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In Pursuit of Value

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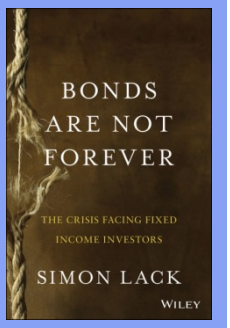

Contact info:

SL Advisors, LLC
210 Elmer Street
Westfield, NJ 07090
908-232-0830
sl@sl-advisors.com
www.sl-advisors.com

Kinder Morgan

Hedge fund investors place considerable importance on the quality of the people in the organization. When I first began interviewing hedge fund managers in the early 1990s, there was often so little hard data made available by the manager that the due diligence process largely consisted of a series of interviews covering all facets of the investment process. Monthly returns were the only source of quantitative analysis, and successful hedge fund investors possessed sound people-judgment skills. In recent years transparency has improved, in some cases substantially as institutional investors have demanded a more open relationship following the 2008 financial crisis. But assessing the people at the top remains of vital importance.

It's not only hedge funds where the quality of senior management is a key consideration. Although the evaluation of public equities is supported by vastly more data than is the case for hedge funds, the people at the top still matter. What they say they'll do and whether or not they carry it out, as well as their overall competence, makes a big difference. Charlie Munger has famously defined "the ham sandwich test", as only investing in companies that can be run by a ham sandwich because one day they will. It's good advice, and as noted recently on our blog the alarm company ADT is currently undergoing such a test as its CEO Naren Gursahaney exhibits a degree of ineptitude totally at odds with the opportunities presented to ADT. Hertz (HTZ) recently joined them as CEO Mark Frissora was forced to blame another disappointing quarter on unexpectedly high demand (advance bookings from business travelers left few vehicles for more profitable, shorter notice leisure travelers). We're invested in both companies because we believe valuations are attractive enough to compensate for the two sorry characters mentioned and provide optionality around activist-driven change. Such appears underway at HTZ.

Kinder Morgan (KMI) is in a different category, in that a good business exists alongside competent management. It remains our most widely held security. Although we run five distinct strategies the investment research can overlap. But KMI is unique for us in that we own it in every strategy. It is, unusually, an undervalued yet reliable dividend paying low volatility stock with management incentives strongly aligned with shareholders, hence its fairly broad inclusion. We've often written about the superior position of the General Partner (GP) in an MLP relative to the Limited Partners (LPs). The LPs are like hedge fund investors and the GP is the hedge fund manager. Asset growth may or may not help the former, but invariably helps the latter. At a time when MLP asset growth is large and visible due to the substantial infrastructure investments required to exploit shale energy reserves in such non-traditional regions as the Bakken in North Dakota, MLP GPs remain a good investment.

Rich Kinder is credited with recognizing that the MLP structure could be combined with growth-oriented infrastructure assets, relying on the MLP's lower cost of equity capital to regularly access the capital markets as needed. Kinder Morgan Partners (KMP) went public in 1996, but Kinder has always recognized that the GP offered the most value, and consequently his holdings were concentrated in that entity. As good as the MLP structure has been, Kinder's recent transaction acknowledged the limits that size ultimately imposes. Just as hedge funds can be too big, so can an MLP. The 50% of the Distributable Cash Flow (DCF) to which KMI was entitled represented an increasingly heavy burden on what KMP had left to pay LPs, and consequently its yield had drifted up to 7% where it reflected the market's very modest assessment of its growth prospects.

You could hear the frustration in Rich Kinder's voice on every quarterly earnings call as he asserted that the

market was undervaluing the Kinder enterprise. KMP's high yield made it difficult to do secondary offerings of equity to invest in new projects or acquisitions without diluting existing LPs. While a GP could in theory raise capital to invest in projects that didn't cover that capital's cost, that wasn't a sustainable long term strategy. At a time of growing M&A opportunities in energy infrastructure, Kinder needed its securities to be an expensive low-yielding currency to use in deals, not a cheap, high-yielding one. Kinder was aggrieved not only because his $8 billion holding in KMI (worth $9 billion after the announcement) made him the biggest investor, but also because an analyst at Hedgeye, a research boutique in Connecticut, had seemingly picked on Kinder Morgan as exhibit 1 in what he perceived to be wrong with the entire MLP sector.

