



Investment Strategists for  
**Successful Families**



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### Bleak Outlook? MLPs May Help Cushion Against Market Volatility

Professional investors, like meteorologists, spend a lot of time studying probabilities. That is because, just as the direction of the recent Hurricane Irene featured a "cone of uncertainty," the financial markets often change course without warning and can wreak havoc on investor portfolios.

Alternative investments, including Master Limited Partnerships (MLPs), may help limit damage from the inevitable financial storms that investors may face. In today's uncertain economy and volatile markets, MLPs - while not immune to the market's gyrations - can provide attractive yields and relatively low correlation to the stock and bond markets.

MLPs essentially operate like toll roads. They collect fees to transport or store natural resources, most commonly oil and natural gas. Traditional MLPs generally fall within four categories: pipelines, terminals/storage, marine transportation, and midstream services.

Over the past decade, the energy infrastructure MLP market has grown tremendously, from about \$20 billion in 2000 to more than \$150 billion today. Similar to the evolution of Real Estate Investment Trusts (REITs), which took decades to catch on with mainstream investors, MLPs only began to attract significant attention from individual investors over the past few years. This was likely due to the stock market collapse of late 2008 and early 2009, as well as the historically low yields on money market funds and other fixed income assets.

### Why Own MLPs?

As with any alternative investment, MLPs offer diversification benefits that can help stabilize

portfolios. They also offer the opportunity for attractive total returns through:

- **A predictable income stream.** Because MLPs are structured around long-term assets, such as pipelines and storage facilities, they offer a reliable source of income. Unlike a direct investment in oil or natural gas, however, energy-related MLPs are less dependent on commodity prices and more dependent on energy demand and volumes. Demand for energy is far less volatile than energy prices and has steadily increased over time, resulting in predictable cash flows for companies in these industries. As long as Americans continue to drive their cars to work and heat or cool their homes and offices, U.S. demand for energy will more than likely continue to grow.
- **Attractive yields.** Average yields for MLPs far exceed those currently available from investment-grade bonds. For example, the JPMorgan Alerian MLP Index exchange traded note (AMJ) currently yields 5.04%, which is about 300 basis points higher than the 10-year U.S. Treasury bond. The distribution rates on most individual MLPs currently exceed 7%.
- **Rising distribution rates.** MLPs have historically been able to increase their cash flows and their distribution rates over time. This has enabled investors to keep pace with, and in many cases, outpace inflation.
- **Low correlation.** While MLPs are not immune to stock market volatility, over longer periods they have exhibited fairly low correlation to stocks and bonds. From 1996 through 2009, MLPs, as measured by the Alerian MLP Index, exhibited a 0.32 price correlation to the S&P 500 Index<sup>1</sup> and a 0.04 correlation to the Barclays Aggregate Bond Index. More recently, from the market's peak this year (April 30, 2011) through August 31, MLPs (as measured by the JPMorgan Alerian MLP Index exchange traded note, AMJ) were down 4.6%, while the S&P 500 was down 13%. Obviously this is only a short period, but it shows how MLP performance can differ from that of the broader stock and bond markets.

What Are the Tax Issues?

MLPs trace their roots back to the Tax Reform Act of 1986. Among other objectives, the Act tried to remedy some of the tax evasion schemes that plagued earlier efforts by Congress to spur investment in energy and natural resources through limited partnerships. The new regulations required MLPs to generate at least 90% of their income from qualified sources, mostly related to natural resources such as oil and natural gas. As a result, the majority of MLPs today reside within the energy sector.

Because they are structured as partnerships, MLPs do not pay corporate income taxes. Taxes are only paid when distributions are received, thus avoiding the double taxation faced by investors in corporations. The general partner (GP) manages the operation and receives a small percentage of the profits. Individual investors act as limited partners and enjoy the lion's share of the cash flow through quarterly distributions. MLPs trade like stocks on the NYSE and NASDAQ.

