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In Pursuit of Value

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Liquidity

A couple of months ago Roger Ibbotson and I were both presenters at a CFA Conference in Toronto. Ibbotson is a professor of Finance at Yale School of Management and also chairman of Zebra Capital Management, an investment firm whose style of investing reflects his work. *Liquidity as an Investment Style* was the title of his presentation, based on his recent academic paper.

Investors like liquidity. Not everybody agrees on its definition; for some it is measured by volume. This superficial metric is used by proponents of High Frequency Trading (HFT), since they argue more volume is always good for investors. The issue of HFT's utility to markets is complex, albeit more widely debated thanks to Michael Lewis's book *Flash Boys*. But measuring volume alone is too simplistic because it doesn't capture potentially adverse activity by algorithms that can increase the costs of trading for others. The actual transaction cost incurred by an investor is a more useful measure, although devilishly hard to measure precisely. Some look at the bid/ask spread to estimate this; institutions that trade heavily use more sophisticated tools that compare their actual transaction prices with market prices prior to their activity to estimate their cost to trade.

Private equity investors often set their return target with reference to returns in public equity markets, such as 5% over the return on the Russell 2000 (a small cap index more reflective of the companies that private equity funds finance). Our strong preference for the flexibility to change our minds makes private investing highly unattractive, so we only invest in publicly listed companies. It's not that we trade a lot – in fact, far from it. But liquidity reduces the penalty for mistakes and their early recognition allows redeployment of capital to more attractive places. Investment relationships with private equity managers can last ten years or more, and if the actual outcome doesn't resemble the glossy brochure shared at inception, it can truly feel like purgatory.

Valuable, but better without the bubbles

Liquidity as an Investment Style takes the view that less liquid stocks offer higher returns than more liquid ones. If liquidity is desirable then it makes sense for investors to set higher required return targets for securities whose entry and exit is more costly. This is not news for most people, but Ibbotson's paper seeks to measure the additional return illiquidity offers. It goes on to posit that illiquidity itself can be a source of "excess return". There are some factors that are already acknowledged to be a long term source of return. Value Investing is one (variously defined, but generally a focus on stocks with low P/E ratios or sometimes low Price/Book Value). Momentum is another, which consists of buying what's going up and dumping what's going down. Such concepts work more often than not, but by no means all the time. The idea that Illiquidity could be another factor like these is interesting, although personally I'm less comfortable with it. The lower return that liquid stocks offer (think of it as the "liquidity discount") provides the holder with the comfort of an easy exit should they so decide. Stocks are not just sold because of bad news. Sometimes investors need cash for reasons quite unrelated to what they're selling, maybe for reasons that were not anticipated. A self-styled long term investor owning illiquid stocks to profit from this may be surprised to find their outlook is not as long term as they thought. Liquidity provides the flexibility to change your mind, and in that respect is different than the factors such as value or momentum listed above.

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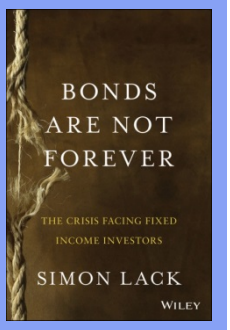

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SL Advisors, LLC focuses on identifying securities that are trading at a discount to intrinsic value.

Moreover, when you dig into the research it turns out that the illiquidity return has a very narrow source. It comes from a handful of stocks in the bottom quartile of liquidity suddenly becoming momentum stocks, no doubt because of a positive development. The vast majority of illiquid stocks stay that way; over the period covered (1972-2011), just 1% jump from the bottom to the top quartile, more than doubling in value as they go (returning 109%). Another 3.5% jump to the next highest quartile, returning 61%. So if you own the bottom quartile of stocks you might expect that 4.5% of them will generate just over a 3% excess return (that is, 1% X 109% added to 3.5% X 61%). That's a good portion of what the phenomenon is worth, and such a narrow source of return likely means that it varies substantially from one year to the next. If the annual returns to illiquidity vary widely, investors are likely to experience markedly different outcomes from seeking to exploit it. This also makes it much harder to persist with the strategy during the inevitable disappointing years, and means it's probably hard to profit from the concept.

Nonetheless, it is an interesting perspective and worth reading if you care about such things. That illiquidity should offer higher returns is widely accepted in Finance.

