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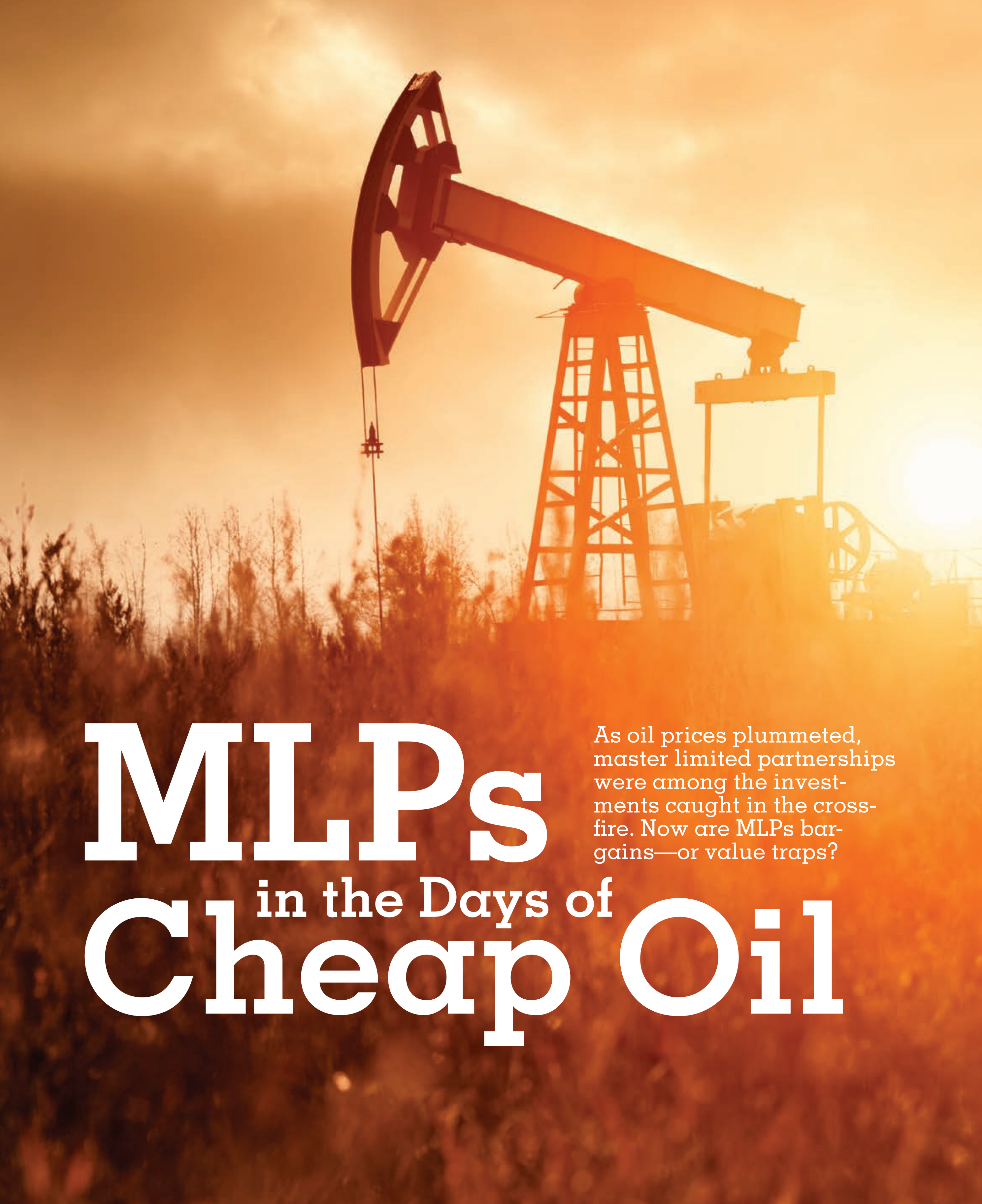

MLPs in the Days of Cheap Oil

As oil prices plummeted, master limited partnerships were among the investments caught in the crossfire. Now are MLPs bargains—or value traps?

