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In Pursuit of Value

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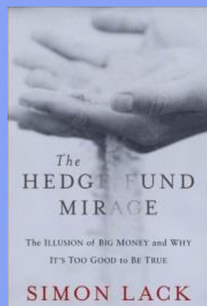

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Annual Letter

Investment Philosophy

Continuing a custom started last January, the first monthly letter of the year reviews our investment philosophy, themes we are following, outlook and performance over the year past. SL Advisors celebrated its fifth anniversary in 2014. The business has grown right from the start, with client assets doubling every year. While the client base has grown, there has been no change in our investment philosophy or people during this time. We put a great deal of consideration into our approach at the outset, and while investment debates are a daily occurrence, the underlying principles remain the same.

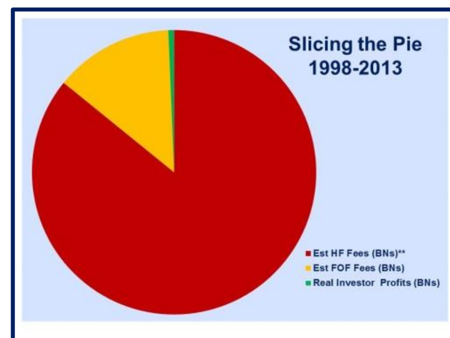
The fundamental challenge facing investors today hasn't altered since the Fed began its extraordinary monetary accommodation in response to the financial crisis of 2008. How is one to preserve the after-tax, purchasing power of one's savings when an entire asset class has been priced so as to be virtually devoid of return? In my 2013 book, *Bonds Are Not Forever; The Crisis Facing Fixed Income Investors,* I discussed a crisis not of plummeting bond prices which ought to be most welcome to those with cash to invest, but rather the continued repression of fixed returns on offer to savers. The stealth transfer of real wealth from savers to borrowers is a time-tested solution to excessive debt, and the U.S. has eagerly availed itself of this strategy with remarkably little push back from those who are heavy investors in bonds. Whether in the long run we are all damned because of this, so far it has been a remarkably successful policy with even its gradual withdrawal through the official end of Quantitative Easing in September causing hardly a financial ripple. Consequently the ECB and Bank of Japan are employing similar moves in response to their own debt-impeded growth challenges. The perpetual surprise for bond markets has been that rates haven't risen. We think similar surprises will continue, and that when rates do inevitably rise it will be slowly. The cost to the Fed of tightening tardily is so much less than the penalty for being early. In addition, Janet Yellen is without doubt the most dovish Fed chair any of us can remember. Her deep and genuine concern for the unemployed is likely to provide greater tolerance for inflation as the modest price for more job growth.

Therefore, SL Advisors has always been a "bond-free" zone. When public policy is to ensure inadequate bond yields the rational investor moves elsewhere. We own no bonds personally and none for our clients either. We manage investment strategies that in concert can represent the complete portfolio solution, as they do for me. If a client wants bonds we're not going to be able to help them. **Deep Value** and **HighDiv**, our two long-only equities strategies provide growth with different levels of volatility. Our **DivCap** strategy combines **HighDiv** with a market hedge to create an attractive substitute for investment grade corporate bonds. Master Limited Partnerships (**MLPs**) are far superior to high yield bonds, and **Low Beta Long-Short** holds some of our best ideas in a concentrated, hedged format.

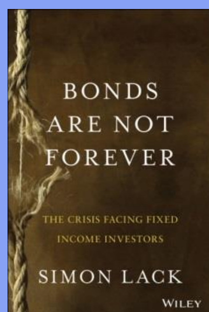
We also treat our clients the way we'd like to be treated ourselves. While people often comment that "our fund" is doing well, we set the business up to manage client assets in separately managed accounts (SMAs). This is a very pro-client structure, since it provides for independent valuation, withdrawals on demand and complete transparency. Although scalable, it does necessitate a higher minimum investment than with a mutual fund. As a result, in 2015 we will be offering our MLP strategy in a format compatible with the 1940 Investment Company Act when we start sub-advising a mutual fund. Finance is notorious for layering fees onto investment products, and one of our requirements in launching this new product was that it be structured such that we could recommend it to friends, and it is.

