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In Pursuit of Value

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Seeing what you own

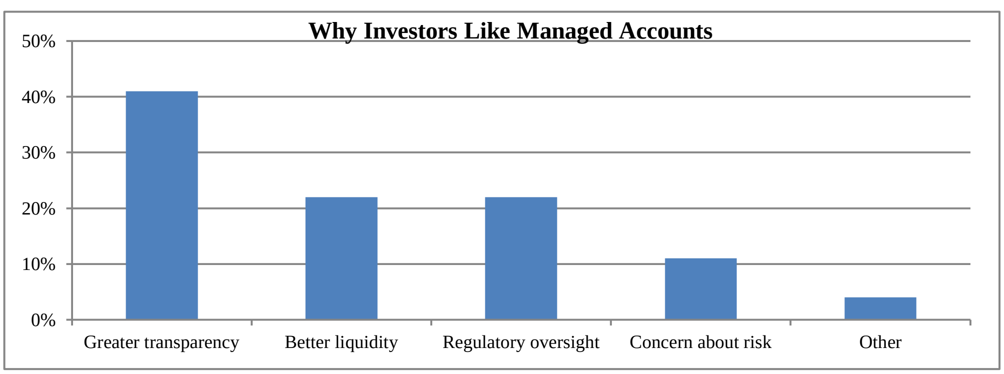
One of the few positives to emerge from the Credit Crisis for hedge fund investors has been the more accommodating attitude by many managers to their clients' needs for improved investment terms. The balance of the client vs. manager relationship has long favored the latter, with fund structures, fees, transparency and liquidity all designed to support the hedge fund manager's business. Traditional assets are routinely managed through separately managed accounts (SMAs), and there is evidence that the hedge fund industry is increasingly moving in that direction.

Two recent papers written by institutional investors should provide further impetus to this movement. In "Separate Accounts as a Source of Hedge Fund Alpha" Chris Vogt of Allstate Insurance and Deepak Gurnani of Investcorp analyze their experience with SMAs across four different portfolios of investments with hedge fund managers. The co-authors illustrate the obvious benefits of transparency in allowing more detailed risk analysis, and custody in ensuring the safety of their assets. Additionally, they find that their SMAs also outperformed the performance of the managers' hedge fund vehicles. While the authors don't identify the reasons for this, their findings run counter to conventional wisdom that use of managed accounts carries a performance penalty in return for other benefits.

SL Advisors, LLC specializes in publicly listed closed end funds.

Andy Weisman is CEO of WR Group Holdings LP, a strong proponent of SMAs which are the basis of their business model. Andy's recent paper "Hedge Fund Investing – The Good the Bad and the Ugly" uses real examples from their own portfolios illustrating some specific benefits. He derives quite subtle insights about risk and managers' behavior that could not have been gleaned as an LP in a fund, still the prevailing investment structure. In one case his team identified a manager's potentially illegal trade related to a secondary offering, and the manager's reluctance to correct his error ultimately led to the account being closed. Another example revealed substantial short option positions for brief periods during the month. Normal month-end reporting that a typical hedge fund might provide would not have alerted the investor to his true risk exposures.

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



Source: Preqin, Feb 2010

One of my own experiences relates to a hedge fund we had seeded when I ran this business at JPMorgan. We invested directly in a manager's fund rather than through an SMA, but required complete position transparency which is rarely provided, so we enjoyed many of the benefits of an SMA. Early stage hedge fund investors help pay for growth in ways that are not always apparent. Our Day 1 $25MM investment was soon invested, and was immediately down 0.40% due to the transaction costs (commissions and bid/ask spread) of deploying our capital. The following month the manager added $25MM from a new investor and deploying their capital cost the fund (including us) a further 0.20%. Subsequent asset growth for this fund was strong, and we bore a decreasing share of the costs of deploying new money as it came in. Our seed investment prospered mightily through our equity-like fee sharing, so our share of transaction costs was recovered many times over although of course this was not the case for the other investors. Transaction costs are shared by all the investors in a fund, but not necessarily equally, as can be seen when it's possible to observe them directly.

I've gone jogging with Chris Vogt in Central Park and have played many soccer games with Andy Weisman, having known them both for several years (in truth I've sometimes jogged behind Chris given our relative fitness levels!). Chris and Andy are very thoughtful investors; their insights on this topic are worth noting for every hedge fund investor.

Closed End Fund Discounts

The sharp reduction in risk appetite that swept across markets in May manifested itself in closed end funds through modestly wider discounts and in some cases smaller premiums. A couple of months ago discounts across the entire sector were only 0.8%. Income seeking investors had pushed prices up, and some of this began to unwind as discounts widened to 2.2% (figures from Morningstar). Bank debt funds, which in April had been driven to an almost 5% premium on hopes that a Fed tightening later this year would increase loan yields, retreated to a 4% discount through the double hit of receding chances of a tightening and wider credit spreads.

SL Advisors runs three separate strategies: Fixed Income, Deep Value and Discount Arbitrage. Contact us for more information, or go to our website: www.sl-advisors.com

What We Own

Royce Micro Cap Trust (RMT) is a closed end equity fund that invests in small and micro-cap equities. In 1972 Charles Royce bought Quest Advisory Corporation and began independent practice focused on small cap stocks. Today Royce Associates runs a wide range of mutual funds, closed end funds and other investment vehicles all focused on small-cap stocks (generally market cap <$5BN). It eliminated its distribution in 2008 as investment returns were insufficient to cover the payments (many funds chose to continue payments out of principal, preserving the illusion of steady returns) and has no doubt lost many income-seeking adherents as a result. However, RMT has a good record of outperforming its relevant benchmark, and is currently at a relatively wide 16% discount to its NAV, not far from the widest levels it reached in late 2008. In fact, out of all 622 U.S. funds ranked by nominal discount to NAV it is #598. It is a holding in our Discount Arbitrage strategy.

Aspen Insurance Holdings Ltd (AHL) is a Bermuda reinsurance company that was founded in 2002 following the jump in rates after the attack on the World Trade Center. They provide insurance and reinsurance coverage on property and casualty risks globally including catastrophe, marine, aviation and other specialized areas. Their underwriting skills are well regarded within the industry. Currently this stock is trading at about two thirds of book value and has very little long term debt. This is a holding in our Deep Value strategy.