



How Do MLPs Respond in Rising Interest Rate Environments?

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With interest rates at historic lows, investors searching for yield have found stable and growing cash flows in MLPs. Comments from Federal Reserve chairwoman Janet Yellen indicate that the long-anticipated Federal Funds Rate increase is finally expected to occur by year end 2015. Investors are now questioning how MLPs have historically responded in rising interest rate environments.



The correlation between the Alerian MLP Index (AMZ) and the 10-year Treasury yield over the past ten years has not been statistically significant, regardless of whether the data is analyzed daily (0.08), weekly (0.09), or monthly (0.07). While MLPs may show no meaningful statistical correlation to interest rates over the long term, not all investors have the luxury of investment horizons measured in decades. In periods of market stress, correlations spike between all asset classes.

Historical Examples

1994–1995: The period of sharpest interest rate increases was in 1994-1995, when the target Federal Funds Rate rose 300 basis points (bps) from 3.00% in February 1994 to 6.00% in February 1995. The market was likely expecting some move in interest rates, as Treasury yields hit a bottom of 5.17% in mid-October 1993 and rose to 5.93%, all prior to the February 1, 1994 announcement. Even though the Federal Funds Rate increased through February 1995, the 10-Year Treasury actually hit its peak on November 7, 1994 to yield 8.03%. During the period from mid-October 1993 to November 1994, on average, MLPs¹ were down 14.0% on a price-return basis and down 4.4% on a total-return basis. But by mid-October 1995—two years following the initial move in Treasuries—MLPs had gained 6.4% on a total-return basis.

2004–2006: During the 2004-2006 period, the target Federal Funds Rate rose by 25 bps every six weeks from June 2004 through June 2006. The news was first announced obliquely by Chairman Greenspan during a Congressional hearing on April 21, 2004. During the month that followed the initial announcement, Treasury yields rose 31 bps, MLPs² fell 4.0%, and the MLP-Treasury correlation jumped to 0.92. By June 18th, less than one month after their near-term low, MLPs had recovered to previous levels, with 30 day correlations falling to 0.24. Indeed, on June 30th, when the rate increase of 25 bps was finally announced, MLPs gained 0.8% that day.

During the actual two-year period from June 30, 2004 to June 29, 2006 when the target Federal Funds Rate increased from 1.00% to 5.25%, MLP yields ranged between 5.7%–7.2% and the correlation between MLPs and Treasuries was higher than normal at 0.55. Contrary to investor fears, MLPs returned 38.7% on a total-return basis, anchored by continued increases in their quarterly distributions.

1// MLPs measured in the October 1993 to October 1995 timeframe include Buckeye Partners LP, Lakehead Pipe Line Partners LP, Leviathan Gas Pipeline Partners LP, Enron Liquids Pipeline LP, Kanab Pipe Line Partners LP, Northern Border Partners LP, Santa Fe Pacific Pipeline Partners LP, and TEPPCO Partners LP.

2// From the time frame of 1995 and beyond, MLPs are represented by the Alerian MLP Infrastructure Index, a capped, float-adjusted capitalization-weighted index of 25 energy infrastructure master limited partnerships.

AMZ Performance Amid Taper Fears



2013: Comments from the Federal Reserve in May and June of 2013 indicated that the Federal Open Market Committee (FOMC) might “taper” its purchases of Treasury securities and agency mortgage-backed securities resulted in a 140-basis point increase in the 10-year Treasury yield from 1.63% to 3.03% in an eight month period (May 2 to December 31). During this time, MLPs rose 73% on a total-return basis. However, performance was quite volatile, as MLPs experienced several V-shaped price swings. By the end of a calendar year (May 2, 2014) MLPs had returned 15.1%.

Today: Midway through 2015, the Federal Funds Rate remains unchanged; however, the MLP yield spread to Treasuries reflects that the MLP market has already begun to price an increase into expectations. The current spread of 372 bps is 41 bps higher than the historical median spread of 331 bps. This additional room is more reflective of a belief that rates will increase, rather than that MLP yields will compress. (Please keep in mind that given the current environment, forward year performance has the potential to be influenced more by commodity prices than by interest rates.)

An Explanation

As history has shown, MLP unit prices initially tend to respond unfavorably to sharp increases in interest rates. MLPs are income-producing equities and when interest rates move, everything with a yield is affected. But over a longer investment horizon, distribution growth has mitigated or outweighed those moves.

From a financing perspective, MLPs primarily use fixed-rate debt ranging from 10 to 30 years to fund their growth projects. If interest rates were to increase, MLP balance sheets would likely be unaffected in the near and medium term, as debt is locked in and interest payments are fixed.

Also, MLP management teams tend to exhibit a higher degree of capital discipline than executives in other industries, signing long-term contracts that guarantee a minimum revenue stream and internal rate of return (IRR) above their cost of capital.

On the income side, many MLPs have a built-in inflation hedge as all interstate liquids pipelines are regulated by the Federal Energy Regulatory Commission (FERC) and set to increase tariffs by PPI + 2.65% each July 1st. This contractual hedge is a trailing response, but it is more favorable than many other income-generating investments.

Not all investors are aware of how MLPs finance their organic growth projects and acquisitions, the inclusion of built-in inflation hedges on interstate liquids pipeline contracts, or the historical examples of MLPs growing their quarterly distributions in periods of rising rates. These investors, fearing the unknown or making certain deductions on faulty assumptions, are likely to participate in a broader sell-off. With the increasing institutionalization of the asset class over the past five years, these sell-offs have been less drastic and their subsequent recoveries have been more immediate than in the past.

In Conclusion

Like other yield equities, MLPs sell off on the news of a potential rise in interest rates, but recover as quickly as they have fallen. But it is in a period of steadily rising interest rates that MLPs demonstrably differentiate themselves from the broader market, as they continue to pay steady—and oftentimes, growing—distributions. Looking forward, the long-term distribution growth outlook for MLPs remains strong, particularly as the energy renaissance in domestic production of natural gas and oil creates billions of dollars of energy infrastructure investment opportunities.