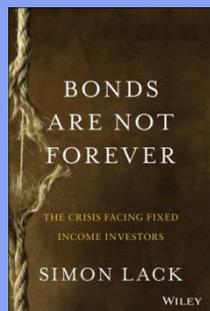




# In Pursuit of Value

February, 2014

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



## Two-Edged Activists

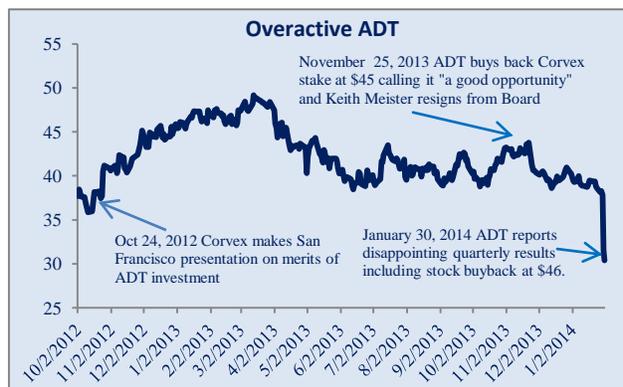
Activist hedge funds draw increasing media attention nowadays. There are good reasons for this; the successful ones invariably carry out deep research on their targets and often lobby for the company to buy back shares, divest an underperforming business or exploit today's low interest rates by increasing leverage. This is all done with the intention of driving up the stock price, and while such effects may be transitory and not always in the company's long term interests, it's worth following what some of these managers do.

Investors need to choose carefully which ideas to consider. Take Eddie Lampert, who runs ESL Investments. He's enjoyed enormous personal financial success, and yet as with so many hedge fund managers it would have been far better to own shares in "Eddie Lampert Inc." (if such was possible) rather than invest alongside him. He is increasingly identified with Sears Holdings (SHLD), and while few can doubt the strength of his conviction about SHLD's long term prospects since he and his fund own two thirds of the company, its stock has followed a volatile and relentlessly downward path for years. It seems as if every quarter the company's operating results show sequential deterioration, and invariably Eddie and his fund buy more shares. Although his public comments remain upbeat, examining the financials can also lead one to conclude he's running the company into the ground so he can scoop up the shares he doesn't yet own from disillusioned investors and then unlock the enormous value that he says remains. It may yet turn out to be a huge winner, but if you can't buy Eddie Lampert Inc. it might be hard to show much of a return.

We have no interest in SHLD, but we follow other activist-linked stocks and one of current interest is ADT. Formerly a division of Tyco, they were spun off as an independent entity in 2012. ADT is the biggest provider of alarm systems in the U.S. with about a 25% residential market share and 90% recurring revenues. There are opportunities for them to grow through acquisitions of smaller competitors as well as through providing more value added and sophisticated equipment. Switching costs are high – their typical customer stays with them for seven years – and Keith Meister of Corvex Capital made a persuasive case for the company's stock shortly after their IPO. As with any activist, he already owned what he was talking about. Meister lobbied for increased leverage and more share buybacks, reasoning that the stable nature of the company's cashflows could support an Enterprise Value/EBITDA ratio above its then-current 6.5. Corvex owned 5% of the company's shares and Meister took a seat on the board.

Warren Buffett is a great source of brief yet memorable quotes on many issues. One of my personal favorites is his secret to a happy marriage: "Marry someone with low expectations." I use this at home tirelessly by warning my wife that her expectations are too high, to which she breezily retorts that in fact they couldn't be any lower. Another Buffett quote comes from Andrew Liveris, CEO of Dow Chemical, who recently noted that Buffett (a shareholder) had advised him to care about those investors who, "...will stay versus investors who will leave." This was in reference to a holding by Third Point (another activist). In other words, pay attention when a CEO is dancing with an activist.

ADT's CEO Naren Gursahaney may be competent, but after stumbling through a dance with Keith Meister it's pretty clear that if you ever hear that Gursahaney is playing cards your most profitable move is to run, not walk, to grab that last seat at the table. Although in late 2012 Meister had extolled ADT's business prospects and believed the stock could rise 50% to \$63, a year later in November 2013 he abruptly resigned his board



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

seat less than a year after joining and sold his shareholdings back to ADT over the weekend at \$44. Since ADT was still following Meister's script to buy back shares, management deemed it reasonable to pay the previous day's closing price for Corvex's block of shares without insisting on any discount for size. Had Corvex sought to sell their shares publicly the market would probably have demanded a steep price concession due to an insider abruptly resigning and unloading their stake at once, and indeed when the news was absorbed ADT's stock price slumped 9%. The sudden about face of the company's hitherto most vocal supporter as well as the extreme gullibility of the CEO both weighed on sentiment. Just recently the company defended this transaction as enabling ADT, "...to retire the shares without incurring transaction costs." Humiliated and still in denial.

We were also owners of ADT because we liked the story, but we concluded that Keith Meister's actions were of greater import than management's and so immediately sold our position (although not at the same price as Corvex, but nonetheless close to our purchase price). CEO Gursahaney affirmed his credentials for most naïve CEO by commenting that purchasing Corvex's block of shares without a price discount represented a good opportunity for ADT given their buyback program – missing the irony that the original buyback proponent was now all too eager to exit his investment as fast as possible. Rather like Groucho Marx observing that he wouldn't belong to any club that would have him, Meister must have concluded that he wouldn't invest with a CEO stupid enough to buy back stock under such circumstances.

