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## MASTER LIMITED PARTNERSHIP INSIDE OUR RESEARCH PROCESS



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*Principal*

At BOS, we spend countless hours researching the investments owned in our clients' portfolios as well as considerable time evaluating investment opportunities as they become available in a publicly-traded format. While many new products become available to investors yearly, few are selected to become part of our clients' portfolios. As we spend so many hours surveying the investment landscape and studying patterns of risk and return for new investments, we thought we would take the opportunity to share some of our recent research with you.

Recently, Master Limited Partnerships (MLPs) became a timely topic for our investment research. Some complicated tax issues related to individual MLP stock issues were resolved with the development of mutual and exchange traded funds that specialize in this sector. The resolution of these tax issues, coupled with our clients' search for yield, made MLP research a high priority for us. Our first step in the research process is an understanding of the qualitative aspects of the investment opportunity.

### *Qualitative Assessment – What is an MLP?*

MLPs were created by the Tax Reform Act of 1986 as limited partnerships that trade like stocks. To qualify for MLP status, a business must generate at least 90% of its income from "qualifying" sources. Most MLPs are involved in the distribution or storage of energy

products, though some real estate and investment companies qualify for MLP status as well.

An MLP unitholder is a limited partner who shares in the profitability of the underlying business. Corporations are incentivized to create MLPs because the MLP does not pay taxes at the corporate level. Therefore, MLP distributions are taxed only once at the unitholder's applicable tax rate. This is more efficient than the double hit to corporate earnings that are taxed first at the company level and then when distributed to shareholders as dividends.

In this environment of low interest rates, MLPs have become increasingly popular because of their typically high dividend yields. In addition, MLPs are formed with high-income businesses such as energy pipelines that have little prospect for growth but provide stable cash flows which are often guaranteed by long-term contracts.

Here is an example of the formation of an MLP. A natural gas exploration company owns a pipeline that delivers natural gas to a number of states in the Midwest and has a ten year contract for delivery through this pipeline. As is typical in the pipeline business, there are virtually no competitors. Since the contract is long-term, the company anticipates that the cash flow will be achieved despite fluctuations in the price of natural gas or demand based on economic cycles.

The company anticipates that most of its growth will come from its mainstay business, energy exploration. At the same time, it suspects that little growth will come from the pipeline business since it is operating under a long-term contract at a fixed price. As a result, the company moves the pipeline business into a partnership and acts as the general partner, operating the business and maintaining some ownership interest. The remaining interest is sold to investors who become unitholders in the partnership but enjoy the liquidity of owning a stock that is traded on the exchange.

### *Quantitative Assessment – Does the Investment Fit in our Clients' Portfolios?*



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After assessing the characteristics of MLPs, we move to a quantitative assessment of the opportunity. MLPs generally provide an attractive yield despite paltry interest rates. In addition, we see the popular press touting MLPs as “recession-proof” because the long-term nature of the underlying contracts leads analysts to believe that cash flows will remain stable even if the economy falters. If the underlying business is not sensitive to economic cycles, and total return is enhanced with a generous yield, will an investment in MLPs provide downside protection in an adverse market?

Our first step is a review of historical patterns of returns and risk to assess how an MLP fund behaves when combined with the other 12 to 15 investments we use in client portfolios. To assess this, we look at the historical return and risk patterns for a typical client portfolio, both with and without an MLP investment. Unfortunately, the data available for MLPs is limited to eight years, a short horizon for assessing the behavior of an investment. For most of the assets in our clients’ portfolios, we have data spanning 25 years or longer to give us a better understanding of how a portfolio behaves in diverse market conditions. The limited data on MLPs makes us inclined to adopt a “wait-and-see” attitude about adding MLPs to client portfolios, even though the short-term data shows some volatility reduction during the sharp declines in stock prices during the financial crisis.

Second, MLPs must be “investable”, that is, the stocks must be available in a format that is diversified, easy to trade and inexpensive. As MLPs gained popularity in recent years, a number of companies have developed mutual and exchange traded funds that pool a large number of MLPs in one publicly-traded investment. This is a positive development as we prefer to own diversified baskets instead of selecting individual stocks to represent an asset class. Pools of stocks help investors avoid the inevitable volatility that comes with any one company. With the growth in formation of MLPs, the development of funds and interest in MLPs among investors, it appears that many of the funds trade with adequate liquidity. In addition, the available funds have

expenses that, while higher than many other investments our clients own, fall within an acceptable range.

Based on our quantitative assessment, MLPs appear to be a reasonable opportunity for our clients. The proliferation of funds makes the asset class investable and affordable, and the risk-adjusted return is attractive when combined with other components of a BOS-managed portfolio. That said, we are wary of the quantitative results given the short period of returns for MLPs. This judgment is part of the third aspect of our research process.

### *Common Sense Assessment – What Could Go Wrong?*

While many aspects of MLP investing make sense, the decision to add any new asset class to client portfolios must include some element of judgment. As part of this process, we consider the potential for unanticipated outcomes that cannot be quantified in risk/return analysis. In the case of MLPs, we have the following concerns:

*Are too many investors chasing too few opportunities, i.e. is this a bubble?* The universe of MLPs is limited to roughly 70 partnerships with a market capitalization just under \$300 billion. For comparison, Warren Buffet’s Berkshire Hathaway alone has a market capitalization of \$330 billion. A search for yield has attracted many investors to the space and the popularity has encouraged fund companies to develop mutual funds and exchange-traded fund products. Risk increases as competing fund companies battle to own a piece of the small MLP fishing pond, driving up prices as they build portfolios.

*What happens if the partnership tax preference changes in future legislation?* As Congress works to resolve our long-range deficit and debt problems, the favorable tax status of MLPs could be altered or abolished. Tax-preferenced Canadian Trust structures used by many energy companies were abolished earlier this year as the Canadian government looked for additional sources of revenue.

*Is the investment really recession proof?* Like most investments, MLPs were not immune from the decline in



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stock prices that came during the 2008 financial crisis. The Cushing 30 MLP Index declined as much as the U.S. stock market in 2008. With no data available for prior recessionary time periods, the jury is still out on this claim.

*What happens if interest rates rise?* Investors must take on price volatility to earn the high yield offered by MLPs. If interest rates rise, we believe that MLPs could decline as investors search for yield in less volatile investments.

## **Conclusion**

Based on these considerations, we do not recommend the addition of MLPs to our clients' portfolios at this time. We do believe that MLPs deserve to be part of our ongoing research efforts. We look forward to sharing more insight on MLPs and other investment opportunities in our meetings with you and in upcoming BOS publications. ♦

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