

3rd Quarter 2011

The Role of MLPs in Investor Portfolios

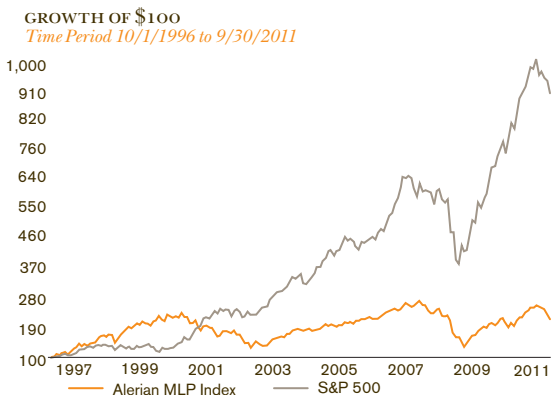
MLP Overview

A Master Limited Partnership (MLP) is a publicly traded partnership traded on a securities exchange, similar to common stocks. Unlike corporations, MLPs are not taxed at the partnership level. Instead, income and depreciation pass through to the investor. MLPs typically distribute all available cash flow in the form of quarterly cash distributions. MLPs are created when a corporate entity places assets into a partnership formed by a general partner (GP), usually the corporation, and then issues limited partnership units via an initial public offering.

“MLPs appear to offer attractive yields relative to other asset classes.”

Benefits of Owning MLPs

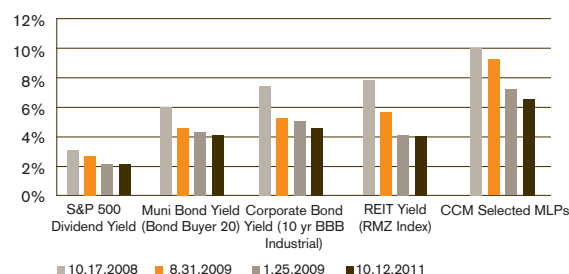
An MLP offers attractive prospects for individuals seeking tax-advantaged yields. The income produced is tax-deferred as most (typically 70-100%) of the income distribution is considered a return of capital which lowers the original cost basis. MLPs historically have low correlation to stocks, bonds and commodity prices. MLPs also act as an inflation hedge and have historically grown distributions faster than inflation. Each year from 2000 through 2010, MLPs annual distribution growth has exceeded the US Consumer Price Index.



While dramatically outperforming common stocks over the past decade, MLPs still offer high relative yields in the form of tax-advantaged income. MLPs have recovered from the distressed fire-sale levels during the credit crisis of 2008, and are now selling at closer to

normalized spreads to the Ten Year US Treasury note. Despite the contraction of MLP yields from over 10% in the fall of 2008 to just over 6% today, MLPs still look attractive relative to alternative yield opportunities.

DO MLPs STILL OFFER ATTRACTIVE YIELDS?



One of the main objectives of owning an MLP is typically for the steady, predictable distribution. In general, investment structures which rely on the “toll road” type business models of transporting hydrocarbon volumes via long-life pipeline are a good example of fee-based steady businesses having minimal commodity risk. The midstream energy infrastructure businesses such as pipelines, and some storage and gathering and processing companies are investment opportunities most likely to deliver predictable distributions.

Midstream Energy Assets

Pipelines & Storage Terminals

Pipeline and Storage MLPs tend to operate long-lived assets that generate stable fee-based cash flow and have high barriers to entry. Interstate pipelines are regulated by the Federal Energy Regulatory Commission (FERC) and are charged volume-based tariffs. Cash flows are frequently dependent upon pipeline throughput, not commodity prices. As regulated entities, the tariffs are rate-based and typically set according to the FERC rule of the Producer’s Price Index (PPI) plus 1.3%. Storage and terminal assets are also frequently fee based with minimal commodity risk. A prolonged decline in demand for crude oil and refined products could negatively impact cash flows given these companies’ reliance on volumes transported.

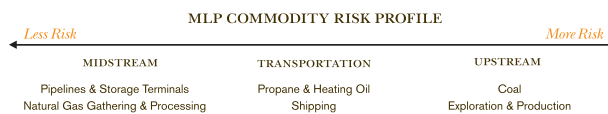
Natural Gas Gathering & Processing

A midstream processing MLP exists to extract natural gas liquids (NGLs) from natural gas

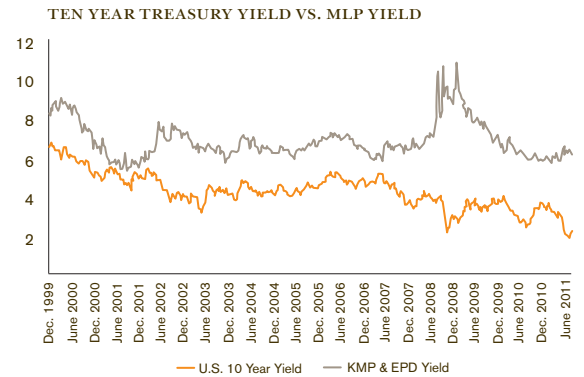
before shipping the dry gas in a pipeline. This creates value for a midstream company as NGL processing or fractionation allows as the processor to earn a margin on the product differential. This also opens the window to commodity risk if they do not transport “fee-only.” Depending upon the contract structure most MLPs in this group have a moderate to low degree of commodity exposure. However, a significant number of these companies hedge extensively to guard against a drop in commodity prices. Understanding the producing regions where an MLP operates is also an important aspect of due diligence, as all are exposed to a decline in volumes if producers elect to curtail drilling activity within their operating area.

