Published by SL Advisors, LLC

In Pursuit of Value

July, 2011

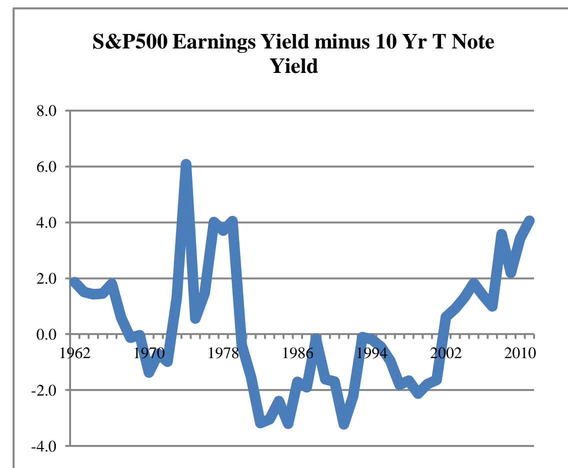
SL Advisors, LLC is a registered investment advisor offering separately managed accounts to individuals, family offices and institutions.

Quarterly Outlook

In a contest for which country can cause the most financial turmoil, Greece clearly punches above its weight. To illustrate by comparison with some U.S. states: Greece's GDP of $330 BN puts it between the states of Maryland and Washington; its population is about the same as Ohio (11.3 million). But its per capita GDP ($29,200) is lower than the poorest state, Mississippi ($33,000). In short, Greece may not be big but it is a big story.

The entire population of believers in Greek solvency now work at the IMF, EU or ECB, and for the rest of us watching their reluctant journey to inevitable restructuring evokes the Kubler-Ross "Five Stages of Grief" model (credit to Michael Cembalest, JPMorgan Private Bank, for first using this analogy). We think we are somewhere between Depression and Acceptance. John Lipsky, with whom I once worked at JPMorgan and who is now acting IMF chief, supported the latest bailout by noting that, "The whole package is pro-growth," in an interview with MarketNews.com. John's comments are without doubt the thoughtful result of careful analysis; we'll simply note they're at odds with the views expressed in Syntagma Square or in the 50% market discount currently applied to Greek debt.

In our Fixed Income Strategy we own no Greek debt but our investments are mindful of its impact. Miniature U.S. interest rates provide meager income, and for that we had been investing up to 35% of our assets in non-US$, mainly in emerging markets where growth, inflation and interest rates are higher. However, during 2Q11 we reduced this position; the pending collision of hope with reality (aka the EU sovereign debt crisis) has the potential to make the US$ comparatively more attractive which passes for a bullish view on the US$ nowadays. Given the current uncertainty we have brought most of these assets "home" and are now solidly committed to high grade US$ corporate bonds with an average maturity of two years. Long term bonds remain unattractive (on which more below) and perhaps the end of quantitative easing will allow yields to rise to fairer levels.



Recent economic weakness has stretched the elastic connecting valuations of equities with fixed income. Stocks fell faster than earnings forecasts, and the corresponding fall in bond yields resulted in an exceptionally wide gap between equity yields (the inverse of the P/E) and 10 year treasuries. Consensus 2011 earnings on the S&P 500 are around $95, which produces a P/E of 13.9 (or an earnings yield of 7.2%). Compared with ten year treasury yields of 3.15% that suggests an equity risk premium of over 4% which, as the chart shows, is historically pretty wide. There's a reason prices are where they are, and the bearish case for stocks and GDP growth has to be acknowledged. In fact it may just be that bonds are an exceptionally poor investment and stocks are simply not as bad. For our part, while we subscribe to the former we can point to stocks that we believe will be good investments. Therefore our equity accounts and our Deep Value Equity strategy remain fully invested.

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

Attractive values can be found in some very large, low beta names such as Kraft (KFT), Microsoft (MSFT) and Johnson and Johnson (JNJ). These all provide broad exposure to global GDP growth at or below market multiples (in the case of MSFT substantially below). They provide a steadying counterweight to the more volatile investments that dominate our Deep Value strategy and the second quarter's weak equity market highlighted their usefulness. Such names also tend to be under owned by active managers because their low volatility often means they lag a rising equity market, as we noted in our April quarterly letter. However, after adjusting for the lower volatility they generally do well (http://seekingalpha.com/article/257956-low-beta-stocks-look-particularly-compelling-today).

We continue to have about 20% in natural gas E&P names. Weak oil prices weighed on the energy sector, but we believe the thematic story is still intact. Range Resources (RRC) is our biggest holding, but we also own Southwestern Energy (SWN), Petrohawk (HK), Devon Energy (DVN) and Comstock Resources (CRK). The New York Times has been running a series of articles under the title "Drilling Down" which examine the environmental issues with hydraulic fracturing (the process by which shale gas is released from the porous rock formations in which it's found). A recent article in the series focused on reserve estimates provided by different companies and used selective e-mails and other documents from various government agencies to cast doubt on the estimated ultimately recoverable (EUR) reserves reported by some companies on their balance sheets. Shale gas wells do have much faster decline rates than conventional wells as the high pressure quickly dissipates. Whether EURs prove to be too high, the current glut of natural gas highlights the industry's success at extracting it. They also commented on Chesapeake (CHK) and their relatively aggressive accounting policies. CHK is the name others in the industry consistently denigrate. Their discoveries are "lucky", their accounting "imprudent" and so on. For our part CHK's risk appetite is beyond our tolerance, so we have never been an investor. As the poster child for independent natural gas E&P names though, they do bear watching. Overall the New York Times series was deeply researched, and while reflecting a liberal bias it nonetheless represents a useful contribution to the ongoing debate.

We've been adding exposure to certain retail stocks. Family Dollar (FDO) is a new name. So called "Dollar stores" meet the needs of low income consumers and in a weaker economy tend to see increased demand from cash strapped buyers. We think FDO is attractive because it's under pressure to improve its operating efficiency to catch up with its peers. Management turned down a buyout bid earlier this year at higher than the current stock price and the company continues to buy back its stock. We expect further focus on steps to increase value for shareholders. Although FDO has over 6,800 outlets in the U.S. and expects to open 300 new ones this year, the socio-economic circumstances of Westfield, NJ do not present an attractive profile for FDO's New Store Location team. Nonetheless, we have traveled beyond our immediate neighborhood to conduct field research.

We also added to our investment in Aegean Marine Petroleum (ANW). Even for value investors looking for unloved stocks, the shipping sector taxes intestinal fortitude. Years of new builds ordered during better times assure that global shipping capacity growth will continue to outpace demand. ANW provides bunker fuel to this expanding market, and so operates with a different business model than their customers. Although margins were under pressure last year, their most recent quarter saw a reversal of this trend. They're also growing revenues strongly, and next year will begin a 20 year contract to supply fuel at both ends of the Panama Canal. We expect higher revenue and recovering margins to lead to improved earnings and a higher stock price for this company.

Finally, in a story just too delicious to pass up, Infovest21 reports that Vikram Pandit, Citigroup's CEO, will soon receive the final $80 million payment agreed when Citi acquired his fund of hedge funds Old Lane when he joined the company. The fact that Old Lane no longer exists, having long ago been written off and the few remaining assets quietly shuffled off to SkyBridge, places this squarely in the "You can't make this stuff up" category. A deal's a deal.

The many positive comments we receive on this newsletter and other communication are most welcome. Please keep them coming and enjoy the Summer!