I spent most of my career at JPMorgan where our clients were institutions. At SL Advisors our clients are generally self-directed high net worth investors although they increasingly include institutions too. I often find myself shocked at the types of advice and fee structures inflicted upon intelligent people whose expertise

lies outside financial services. We have a two-fold response to this. One is to offer a fair deal to clients. The other is to point out, as loudly as possible, some of the more egregious betrayals of trust that occur when clients who hope they have found a financial advisor with the ethics they'd expect from their doctor, transact with providers of advice whose loyalties lie elsewhere. Improved regulation may help, but a better informed investor most assuredly will. *The Hedge Fund Mirage; The Illusion of Big Money and Why It's Too Good to Be True* was my first effort to tell investors what they ought to know. Back in 2011 when I wrote it, a fantastically profitable hedge fund industry had somehow managed to divert virtually all of that return to managers and allocators. Although controversial, the book argued that an over-capitalized hedge fund industry would continue to deliver disappointing results. Fortunately for my reputation as a forecaster if less so for hedge fund clients, subsequent years of mediocre results delivered at great expense increasingly cause former hedge fund proponents to publicly question their mission. I'm still regularly invited to make presentations at conferences. The pie chart showing the division of profits among hedge fund managers, funds of hedge funds, and (barely visible) clients unfailingly draws a broad chuckle from the audience. This is especially so when I note that the annually updated pie chart had to be abandoned following hedge fund losses in 2012 as this rendered the green, "Client Profits" slice negative and therefore beyond the portrayal abilities of PowerPoint. Fortunately, a return to modest hedge fund profits in 2013 restored the pie chart's utility.



SL Advisors, LLC focuses on investment strategies that provide income without relying on fixed income securities



Hedge funds are not the only problem though, and after three years of fairly regular exposure I'm inclined to think enough has probably been heard from me on this topic. Maybe it's because I've finally had to concede to being middle-aged (a state some believe I reached long ago) but in today's America opinions rarely change. Political discourse is usually past one another and simply reinforces existing convictions. So it is with hedge fund investors; there are probably few remaining whose opinion will alter. Nonetheless, many other types of investor can benefit from improved information. In 2015 look out for my next book, *Dodging the Potholes on Wall Street; Putting the Investor First*, written with several friends as co-authors in which each chapter explains why a commonly recommended investment is to be avoided. Regular readers of my blog will also be familiar with my diatribes at securities such as non-traded REITs, a product that will live in infamy as FDR might have said. As long as an investment product with 15% up- front fees is being sold, there will be material for part-time bloggers wishing to illuminate unsavory activity.

Investment Themes

Our investment strategies are summarized on Pg. 8 as well as on our website. Those interested in more detailed information need only ask. Their performance and outlook will be provided later in this letter. Thematically, two big ideas run through all five investment strategies to varying degrees. The Low Beta Anomaly is the name given to a fascinating weakness in the Capital Asset Pricing Model (CAPM). Conventionally, if you take greater risk you expect a higher return and this is the foundation of CAPM. Although it provides an elegant framework with which to value securities as well as making common sense, the world consistently fails to conform neatly to the one described by CAPM. Perversely, low risk (or "Low Beta") stocks outperform their High Beta cousins, not only when adjusting for their lower risk but often in simple, nominal terms. This regular occurrence is not in question, although there are several theories that seek to explain the phenomenon. One that we find compelling comes from the field of Behavioral Finance, an area with much to offer in the analysis of financial markets. Economic theory is often undone by the inconvenient intrusion of humans whose actions don't mimic those of the economic agents present in the theory.

Consider the typical equity manager actively managing client assets. Although his simple motivation should be to pick stocks that will outperform his benchmark, which is probably the S&P500, there are subtle forces that will draw him towards higher risk names. Here, with apologies, some algebra: Our friend CAPM divides the return on a stock into three parts: the simplest is the risk-free rate, **r**, which is the minimum that every investment should deliver. The other two are more interesting; one comes from the overall market return above **r** (called here simply **M**) combined with the stock's sensitivity (known as Beta, **β**). The other comes from the stock's *additional* return (known as Alpha, **α**), which is the amount by which the stock returns more

than if it just maintained its historic relationship with the market. So you expect to get **r + βM + α**. For the overall market **β = 1.** The **βM** bit is not that hard to get and is cheaply provided by firms such as Vanguard; the **α** is what everybody wants and it draws much higher fees. Therefore, much energy is expended trying to make **βM** look like **α**.

If the algebra looks complicated, simply think of a stock's return as coming in part from maintaining its historical relationship with the market and in part from doing a bit better or worse than this (i.e. doing the unexpected). Correctly anticipating the unexpected is the hard bit.

