Master Limited Partnerships: An option for investment diversification

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Diversification is an important part of a sound investment strategy. Yet achieving true diversification requires investment vehicles that have low correlation to one another—in other words, they don't react in a similar manner to market developments. During periods of significant economic growth, typical investments tend to demonstrate significant correlation, even across dissimilar industries. Investments that are minimally correlated with the market as a whole are challenging to find. This, plus a history of strong returns, may explain a growing interest in investments known as master limited partnerships (MLPs). In this article, we will provide an overview of what MLPs are, their potential benefits, risks and tax treatment, and the vehicles available for investing in them.

WHAT ARE MLPs?

Generally speaking, MLPs are businesses that operate under a partnership structure rather than as a typical C corporation (whose income is taxed at the corporate level and then taxed again when it is distributed to owners through dividends). MLPs are pass-through entities, which means they are not taxed at the corporate level; instead, distributions from MLPs are taxed as income of the individual partners. MLPs are businesses that own or operate real or tangible assets, but investing in them does not require purchasing or operating the assets themselves.

MLPs are especially prevalent in the energy and natural resources industry. They enable investors to gain asset exposure through ownership of pipelines, terminals, and storage facilities—yet without requiring the investor to personally own or operate these assets.

In the energy industry, MLPs operate in three segments of the supply chain:

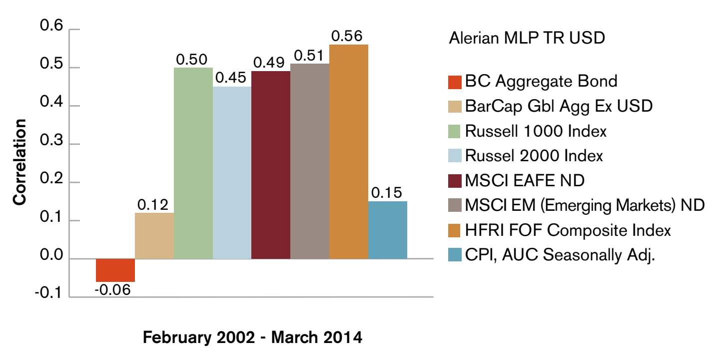
- Upstream: Resource exploration and production (18%)
- Midstream: Transportation via oil and natural gas pipelines (72%)
- Downstream: Refining into finished products (10%)

The supply chain segment in which an MLP operates can have a significant impact on its risk profile. Upstream and downstream segments are more volatile in nature due to their business model. Because they actually take receipt of the commodity, their value fluctuates significantly with the price of that commodity. Midstream MLPs never own the commodity. They simply charge a fee for transportation and storage of the commodity. Therefore, midstream MLPs have minimal exposure to commodity price fluctuations and tend to be less volatile.

BENEFITS OF INVESTING IN MLPs

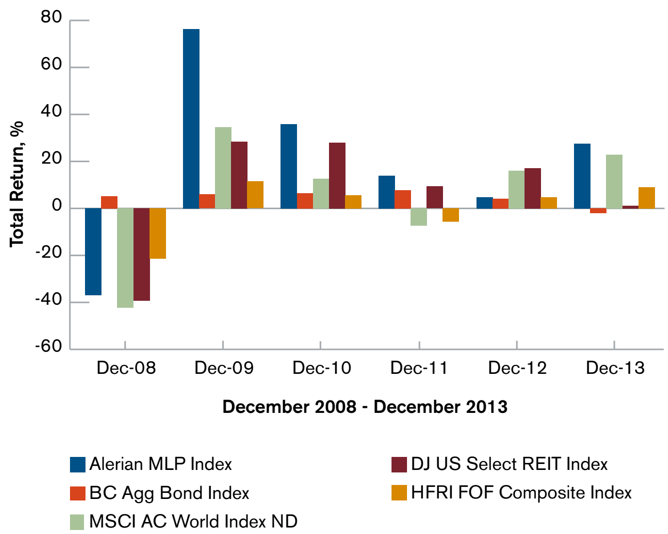
One of the most common reasons for investing in MLPs is to diversify a portfolio's returns. MLPs have a fairly low correlation to most asset classes and over the past decade-plus have been negatively correlated to the broad fixed income market. The following chart shows the correlation between the Alerian MLP Total Return Index (a widely known benchmark of energy MLPs representing about 75% of the available energy MLP market) and other capital market indices, demonstrating negative correlation between MLPs and the broad fixed income market and medium to low correlation with other asset classes.

FIGURE 1: CORRELATION OF MLPs TO OTHER ASSET CLASSES



Although past performance is no guarantee of future results, MLPs have performed well over the past several years compared with other asset classes that are considered to be good diversification options. The following chart shows that MLPs (as represented by the Alerian MLP Index) have outperformed the Barclays Capital U.S. Aggregate Bond Index, the MSCI All Country World Index, the Dow Jones U.S. Select Real Estate Investment Trust (REIT) Index, and the HFRI Hedge Fund Index in four of the last six calendar years.

