Master Limited Partnerships

CanterburyConsulting

Master limited partnerships (MLPs) serve an important role in a diversified investment portfolio. In addition to an attractive total return, MLPs provide portfolio diversification and a potential hedge against unanticipated inflation

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Introduction

A master limited partnership (MLP) is a publicly traded partnership that receives preferential tax treatment if at least 90% of its gross income is from qualifying sources. Qualifying income includes "…income and gains derived from the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil, or products thereof), or the marketing of any mineral or natural resource (including fertilizer, geothermal energy, and timber)…."[1] More simply put, MLPs provide investors with the liquidity of stocks with the income stability of bonds, with a preferential tax benefit.

History of MLPs

The MLP originated from oil and gas upstream assets; however, the focus quickly shifted to an assortment of operating businesses, many of which had no relation to energy. The first MLP IPO was in 1981, and more than 100 additional MLPs came to market over the next seven years.[2] The proliferation of MLPs spurred Congress in 1987 to enact legislation that would severely restrict the industry. Unlike a corporation, which pays tax on its own income, the income earned by an MLP is passed through to its owners. The new legislation required that, for an MLP to be taxed as a flow-through entity, at least 90% of its gross income must be qualifying. Congress wanted to force non-energy and real estate businesses operating as MLPs to pay federal income tax. At the same time, Congress wanted to encourage companies to develop our nation's energy infrastructure by allowing them to operate under the current MLP structure. The MLP environment we know today was born from a desire to support energy independence in the United States. Our nation's growth was dependent on foreign producers, and it was important to develop and maintain a significant amount of independence.

Prior to 1997, the MLP space was immature, consisting of long-haul pipelines that generated stable cash flow and were less concerned about growth. As a result, they tended to trade like bond surrogates.

Rich Kinder and Bill Morgan introduced the modern-day MLP after acquiring pipeline assets from Enron in 1997 and forming Kinder Morgan Energy Partners, L.P. Their partnership was less concerned about the stability of cash flow and more interested in acquiring third-party midstream assets. Thanks to Kinder Morgan, distribution growth is now a top priority for many MLP management teams.

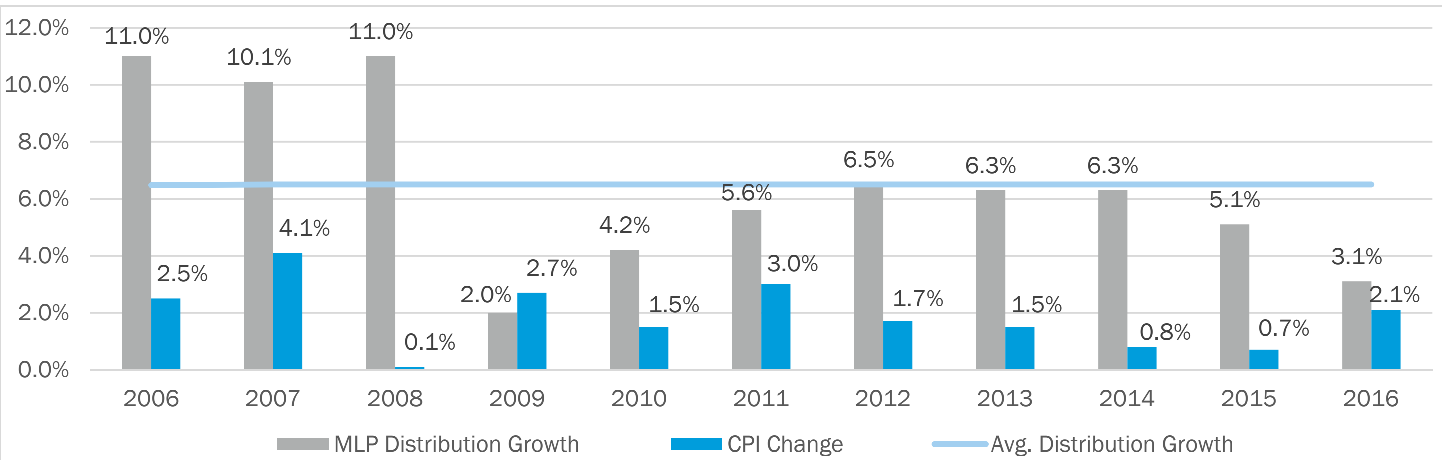
Today, energy MLPs are divided into a three-part value chain: upstream, midstream, and downstream. Upstream assets are engaged in the exploration and production of crude oil, natural gas, and natural gas liquids. Downstream assets distribute a consumable product to residential, commercial, and industrial customers. Midstream assets are focused on gathering, storing, marketing, and transporting oil and gas. Midstream MLPs are typically referred to as a tollbooth-style operation, because the income generated is similar to income received from a monthly parking permit or a highway toll. As a result, these MLPs are more significantly affected by volume than the price of the underlying commodity. This is the primary reason why Canterbury prefers allocating to midstream MLPs.