WHEN OIL PRICES DROPPED in late 2014, investors turned their backs on almost every investment tied to the energy sector. Oil and gas stocks fell sharply, making the energy sector the S&P 500's worst-performing sector by far in the fourth quarter. The carnage extended to master limited partnerships (MLPs), the corporate structures that encourage private investment in energy-related projects ranging from drilling and exploration to transportation and storage.

MLPs fell nearly 14 percent during the fourth quarter of 2014, their largest quarterly loss since late 2008. They have continued to slide during the first two months of 2015, falling 2.5 percent. By contrast, the S&P 500 rose nearly 5 percent in 2014's fourth quarter and was up nearly 2.5 percent during the first two months of 2015. "With commodity prices falling, there was a lot of uncertainty and probably a little bit of fear, and that spread to anything related to the energy sector," says Brian Kessens, a managing director and portfolio manager at Kansas-based money management firm Tortoise Capital Advisors.

With oil prices low and volatile, and global oil demand shrinking,[1] are MLPs losing their luster? Many experts say the answer is no. In fact, portfolio managers and financial advisors familiar with the MLP space say now may be a great time to snap up bargains—as long as you choose wisely. "There are a lot of opportunities out there right now," says Brian Watson, director of research at Oppenheimer SteelPath, which manages several MLP funds. "But MLPs are a diverse group, so it's important to look carefully so you know what you're buying."

The oil price equation

MLPs' recent losses probably took many investors by surprise. The Alerian MLP Index, an industry benchmark, has risen steadily—sometimes spectacularly—since 2008. In 2009, the index gained a whopping 62 percent, more than doubling the nearly 27 percent return of the S&P 500.

What drew investors toward MLPs? In a word, growth. For many years, MLPs were considered relatively stodgy, low-growth investments that appealed to income-minded investors because of their relatively high yields. Investors were also drawn to MLPs' attractive tax advantages, which allow taxes to be deferred on much of the income the partnerships distribute to investors.

The U.S. energy renaissance changed everything for MLPs. The emergence of fracking led to a sharp rise in spending to build domestic energy capacity and led to the creation of scores of new MLPs. Fewer than 30 publicly traded MLPs existed in 2000; today there are well over 100. The boom also drew in investors, who began to favor MLPs for strong potential income growth as well as current yield.

Last year's unexpected decline in oil prices interrupted the party. Crude oil traded at just under $50 a barrel in February, down about half from its 52-week high[2] to the lowest level since the Great Recession.

Several factors contributed to the drop in oil prices. The same U.S. energy boom that fueled the rise of MLPs in recent years led to a supply glut. By the end of 2014, U.S. oil production exceeded 9 million barrels a day, up from 5.4 million barrels a day four years before. The rise in domestic production also reduced U.S. oil imports from OPEC countries, which fell from 3.7 million barrels a day in 2013 to 2.9 million barrels a day in late 2014.[3] Meanwhile, demand fell as a result of persistent global economic weakness and greater emphasis on energy efficiency and alternative energy use. When OPEC decided in November not to cut production, choosing to defend its market share rather than maintain high prices, oil plummeted.

Not all MLPs are created equal

The tanking of oil prices led to losses across the MLP market, but some partnerships were hit harder than others. Take upstream MLPs, which typically are involved in exploration, drilling and production of oil and natural gas. Such partnerships were among the worst performers late last year, losing roughly half their value in the fourth quarter. "The upstream MLPs are directly affected by the commodity price of crude oil and natural gas," says Kessens of Tortoise Capital Advisors.

