Published by SL Advisors, LLC

In Pursuit of Value

November, 2014

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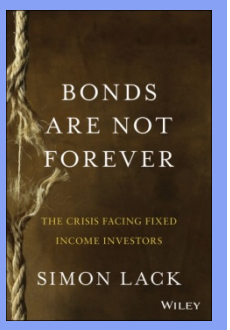

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Energy

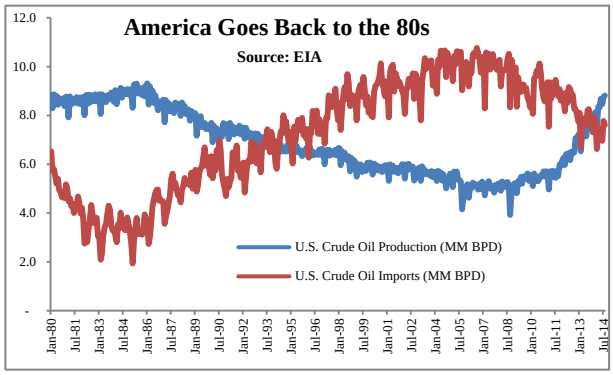
Energy drives all of human activity. It's a key input into all economic output, and its gyrations drove equity market returns in October.

I have a friend who's now retired from bond trading but he continues to be the best judge of market emotion and near term direction of anyone I know. I spoke to him in mid-October about where he thought things were headed. As our clients and regular readers know, we design our strategies so as to not be overly dependent on our near-term market call, because it's too hard. But there are a few people who are good at it, and my friend noted the growth headwinds that had been accumulating for several months before investors suddenly focused on them in recent weeks. He correctly assessed that a near term low had probably been made.

October was going so well until the market rallied

We have a decent amount of exposure to the energy sector across our investment strategies. Master Limited Partnerships (MLPs) are of course squarely in the energy infrastructure sector. A few of them exist as C-corps rather than partnerships, and therefore their attractive dividends and growth prospects combined with very stable businesses make them eligible for our two low volatility strategies (Hedged Dividend Capture and High Dividend Low Beta). Our Deep Value Strategy similarly includes names such as Kinder Morgan (KMI) and Williams Companies (WMB) as well as other MLP General Partners (GPs) well positioned to profit from continued capital investment in support of America's shale development. Chicago Bridge and Iron (CBI) has these and other companies as customers for its global infrastructure construction business. And because natural gas is the biggest input into the production of nitrogen fertilizer, we own Agrium (AGU) which we believe it well positioned to turn cheap North American natural gas into the profitable delivery of nitrogen to a global market.

Our diverse energy-related investments are not predicated on correctly predicting the future price of oil or natural gas but rather come together as a series of attractive themes based on identifying a long term competitive edge.



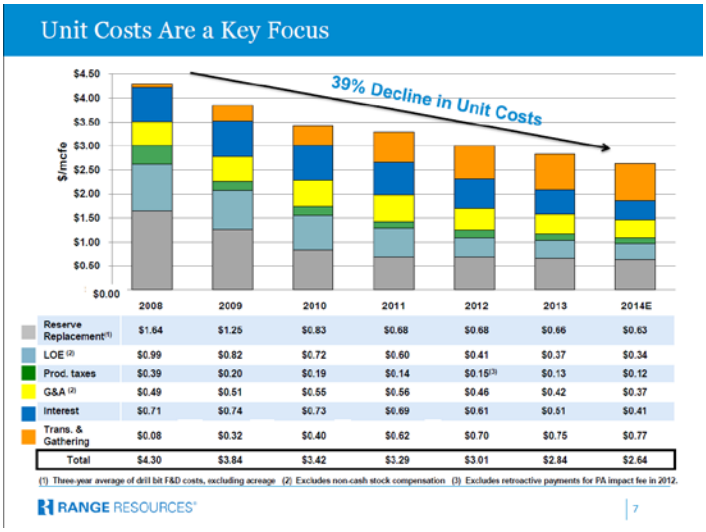
Many observers described the collapse in oil in October as the result of slowing global demand and increasing North American production. Dennis Gartman of the Gartman Letter must like John Kerry (who is referenced in Wikipedia under "Flip-flop") because Gartman was bullish on oil in September, before bearishly asserting crude would "go the way of whale oil" in October. Calling markets is obviously not easy. As my friend mentioned earlier pointed out though, these were not suddenly new issues between September 30th and October 15th when crude oil futures on the NYMEX plunged from $93.34 to $80.76. U.S. crude oil output since 2009 resembles an airplane taking off with no visible intention of reaching cruising altitude. The needs of domestic

refiners for different grades of oil than are produced domestically will ensure continued imports, but clearly the happy crossing of the production/import lines didn't come as a complete shock. The surprise was the Saudi's lowering their prices in early October rather than leaning against the prevailing trend, generating all kinds of conspiracy theories about influencing the behavior of other OPEC members whose domestic expenditure relies on far higher prices.