The universe of MLPs has expanded significantly over the last several years. In 1995, there were only 16 MLPs, which combined had a total market cap of $7B. Just nine years later, in 2004, there were 38 MLPs which combined had a total market cap of $100B. As of December 2016, there were 111 MLPs, with a total $400B in market cap. As of December 2016, there were 111 MLPs, totaling $400B in market cap.

Benefits of MLPs

While the origins of the industry are rooted in tax benefits, MLPs serve an important role in a diversified investment portfolio. Most MLPs achieve their total return through a combination of current yield, distribution growth, and price appreciation, which differs from traditional stocks and bonds. In addition to attractive total return characteristics, MLPs provide portfolio diversification and a potential hedge against unanticipated inflation. For many of Canterbury's client portfolios, a primary objective of MLPs is to provide a hedge against inflation. There are multiple reasons why MLPs can fill this objective:

- Since 2004, the asset class has exhibited an annual distribution growth rate of approximately 8% (which includes distributions and non-cash deductions). This outpaces even the most aggressive inflation expectations.
- The Federal Energy Regulatory Commission allows certain tariff-based MLPs (i.e., midstream assets) to increase their pipeline fees according to the Producer Price Index (PPI).
- Many storage-based MLP contracts (also a midstream asset) adjust to CPI; any rise in inflation is at least partially offset by the MLPs' pricing.



Source: Salient MLP Team (2016) White Paper

Distribution growth is the primary inflation-hedging benefit of MLPs, as it does the most to preserve purchasing power. The MLPs that focus solely on distribution yields will be less effective in a rising interest rate environment, which will decrease their ability to effectively hedge against inflation.

Risks

Maybe more so than other areas of the market, MLPs are exposed to several risks that could affect their abilities to protect against inflation and provide an attractive total return. The following are a few of the risks for the MLP space in general:

- **Economic Weakness:** A recession, or even a slow economy, could reduce capital expenditures and place pressure on commodity prices, which will have a negative effect on MLPs.
- **Interest Rates:** A rapid upward move in interest rates will likely create near-term pressure on MLPs, because investors can subsequently buy less-risky bonds trading at higher yields.
- **Commodity Prices:** Significant and sustained weakness in oil and natural gas prices that lead to future production declines would negatively impact MLP valuations and distribution growth. From 2014–2016, MLPs experienced a 58% drawdown (peak to trough) as OPEC increased oil production.
- **Correlation to Oil:** MLP's correlation to oil has been relatively stable at 0.5 (2006–2016); however, the correlation increased to 0.8 at the peak of the 2014–2016 energy drawdown. The correlation subsequently declined as oil prices rebounded thereafter.
- **Fund Flows:** Positive fund flows have been a driver of MLP performance over the past decade, fueled in part by low interest rates. However, outflows during

the recent energy downturn negatively affected MLP performance as retail investors left the space.

— **Tax Laws:** While it would require a complete tax reform, any negative adjustment to the current tax treatment of MLPs could trigger a sell-off from taxable MLP investors.

MLPs are a good diversifier, inflation hedge, and total return generator within an investor's real asset allocation. Risks pertaining to the energy complex can create short-term volatility; however, long-term trends remain positive. The continued growth in U.S. shale and the industry's emphasis on lowering costs should benefit MLPs going forward. The over-saturation of the retail investor and their focus on absolute yield also adds opportunity for active managers to outperform.

Tax Status

Since MLPs are pass-through entities, each limited partner is entitled to its share of non-cash deductions (i.e., depreciation and amortization) associated with the MLP. The degree by which these non-cash deductions reduce taxable income for each limited partner varies slightly, but most MLPs have a tax deferral of greater than 80%. For example, for every dollar of cash distributed to a limited partner, 20 cents is taxed at the limited partner's ordinary income rate in the year it was received, and the rest is deferred.

The example below illustrates the cash flow and tax consequences for a purchase of a single unit of an MLP for $20 that yields 10% and has a tax deferral of 80%.

