ETF Report

THE MAGAZINE FOR ETF ADVISORS DECEMBER 2014

ETF.com/ETFReport

PUBLISHED BY ETF.com

Q&A

THE DIE-HARD APPEAL OF MLPs

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Oil prices may be tanking, and key players may be rethinking the MLP structure, but appeal of the space among income-hungry investors goes on unabated, says the president and CEO of Alerian

By Cinthia Murphy

Kinder Morgan shook up the world of master limited partnerships (MLPs) this year when it decided to give up on the MLP structure altogether. Kinder is one of the segment's key players, and one that helped propel MLPs into the investor mainstream as a good structure to offer income and growth potential.

But while the move made headlines, it's unlikely to change much in a space that remains the beneficiary of strong investor demand for bond alternatives, Kenny Feng of Alerian, the leading provider of MLP indexes, told ETF Report.

MLPs usually claim they're less sensitive to oil prices than other energy sector plays. But we've seen a dramatic drop in oil prices this year. That can't be good for MLPs, can it?

The point of less sensitivity is important. Oftentimes when people talk about investing in MLPs, they say they have little or no exposure to commodity prices. But that's an overgeneralization. Energy MLPs—and the universe of MLPs—have expanded up and down the energy value chain over the past 10 years or so. It used to be that people thought about this space as a transportation and storage business, but that's no longer the case. So to say MLPs as a whole have little or no sensitivity to commodity price is an overstatement. It is true, however, that most midstream MLPs have long-term contracts that are fee-based or take-or-pay, which insulates them from direct commodity price exposure over the near and medium term.

You also have headline risk. If you get to a place where oil prices are lower for a sustained period of time, and below certain marginal costs for production, you're going to see rigs laid down, and you're going to see midstream projects be re-evaluated. A sustained period of lower oil prices can't be good for MLPs from that perspective.

What's your view of the Kinder Morgan decision in August to move away from the MLP structure? Do you expect other larger MLPs to follow suit?

The parent security of Kinder Morgan had been the worst-performing pure-play C-Corporation general partner over the past 12 months. Look at it on a trailing one-year, three-year and five-year basis, and it's underperformed broader benchmarks. Because of that, and the fact that Kinder himself had gone out and said he was frustrated with the way that the market was valuing his companies, it wasn't a question of if a transaction would happen, but rather when and in what form.

Still, Kinder was a pioneer in the MLP structure. In 1981, the first MLP was formed, but it wasn't until 1997 when you saw many investors become very income-focused, and MLPs stood out as a set-and-forget type of security that would offer income, and serve as a bond substitute. Kinder then came along, and all of a sudden, MLPs became an income-plus-growth vehicle. The fact that somebody who had been a tenant, so to speak, of the MLP building and decided to abandon that structure was surprising.

But I'd point out a few basic points about their decision: One is that the company is very large. When you're that big, and you're a distribution growth model, it takes more to move the needle. They also had a cost-of-capital problem because the general partner was taking a significant amount of the cash flow via its incentive distribution rights for a long time. As a result, it was going to be harder for them to build things or buy things and earn a reasonable rate of return.

In addition, they had four publicly traded securities, which is complicated for investors to digest. And the CEO had been acquisitive. If you look at their growth profile over the years, they've increasingly moved towards an acquisition-focused model.

Long story short, I think it was the best pretax outcome for investors. The implications for the space aren't all that many because it doesn't seem likely that any large MLPs in the near- to midterm are going to be in a similar place that Kinder was in.

How would you characterize what differentiates the Alerian MLP indexes?

Let me say that we are an independent index and education provider. We are not associated with an investment bank. We do not have an asset management business. So, in the age of skepticism in which we live in today, perception sometimes is as important as reality. When it comes to our indexes, no one has to worry that we're sitting out there managing assets and having a conflict as it relates to our index business.

Another distinction is that we have our own database of shares outstanding, and float adjustment factors. Most segments that have enough clout to be considered their own asset class are very liquid, and are going to have most of the shares held in public hands. But the MLP space is unique in that 70% of MLPs trade less than $10 million per day, and 66% of companies have a float-adjusted market cap below $2 billion. The average float in this space is about 65%. Our methodology reflects these nuances, which do make a difference relative to some other asset classes that may be more familiar to investors.