What seemed clear to us was that a lower oil price helps more than it hurts. The Economist noted that the approximately $30 drop in crude oil that's taken place since June, if maintained for a year, would represent a shift of $1 trillion from producers to consumers. Because consumers are more likely to spend their windfall than producers, it's worth about 0.5% to global GDP. Unless you're an oil E&P company or a provider of infrastructure to the marginal producer, this is a good thing. This second point is something we care about, since the growth prospects of many MLPs including those we own is predicated on the continued development of domestic oil and gas production. Horizontal drilling in shale formations is characterized by wells with much faster decline rates than with conventional drilling. The high pressure created by "fracking" initially delivers great volumes that quickly decline even while ultimate recovery can extend for many years. The relatively high early production delivers a similarly fast return on the capital expenditure incurred in drilling the well. This allows shale drillers to be somewhat more responsive to near term prices in their production decisions. The continued increase in U.S. production demonstrates that the technology keeps improving, further reducing operating costs.

Some reports have the Saudis looking to force marginal U.S. producers out of business by maintaining current prices. However, domestic operators offer a different perspective. Enterprise Products (EPD) CEO Michael Creel recently said that most if not all drillers in the key oil plays such as Eagle Ford, Permian and Bakken are profitable at prices below today's, and didn't see much danger of U.S drilling grinding to a halt. NuStar's (NS) recent investor call reported that producers were not cutting back, not least because short term output was already contracted and unaffected.

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



Domestic costs of production continue to fall. For example, Range Resources (RRC) is an E&P name we've long followed that is primarily in the Marcellus shale in SW Pennsylvania. As shown in the chart, their production cost for gas per MCFE (thousand cubic feet equivalent) has declined 39% since 2008. Economies of scale as well as improved knowledge and technology have driven this result. Moreover, this has happened in spite of Transportation and Gathering costs rising from $0.08 per MCFE to $0.77. Incidentally, Markwest Energy Partners (MWE), one of our MLP holdings, is one of the beneficiaries of this increased line item.

Vaclav Smil is a prolific author of books that explain how science interacts with commerce in today's society. He is apparently Bill Gates' favorite writer. Smil digs into the most fundamental details of how the modern world works backed up by startling data. For example, in his book simply titled *Energy*, the chapter on the biosphere and use of hydropower informs that the planetary water cycle (i.e. precipitation to evaporation) moves almost 580,000 km^3 annually, which equates to an average annual rainfall of 1.1 metres (I think London and Seattle get more than their fair share). He notes that the modern extraction of crude oil was stimulated by the desire for a cheaper alternative to whale oil, whose subsequent demise Dennis Gartman apparently believes crude oil will shortly follow. All of which hopefully shows that researching the energy sector never ceases to be interesting.

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			21%	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	-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	0.1	0.9			4.8
Index	*0.7*	*0.7*	*0.6*	*0.6*	*-1.8*	*0.4*	*0.2*	*0.9*	*0.3*	*0.9*			*3.6*

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			67%	Index		70%
	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	-0.5	2.2			10.2
Index	*-2.5*	*3.7*	*2.1*	*1.9*	*1.0*	*2.2*	*-3.8*	*3.8*	*-0.9*	*4.9*			*12.9*

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			177%	Index		145%
	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	-5.6	-1.4			5.3
Index	*-3.5*	*4.6*	*0.8*	*0.7*	*2.3*	*2.1*	*-1.4*	*4.0*	*-1.4*	*2.4*			*11.0*

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			222%	Index		162%
	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	-1.5	-4.0			24.9
Index	*0.6*	*-0.2*	*1.5*	*4.3*	*3.4*	*5.9*	*-3.5*	*8.2*	*-1.6*	*-4.8*			*13.7*

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			113%	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	-0.6	-0.9			3.2
Index	*-0.1*	*1.6*	*-0.2*	*-0.7*	*0.5*	*0.9*	*-0.9*	*1.1*	*-0.8*	*-1.7*			*-0.3*

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/

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