Published by SL Advisors, LLC

In Pursuit of Value

February, 2011

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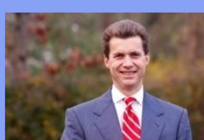
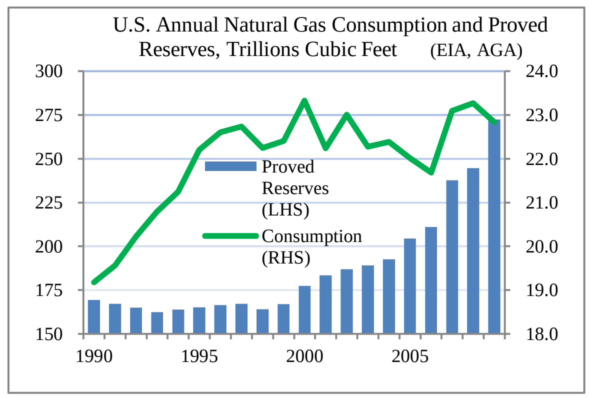


Politics and U.S. Energy Policy

It should be no surprise that government policy is of great consequence to investment returns. As a result of the Credit Crisis this is perhaps more true than at any time since the Great Depression in the 1930s. Federal tax and spending policies always figure prominently, but today's highly expansionary fiscal policy, the pace of its withdrawal and ultra low interest rates are all major factors governing the economic outlook and investment returns.

Regular readers will be familiar with our investment in the natural gas sector, and I won't list each reason in detail here; simply put, natural gas is cleaner than other fossil-based fuels; cheaper on an energy-equivalent basis than crude oil derived sources; and it's here, in the U.S. The T Boone Pickens Plan to convert trucks from diesel to natural gas mitigates many challenges facing the U.S. It reduces our reliance on an unstable region where we've fought three wars in the last twenty years; it reduces our trade deficit; it provides a "bridge" to renewable energy sources which are many years' of development and investment away from providing a meaningful alternative to fossil fuels. It's so obviously in the best interests of the U.S. to promote the use of domestic natural gas that the current failure to do so begs examination. The chart shows our relatively steady annual consumption alongside growing proven reserves thanks to recent advances in shale drilling technology. The U.S. Energy Information Administration (EIA) estimates that ultimately recoverable reserves are 2.1 quadrillion cubic feet (7-8 times proved reserves, or about 90 years of consumption at current levels).



I was in Texas in December visiting with a number of energy companies, and more recently attended a lunch sponsored by the American Gas Association (AGA), both of which offered rich insight into the political impediments to smart energy policy. Start with the coal industry, which is heavily unionized (and therefore politically organized), and a generous supporter of like-minded politicians. At least coal exists in abundance domestically, although the phrase "clean coal" is most appropriate as a comparison with "old coal" rather than alternatives. In any case, global warming took a backseat to more immediate economic concerns when Lehman failed in 2008, and weekly snowstorms in the north-east U.S. are not drawing adherents to Al Gore no matter how tenuous the relationship between seasonal weather fluctuations and global ocean temperatures. "Big Oil" is of course, well, bigger in Washington, DC than the fragmented natural gas industry. Chesapeake Energy (CHK), the largest independent natural gas E&P name, has a market cap of $18BN, versus $398BN for Exxon Mobil (XOM), so no matter how telegenic its CEO Aubrey McClendon, XOM and its peers have a substantially greater impact on jobs, taxes and (presumably) Congress. Lastly, the auto companies were lukewarm on alternatives to gasoline until high oil and their own government bailout changed minds.

Dave Parker is retiring as President and CEO of the AGA. He provided a political update at the lunch I recently attended, and I had an opportunity to chat with him afterwards. The Environmental Protection Agency (EPA) is contemplating stricter emission rules that will force older coal burning power plants to invest in expensive "scrubbers" or close if the required expenditure is uneconomic. If these standards are implemented it will increase natural gas demand and reduce the use of coal. The Administration is in favor of improved emission standards through regulation (the legislative route having failed) and House Republicans are against. Dave's view on how this will resolve itself was fascinating to one like me who spends much more time looking at financial numbers than opinion polls. To summarize the outgoing AGA President and CEO: President Obama will govern from the center so as to win re-election, delaying more liberal elements of his agenda until that time. Of the 33 senators up for re-election in 2012, 21 are Democrats (and two are independents) including Senators Brown (Ohio), Casey (Pennsylvania) and Rockefeller (West Virginia), all of coal-rich states. Dave's analysis begins, as he says, with the electoral college. Many will respond with a shake of their heads at the process through which policies are made. Sausage making is not pretty. But really, senate elections in coal-mining states whose outcome is determined in part by each candidate's degree of support from coal miners seems more democratic than any plausible alternatives.

For our part, we've combined an assessment of what should suit America with an analysis of the operating performance of relevant companies, and as a result are invested in companies with low operating and acquisition costs combined with large potential reserves, such as Range Resources (RRC) , Comstock Resources (CRK) and Southwestern Energy (SWN). These stocks have generally outperformed their peers in recent months. However, our investment thesis is certainly more balanced and better informed through the political realism of people like Dave Rogers.

What We Own

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

Berkshire Hathaway (BRK-A) is an insurance company that is increasingly becoming an operating company. The Burlington Northern acquisition last year was substantial; having already bought 22.6% of the company worth $7.7BN, Buffett finished the job by spending $26BN for the 77.4% he didn't already own. Even by the standards of Berkshire it was a large acquisition, and continued the steady expansion of Berkshire from an insurance company to one with a large portfolio of operating businesses. In fact, one way to value BRK-A is to separate out the value of the public equities that they hold plus cash and then apply a multiple to the operating earnings (excluding investment income) generated by the insurance and non-insurance businesses. Whitney Tilson of T2 Partners has done an interesting analysis on this basis, and through it arrives at a fair value for BRK-A some 30% higher than current levels. Using Dec 31 market prices the portfolio of public investments BRK-A owns is worth $88,000 per share. Using a forecast of full year 2010 pre-tax operating earnings of $7,200 for the operating businesses (ex investment income), the current share price of $124,000 implies that these operating businesses can be bought for a multiple of 5. This is at the low end of the historic range for the past decade, and there's some reason to think that Berkshire's own internal valuation typically assigns a multiple of 10-12 (based on a careful review previous annual letters). BRK-A has substantially lagged the market over the past several months, and such periods have in the past continued for several quarters. However, Berkshire reports earnings in late February, and while there's no way to predict when its underperformance may end, in the past it has made up lost ground following such announcements. Some further clarity around succession planning would also no doubt be helpful. We think it's a safe bet that someone like Buffett who has been so vocal on issues of corporate governance will have put in place an appropriately thoughtful process to run Berkshire's disparate businesses when Buffett himself leaves, whether his departure is sudden and unexpected or on his own schedule.

Not coincidentally, one of our larger holdings Boulder Total Return Fund (BTF) has 40% of its assets in BRK-A and currently trades at a 17% discount to its NAV. We've liked BTF for some time based on its wide discount to NAV (caused by the absence of a distribution and consequent unattractiveness to traditional yield seeking investors) and large ownership by the portfolio manager. It must be conceded that there is no obvious catalyst to narrow this discount which has persisted for a couple of years. Timing is rarely easy. Nevertheless, the relatively attractive pricing of BRK-A adds to BTF's current attraction. BTF is a holding in both our Deep Value and Discount Arbitrage Strategies.