*	*2.3*	*2.6*	*-1.8*	*0.6*	*0.9*	*16.0*
2013	**5.4**	**4.1**	**6.0**	**1.9**	**-1.6**	**-0.4**	**4.0**	**-4.6**	**1.1**	**5.5**	**0.7**		**24.7**
Index	*5.2*	*1.4*	*3.8*	*1.9*	*2.3*	*-1.3*	*5.1*	*-2.9*	*3.1*	*4.6*	*3.0*		*29.1*

The Index is the S&P 500 including dividends. Returns are net of fees. Past performance is not indicative of future returns

SL Advisors runs a variety of strategies focused on generating attractive risk-adjusted returns using public equities in long-only and long-short format. Contact us for more information, or go to our website: www.sl-advisors.com

Deep Value Strategy Monthly Returns (%)							Since Inception			150%	*Index*		*116%*
	Jan	**Feb**	**Mar**	**April**	**May**	**June**	**July**	**Aug**	**Sept**	**Oct**	**Nov**	**Dec**	**YTD**
2009							**8.5**	**1.0**	**11.3**	**0.4**	**3.5**	**9.8**	**39.3**
Index							*7.6*	*3.6*	*3.7*	*-1.9*	*6.0*	*1.9*	*22.6*
2010	**-1.1**	**3.8**	**6.6**	**3.5**	**-5.6**	**-4.5**	**5.2**	**7.0**	**7.8**	**1.2**	**1.0**	**2.7**	**30.2**
Index	*-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**	**2.2**	**1.9**	**2.5**	**-2.3**	**-2.9**	**0.6**	**-5.2**	**-9.2**	**12.3**	**-0.5**	**-0.6**	**-2.3**
Index	*2.4*	*3.4*	*0.0*	*3.0*	*-1.1*	*-1.7*	*-2.0*	*-5.4*	*-7.0*	*10.9*	*-0.2*	*1.0*	*2.1*
2012	**4.4**	**5.2**	**0.9**	**2.0**	**-8.8**	**3.8**	**0.7**	**3.6**	**3.3**	**-0.9**	**-2.6**	**1.0**	**12.4**
Index	*4.5*	*4.3*	*3.3*	*-0.6*	*-6.0*	*4.1*	*1.4*	*2.3*	*2.6*	*-1.8*	*0.6*	*0.9*	*16.0*
2013	**6.4**	**0.6**	**4.3**	**1.6**	**2.1**	**-1.6**	**4.3**	**-1.2**	**1.7**	**3.1**	**2.1**		**25.7**
Index	*5.2*	*1.4*	*3.8*	*1.9*	*2.3*	*-1.3*	*5.1*	*-2.9*	*3.1*	*4.6*	*3.0*		*29.1*

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.

Returns for each strategy shown at right are from a single continuously managed account. The Hedged Dividend Capture, Deep Value and MLP Strategies have all been independently verified and attested to by Marcum, LLP. Documentation available on request.

MLP Strategy Monthly Returns (%)							Since Inception			150%	*Index*		*126%*
	Jan	**Feb**	**Mar**	**April**	**May**	**June**	**July**	**Aug**	**Sept**	**Oct**	**Nov**	**Dec**	**YTD**
2008	**-0.7**	**3.0**	**-0.8**	**1.9**	**4.2**	**-10.7**	**-2.0**	**0.6**	**-14.9**	**-1.1**	**-25.4**	**7.4**	**-36.1**
Index	*-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	**15.4**	**-2.1**	**5.0**	**5.8**	**9.9**	**-1.1**	**10.1**	**0.1**	**1.0**	**2.3**	**6.2**	**5.0**	**73.3**
Index	*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**	**-0.5**	**5.1**	**5.8**	**-1.6**	**5.0**	**2.0**	**3.2**	**2.7**	**37.2**
Index	*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**	**-3.0**	**-0.3**	**-3.4**	**9.1**	**0.2**	**6.8**	**15.8**
Index	*3.0*	*3.5*	*-0.6*	*3.3*	*-5.0*	*1.1*	*-1.9*	*-1.1*	*-4.1*	*10.3*	*-0.2*	*5.8*	*13.9*
2012	**1.7**	**5.2**	**-3.7**	**0.9**	**-7.1**	**3.1**	**5.9**	**3.2**	**2.3**	**-0.7**	**0.4**	**-3.2**	**7.4**
Index	*1.9*	*4.2*	*-4.0*	*2.2*	*-7.5*	*3.3*	*5.1*	*1.6*	*2.0*	*0.5*	*-0.8*	*-3.1*	*4.8*
2013	**12.9**	**1.7**	**5.8**	**-0.5**	**-1.2**	**2.6**	**0.3**	**-0.4**	**1.2**	**2.4**	**4.0**		**32.1**
Index	*12.6*	*0.9*	*5.4*	*0.9*	*-2.0*	*3.1*	*-0.5*	*-2.5*	*2.3*	*2.7*	*0.9*		*25.5*

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.

Low Beta Long-Short Monthly Returns (%)							Since Inception			102%	*Index*		*-1%*
	Jan	**Feb**	**Mar**	**April**	**May**	**June**	**July**	**Aug**	**Sept**	**Oct**	**Nov**	**Dec**	**YTD**
2011			**-3.5**	**19.4**	**6.5**	**4.5**	**0.0**	**9.1**	**-1.1**	**6.7**	**1.9**	**1.5**	**52.6**
Index			*-0.9*	*0.5*	*-1.4*	*-1.6*	*-0.1*	*-3.5*	*-3.0*	*0.8*	*-0.9*	*-0.4*	*-10.0*
2012	**-5.1**	**-1.6**	**5.7**	**3.3**	**1.1**	**2.4**	**3.2**	**-2.2**	**2.1**	**0.7**	**0.2**	**-1.3**	**8.6**
Index	*1.7*	*1.4*	*0.0*	*0.1*	*-1.7*	*-0.3*	*0.5*	*0.5*	*0.4*	*-0.5*	*0.4*	*0.9*	*3.5*
2013	**7.9**	**6.2**	**6.5**	**3.2**	**-2.1**	**-0.7**	**4.0**	**-2.1**	**0.3**	**0.4**	**-2.8**		**22.0**
Index	*2.0*	*0.4*	*0.7*	*0.6*	*0.7*	*-1.3*	*1.0*	*-0.9*	*1.0*	*1.2*	*0.4*		*5.9*

The Index is the HFRX Global Hedge Fund Index. 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 client assets of $1.89 trillion (as of September 30, 2012). 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 High Dividend Low Beta Strategy
This is the long-only version of our Hedged Dividend Capture Strategy (Long/Short), which has been actively managed and deployed since October 2011. Academic research has shown the Capital Asset Pricing Model (CAPM) fails to explain risk-adjusted returns. Over long periods of time, high beta stocks tend to under-perform and low beta stocks tend to out-perform, on a risk-adjusted basis, which is inconsistent with predicted performance by the CAPM. This strategy allows investors to take advantage of this persistent anomaly.

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 Low Beta Long-Short Strategy
Low Beta Long-Short is more concentrated than Hedged Dividend Capture ("DivCap") with added leverage and is not restricted to dividend paying stocks. It includes our best ideas from DivCap weighted according to conviction rather than diversified, equal weight allocations. It is managed to be beta neutral and returns are driven very largely by individual stock selection. Interactive Brokers is custodian for assets in this strategy only.

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