Money follows performance as every manager knows. The benefits of doing better than the crowd far exceed the penalties for doing worse, as long as the manager is only managing other people's money. It's the principal-agent problem, which occurs throughout finance. The manager who is simply an agent in effect has a call option, which is to say lots of potential upside through asset growth if he beats the crowd versus fairly limited downside (at worst, look for another job) if the crowd beats him. The rational response is to buy stocks with a high beta (i.e. **β > 1**) and to avoid the others. In a rising market, our rational manager should beat the averages (unless he's a truly terrible stock picker). Since few investors know their Greek CAPM alphabet and can't tell **α** from **β**, money will surely flow in. Collectively, the avoidance at the margin of low beta stocks by the many agents who actively manage money is, we believe, responsible for the outperformance of such stocks. High beta names are over-owned, and therefore underperform because they are expensive, which explains why so many active managers struggle to beat the indices over time.

The problem is that the investor's interests in this example aren't fully aligned with those of the manager. Underperformance doesn't hurt the manager enough. The solution is for investors to reject managers who aren't substantially invested alongside their clients. This mitigates the Principal-Agent problem and ensures that since the manager is also managing his own money he'll seek outcomes that offer a return commensurate with the risk. The consequent alignment of interests is to the client's benefit. Not enough managers of mutual funds and other vehicles are significantly invested in their own products. As long as that remains the case, divergent interests will continue causing high beta names to be over-owned. And frankly, who wants to invest with someone that isn't investing alongside you?

An additional appeal of low beta names is they tend to be stable, understandable businesses with cashflows that grow fairly predictably, financed with low levels of debt. The steadiness of their operating results is usually reflected in their stock prices.

The Low Beta Anomaly suggests that owning what active managers generally don't exploits a persistent inefficiency. Two of our strategies (**HighDiv** and **DivCap**) are built on this but it's a factor we consider across everything we do.

Our second big idea is around the most effective way to profit from the boom in shale oil and gas production. The story of 2014 has surely been about the falling price of crude oil, just one of the consequences of America's resurgent production of fossil fuels. Our chosen path to invest in the shale boom has been through Master Limited Partnerships (MLPs), which own and operate much of the physical infrastructure that gathers, processes, moves and stores crude oil, natural gas and refined products. Their toll-like business models generate reliable cashflows based largely on fee income and have long been an attractive asset class for yield seeking investors. Before the shale boom, regular distribution growth came from inflation-linked price escalators and from squeezing costs so as to run more efficiently. The growth in U.S. energy production has translated into faster growth for MLPs as they invest heavily in new infrastructure.

The common structure of an MLP includes a General Partner (GP) that runs the MLP and collects an increasing share of the cashflows the MLP generates. This remarkable position means that asset growth at the MLP level assuredly drives profitability for the GP, since it shares in the increased cashflows without having to provide the capital necessary to fund that growth. In this respect, MLP GPs look a lot like hedge fund managers, and therefore MLPs like hedge funds. It's not a perfect analogy, because MLPs themselves regularly deliver far better returns for their investors than hedge funds do. But the preferential role of the GP is like the hedge fund manager in that benefits accrue from managing increasing amounts of other people's money. As more GPs have become publicly traded, we have shifted our focus to them and away from MLPs (although some MLPs have no GP and those can also be attractive). Hedge fund managers have kept far too

much of the profits earned from investors' capital. Investing in MLP GPs affords a similar opportunity to earn a return from the management of growing pools of assets. The General Partner of an MLP is to its MLP as a hedge fund manager is to its hedge fund.

The Low Beta Anomaly and MLP GP themes are two big ideas. At the same time, any investment we make has to be in a company with a strong balance sheet and manageable debt. In fact, we avoid debt in just about every way possible. We don't invest in it; we don't invest in companies that issue too much of it; and we don't use it ourselves, other than sparingly in our Low Beta Long Short Strategy. Excessive debt risks losing control of your investment, and holds you hostage to otherwise temporary setbacks. It was at the root of the 2008 financial crisis. Long-only strategies can earn quite acceptable returns without leverage.

The collapse in crude oil is the dominant story of 2014, and since MLPs are in the energy sector it's inevitable that they've been affected. The Alerian Index was +15% for the year by mid-June before conceding all of those gains to finish the year +5%. Distribution yields of around 5% combined with growth of 4-6% implies an annual total return of 9-11% over the next several years. We think holding the GPs offers the prospect of substantially better returns through lower yields combined with much faster distribution growth fuelled by ongoing development of new infrastructure.