During the ten months or so following release of Hedgeye's report, written by Kevin Kaiser, all four of the Kinder Morgan stocks stubbornly underperformed a booming MLP sector, perhaps reflecting some sympathy with Kaiser's view. Finally, Rich Kinder did what you'd expect of somebody who'd already demonstrated exquisite investment insight more than once in his career; he recognized the new paradigm and abandoned the MLP structure that once worked but no longer suited his purpose. Additionally surprising was the tax shield unlocked through the consolidating transaction, as KMI established new, current market values for the assets acquired from its MLPs forming the basis for a much bigger tax-deductible depreciation charge. The $20 billion estimated value of the tax shield was behind both a higher KMI dividend and faster growth, creating a substantial savings for shareholders that has curiously drawn far less scrutiny than less significant "tax inversions" (such as the recent Burger King/Tim Horton's deal).

It's too soon to claim victory on the Kinder Morgan story (although Hedgeye has removed its original critical report from its website); there are more developments to come. Kevin Kaiser's bold attacks on Kinder Morgan highlight the importance of researching and understanding your investments. It provides the confidence to hold and/or buy as spooked investors rush to sell. On Kinder Morgan's fourth quarter earnings call, with KMI trading at around $35 and perhaps reflecting his frustration at the negative narrative propagated by Hedgeye's research, Kinder said, "I've purchased over 800,000 shares in December alone. So I guess my message to those who saw the story less positively was you sell, I'll buy, and we see who comes out the best in the long run." It's nice to invest along CEOs with a passion for investor returns. Kaiser was highly critical of what he termed "the "dumb money" invested in MLPs. Presumably the weakness in KMI's stock price following Kaiser's initial barrage at the company was some of this dumb money leaving.

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

KMI impacted all our investment strategies in August, but it's still more or less just recouping the last year's underperformance relative to the Alerian MLP index. One major insight from the consolidation of the Kinder Morgan's four publicly traded vehicles into a simpler structure with one public equity security is the desire to lower both the cost of debt and the cost of equity in order to be competitive to make large acquisitions. The strategies are positioned to benefit from a wave of M&A we expect to see in the North American energy infrastructure industry.

Dodging the Potholes on Wall Street

This is the working title of my next book. Each chapter will cover a type of investment frequently sold to uninformed buyers that should carry a substantial warning label. I am fortunate to be collaborating with several other industry professionals who have each agreed to write a chapter. The examples will be drawn from actual situations that we've encountered in our respective businesses, and we hope to enhance investors' understanding about certain products and thereby in some modest way improve the standard of financial advice provided by our industry. The book will be published next year.

We have no shortage of material, but if any reader of this newsletter has an example that they'd like to share with the authors, we'd certainly love to hear from you.

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			19%	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*	*1.7*	*3.3*
2014	-1.7	0.1	1.9	2.5	0.1	-0.1	-2.2	3.1					3.7
Index	*0.7*	*0.7*	*0.6*	*0.6*	*-1.8*	*0.4*	*0.2*	*0.8*					*2.2*

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			65%	Index		64%
	Jan	Feb	Mar	April	May	June	July	Aug	Sept	Oct	Nov	Dec	YTD
2011										5.9	0.1	4.0	10.3
Index										*5.9*	*1.2*	*3.2*	*10.5*
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	*-0.5*	*1.9*	*2.8*	*1.1*	*-1.6*	*4.2*	*2.1*	*-0.9*	*1.7*	*-0.1*	*-0.2*	*-0.5*	*10.3*
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	*5.0*	*2.7*	*4.9*	*3.8*	*-3.4*	*0.6*	*4.2*	*-4.8*	*2.0*	*4.6*	*1.2*	*1.1*	*23.6*
2014	-3.5	2.5	2.0	2.9	1.3	0.8	-2.4	5.1					8.8
Index	*-2.5*	*3.7*	*2.1*	*1.9*	*1.0*	*2.2*	*-3.8*	*3.8*					*8.6*

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

Deep Value Strategy Monthly Returns (%)							Since Inception			197%	Index		143%
	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	1.3	4.7	-2.3	6.3					13.1
Index	*-3.5*	*4.6*	*0.8*	*0.7*	*2.3*	*2.1*	*-1.4*	*4.0*					*9.9*

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			241%	Index		179%
	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	5.5	9.5	-3.9	7.4					32.2
Index	*0.6*	*-0.2*	*1.5*	*4.3*	*3.4*	*5.9*	*-3.5*	*8.2*					*21.4*

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			116%	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	-1.0	3.6	-0.7	5.1					4.7
Index	*-0.1*	*1.6*	*-0.2*	*-0.7*	*0.5*	*0.9*	*-0.9*	*0.9*					*1.9*

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.

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

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

Follow us on **Twitter** @SimonLack

Contact info:

SL Advisors, LLC
210 Elmer Street
Westfield, NJ 07090-2128
908-232-0830
sl@sl-advisors.com
www.sl-advisors.com