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In Pursuit of Value

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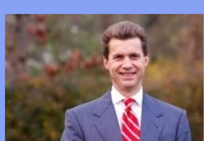
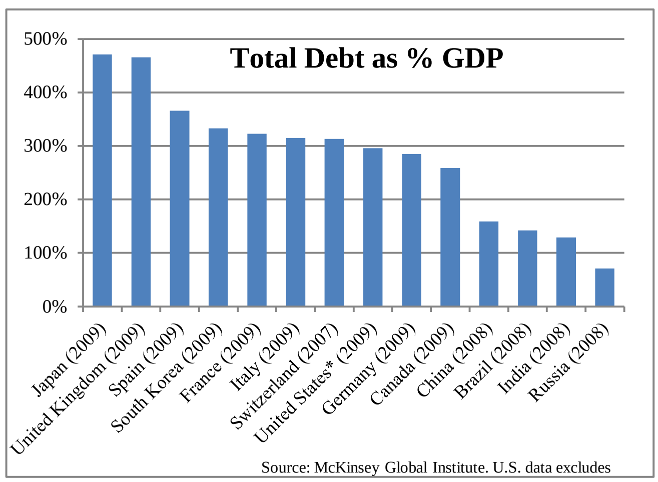


Fear of Debt

When I was a little boy my grandmother used to sit me on her knee and tell me that money in the bank was your best friend. Like all of us, her beliefs were colored by her formative years which included the 1930s Depression (experienced in the UK, but not substantively different from the U.S. version). Some years later as a young man early in my career on Wall Street when she was in her twilight years I was proud to be able to tell her that I had followed her advice. I know it made her happy.

The fear of debt that my grandmother reflected has long been lost in western societies. The consequences of excessive borrowing by consumers, the financial sector and governments will impact investors for many years to come. As we navigate through an episode during which debt is the overwhelming factor driving markets and it seems everything we read concerns just this topic, let me try and offer some less common perspectives.

To start with the EU, now that policymakers have at least joined the rest of us and acknowledged Greek insolvency, it seems to me that the banks who loaded up on Southern European bonds are receiving far too little blame. Yes, Greece has confessed that the budget numbers on which its entry into the Euro was based bore little relation to reality. And the country seems to have almost entirely dropped the habit of paying taxes. But the strict budget rules imposed on Euro members by Germany at inception and enshrined in the Maastricht Treaty (budget deficits no more than 3% of GDP; total debt no more than 60% of GDP) had already been widely flouted and in any case should be unnecessary if prudent lending practices are followed. After all, Texas borrows what Texas wants, and Illinois does the same. The fact that they share the same currency doesn't require centrally imposed borrowing rules.



Source: McKinsey Global Institute. U.S. data excludes

Unfortunately, while entry into the Euro eliminated the currency risk of French banks lending to Greek ones, it didn't transfer Northern European frugality to the Mediterranean. But BIS capital guidelines did allow all EU sovereign debt to be treated by banks as if it carried no credit risk, so French and German banks duly piled in. They decided to suspend critical thought and instead hide behind a regulator's opinion. It was a form of regulatory arbitrage. Letting others do your thinking for you should draw the results it deserves, and if there is ever economic justice in this arena it will result in poorer French and German banks, and bankers.

In the U.S. the rating agencies are important actors in the theatre that demands our unwilling attention. Among many negative outcomes, a rating agency downgrade of the U.S. may unleash a Made in Washington recession. We don't know its impact, and we will probably find out soon. But who, really, is going to change their own opinion of U.S. creditworthiness simply because S&P changes theirs?

Anybody even casually following U.S. fiscal policy in recent years has already reached their conclusion – either that substantial changes are required, and that U.S. government bonds are a poor choice for all return-driven investors but especially so if the US$ is not your home currency; or (if you're a foreign central bank) that the alternatives are unappealing and best to keep buying. When Moody's issues a credit rating on a corporate issuer they have access to management and to non-public information as well as publicly available financial reports. Their rating at least has the potential to be insightful. But they don't have any such insight regarding U.S. creditworthiness. Their rating is a political judgment. They don't know any more than I do about how we as a country will reconcile future obligations with available resources. "Anyone with an IQ greater than room temperature" (to use T Boone Pickens' wonderful phrase) already incorporates the Administration's long term budget outlook (which is brief and irresponsibly devoid of a plan) into their own desired credit exposure to the U.S. So we are left to ponder how "rules-based" investors, those who outsource their thinking, will react. Will they change their rules and hold non-AAA debt? Or will they sell? And if they all sell, the recession that follows will surely turn them back into buyers. Contemplating the actions of non-thinkers is a necessary tool for today's thoughtful investor.

Finally, as the debate over entitlement reform gathers steam, try considering it from this perspective: America promised itself more than America wants to provide; or more accurately, a generation promised itself more than it put aside. Although there are no bright lines separating one cohort that's to blame from another that isn't, in simple terms it's this: we baby boomers have collectively lived through and voted for a series of governments that generally reflected the popular will, which included not setting aside money today to pay for tomorrow's promises (remember "Read my Lips; No New Taxes"?). It seems wholly reasonable that the consequences of this poor planning should be visited just on the same generation that didn't think when they should have, and not upon everybody including those too young to have voted either for or against George Bush Sr. The morality seems self evident. Means-tested entitlements is an oxymoron, but fairness surely requires that collectively, what wasn't prudently put aside by one generation shouldn't be taken from the next.

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

Natural Gas

Regular readers are familiar with our investment in selected natural gas E&P names. In July BHP Billiton agreed to acquire Petrohawk (HK) for $15BN (including the assumption of debt), which caused the stock to jump 62%. For the past year, every time we heard Petrohawk's CEO Floyd Wilson speak, he asserted that the assets they owned better belonged in a bigger company with a lower cost of capital able to develop them over twenty years or more. We maintained a small long position in HK for this reason, and even an exposure under 3% can still give a nice bump when it moves that much. While we no longer own HK, we continue to like the natural gas story in the U.S. We think it will provide a bigger share of America's electricity in the future, and may also play an important role in transportation. We still have around 20% of our Deep Value Equity strategy invested in the sector. The stocks can be volatile but we think the story still has several chapters to play out. We think other integrated energy companies will look for similar opportunities to buy shale gas assets while spot natural gas prices remain depressed – ironically because of the success of shale gas drilling. Among the names we own are Range Resources (RRC), Southwestern Energy (SWN), Devon Energy (DVN), Comstock Resources (CRK) and a recent addition which is drilling for gas in the Gulf of Mexico and is not involved in shale gas, McMoRan Exploration (MMR).