Not everybody agrees, however. To find the naysayers we must revisit a topic I have covered before, non-traded Real Estate Investment Trusts (REITs). This particular backwater of Wall Street seems to harbor many of the things that give Finance a bad name. Non-traded REITs (NTRs) are notable for underwriting fees as high as 15% (paid by the investor and shared with the broker recommending the investment); additional fees when the NTR buys properties, maintains them and sells them; numerous conflicts of interest; and no public market liquidity. As registered securities they can be sold to anybody. As unlisted securities they don't draw much research because there are no commissions to be earned from trading. Their multiple investor-unfriendly features are why their sponsors operate in that regulatory gap: an illiquid security whose sale would normally be restricted to sophisticated investors, but whose SEC registration renders them publicly available.

While the illiquidity of NTRs ought to mean they have a higher expected return (i.e. need to be sold to investors at a lower price to compensate), some proponents have sought to turn this hitherto unattractive feature into a selling point. Sameer Jain is the Chief Economist of American Realty Capital (a big distributor of NTRs). Jain is a graduate of both MIT and Harvard, so presumably has a passing familiarity with financial theory. And yet, on a website recommending his chosen sector he lists as one of the advantages, "Illiquidity that favors the long-term investor". As he goes on to explain, liquid REITs are inferior because "…the share price can drop below the value of the underlying real estate". By contrast, because you can't sell an NTR you benefit from, "…the inability of investors to "panic sell" their securities."

Jain further notes that conventional, publicly traded REITs are subject to more market volatility than NTRs which, he asserts, makes them *more* risky. This is because NTRs don't trade, and they update their asset values infrequently. Of course, publicly traded REITs aren't inherently more risky, their prices are simply more current. Yet Mr. Jain argues that, because your brokerage statement will show fewer fluctuations in NTRs (because there are no new prices), rational investors (as oddly defined by Jain) should demand a higher return for publicly traded REITs versus the NTRs he prefers. He wants you to choose the illiquid security over the liquid one. This is in spite of the fact that the Financial Industry Regulatory Authority (FINRA), which regulates American Realty Capital, has a warning on its website that the, "Lack of a public trading market creates illiquidity and valuation complexities for NTRs."

What's wrong with this is that Sameer Jain's educational background leads the casual reader to assume he's intelligent. Evidently, the presumption of a high IQ should not be confused with a genuine desire to offer investors good advice. It's hard to comprehend why he holds such a view, and causes one to consider an alternative plausible explanation, that he's disingenuously offering "advice" that benefits his business while believing something different. When Wall Street analysts were caught doing this during the dot.com bubble it resulted in large fines and the subsequent inclusion of an Analyst Certification on every report saying that the writer believed what he wrote. Of course it shouldn't have been necessary, and yet you can still find examples of people writing what they surely know cannot be right.

It's what gives Finance a bad name. Daylight is often the best disinfectant.

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			22%	Index		2%
	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	1.1		5.9
Index	*0.7*	*0.7*	*0.6*	*0.6*	*-1.8*	*0.4*	*0.2*	*0.9*	*0.3*	*1.0*	*-0.2*		*3.4*

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			71%	Index		75%
	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	-0.9	2.2	2.4		12.9
Index	*-2.5*	*3.7*	*2.1*	*1.9*	*1.0*	*2.2*	*-3.8*	*3.8*	*-0.9*	*4.9*	*2.8*		*16.1*

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			175%	Index		152%
	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	-0.7		4.6
Index	*-3.5*	*4.6*	*0.8*	*0.7*	*2.3*	*2.1*	*-1.4*	*4.0*	*-1.4*	*2.4*	*2.7*		*14.0*

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			223%	Index		156%
	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	0.3		25.2
Index	*0.6*	*-0.2*	*1.5*	*4.3*	*3.4*	*5.9*	*-3.5*	*8.2*	*-1.6*	*-4.6*	*-2.6*		*11.0*

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			118%	Index		0%
	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	2.3		5.5
Index	*-0.1*	*1.6*	*-0.2*	*-0.7*	*0.5*	*0.9*	*-0.9*	*1.1*	*-0.8*	*-1.3*	*0.4*		*0.4*

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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