Among institutional investors, however, MLP ownership remains low. That's because MLP distributions and income allocations are considered non-qualified sources of income, which makes it challenging for mutual funds and other registered investment companies to manage the tax reporting requirements when they own them. In addition, investors generally should not own MLPs in IRAs, pension or profit sharing accounts as they generate Unrelated Business Taxable Income (UBTI). If the account earns more than \$1,000 of UBTI annually, the UBTI income above \$1,000 is subject to tax even though the securities are held in a retirement account.

Risk Factors

As with any high-yield investment, MLPs do come with risks. Perhaps the most obvious, yet

least likely, is the risk that regulators may tinker with the favorable tax treatment that MLPs currently enjoy. In fact, President Obama has made references to closing certain "tax loopholes," that could jeopardize the ability of MLPs to pass through taxes to limited partners. Given today's highly-charged political climate, however, we don't believe any significant changes to the tax code are likely to occur.

The fees that MLPs charge their customers are currently pegged to the Producer Price Index, plus an additional 2.65%. These fees are regulated by the Federal Energy Regulatory Commission (FERC), and thus are also subject to regulatory risk.

A decline in the demand for energy could also have a negative impact on the volume of oil or gas that passes through pipelines and storage facilities. However, with a growing U.S. population that continues to migrate to the suburbs, any significant, long-term decline in energy demand remains unlikely. In fact, most forecasters expect that North American demand for energy will continue to grow in the foreseeable future, despite increased conservation efforts and the growing use of alternative energy sources.

Looking at the other side of the supply/demand equation, a major terrorist attack or a war in the Middle East could disrupt the supply of oil or natural gas that flows through pipelines and storage facilities. Such a disruption could damage MLPs' ability to generate revenue.

A significant rise in interest rates would also have a negative short-term impact on MLPs, as their high yields relative to other fixed-income assets are one of their primary appeals. For example, in April 2004, yields on the 10-year U.S. Treasury rose 100 basis points over the course of 20 days, which caused yield-sensitive equities, including REITs, utilities, and MLPs to decline 14% - 18% during that period<sup>2</sup>. However, it's important to remember that MLPs have the ability to increase their cash flows and distribution rates, which can help offset the impact of rising interest rates.

### Gaining MLP Exposure Through Mutual Funds

Understanding the risks that are involved with individual MLPs requires specialized expertise and research. Therefore, we prefer to gain exposure through mutual funds that specialize in MLPs. While there aren't many available options, several do exist that are operated by seasoned managers with a long history in the MLP arena. We believe fund managers who concentrate in this space have the resources to research the best opportunities and assess the quality of new entrants to the field, while providing additional diversification benefits. Mutual funds also simplify tax reporting for investors by providing a single 1099 form, rather than individual K-1 forms.

At Emerald, we own MLP funds within two of our investment strategies - *Hybrid* and *Global Cycle*. We entered these positions toward the end of last year and they represent average weightings for each respective portfolio. We like having exposure to this space in Hybrid, given the relatively low market correlation that MLPs have exhibited, their ability to deliver absolute returns over longer periods, and the steady income stream that they typically provide. The same investment rationale applies to owning MLPs in our Global Equity model. In this case, the specific energy infrastructure theme associated with MLPs also aligns well with the Global Cycle strategy. This strategy focuses on selective investment themes that we believe offer considerable growth potential over the longer-term. Energy infrastructure remains one such theme, given the current economic landscape and the opportunities that we expect to develop in that area.

In sum, MLPs offer a compelling alternative to other traditional investment styles. In today's highly volatile and unpredictable equity markets, ongoing global economic concerns, and

historically low yields, we believe MLPs can provide a reliable source of income from a favorable sector, while also offering the potential for attractive total returns over longer periods. Given the recent market pullback and ongoing roller coaster ride we are likely to face, MLP's attractive total return characteristics have earned them a prominent place in two of our strategies.

1. Source: Master Limited Partnership Primer, SteelPath Fund Advisors
2. Ibid

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## Disclosure Green Thought\$

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