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Perspectives

Master Limited Partnerships: A missed investment opportunity?

Since recent market commentary has been focused on sectors and regions that have rocketed in the last few years, investors have been left to believe that all stocks are overvalued. This is far from the case. Certainly, there are specific firms across regions and industries that have strong growth potential with depressed prices just waiting for investors to find them. But, there is also an entire sector of firms trading at prices well below the valuation of the broader stock market and well below historical averages. Many of those firms have spent the last few years cleaning up their balance sheets, improving their operational efficiency and cultivating future growth prospects, all while paying fat dividends. The industry: Energy. The investment opportunity: Master Limited Partnerships (MLPs).[1]

Yes, MLPs took a huge hit from mid-2014 through early 2016 as oil prices tanked to about $25 a barrel from over $100 over that period. Since headwinds remain, it should be understood this investment isn't for everyone. But, the current valuations at which many MLPs are priced may not reflect the balance sheet and operational improvements made since the crash of oil prices; plus there are certain areas of that market less tied to the price of oil (pipelines, for one).

According to Chickasaw Capital Management, as of May 2018, the Alerian MLP Index was trading at a discount of 29.1% to the long-term average price to distributable cash flow, while the S&P 500 Index was trading at an 11.6% premium to historical average price to earnings ratio. Furthermore, the firm notes that the average analyst consensus for the Alerian Index's yield is 8% (with a distribution coverage ratio of over 100%) and the average forecasted growth rate in cash flows is 6.5% for 2018. This is both a healthy yield and a favorable underlying growth forecast that could translate to strong returns for investors. The S&P 500, by comparison yielded less than 2% and the Bloomberg Barclay's Aggregate Bond Index about 2.5% as of mid-June.

The oil price story is important and should also be considered. After a precipitous decline, the price of oil has stabilized but at a much lower price (around $50-60 a barrel). What does this mean for MLPs? Within the universe of MLPs, investors will find firms in three main areas—upstream (exploration and production), midstream (processing, transporting, and storing), and downstream (refining, marketing, distribution). Most MLPs in existence fall within the midstream universe which is less tied to the price of oil than the other two. This is because many midstream firms simply transport oil from one location to the next and cash flows are often locked in by long-term contracts.

While there are no guarantees in investing, this seems to be an area where the fundamentals have improved and the valuations look reasonable. For investors who agree with this assessment, there are a number of ways to gain access to MLPs, each with their own quirks and caveats.

How to Invest

There are typically two ways an energy firm is structured, which has implications for investors. The first is a traditional corporation, which is like any other publically traded firm. The second is a master limited partnership (MLP), which takes the tax benefits of a partnership (where profits are taxed only on distributions made to investors) and adds the liquidity of a publicly traded company. On the issue of taxation, a traditional corporation is taxed on the profits it earns, and the distributions paid to shareholders are also taxed (double taxation).

Investors generally prefer to own diversified mutual funds or similar, rather than owning a single energy firm or MLP. From here, there are two types of mutual fund structures (open, closed, and exchange traded alike) to choose from. The first is a traditional mutual fund which is called a Registered Investment Company (RIC). This is exactly like any other mutual fund in existence (again, open, closed,

1 Mesirow Financial Retirement Planning and Advisory ("RPA") owns Master Limited Partnerships ("MLPs") in their client accounts. Affiliates of RPA do not currently hold any MLPs. Employees of RPA do invest in MLPs. This information is deemed to be reliable but additional diligence has not been made. Please note, investment opinions change over time.

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and exchange-traded alike) in terms of regulation, reporting, and taxation (income and capital gains are not taxed at the fund level, but are taxed once investors receive payments). One important caveat for MLP-focused funds that are organized as RICs is that they are limited (like all other mutual funds) to investing 25% in a single industry. In this case, that means no more than 25% can be invested in MLPs. The rest can be (and typically is) invested in other energy-related firms that are not organized as MLPs. The second type of structure is called a C-Corporation, which has no limit to the number of MLPs it can hold. C-Corporations are taxable at the fund level, however, and investors face double taxation from this structure (income and gains from the underlying investments are taxed at the fund level and are taxed again when paid to investors).

Which structure is best for any given investor depends on his or her time horizon, investment outlook, and portfolio goals. Because RICs are limited in the percentage of MLPs they can hold, those funds tend to have lower yields than funds structured as C-Corporations. The double taxation of the C-Corporation can hinder returns, especially in an up market, though can soften the blow during selloffs. The limitation on RICs also means there's less direct exposure to MLPs, though most RIC-structured MLP funds hold nearly all their assets in energy and related sectors, even if the MLP allocation is capped at 25%. In fact, the number of MLPs has shrunk over the years thanks to mergers and acquisitions as well as a trend of MLPs converting to traditional corporations. Investors can find a fund's organizational structure either on the firm website or within the fund's prospectus.

As with any investment, investors need to consider their entire portfolio allocation and what role each investment plays. Additionally, when investing in a fund (open, closed, or exchange-traded), investors must fully understand the fund's management team, investment process and philosophy, and historical performance patterns, especially in downturns. No investment is without risk.

About Mesirow Financial

Mesirow Financial is an independent, employee-owned firm founded in 1937. As specialists in investment, risk management and advisory services, we are committed to helping our institutional, corporate and individual clients achieve their objectives. Our professionals are inspired by an entrepreneurial desire to develop tailored solutions designed to deliver measurable results. To learn more, please visit mesirowfinancial.com.

Sources: Morningstar, U.S. Energy Information Administration, Chickasaw Capital Management

The Standard & Poor's 500 Index, often abbreviated as S&P 500, is an American stock exchange market index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ. The S&P 500 index components and their weightings are determined by S&P Dow Jones Indices.

The Alerian MLP Index is the leading gauge of energy Master Limited Partnerships (MLPs). The capped, float-adjusted, capitalization-weighted index, whose constituents represent approximately 85% of total float-adjusted market capitalization, is disseminated real-time on a price-return basis (AMZ) and on a total-return basis (AMZX).

The Bloomberg Barclays US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market.

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