Lower prices make the extraction of oil and gas less attractive, so many upstream MLPs began to hedge production—and with slower drilling comes a declining revenue outlook. A growing number of upstream MLPs have recently reduced their distributions—the regular dividend-like payments the partnerships make to limited partners. In some cases the cuts were considerable: Wunderlich Securities equity analyst Abhishek Sinha observed in a recent research note that three upstream MLPs have slashed distributions by 35 percent, 50 percent and 66 percent this year, and he expects more cuts to come.[4] Sinha writes that the new commodity environment means that distribution cuts among those MLPs with "significant commodity exposure and a stretched balance sheet is inevitable as they readjust to the new environment." Among MLPs tracked by the Yorkville MLP Commodity Universe Index, which includes upstream MLPs involved

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[1] International Energy Agency Oil Market Report, February 2015

[2] Source: Nasdaq

[3] Bloomberg, "America is Shaking Off its Addiction to Oil," December 11, 2014.

[4] Sinha, Abhishek, "Upstream MLPs: A Few More Hurdles to Cross Before Normalcy Could Prevail," Wunderlich Securities, Feb. 17, 2015.

in exploration and production, distributions declined by more than 6 percent during the first two months of this year.

"With upstream MLPs, you're making a huge call on where energy prices are headed," says Will Hershey, a member of the investment committee of Yorkville Capital Management, a New York-based asset management firm that focuses on investments in the energy industry. "From a risk-reward perspective, upstream MLPs don't look as attractive as other types of MLPs."

Hershey and his colleagues see greater value among midstream MLPs, which tend to be more insulated from oil price volatility than their upstream peers. Midstream MLPs generally operate infrastructure such as storage facilities and pipelines for oil and gas, and have less direct exposure to commodity prices. Those characteristics have helped keep distributions relatively healthy among midstream MLPs: The Yorkville MLP Infrastructure Universe Index, which includes MLPs involved in midstream subsectors such as storage and pipelines, reported a 12.1 percent increase in distributions during the first two months of 2015.

Midstream MLPs' health results in large part from the long-term contracts they have with producers to store or transport oil or gas. The longer the contract, the more predictable the MLP's cash flow and the greater the likelihood of stable distributions over time. "Contract-based midstream MLPs may offer a lower yield than upstream MLPs, but what you give up in yield you typically get back in the safety of distributions," says Jim Hug, a member of Yorkville Capital Management's investment committee.

New opportunities

The recent sell-off in MLPs may present investors with appealing opportunities. Yorkville's Jim Hug argues that the sharp sell-off across the MLP market stemmed from indiscriminate selling by scared investors, not problems with most MLPs' fundamentals. "Investors really didn't understand what they owned," says Hug. "We saw people throwing the baby out with the bathwater, exiting companies that had little to no exposure to falling oil prices."

Scott Roulston, managing director at MAI Capital Management, an independent investment advisor in Cleveland, agrees that the broad downturn in the MLP sector offers attractive buying opportunities. He notes that institutional investors have taken notice, as several public pension funds—including the Ohio Police and Fire Fund, of which Roulston is a trustee—have increased allocations to MLPs in recent months. What's more, Wilshire Associates, an investment firm that provides consulting to several public pension funds, recently recommended that such funds increase their allocations to MLPs. "We're seeing confidence in the pension space," says Roulston.

That confidence was reinforced by the February IPO of Columbia Pipeline Partners, an MLP that was formed by NiSource, a natural gas and utilities company. The public offering raised more than $1.1 billion—the largest MLP IPO on record—and many on Wall Street considered it an indication of continued growth in the sector.[5]

> "The more clarity companies have in terms of future cash flow, the more comfortable they'll be in **making predictions** about distributions."

Roulston and others agree that investors should understand that MLPs are not all alike, and should carefully evaluate individual MLP investments before purchasing. Fortunately, public records such as quarterly and annual filings with the SEC offer detailed information about MLPs' operations, including ongoing relationships with partners and descriptions of long-term contracts.

