Published by SL Advisors, LLC

In Pursuit of Value

July, 2012

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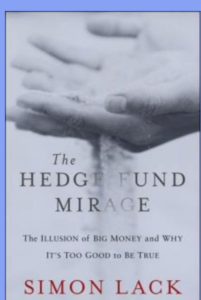
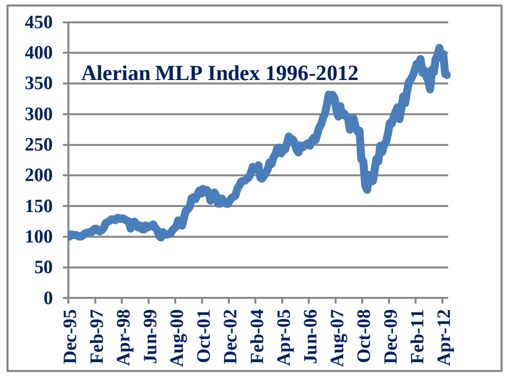


MLP Update

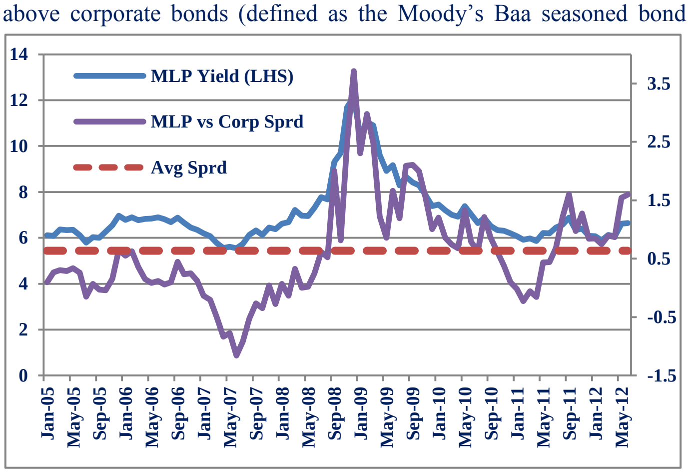
Master Limited Partnerships (MLPs) are attractive income generating investments that belong in most taxable portfolios for those clients willing to deal with K-1s for tax filing as opposed to 1099s. Current distribution yields are above 6% and typically most of those distributions are characterized as a return of capital for the investor, resulting in a deferral of the income tax liability on that income.

MLPs have generated a total return of 15% p.a. since 1996 according to the Alerian MLP Index (AMZX). The combination of attractive distribution yields and steady distribution growth linked in many cases to PPI creates an attractive risk-return profile. MLPs are equity interests and can suffer sharp moves as happened for example in 2008 when retail investors and hedge funds were aggressive sellers. However, the businesses are far more stable than their equity price moves might suggest, and a diversified portfolio owned without leverage can provide a useful source of income.



So far this year the performance of MLPs has been relatively poor. Following a strong 14% return in the AMZX last year, weak demand has caused the sector to lag both stocks and bonds through 1H2012. YTD performance for MLPs is -0.4% compared with +9.5% for the S&P 500 and +5.7% for the Dow Jones Corporate Bond Index. However, MLP fundamentals haven't weakened, and the result is that lower prices combined with continued distribution growth have pushed MLP yields higher to attractive levels compared with corporate bonds.

The chart below shows the current yield on the Alerian Index (6.6%) and highlights that it's currently 1.6% above corporate bonds (defined as the Moody's Baa seasoned bond index, equivalent to S&P BBB, as published by the Federal Reserve). This is back to the widest levels seen since the Credit Crisis.



The weaker growth outlook and the consequent drop in oil prices have hurt sentiment, although midstream MLPs (which is the sector we focus on) have little direct exposure to commodity prices. They are sensitive to the volumes of oil and natural gas that they store, move and refine and to the extent that a weak economy hurts volumes that can show up in financial results. But volumes are not substantially different, and many MLPs are likely to increase their distributions by 5-6% or more. Combined with current yields of 6.5% this creates a potential one year return of 11.5-12.5% assuming no change in yields.

Tax reform is a potential concern. Prior unsuccessful Congressional attempts at taxing carried interest have not included MLPs, but should wholesale tax reform receive serious consideration following the election MLPs might suffer through the uncertainty. However, we think an adverse outcome is unlikely since the National Association of Publicly Traded Partnerships (NAPTP) is an effective lobbying group and the tax benefits largely accrue to passive investors.

In recent years a substantial number of MLP funds have been launched, including exchange traded funds (ETFs), exchange traded notes (ETNs) and closed end funds. None of them preserve the tax characteristics of the underlying investments, and while they can make sense for a retail investor with perhaps $100K to invest, the conversion of K-1s to a 1099 comes at a considerable cost in terms of additional taxes. A portfolio of direct holdings of MLPs is the most tax-efficient way to invest.

In summary, MLP valuation is relatively attractive compared to corporate bonds.

Quarterly Outlook

The economic outlook moderated during the quarter, and valuations became somewhat more attractive. Our overall view remains that conventional fixed income represents an exceptionally poor investment. Government bond yields are negative in real terms and corporate bonds are scarcely better once taxes are figured in. U.S. public policy remains one of transferring real wealth from savers to borrowers; the most appropriate asset allocation is to minimize fixed income exposure in favor of a barbell using equities and cash. The Equity Risk Premium (S&P500 Earnings Yield less 10 Year Treasury Yield) remains over 6%, a level last seen in the early 1970s. $100 of 1.6% yielding ten year treasuries could be sold, $22 of the proceeds invested in the S&P500 (yield 1.9%) and 4% dividend growth with unchanged dividend yields will cause the equity investment to generate the same after tax return as the bonds, while keeping $78 in cash. This illustrates how poor an investment bonds are. We think MLPs and our Hedged Dividend Capture Strategy are far better in terms of income generation.

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

Nonetheless, mutual fund investors continue to build their holdings in bonds, with Lipper reporting $19.9BN of net inflows in June (compared with $3BN in redemptions from equity and "mixed asset" mutual funds). Retail investors are buying what's worked, although the relentless Math as described above will inevitably lead to declining and ultimately negative returns from this strategy.

Substantial macro concerns continue to weigh on the market, including the slow trainwreck that is Euro-zone efforts to save the common currency through austerity and unclear U.S. fiscal policy including the January 1, 2013 "fiscal cliff" of sharp spending cuts and tax hikes based on current law. The outlook often appears worse from a top-down perspective than it does when analyzing individual companies; that is clearly the case today. Our Deep Value Equity Strategy remains largely invested with around 5-6% of cash available if certain target companies become more attractively priced. Our biggest thematic bet remains natural gas E&P names. The thinking behind this and our other investments can be found regularly updated on our blog.

The Economist Book Review

I was very happy to see that The Economist reviewed *The Hedge Fund Mirage* this weekend. If I could read only one weekly magazine (or newspaper since that is how they refer to themselves) this would be it. The Buttonwood column featured my book back in January, and the thoroughness of the journalist on that story (whose research included reviewing the spreadsheets I had analyzing hedge fund returns) speaks well of the rigor with which they go about their work. Such is my regard for the quality of their journalism that I would unquestioningly accept their views about my book; happily they found much to like. Meanwhile the hedge fund industry continues to support the ideas in my book by delivering mediocre results at great expense.