Risks of Owning MLPs

With any investment there are inherent risks. In regard to MLPs, several specific risks need to be discussed. First, MLPs are not a monolithic asset class and consist of a variety of operating energy businesses with a range of unique associated risks. This spectrum of risk often escalates with the degree of commodity sensitivity. Within the MLP energy area there are several types of MLPs based on the underlying assets and the purpose of the entity. The diagram below graphically depicts the three major categories and the underlying risks related to the commodity exposure:



Second, valuation and interest rate sensitivity are current risks. MLPs today are trading at relatively high multiples. The potential impact of interest rates rising from generational lows would compress the relative yield investors are willing to pay for MLPs. Investors generally invest in MLPs seeking yields superior to those available in equities, treasuries, and taxable fixed income. MLPs add an additional layer of risk through execution issues, changes to the price and volume demand of the underlying commodity, and swings in interest rates. To compensate for the additional risk, investors demand a risk-premium over the risk-free rate, known as a “spread”. In a rising interest rate environment, the premium demanded by investors may suggest a lower market price of the MLP units to achieve the required spread (yield). As seen below, MLPs are back to the low end of their historic yield range, despite the wide relative spread to the 10 Year US Treasury.



The low interest rate environment has created a thirst for yield among investors. Although MLPs offer attractive yields relative to US Treasuries and other traditional fixed-income securities, many are now trading at valuations beyond our recommended target. Still, we follow the sector closely and continue to hold selected MLPs for appropriate accounts. Given constant changes in the markets and volatile price movements in MLP share prices, relative attractiveness of the securities approved for portfolio consideration is best confirmed on a real-time basis.

Third, there is a need for MLPs to grow their assets. In order to maintain the tax-deferred portion of distributions, MLPs must continue to make investments; otherwise the tax shield created via depreciation declines. MLPs must grow their asset base to have something to depreciate. This need for growth creates an acquisition treadmill and can potentially encourage MLP managers to pay top dollar for assets. Therefore, the risk of overpaying for acquisitions is heightened.

Fourth, is the potential disproportionate benefit to the GP of incentive distribution rights (IDRs) relative to the MLP. The general partner of an MLP typically receives a small initial share of the distributable cash flow which increases as the distributions rise. This is tiered so that as the available cash flows rise, the GP collects an increasing share called an incentive distribution right (IDR). MLPs with high IDRs will see slower distribution growth than MLPs with low or no IDRs. IDRs are usually capped at 50% to the GP, as high IDRs increase the cost of capital for MLPs. Some MLPs have proactively repurchased their GPs to eliminate the IDRs and others have adjusted the IDRs to a 25% maximum.

Lastly, tax reform could potentially remove the pass-through tax shield which could impact the

MLP market. Congress continues to look for ways to increase tax revenue, and the pass-through entity shield for MLPs could be at risk. The issue has come to light several times in the past few years, but recently the risk appears diminished. The American Jobs Act sought to target the carried interest provisions in investment partnerships (private equity and hedge funds), not MLPs. A study conducted by the Joint Committee on Taxation in December 2010 estimated only a \$500 million per year tax savings by taxing MLPs. The magnitude of taxing the MLP structure does not appear great enough to risk the political fallout from the constituents holding MLPs, specifically those seeking yield for income requirements.

Other Issues

There are several reporting requirements for MLP investors given the partnership structure. For Federal Tax Purposes, an MLP investor receives a Form K-1 from each partnership, adding a layer of complexity in preparation of a personal tax return. In some cases, MLPs have assets in multiple states. Therefore, if a minimum level of income required to file a state tax return is reached, the tax preparer must complete multiple filings (one for every state in which taxes must be paid). Relying on a partnership for timely distribution of Form K-1 to meet a tax filing deadline may be an additional concern for some investors. Given the tax complexity of partnerships, consultation with a tax advisor is recommended. Finally, the sale of the MLP investment presents a bookkeeping item; a portion of the

distribution is considered return of capital. Due to the return of capital characteristics of MLPs, each year the cost basis of the investment needs to be decreased with respect to the amount of capital returned. The Internal Revenue Service (IRS) places a prohibition on the generation of unrelated business taxable income (UBTI) in a tax-exempt investment vehicle (a 401k, IRA or similar structure). MLP income is considered income earned from business activities unrelated to the entity's tax-exempt purpose. When a tax-exempt entity receives UBTI in excess of \$1,000 per year, the investor is required to file IRS Form 990-T and pay tax on the UBTI. An investor needs to be cognizant of the additional layer of tax preparation cost and taxes owed.

Conclusion

Master Limited Partnerships offer high relative yields in the form of tax-advantaged income for individual investors. Despite the contraction of MLP yields from over 10% in the fall of 2008 to just over 6% today, MLPs still look attractive relative to alternative yield opportunities. However, the area is not without risk and the potential exists for interest rates to rise from generational lows, compressing the relative yields investors are willing to pay for MLPs.

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