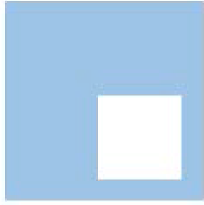

ATR Advisors

ABSOLUTE TOTAL RETURN
FOURTH QUARTER 2014 COMMENTARY

By: Shawn Blau, PhD

The fourth quarter was a very challenging one for ATR, and a real "gut check" for the ATR portfolio.

After strongly out-performing the S&P 500 Stock Market Index in the first half of the year, we ended up under-performing the S&P 500 Index in the second half of the year. How could this happen? Is it going to keep on happening? I'd like to use this commentary to answer these important questions.

Specifically, what happened is that two of our top investment categories – the energy Master Limited Partnerships (MLP's), and the Business Development Companies (BDC's) both under-performed in the quarter.

The MLP's, represented by the AMZX Index, were up 16.3% in the first half of 2014, from January 1 – June 30. Then, the Organization of Petroleum Exporting Countries (OPEC) changed their marketing approach, and the price of crude oil plummeted in the second half of the year. Although, most of the MLP's have little or no direct exposure to the price of oil, they were lumped in with the entire energy sector, and experienced unprecedented price volatility in the second half of the year.

Secondly, the BDC's, represented by the WFBDC Index, were up 4.24% in the second quarter of 2014. Then, they also strongly under-performed the S&P 500 in the second half of the year. In this case, the main reason was that three stock market indexes – the S&P Mid-cap Index, the S&P Small-cap Index, and the Russell 2000 Index – decided not to include the BDC's in their indexes. This forced many institutional investors, who were obligated to track one of these indexes, to stop investing in the BDC's. The industry predicts that this loss of institutional investors will eventually be replaced by individual investors. But, the process was not completed by the end of 2014.

It is our strong belief that the mid-stream MLP's, and the BDC's, both represent excellent values at these levels. And we do normally expect any one of our sectors to under-perform in any one quarter – or else we could never buy stocks at an attractive price. But this is one of the first times that two of our biggest sectors both under-performed in the same quarter.

Our approach to analyzing stocks, which has guided the ATR strategy for the past decade, is based on our belief that when you buy a stock you're not just buying one thing which has a single value for everybody. Rather, you are buying a collection of rights that you as a shareholder have with the company and with the company's management. This collection of shareholder rights can vary; but, in general, they usually include among others the following,:

- The right to collect dividends that are announced by company management;
- The right to tender your shares of stock for "buybacks" when management announces share re-purchases;
- The right to vote on important company matters, when management brings them to a shareholder vote;
- The right to sell your shares on the open market, when other investors are willing to pay more;
- The right to participate in buyouts, when either a public or a private company decides to purchase your company.

We believe that each of the above shareholder rights, and others as well, are a separate marketplace, and at different times different investors are willing to pay different amounts for each of them. For example, sometimes investors who need dividends are willing to pay more than investors who want to participate in shareholder votes. Sometimes, it's the opposite, and the right to vote your shares may be worth more than the right to collect a dividend.

The whole ATR strategy is based on our observation that the value of dividend rights and buyback rights are both easy to calculate, while most of the others are vague and depend on "animal spirits." Therefore, we can see when the market may be under-pricing the dividend rights and buyback rights of our stocks, and we can step in and pick them up at a bargain.

Accordingly, we believe that both the MLP's and the BDC's represent significant buying opportunities at this point. However, we recognize that investors don't want to experience the price volatility that both sectors had in the 4th quarter. Therefore, we are working to keep the "value," but reduce the volatility.

It is important to remember that this is not the first time that MLP's have experienced this kind of short-term price volatility. In 2008 – 2009 during the Financial Crisis, oil dropped by a full 77% from about $145 to about $34 per barrel. Despite this unprecedented volatility, very few MLP's even cut their dividends (partnership distributions) during that period, and about 4/5 of the MLP universe either maintained or increased the cash they returned to shareholders. This created a great buying opportunity back then, in which MLP's returned about 80% (including distributions) in 2009 - 2010, and have achieved annualized total-returns well surpassing the S&P 500 since 2009.

Since the Financial Crisis, the growth of Exchange Traded Portfolios (ETF's, ETN's) and index funds have allowed hedge-funds and other institutional traders to make even larger short-term bets on energy prices. This could make short-term price moves in the MLP sector ever more volatile.

But, at the same time, the MLP sector is significantly stronger fundamentally than it was back in the Financial Crisis. Back then, the US capital markets froze, which affected the MLP's substantially. At this point, the MLP balance sheets are significantly stronger.

We have accumulated a significant amount of cash in the portfolios. We intend to put this to work in the next month or so, to take advantage of good opportunities in US companies that continue to repurchase their own shares, in US companies that are potential targets of Mergers & Acquisitions, and possibly in some European companies that may benefit from looser monetary policies by the European Central Bank (ECB) in 2015.

So, we continue to look out for long-term values in both dividend-payers, and management buybacks. However, we have a renewed appreciation for volatility, and are committed to reducing the volatility of our portfolios.

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