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In Pursuit of Value

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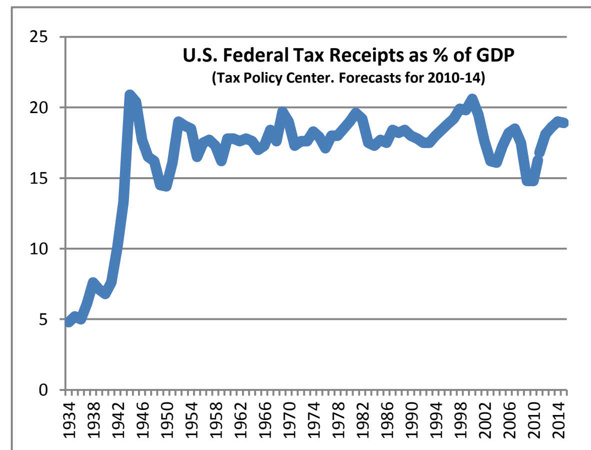
SL Advisors, LLC is a registered investment advisor offering separately managed accounts to individuals, family offices and institutions.

Taxes

October 15th was tax filing day, for those of you in need of extensions from April 15th (like me) while awaiting K-1s from investments structured as limited partnerships. When your accountant e-mails your draft tax return with a warning not to print it (it was 235 pages), something is clearly very wrong with the way the U.S. collects its tax revenues. Not surprisingly therefore, the topic at hand is Taxes.

Let me assert at the outset financial modesty. While tax code complexity is a rich subject, do not infer that this victim of complexity is in some subtle way suggesting great wealth. Many of my friends and readers no doubt have substantially greater resources. It takes less than you might think to assemble a portfolio of private investments and limited partnership interests, and while the investment results have been satisfactory overall reporting on them to the IRS is not. I am not General Electric, and reviewing for accuracy my tax returns to the Federal government, two states and a city is only possible in general terms.

That the U.S. tax code is too complex is about the only tax issue on which everyone agrees, although most would agree that taxes are too high as well. Federal taxes as a share of GDP have remained between 15% and 20% since World War II despite large changes in tax rates, and the next few years will see that share head up towards the high end of it historical band. KPMG recently issued a report on global income tax rates which found the seven year decline in tax rates is over. Top marginal rates are rising around the world, led by the UK where the 10% top rate increase (from 40-50%) was this year's highest. Flat tax structures are generally being altered in those few countries that experimented (Estonia and Latvia) but top marginal tax rates are largely in the 30-50% range. Nine countries have no income tax, and not all of them require moving to the Middle East (Bermuda and the Cayman Islands hold a certain appeal). The U.S., with its 35% top marginal rate (for now) appears quite reasonable. However, the top tax rate in the U.S. is not 35% as anyone who lives here knows too well. State and city taxes can drive that up to 50%, and KPMG like many others who analyze the issue excludes these taxes from their report. 50 states make the tax code too complex for KPMG as well, but the incomplete comparison is almost as annoying as the tax code itself. When the top marginal Federal rate inevitably rises, U.S. residents of high tax states will be worse off than all OECD countries except those in Scandinavia, and even non-OECD China.



41 states in the U.S. impose their own state income tax. They are not required to ensure consistency with neighboring states either – in fact, a New Jersey resident that works and maintains a pied-a-terre in New York City can easily find both states asserting primary residency and thus taxing all income (including investment income not earned in either state) at higher, resident (rather than non-resident) rates. Most people would assume you can only have one primary residence, and would further assume that where state rules create the seemingly impossible, the Federal government can impose order. In this case, most

people would be wrong. States' rights, whose limits we thought were defined through the Civil War, still flourish in the tax code. Evidently at least one northern state which successfully fought to constrain states' rights still sees fit to assert them in its collection of revenue.

Certain states have implemented bizarre tax regulations, showing both ingenuity and a sense of humor. For instance, according to the Tax Foundation: Alabama taxes the sales of playing cards and also requires retailers of cards to obtain a license; Illinois taxes candy at a higher rate than food (though happily Twix bars are food – Lincoln would surely smile); and several states as well as the Federal government tax income from illegal activities (such as drug dealing). Well, why not?

Ensuring compliance with the tax code creates employment for 73,000 tax examiners (as of 2008) and few will question the Bureau of Labor Statistics' forecast that their employment totals will keep up with the economy as a whole.

What We Own

Boulder Investment Advisors in Boulder, Colorado runs two eponymous closed end funds (**Boulder Growth and Income Fund, BIF; Boulder Total Return Fund, BTF**). The funds are similar, in that they hold substantial positions (around 25%) in Berkshire Hathaway (BRK/A) along with smaller positions in Wal-Mart (WMT), Johnson & Johnson (JNJ) and others large cap stocks. The PM Ernest Horejsi clearly admires Warren Buffet not just as an investor but also in the way he describes his investing style. Although both funds used to sport double digit distribution yields, these were suspended in 2008 and consequently both funds' prices have dropped to close to a 20% discount to NAV. They are among the cheapest closed end funds in the market. We currently favor BTF but follow both quite closely.

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

Perhaps recognizing this potential value opportunity, Eric Horejsi and other insiders own 41% of BTF. The question is, how will they exit? They could of course keep these positions indefinitely, and perhaps even transfer them to heirs at the appropriate time. However, if the insiders are planning to realize value in the next few years (through a special distribution, a share buyback or even converting to an open-ended mutual fund) the lame-duck session of Congress will likely clarify the tax consequences of their options, and perhaps inspire a value-creating move late this year before a possible increase in capital gains tax for 2011. The downside for shareholders if Boulder does none of these things is limited given the wide discount. We currently own BTF in our Discount Arbitrage Strategy.

WisdomTree Dreyfus Emerging Market Currency (CEW) is an ETF that provides long exposure to a basket of emerging market currencies. Unusually though, it does this by investing its cash in short dated U.S. agency debt and using FX forwards to generate the desired currency exposure. We continue to maintain 15-20% of our fixed income investments in non-US dollar currencies – it's one of the few areas that still provides decent yields as the Federal Reserve squeezes the last bit of return out of domestic bonds.

We have reduced our exposure to BZF, a similar WisdomTree ETF but focused 100% on Brazil. The Brazilian Real has rallied strongly and so we've rotated some of this exposure into the more diversified CEW. While short term interest rates in Brazil are above 10% and the currency has further appreciation potential, the authorities have been taking steps recently to limit inflows. In addition that bellwether of currency values the Economist Magazine's Big Mac Index shows it to be one of the most overvalued currencies on a purchasing power parity basis. For the U.S. investor in need of income, part of the solution is to be found outside the U.S. CEW is a holding in our Fixed Income Strategy.