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In Pursuit of Value

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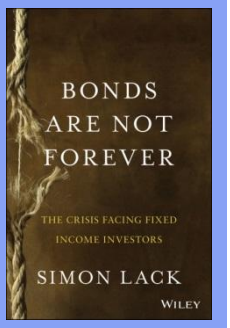

Flash Boys

Michael Lewis is a great writer. I have read most of his books from *Liar's Poker* on, and many essays that he has written over the years. I even read and enjoyed *MoneyBall*, his description of how the Oakland A's baseball team used statistics to uncover hidden talent; if a book on baseball can retain a reader whose sports interest is almost exclusively English football, it must be well written.

Flash Boys is a good read, but beyond that it must be Lewis's most impactful book (although Salomon's former CEO Jon Gutfreund may disagree since in discussing Liar's Poker with Michael Lewis he apparently said, "Your f*** book destroyed my career, and it made yours."). While we already knew that High Frequency Trading (HFT) has in recent years come to represent a substantial part of equity volumes, Lewis illustrates through market participants the patent absurdity of the current market structure. The book opens with the story of how $300 million was profitably invested to bury a dead straight fiber optic line from New York to Chicago (thus shaving tiny fractions of a second off order transmissions and facilitating arbitrage of slower orders), elegantly illustrating one winner in the zero-sum game. Even more startling was the discovery by Brad Katsuyama (then of Royal Bank of Canada) that HFT firms were front running his orders. After much dogged research and detective work, Brad figured out that the market's decentralized structure resulted in his orders reaching various liquidity pools at different times, allowing the algorithms used by HFT firms to exploit the time gap by using information gained at the closest exchange to get in front of the order as it traveled farther afield.

Today's Stock Market - No Buttonwood Tree Here*

Such differences are measured in hundredths of a second; yet while invisible to humans, trading algorithms are well able to slip in the way of a market order and gain a penny here, a penny there. It is obviously front running, which under laws written before HFT was contemplated is illegal when carried out by humans. The subsequent investigations announced following the publication of Lewis's book (some of which were apparently already under way) will show us whether the owner of a front-running algorithm is as culpable as a broker doing the same thing the old fashioned way.

Once you grasp the distortions caused by all this, and perhaps even grudgingly admire the intellect so effective in its misdirected pursuit of structural inefficiencies, surely the most obvious question is how this all happened in the first place? The quaint prism through which we view financial markets as efficient reallocators of capital may seem outdated in describing today's equity market, but nonetheless dozens if not hundreds of regulators and other market participants have collectively presided over and built a system that is patently not doing what the rest of us imagined it should. It's easy to attribute this to the inevitable advance in IT, but personally I think one glaring problem was the conversion of the NYSE to profit-making status. The premium rent charged HFT firms to locate their computers physically in or next to the exchanges (so as to shave more of those milliseconds) always sounded suspicious; an exchange run as a public utility would probably have considered the public interest in such an arrangement before aiding those few who profit from the higher transaction costs of many.

Then there's the payment for order flow. Apparently some brokerage firms have clients whose trade execution is sufficiently inept that it's worth paying for the chance to trade with them. Part of the appeal

comes from the ability to direct orders to "dark pools" which are seemingly created for HFT firms to scalp an extra penny many billions of times over the course of a year. The irresistible analogy is with a casino offering inducements to its biggest punters. But the stock market isn't meant to be a casino. The fact that the apologists for all of this invariably make their living from the current state of affairs simply reinforces the justifiable sense of wrong felt by so many. More volume doesn't necessarily equal greater liquidity, and even some hedge fund managers (such as David Einhorn) are crying foul.

So in recent years we've witnessed a suspension of sound judgment by the people who run the exchanges through which investors seek to grow their funds ahead of taxes and inflation, and of some of the brokerage firms who are not necessarily seeking best execution on behalf of their clients. How is an investor supposed to respond?

One solution is to trade less, and it doesn't take the existence of HFT firms to render this sound advice. The constant media focus on short term market direction is a response to the desire of so many to trade profitably. Stocks are so cheap to trade (at least, excluding the HFT tax) that many individuals do use the market as a casino, and this has helped create the HFT opportunity. Interactive Brokers for example discloses the percentage of its retail FX accounts that are profitable each quarter as required by the National Futures Association, and the money makers are always fewer than 50% of the total. Taxes take a further toll, since the slothful trader pays long term capital gains tax rather than ordinary income and perhaps doesn't pay it for a long time either.

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

Another point is to recognize the inherent conflict of interest faced by the broker-dealer (B-D) compared with the financial advisor. Of course there are many honest brokers in the industry and I count some of them among my friends. If you invest through a broker I hope you've found one of the good ones. At its worst, the B-D wants you to trade often (because your commissions are his revenue) and, if selling you something from inventory (i.e. acting as principal) wants you to pay a high price. Neither is going to make you richer over the long run. Financial advisors have a much clearer alignment of interests with their client since both parties simply want good investment outcomes for the client. Advisors that invest alongside their clients reinforce this alignment. Payment for order flow is one example of brokers unsuccessfully juggling profitability with their clients' best interest. Charles Schwab, where we custody most of our assets and through whom we execute our trades, has come out strongly critical of HFT activity. Founder "Chuck" Schwab described it as "a cancer" in an April press release. I'm happy to report that Schwab doesn't run a "dark pool" and doesn't profit from selling their order flow (though they're not totally beyond reproach, since *Flash Boys* noted that in 2005 they did enter into such an agreement with UBS). But Schwab is more clearly on the right side of this issue than many.

Using limit orders rather than market orders also provides some protection. We almost always enter our orders using limits; we're willing to buy at $25, but not at $25.05. Cheaper is less risky for most investments, so we pick a price at which we're comfortable and submit the order. Values change far less than prices, and if we miss the trade, well, there will always be another one. Entering a market order to buy at the "best" available price assigns unreasonable urgency to the transaction and, as we've seen, now provides a juicy opportunity to others. No doubt limit orders can also be gamed, but the highly rapid HFT strategies seem more likely to act as sand in the gears of investing activity than to cause significant repricing of individual equities.

The E.U. (notably excluding the UK) has long been a proponent of a transaction tax, dubbed a Tobin Tax after the economist credited with the idea. How ironic but appropriate that in America we have seemingly implemented our own transaction tax and yet ensured that it's administered by the private sector.

*The founding members of the original New York Stock Exchange are said to have gathered beneath a buttonwood tree in lower Manhattan.

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

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 Monthly Returns (%)							Since Inception			18%	Index		1%
	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	0.1	1.9	2.5									2.8
Index	*0.7*	*0.7*	*0.6*	*0.3*									*2.4*

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			57%	Index		76%
	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	2.5	2.0	2.9									3.9
Index	*-3.5*	*4.6*	*0.8*	*0.7*									*2.6*

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			170%	Index		127%
	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	5.2	0.3	2.3									2.7
Index	*-3.5*	*4.6*	*0.8*	*0.7*									*2.6*

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			186%	Index		145%
	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	2.6	3.8	2.5									10.9
Index	*0.6*	*-0.2*	*1.5*	*4.3*									*6.2*

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	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	-0.6	1.2	3.0									-2.1
Index	*-0.1*	*1.6*	*-0.5*	*-0.7*									*0.2*

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.

Bonds Are Not Forever; The Crisis Facing Fixed Income Investors
is now available at Amazon.com.

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

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