We go through all press releases, all SEC filings and rely on our methodology guide to build the indexes. This process is replicable—anyone can actually replicate our indexes if they choose to do the work behind all that. We think that's extremely important from a benchmarking/beta equals 1 standpoint. That's what differentiates us.

If you're an advisor looking to get into the MLP space, what should you be looking for in an MLP index?

This is really a question of suitability—client objectives and risk tolerance. If you are a U.S. taxable investor who does not mind state filings, K-1s, and you're comfortable building your own portfolio, you're always better off investing in MLPs directly. That is because of the tax-deferred return-of-capital nature of MLP income.

If you don't fall into that bucket, the question then becomes how you feel about passive versus active management. Once that's answered, you can decide whether you want an ETN, an ETF, a closed-end fund or a mutual fund, and if you choose one of the last three, whether you want that wrapper to be RIC compliant and be limited to 25% MLP exposure or 100% MLPs and be subject to corporate taxation.

Investors often ask why there are so many exchange-traded products as well as closed-end and mutual funds that are tracking the space. Pre-1997, the investor market was essentially retirees looking for a fixed-income substitute, but over time, particularly since 2004, the investor market has become far more heterogeneous.

People just have different answers to the following questions: How do I feel about leverage? How do I feel about financial institution credit risk? How do I feel about active versus passive management? How do I feel about the capital market assumptions that I'm making for returns in the future in the MLP space? Are more of the returns going to come from income, or is more of it going to come from growth? Am I a taxable investor, or am I a tax-advantaged investor?

The answers to these different questions are going to govern what product structure is most suitable for you.

There are today about 100 MLPs and at least 22 ETPs tracking them. Is the fund space overcrowded?

You're coming at this from an ETP standpoint, but if we combine that with closed-end funds and mutual funds, the joke is that there's going to be more investment vehicles tracking the space than there are MLPs. But I would argue that it all really depends on the composition of new funds coming to market.

We don't believe there's a need for even a few additional vanilla ETNs and ETFs in this space. But there is certainly the possibility for different elements of innovation. Again, the active side is one way I can see that happening. You've also seen different fundamental indexes come out. Whether or not it's overcrowded, investors will decide that by virtue of the assets that flow into them.

What are the key trends you see in the MLP space?

Let me first give the risk side of the picture. We've seen how MLPs have performed over the past couple of weeks [early October], and we're reminded that commodity prices aren't an issue until they are. This is the energy business. Maybe your exposure isn't directly on the price side, but certainly it's on the volume metrics side. Nobody foresaw the price swings in oil. It's important for investors to understand that this is a risk, however small, but still a risk.

Capital markets access is another issue. At some point you're going to see a change in interest rates. Capital market access is extremely important for the MLP space by virtue of their distribution policy, and the manner in which they grow through organic projects as well as acquisitions. They need to be able to fund projects.

As far as other trends, I would say:

- **M&A.** Besides the whole Kinder consolidation, you've also seen a handful of transactions announced recently. People are looking at footprints and saying to themselves, if I don't have access to this footprint right now, and there's a significant synergy that could come from our businesses, am I willing to pay a specific premium to get to that long term of creation and continue the longevity of my growth profile?
- **Regulation.** We don't believe you're going to see a fracking ban. We do think you're going to see more regulation, which could increase the cost structure for some of the upstream guys.
- **Specialization.** That's another trend that's starting to re-emerge in a meaningful way. We're seeing spinoffs that result in more pure-play midstream companies. For example, we recently saw one announce it was separating its utility business from its energy infrastructure business. This notion of more midstream companies being isolated from what used to be a more integrated value chain is a trend.
- **A discussion about subsector classification.** Many segments are now exploring, to varying degrees, whether they can be part of the MLP structure. When the IRS provides greater clarification around the definitions of qualifying income, that's going to give people a renewed impetus to explore whether different types of businesses can find their way into the structure.

The MLP footprint could go beyond the energy segment, then?

Exactly. It's always been natural resource driven, but you're seeing these different flavors pop up that are not just the traditional oil and gas businesses. It's a function of the fact that the demand for MLP paper has increased significantly. People no longer look at MLPs as an emerging structure, but as a legitimate structure. If investors are bidding up companies that promise stable and growing income, more and more businesses—paper and packaging, chemical companies—are going to consider whether that's a valuations arbitrage opportunity for them.