Hypothetical Example - MLP Taxation

	Year 1	Year 2	Year 3
Purchase Price	$20.00	-	-
Sale Price	-	-	$23.00
Capital Gain	-	-	$3.00
Distribution per Unit	$2.00	$2.00	$2.00
Distribution Subject to Tax (20%)	$0.40	$0.40	$0.40
Deferred Distributions	$1.60	$3.20	$4.80
Taxation:			
Current Year Distribution (30% tax rate)	$0.12	$0.12	$0.12
Deferred Distributions (30% tax rate)	-	-	$1.44
Capital Gains (15% tax rate)	-	-	$0.45
Total Tax	$0.12	$0.12	$2.01
Total Holding Period Return, Net of Taxes			**33.80%**

Source: Salient Capital Advisors

In this example, for an MLP unit that was purchased for $20 and sold three years later for $23, the capital gain would be $3 and the amount of recapture allocated to the unit holder is $1.60 per year (or $4.80 over the three-year holding period). The unit appreciated 15%, but based on the yield and tax deferral, the total return for the three-year holding period was 33.8%, net of taxes.[4]

Similar to inherited common stock, an inherited MLP receives a step-up in its cost basis upon the death of the owner. The new cost basis is the fair market value at the previous owners' death; any capital gains or ordinary income are eliminated, making MLPs an attractive option for estate tax management.

Conclusion

MLPs serve three key roles in a diversified investment portfolio:

— Preserve purchasing power

— Generate uncorrelated returns to other asset classes

— Provide attractive risk-adjusted returns

Despite the perception as a niche segment of the market, MLPs represent a growing and well-established set of companies that play an important role in an investor's portfolio. Canterbury recommends an allocation to MLPs for any client who is interested in achieving the three goals listed above.

About Canterbury

Canterbury Consulting is a leading investment advisory firm, overseeing more than $17 billion for foundations, endowments, individuals, and families. Founded in 1988, the Company designs and manages custom investment programs aligned with each client's goals. Canterbury acts as the investment office for its diverse clients and provides objective investment advice, asset allocation, manager selection, risk management, implementation, and performance measurement. Canterbury Consulting strives to deliver performance and service that exceeds the needs and expectations of its clients.

Disclosure

The comments provided herein are a general market overview and do not constitute investment advice, are not predictive of any future market performance, and do not represent an offer to sell or to buy any security. The views presented herein represent good faith views of Canterbury Consulting as of the date of this communication and are subject to change as economic and market conditions dictate. Though these views may have been developed by information from sources that we believe to be accurate, we can make no representation as to the accuracy of such sources or the adequacy and completeness of such information.

Sources

1. *U.S. Code, Title 26, Internal Revenue Code, Subtitle F, Chapter 79, Subsection 7704.*
2. *Fenn, T. (2014). Master Limited Partnerships (MLPs): A General Primer [White Paper]. Retrieved from: https://www.lw.com/admin/Upload/Documents/Latham-Master-Limited-Partnership-Primer-2014.pdf*
3. *Salient MLP Team (2016). Master Limited Partnerships [White Paper]. Retrieved from: http://www.salientpartners.com/wp-content/uploads/whitepaper-mlp-primer-2014.pdf*

APPENDIX

Investment Vehicles

From an investment perspective, Canterbury believes the best investment vehicles available to access the MLP opportunity set meet the following characteristics.

- **Are Active:** Inefficiencies due to complexities in structure and taxation, as well as a dominant retail presence, make MLPs an attractive market to access through active management.
- **Avoid Double Taxation:** A 35% tax drag creates an undesirable headwind to performance.
- **Avoid Counterparty Risk:** There are enough risks in the MLP market without the added risk of not being paid or losing investor collateral if the counterparty defaults on payment due from them.
- **Maintain Significant MLP Exposure:** Exposure to non-MLPs can overlap with other exposures in an investor's portfolio (diversification degradation).

This leaves us with a preference towards limited partnerships and separate accounts when investing in MLPs. These structures do have the added burden of complex tax reporting and exposure to UBTI. For investors concerned with tax reporting and potential UBTI exposure, a RIC-style mutual fund could be considered. The cost to investors in this structure is generally higher fees and reduced MLP exposure (a RIC structure can have no more than 25% of its assets in MLPs).

Given the complexity of the asset class, we recommend you consult with your investment advisor prior to making an investment in MLPs.

Source: Salient MLP Team (2016) White Paper

	Passive Strategies		Active Strategies				
	ETN	ETF	Closed-End Fund	Mutual Fund (C-Corp)	Mutual Fund (RIC)	Limited Partnership	Separate Account
Liquidity	Daily	Daily	Daily	Daily	Daily	Quarterly	Daily
Tax Reporting	1099	1099	1099	1099	1099	Consolidated K1	Multiple K1s
Double Taxation	No	Yes	Yes	Yes	No	No	No
Taxation of Distribution	Interest Income	Mostly Return of Capital	Mostly Return of Capital	Mostly Return of Capital	Dividend and ROC	Mostly Return of Capital	Mostly Return of Capital
UBTI	No	No	No	No	No	Yes	Yes
Counterparty Risk	Yes	No	No	No	No	No	No
Leverage	No	No	Yes	No	No	No	No
Limit on MLP Exposure	No	No	No	No	Yes	No	No