Many MLPs offer long-term distribution forecasts as guidance for analysts and investors. Roulston examines MLPs' cash flow to find companies with the potential to offer annual distribution growth of 10 percent or more. Cash-flow predictability depends on a number of factors, including the length of contracts the MLP has entered into as well as the creditworthiness of the partners purchasing the MLP's services. "The more clarity companies have in terms of future cash flow, the more comfortable they'll be in making predictions about distributions," Roulston says.

Roulston is bullish on natural gas MLPs. He notes that several liquefied natural gas (LNG) plants are scheduled to come online in the next few years, which should make the U.S. a major exporter of natural gas. "That means major investment in infrastructure," says Roulston. The Interstate Natural Gas Association of America expects more than $350 billion to be invested in natural gas and LNG infrastructure over the next two decades.[6]

Brian Kessens of Tortoise Capital Advisors sees particular appeal among natural gas MLPs with infrastructure in the northeast U.S., which stand to benefit from their proximity to the Marcellus Shale reserves in West Virginia, Pennsylvania and New York. He doesn't worry that declining oil

[5] WSJ.com, "Columbia Pipeline: Biggest MLP IPO on Record," February 12, 2015.

prices will affect this MLP subsector: "Natural gas pipelines are agnostic to crude oil," he says.

Yorkville Capital Management's Will Hershey says valuation declines are likely to spur more mergers and acquisitions among MLPs, and expects some larger MLPs to grow through acquisition. For example, publicly held infrastructure giant Kinder Morgan in February acquired midstream operator Hiland Partners for $3 billion. "These types of deals illustrate how attractively valued some MLP assets are to management of these companies," says Hug. "That's encouraging for all investors."

What it all means for investors

The differences between MLPs mean investors must choose carefully when investing in this sector. "Investors need to be more selective, especially in a environment where oil prices have declined," says Yorkville's Hug. "It's critical to distinguish between the higher-yielding, higher-risk investments, and a pipeline doesn't take on as much risk."

MLPs may be hard-pressed to repeat the lights-out returns they have posted in recent years. In today's environment, investors need to consider not just the income they emphasized prior to the oil boom or the growth they favored during it, but the combination of the two. "We use a total return approach," Roulston says. "We look at the opportunities that offer growth plus income, which often means looking beyond the highest yields."

Oil prices will continue to move up and down, sometimes dramatically. Brian Watson from Oppenheimer SteelPath counsels investors to remember that MLPs' short-term returns can, to varying degrees, be tied to the pricing cycles of commodities, even if the businesses' results are relatively insulated. He notes that investors should factor a degree of risk into their expectations for their MLP holdings—and that some years will be better than others. "These cycles happen," he says. "You need to know the fundamentals of each MLP—and never assume that oil prices will stay high forever." ■

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[6] The INGAA Foundation, "North American Midstream Infrastructure through 2035: Capitalizing on Our Energy Abundance," March 18, 2014.

MLP Roundtable

Expert voices weigh in on trends and developments in the MLP market

MUCH OF THE DISCUSSION about MLPs in recent months has revolved around the sharp declines in oil prices. But beyond oil-price volatility, what's affecting the MLP market? What trends should investors watch out for, and what opportunities are available now? We spoke with two MLP experts: Jeff Jorgensen, director of research for Center Coast Capital Advisors, and Matt Sallee, portfolio manager with Tortoise Capital Advisors. The following is an edited transcript.

Q: What trends are you currently seeing in the MLP space?

JEFF JORGENSEN: From the beginning of 2013 to August of 2014, everything went right for MLPs. A lot of asset managers flooded into the space, and a lot of new MLPs were created. People were picking any MLP investment and netting a nice return.

But MLPs are not all created equal. The MLPs based in more marginal drilling regions or formed by marginal sponsors have gotten punished as commodity prices have fallen. Those are the ones that benefited the most from the ideal market conditions in previous years. Now they don't have the fundamental quality to perform without them.