Performance and Outlook

MLPs

Our core MLP strategy returned +21.1% in 2014, substantially better than the Alerian Index which finished the year +5.0%. By mid-year, before the collapse in oil we were +28% versus +16% for the index, and increasing our margin of outperformance during the sell-off highlights that our edge doesn't simply rely on a bull market for MLPs. Generally, the GP bias served us well. Energy Transfer Equity (ETE) was the biggest driver of performance as its four underlying MLPs, Energy Transfer Partners (ETP), Regency Energy Partners (RGP), Sunoco Logistics (SXL) and Sunoco LP (SUN) all drove distributions higher. The MLP Strategy is only really appropriate for U.S. taxable investors willing and able to accept K-1s for tax reporting. So we also run another version of our MLP strategy for non-U.S. taxable investors, called (accurately, if not eloquently) the GP C-Corp Strategy. We're renaming it the Energy Infrastructure Strategy. Because this only invests in conventional corporate equity securities, all the tax reporting is based on 1099s. It was +14.5%.

The Energy Infrastructure Strategy is the basis for our first mutual fund, being launched in 2015, and with lower minimums than for our separately managed account strategies. Please contact us if you'd like additional information.

As MLPs have followed other energy stocks lower, the fundamental question is how sensitive are their businesses to crude oil? The simple answer is, not very. The long term relationship between crude oil and MLPs is very weak. Midstream MLPs rely on fee-driven economics with contracts extending out many years. Volumes handled are far more important than prices. In fact, it's more likely that low prices will stimulate demand as Americans drive more readily to the mall and spend their savings from fueling their cars. "Demand Destruction", caused by a recession or excessively high prices, is what MLP investors fear. Instead, what we'll see is a reduced wealth transfer from consumers to oil producers, likely to be worth 0.5% in additional U.S. GDP next year. Pipelines also are able to take full advantage of the low interest rate environment using responsible amounts of debt given the predictable nature of their cash flows to enhance returns.

There is a negative side though, which is that marginal E&P projects will be shelved or cancelled outright. This won't just be limited to U.S. shale plays, and there's plenty of evidence that conventional drilling activity around the world is slowing down. Day rates for offshore drilling rigs are under severe pressure and Halliburton recently announced layoffs because of reduced demand for their services across Europe, Russia, the Middle East and Africa. But some capital investment in U.S. shale will inevitably be curtailed. We think the overall impact is likely to be muted. The steady technological improvements behind shale extraction make the U.S. one of the few areas where production costs are falling. Moreover, MLP managements are generally fairly sanguine about the outlook with few surprises in forward guidance for 2015 emerging during the most recent round of earnings calls in November. Lower prices will also stimulate demand. Following a year of

modest returns for the index, distributions continued to grow with the result that MLP yields now average around 6%. Our bias towards GPs and good security selection were responsible for our substantial outperformance of the index. We continue to think the sector offers compelling long term value at current levels.

High Dividend Low Beta (HighDiv)

This strategy had a good year. Since, as the name suggests, we hold stocks with a low beta (typically around 50-65% of the S&P500) we generally expect returns to be around the same proportion of the index over the short term. We benchmark ourselves against the S&P500 Low Volatility Index since that's the most representative index, and both the strategy and the index kept pace pretty well with the S&P500 (up 12.7% and 17.5% respectively, versus the S&P500's return of 13.7%). The advantages of exploiting the Low Beta Anomaly were readily apparent in 2014 as the tortoise plodded steadily along with predictable earnings growth to beat the frantic hare.

The impact of specific names was muted in this strategy by design, since it's supposed to extract a return through broad exposure to low beta stocks as described earlier. The largest cause of divergence was our preference towards pipelines in place of utilities in the index. While pipelines declined with the price of crude, utilities advanced. The most notable outperformer was soft drinks maker Dr. Pepper (DPS), and the biggest laggard was pipeline operator Oneok Inc. (OKE).

Hedged Dividend Capture (DivCap)

DivCap similarly had a good year against its benchmark (+6.2% versus +3.7%). It continues to be an attractive substitute for a portfolio of investment grade bonds in our opinion. DivCap is uncorrelated with equities but the combination of long positions and the short S&P500 position provide positive net dividend income and exposure to future dividend growth without entailing direct equity market exposure.

Deep Value Equity

We had a difficult year in this strategy, mostly due to concentrating our efforts on sectors that performed poorly (+2.7% versus +13.7%). We generally have an overweight to the Energy sector, and so while we do so without seeking direct exposure to oil and gas prices, few energy-related stocks performed well in 2014. We also tend to avoid health care since it's not our expertise nor cheap, and for the second year this was the strongest sector in the S&P500 which helped the benchmark but not us. The differences in sector returns are striking: S&P Energy was -9% and within that Energy Exploration and Production was -29%, while Health Care was +25%. Given our sector biases this represented a substantial headwind. Value strategies tend to be drawn towards the Energy sector where valuation metrics such as P/E and Price/Book are lower than in Healthcare or Technology. Nonetheless, the magnitude of the difference in sector performance and our own result against the S&P500 was not something we anticipated. We also had a significant amount of small-cap exposure (the small-cap Russell 2000 was +5%), which turned out to be a poor place to be, and were wrong on a couple of non-energy names.