We thought perhaps Meister had some private insight on the company's prospects not available to non-board members. The upcoming investor day was likely to reveal any issues of concern, but in fact it came and went with little news and later Corvex announced it was invested in Williams Companies (WMB), of which more later. Little of note happened with ADT until late January when they announced quarterly earnings that showed deterioration in operating margins, customer acquisition costs and customer retention. The company revealed that its buyback during the quarter had resulted in spending \$1.2 billion to buy stock at an average price over \$46 per share, and following earnings it traded below \$30. What's truly amazing is that Meister and Gursahaney both presumably had access to the same internal management reports during the quarter, and yet arrived at starkly different places in terms of the true worth of the company. The CEO's exposure as financially unsophisticated or agnostic to his shareholders' returns is complete. Seats to play poker at the same table as Gursahaney no doubt trade at a premium.

Although activist investors are popularly believed to be promoting value for all shareholders, their interests are quite obviously narrowly commercial and not nearly as high-minded as casual observers may believe. In fact, given a few more episodes such as this one it wouldn't be unreasonable for the target of an activist hedge fund to drop in price once the interest becomes known, reflecting the very real possibility that the company will take steps to satisfy a single vocal shareholder at the expense of others. Perhaps a Corvex Discount will be applied to the next unwitting victim, sharply reducing the profitability of such a strategy. ADT and its shareholders would unquestionably have been better off if Corvex had never taken an interest in them.

For our part, at current pricing we like the ADT story again. Their operating results were disappointing along several metrics but home security is a business that is attracting interest from cable and telco companies. Google's recent acquisition of Nest (an internet-linked home thermostat) reflects the interest in an "internet of things," and at a free cashflow yield of 14% (assuming no growth at all) we think we can wait for ADT's current management to improve recent performance or be acquired by a bigger firm. We had a small position before their earnings and added afterwards. To quote Buffett again, "...invest in a business that can be run by an idiot, because one day it will be."

To return to WMB, this company owns the GP of Williams Partners (WPZ), and represents an attractive way to invest in the growth of domestic energy infrastructure since basically WPZ owns and finances the assets while remitting half the distributable cashflows back to WMB. WMB is to WPZ as a hedge fund manager is to his fund; increased assets at the fund (read WPZ) may or may not be good for the fund overall, but will most assuredly be good for the manager (read WMB). WMB's "Incentive Distribution Rights" give it a chunk of the distributable cashflow (DCF) generated by WPZ, just as a hedge fund manager keeps a percentage of the profits of his fund. As WPZ develops and operates new energy infrastructure assets, funded by the issuance of new WPZ debt and equity, WMB will oversee the process and garner its share of the increasing DCF without having to put up any capital.

We wrote about this theme in more detail last month, and WMB is a holding of ours. One might expect a hedge fund manager to quickly recognize the similarities between the two business models. Corvex recently announced an investment in WMB, which provided a nice lift to our investment (the Corvex Discount remains a theoretical concept for now). Activist interest in a stock can be good, but nobody should confuse a relationship with an activist hedge fund manager as friendship.

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](http://www.sl-advisors.com)

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.

Hedged Dividend Capture Strategy (%)							Since Inception				13%	Index			0%
	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	-0.4	9.3		
Index	0.4	0.2	0.0	0.5	0.2	-0.6	0.6	-1.6	-0.1	1.4	0.6	0.3	1.8		
2014	-1.7												-1.7		
Index	0.8												0.8		

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				46%	Index			66%
	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	0.8	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	2.5	32.3		
2014	-3.5												-3.5		
Index	-3.5												-3.5		

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

Deep Value Strategy Monthly Returns (%)							Since Inception				151%	Index			114%
	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	2.0	5.1	31.9		
Index	5.2	1.4	3.8	1.9	2.3	-1.3	5.1	-2.9	3.1	4.6	3.0	2.5	32.3		
2014	-4.7												-4.7		
Index	-3.5												-3.5		

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 (%)							Since Inception				162%	Index			132%
	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	3.4	36.6		
Index	12.6	0.9	5.4	0.9	-2.0	3.1	-0.5	-2.5	2.3	2.7	0.9	1.6	27.6		
2014	1.5												1.5		
Index	0.6												0.6		

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				95%	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	2.0	24.5		
Index	2.0	0.4	0.7	0.6	0.7	-1.3	1.0	-0.9	1.0	1.2	0.6	0.4	6.5		
2014	-5.6												-5.6		
Index	-0.1												-0.1		

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 outperform, 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.

***Bonds Are Not Forever; The Crisis Facing Fixed Income Investors  
is now available at [Amazon.com](http://www.amazon.com).***

Our blog, *In Pursuit of Value*, is at: <http://www.sl-advisors.com/blog/>

Follow us on **Twitter** @SimonLack

**DISCLOSURES:** This document is not an offer to sell (or solicitation of an offer to buy) securities in the United States or in any other jurisdiction. Any reproduction or distribution of this document, as a whole or in part, or the disclosure of the contents hereof, without the prior written consent of SL Advisors, LLC, is prohibited. Notwithstanding the general objectives and goals described in this document, readers should understand that SL Advisors, LLC is not limited with respect to the types of investment strategies it may employ or the markets or instruments in which it may invest (subject to any contractual arrangements and/or applicable law). Over time, markets change and SL Advisors, LLC will seek to capitalize on attractive opportunities wherever they might be. Depending on conditions and trends in securities markets and the economy generally, SL Advisors, LLC may pursue other objectives or employ other techniques it considers appropriate and in the best interest of its clients (subject to any contractual arrangements and/or applicable law).

#### *Contact info:*

*SL Advisors, LLC  
210 Elmer Street  
Westfield, NJ 07090-  
2128  
908-232-0830  
[sl@sl-advisors.com](mailto:sl@sl-advisors.com)  
[www.sl-advisors.com](http://www.sl-advisors.com)*