MATT SALLEE: Many MLPs are likely to lower their capital budgets in response to lower oil prices. You've already seen the number of rigs actively drilling for oil and gas in the U.S. decline by about 40% in recent months. Some drilling just doesn't make economic sense at $50 a barrel. In the near term, that will result in the leveling off of domestic oil production. We still believe the U.S. energy production growth story is intact, but it's taking a pause.

In some cases, that means MLPs may defer programs such as building a processing plant, whether in the Permian Basin or in the Bakken shale. Companies are likely to defer activity for a year or so until they're confident that oil prices have bottomed. This also may mean lower distribution growth as some MLPs hold some cash flow back and wait until the environment turns back to growth.

Q: What trends do you expect to see in the MLP market in the coming years?

JORGENSEN: I think in the short term, MLP performance will be driven more by commodity prices than it has been in the past. We've seen an increased correlation between MLP market performance and crude prices in recent months, and I think an MLP recovery will be governed in part by a rebound in oil prices.

Over time, though, I think you'll see the quality names differentiate themselves. As investors realize that cash flows are stable regardless of commodity prices, they'll come back into the MLP market and help drive a recovery. But it'll be a cautious re-entry, as opposed to the flood of investors we saw entering the MLP space in 2013.

SALLEE: I believe we'll see higher crude prices, higher drilling activity and a resumption of the production growth story—but not for a year or two. The growth story is not over for MLPs. When I look back at historical distribution growth of midstream MLPs, distributions grew in 2009 and grew a lot in 2010. So MLPs grew their distributions even through a financial shock that was more severe than what we're going through now. I think this is likely to play out in a similar fashion.

If oil prices stay in the range of $50-$60 per barrel, I think Merger & Acquisition activity will increase among MLPs. We could see healthy midstream MLPs acquire assets from exploration-and-production MLPs that are trying to live within their cash flows. If the upstream companies have midstream assets they can part with, they may do that to fund their drilling budgets. And we also may see large energy companies like Kinder Morgan and Plains All American Pipeline looking for acquisition targets in the midstream space.

Q: Where can investors find opportunities?

JORGENSEN: MLP sectors have recovered across the board after a very irrational response this fall and winter. But so many people threw the baby out with the bathwater that there are still names within each subsector that I think remain unfairly beaten-up. I think now it's more about looking for value on a name-by-name basis than looking at sectors as a whole.

The good news is that investors are finally starting to dig in and do the research that they should have been using all along. From looking at contract structures to their management teams, it takes real due diligence to identify how these companies are different—which ones are quality partnerships and which are not.

SALLEE: I see opportunities among high-quality MLPs in the gathering and processing sector. These MLPs trade at attractive valuations, though they do face headwinds as oil prices remain low. I also believe MLPs involved in refined products such as gasoline, diesel and jet fuel are interesting as lower prices are stimulating higher demand. So far this year, demand for refined products is up 5 percent over the same period last year. More flows through the pipelines means greater cash flows for these companies.

Ultimately, I believe that investing in midstream MLPs is the way to go. Investments in other sectors, such as upstream MLPs, need to be done with caution, and investors must understand that these offer a very different risk proposition than investing in a pipeline MLP. ■

Disclosure to be added to the Proof of this Reprint

RISKS & DISCLOSURES:

As of February 28, 2015, the last date Fund portfolio holdings were publicly available, the following securities mentioned in this Commentary maintained the following percentages of Fund assets: Kinder Morgan Inc. (KMI) 8.80%, Plains All American Pipeline (PAA) 5.86%, Columbia Pipeline Partners LP (CPPL) 1.36%.

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- The Fund concentrates its investments in master limited partnerships (MLPs), which involve additional risks compared to those from investments in common stock, including, but not limited to, cash flow risk, tax risk, and risks associated with limited voting rights.
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- The Fund is not required to make distributions and in the future could decide not to make such distributions or not to make distributions at a rate that over time is similar to the distribution rate it receives from the MLPs in which it invests.
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