Like energy investing, this Florida chip shot is not for the faint of heart.

Our approach to Deep Value is most definitely one of bottom-up security selection, although performance since the Summer makes it appear to be very much top-down, sector driven. Several of the opportunities we have found most attractive are in Energy, and the collapse in oil has hurt the stock prices of companies with any nexus to oil regardless of the robustness of their business model. It's a disappointing annual performance and Deep Value clients will draw some meagre solace from the knowledge that your portfolio manager has endured what they have. The collapse in oil prices affected energy companies with limited or no direct oil exposure more than we expected. There's no known reliable method for investing at the low; buying a stock that's down 35% from its high as it falls further to down 67% will cause a 49% loss on your invested capital (as happened to us

briefly with U.S. Silica).

Our biggest lost was in Chicago Bridge and Iron (CBI). They design, build and maintain energy infrastructure globally across a broad range of areas including gas processing, liquefaction, electric power plants (including nuclear) and transportation. Although they're in the energy sector, they are most exposed to overall economic activity. The collapse in oil is undoubtedly negative for companies that produce and sell it, as well as for the service providers that support them. However, we expect the improvement in GDP that comes with lower oil to result in more, not less energy consumption. This should therefore benefit CBI since they're in the business of facilitating the production of power. They currently trade at just over 7 times next year's consensus EPS which is expected to be 13% higher than in 2014. Investing in CBI was never intended to represent a view on crude oil, but since June 30th its 38% drop is four times that of the overall S&P Energy Sector (-9%). Investors that allocate assets to sectors wind up selling all the stocks in a sector when they exit with little discrimination. There are many similar examples but CBI represents our most costly experience. We initially invested in the Spring of 2013 and added this Summer. We think the stock is substantially undervalued, but were obviously early in committing capital.

Another name we like is U.S. Silica Holdings (SLCA). They produce the sand used in "fracking," the method by which shale oil and gas are released from the porous rock in which they're found. Unlike CBI, SLCA is clearly at risk to cutbacks in U.S. shale E&P, and they're also a small cap name. Their strong competitive position and 80-90% committed 2015 output as well as the potential to convert part of their business to a more tax-efficient MLP structure induced us to make a small investment following a 35% pullback from their recent high. Even this price concession proved totally insufficient as the price subsequently recorded a two thirds loss from its Summer levels. We think that the current valuation of just under 9 times next year's consensus EPS with 20%+ growth provides decent margin for safety against further business deterioration. However, we were obviously early in buying this one too.

On the non-Energy side, IBM's relentless stock buybacks couldn't ultimately disguise their deteriorating revenues. We probably gave management too much credit in expecting them to achieve a long-held target of $20 in operating earnings per share by next year. When they finally acknowledged this was unrealistic and dropped it, the stock fell further. We have reduced this position in favor of better opportunities.

Good performance came from long standing positions in Berkshire Hathaway (BRK) and Burger King (BKW). Ironically two large energy companies, Williams Companies (WMB) and Kinder Morgan (KMI) both helped results. They each completed corporate restructurings in late 2014 which set the stage for faster growth going forward.

For Deep Value clients (which includes me), 2014 was a year to forget. Not surprisingly, we like the portfolio we currently hold and believe that it offers a compelling risk/return profile. However, we're not happy with the result in 2014 and look forward to a substantial improvement.

Low Beta Long/Short

Performance was modest although better than the benchmark (+6.8% versus -0.4%). and we did manage to record a fourth consecutive positive year. Gains on Mondelez (MDLZ), Burger King (BKW) and Berkshire Hathaway (BRK) were partially offset by losses on IBM.

Conclusion

Broadly speaking our investment themes worked. Investing alongside the operators of energy infrastructure as they grow their asset base in support of America's developing energy independence represents a powerful alignment of interests. Holding low volatility, steady if unexciting companies means avoiding many of the more volatile names favored by active managers. We believe the Deep Value strategy is well positioned to profit from a rebound following several months of oil-related weakness. Most importantly, Henry and I value the confidence and support a growing number of clients have placed in us. Every day we are managing your money alongside our own and we never forget your trust in us. We look forward to doing more of what worked and improving on what didn't in 2015.