U.S.News & WORLD REPORT

June 15, 2016

How to Mine for Yield with MLPs

Investors OK with risk should look at master limited partnerships.

By Jeff Brown

Fixed-income investors dismayed by skimpy earnings on bonds and bank savings might be wise to look further afield – maybe as far as the Permian Basin of Texas or Marcellus Shale country in Pennsylvania, where one can buy into an oil or gas processing plant, storage field or pipeline.

If that sounds like a game for just the big boys, think again.

Ordinary investors with a stomach for risk can play too, with master limited partnerships, or MLPs, a kind of fund traded in "units" like a stock.

FOCUS ON OIL AND GAS.

While MLPs can be set up in various industries, the vast majority of the nearly 150 in business today specialize in oil and gas.

"The typical MLP yield today is between 6 percent and 8 percent, but there are some good companies that are yielding as much as 11 percent and are poised for growth," says Jimmy Vallee, an MLP specialist and head partner at the Paul Hastings law firm in Houston.

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> — Jimmy Vallee
> MLP specialist,
> Head Partner,
> Paul Hastings
> Law Firm
> Houston, TX

MLPs can be kind at tax season, too.

Among the 10 largest MLPs, four offer yields exceeding 8 percent, according to MLP Data. They are Enviva Partners (ticker: EVA), Ciner Resources (CINR), DCP Midstream Partners (DPM) and Oneok Partners (OKS).

Many experts think MLPs are especially attractive today. Energy prices have recovered somewhat from recent lows but are still well below their peaks.

"Midstream (MLP) valuations remain attractive and we feel investors will be rewarded in the long-term as fundamentals strengthen throughout 2016 and 2017," says Matt Sallee, portfolio manager for Tortoise Capital in Leawood, Kansas, referring to MLPs that specialize in gathering, processing and transporting oil and gas. Tortoise operates a number of closed-end mutual funds focused on MLPs.

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NOT SHARES OF STOCK.

Though they are bought and sold on the stock market, or through mutual funds or exchange-traded funds, MLPs are not the same as shares of ordinary public corporations. In fact, they are not corporations but limited partnerships, Vallee says.

"Therefore, instead of two levels of tax, as is the case with a corporation, there is only one level of tax – that at the level of the unit holder," he says. "Moreover, deductions like depreciation are also passed through to the unit holders, thereby offsetting some or all of the unit holders share of the income, and resulting in the actual taxable income to the unit holder being very low."

The low taxes and allowance for depreciation and other deductions help explain MLPs' relatively high yields. Depreciation, however, does add to the tax cost when units are sold.

THE MLP INVESTOR.

"MLPs are appropriate for long-term investors interested in attractive total returns, including a high level of current income," says Jay Hatfield, president of Infrastructure Capital Advisors, a New York-based investment advisor that manages exchange-traded funds and hedge funds.

"They need to, however, be prepared to accept price volatility, as MLPs tend to trade (in price alongside) more risky energy shares, even though the underlying businesses are less volatile than energy exploration companies."

MLPs are appealing because pipelines, processing and storage are used regardless of whether energy prices are up or down, so investors hope to continue receiving income even in lean times. Still, that hope can be dashed if low prices cause oil producers to stop using fields that feed the pipes, tanks and processors the MLP owns.

FOR THE LONG HAUL.

MLPs, Hatfield says, should be considered long-term holdings. "Longer term, the yield and growth in distributions are likely to offset the short-term volatility related to commodity prices," he says.

Vallee agrees. "Investors looking strictly for capital appreciation – the old buy low, sell high type of investor – should stay away from investing in MLPs, which are designed to be held for the long term to realize the full cash-flowing benefits of the investment," he says.

As a long-term holding, an MLP can also help diversify a portfolio, Hatfield adds, because they are driven by factors different from those affecting other fixed-income holdings, such as bonds.

Because of the favorable tax treatment, MLPs should be held in taxable accounts, Vallee says. Putting them in a tax-deferred account, where withdrawals are taxed as income, could actually increase the tax burden.

MLPs are best for investors seeking current income rather than long-term growth, says Matthew Spiegel, professor of finance and director of graduate studies at the Yale School of Management. This is because an investor who reinvests the dividends would be taxed on them every year, he says. That investor would be better off with a holding whose returns came through capital appreciation, which is not taxed until the investment is sold.

WHAT SHOULD THE INVESTOR LOOK FOR?

"The prudent MLP investor will look for stability of cash flow and creditworthiness in seeking out good MLP investments," Vallee says.

"MLPs that have multiple long-term contracts with creditworthy counterparties like super-major oil companies and large independent oil companies, that have a history of steady cash flow and distributions, are ideal for the MLP investor," he says.

Also, watch out for firms with too much debt, he says.

Currently, Vallee recommends "midstream" MLPs which

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specialize in gathering, processing and piping oil and gas.

MLPs which focus on exploration and production, on the other hand, "are experiencing a significant amount of distress in the extended period of low commodity prices," he says. ■