FIGURE 2: ANNUAL ROLLING PERFORMANCE

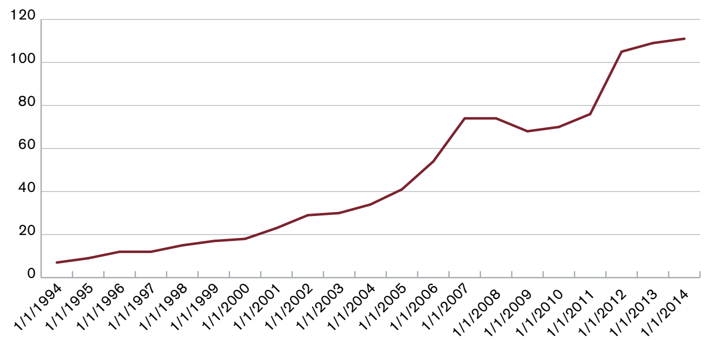


MLPs have other benefits as well:

- Many types of real assets have little liquidity, and their value cannot be known with certainty on a day-to-day basis. MLPs, on the other hand, are bought and sold like any publicly traded security and, as a result, have excellent liquidity.
- MLPs offer investors a steady income stream with regular cash distributions and the opportunity for capital appreciation. They distribute cash flow to their investors in a fashion similar to how dividends are distributed by C corporations.
- MLPs can also assist in protecting against inflation. For instance, the Federal Energy Regulatory Commission annually adjusts tariffs on the oil and gas pipelines to the Producer Price Index for finished goods plus 2.65%.
- Because they are partnerships, MLPs do not incur the double taxation that corporate profits do.

All of these benefits have led to strong growth in the MLP sector.

FIGURE 3: GROWTH IN THE NUMBER OF ENERGY MLPs



Source: National Association of Publicly Traded Partnerships

RISKS OF INVESTING IN MLPs

Historically, the most significant risk of investing in MLPs has been regulatory risk. If the tax structure or treatment that governs MLPs were changed significantly, it could dramatically affect the entire asset class. However, the federal government broadened the definition of what types of businesses qualify as MLPs in 2008. The risk that the MLP tax structure would change in a negative way for investors in the near future does not seem likely.

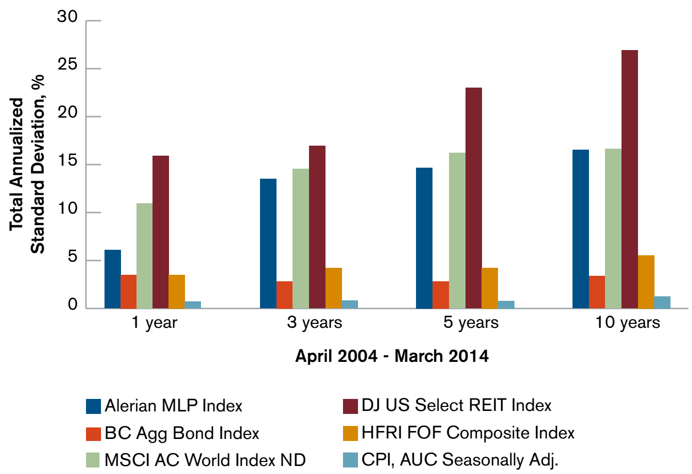
Another significant risk of investing in MLPs is tax risk. For taxable or individual investors, MLPs provide a tax-advantaged investment in which a significant portion of cash distributions is tax deferred. However, for some tax-exempt institutional investors such as corporate retirement plans, endowments, and foundations, MLPs can be problematic because of the generation of unrelated business taxable income (UBTI), which is income earned from business activities unrelated to an investing entity's tax-exempt purpose. This tax treatment and the associated administrative burden are the main reasons why some tax-exempt institutional investors have historically not invested in MLPs.

Although corporate retirement plans, endowments, and foundations are subject to tax on UBTI, some of the larger institutions may be equipped to handle UBTI issues with experience from other investments. In addition, some investment managers offer solutions that address tax and administrative issues. The vehicles used by investment managers have both pros and cons depending on the legal structure of the investor. Public pension plans to this point have been considered to be exempt from tax on UBTI. Ultimately, investors should seek advice from a tax advisor and investigate all tax implications before any investment is made.

The volatility of MLP returns can be significant. Recently, new types of MLPs have been launched. These new MLPs are outside of the traditional MLP pipeline and energy infrastructure industries. Instead of paying regular cash distributions, many of these new MLPs pay variable distributions. While the yields they offer are higher, these new nontraditional MLPs are much more volatile and risky compared to midstream energy MLPs.

The following chart shows the short-term and long-term volatility of MLPs as measured by standard deviation. Over the past one-, three-, and five-year periods, the Alerian MLP Index had less risk than global stocks and domestic REITs, but more risk than the broad fixed income market and hedge funds, as represented by the HFRI FOF Composite Index. Over the past 10-year period, the standard deviation of MLPs was in line with global stocks, significantly lower than the risk of domestic REITs, but significantly higher than the broad fixed income market and hedge funds.

FIGURE 4: RISK TO DATE



MLP INVESTMENT OPTIONS

There are a variety of ways to invest in MLPs. Shares in individual MLPs can be purchased on major exchanges as with any other security. They can also be purchased as part of:

- Mutual funds
- Closed-end funds
- Exchange-traded funds (ETFs)
- Exchange-traded notes (ETNs)
- Commingled funds
- Separate accounts

In addition, there are a variety of products that include MLPs as one sleeve of a portfolio, along with other sleeves or asset classes such as real estate, floating rate debt, Treasury inflation-protected securities (TIPS), convertible securities, commodities, and natural resource stocks. When investing in these diversified products, the exposure to any one asset class or type of security is limited, thus reducing the risk to the investor when one of the asset classes is struggling. Careful consideration should be given to the structure selected, and the tax implications of the same, prior to investment to make certain that the product or vehicle to be utilized meets targeted goals with maximum tax efficiency.

CONCLUSION

For investors seeking an asset class with a relatively low correlation to most other asset classes and the potential for strong returns, MLPs are worth considering. They offer liquidity, regular cash distributions, and some protection from inflation. If investors decide to add MLPs to their portfolios, they have many options to choose from. The key risks with MLPs are regulatory risk, tax risk, and volatility. Despite these risks, the MLP sector continues to grow thanks to the many advantages it offers.

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