April 2009

MLP *Insight*

An interview with Malcom Day

Chairman, MLP Investment Committee, Eagle Global Advisors

MALCOM DAY is Chairman of the Master Limited Partnership Investment Committee at Eagle Global Advisors. He is also a member of the Domestic and International Equity Committees. Prior to joining Eagle, he founded Partners Investment Management & Research, LLC, an advisory firm specializing in publicly traded partnerships. Mr. Day was also employed previously by Criterion Investment Management Company and Payden & Rygel Investment Counsel where he managed portfolios in excess of $5 billion.

He earned his Bachelor's degree in Engineering from Northwestern University and his MBA from the Anderson School at UCLA. A Chartered Financial Analyst, Mr. Day is also a member of the CFA Institute and the CFA Society of Houston.

What are Master Limited Partnerships?

A master limited partnership is an exchange traded security of a real business with real assets that generates real cash flow. They are organized as partnerships as opposed to the more common C-corporation. The main difference is that they trade as limited partnership interests rather than shares of corporations, and master limited partnerships are divided into units rather than shares and pay distributions rather than dividends. Really, the main advantage from a company's perspective to being a master limited partnership is that it's more tax efficient. You don't pay a corporate tax if you're a limited partnership. All the income and deductions flow through to the investors who own the securities, so you avoid double taxation of income.

What is your investment decision-making process ? What do you look for in an MLP?

What we look for in our portfolio construction process is a diversified portfolio of MLPs, but in individual MLPs, we're looking for the ones with the highest risk adjusted total return potential. When investors look at the master limited partnership asset class, a lot of them make what we consider to be a mistake, which is to concentrate just on the yield of the partnership. That focus on yield tends to create a higher yielding, but ultimately lower total return portfolio, whereas we want our investors to have high total returns. What we find in our analysis through a review of the market is that typically, the partnerships that grow their distributions the fastest are the least appreciated in terms of their total return. To put it another way, distribution growth is under-appreciated by the market in general. By focusing on the partnerships that have the most favorable outlook for distribution increases, we can invest in the partnerships that will generate the highest rates of return for our investors.

What are some of the MLPs that you've invested in over the past 12-18 months and the reasons why you like them?

We don't give out specific names of MLPs that we are investing in for our clients. What I can say is that the largest MLP is a company called Kinder Morgan Energy Partners (KMP). It's headquartered here in Houston. A large number of the energy MLPs are headquartered in Houston and more broadly, Texas. A couple of the advantages that we bring to our investors are our location and our connections with the master limited partnership community.

Kinder Morgan Energy Partners was one of the earliest MLPs to demonstrate the power of growth in their distribution. The total return in Kinder Morgan Energy Partners was roughly 600% in the six-year period ending in 2002. The reason they were able togenerate that kind of return was because they made a lot of successful acquisitions of energy infrastructure assets, such as pipelines and storage terminals, at accretive multiples. That allows the partnership to pay out the incremental cash flow from that accretion. That's really the key to success in long-term master limited partnership investing, the ability to grow the cash distribution successfully over time. Kinder Morgan certainly showed relatively early in the process how that could work and the power of the growth in distribution over time in generating returns for limited partner investors. Today, Kinder Morgan is, as I mentioned, the largest energy master limited partnership. It has a footprint that encompasses the entire United States. Key areas of investment for the partnership are refined products pipelines, which carry key commodities like gasoline, jet fuel and diesel from refinery hubs to population centers. For example, they have a key pipeline that delivers gasoline into the rapidly growing Phoenix, Arizona and Tucson, Arizona areas as well as other growth areas in California and the Southeast United States. They also have an extensive natural gas pipeline network and a large number of storage terminals for liquid storage, which is things like oil, gasoline, jet fuel, diesel, as well as bulk products, which might include items such as coal. They also have a very successful carbon dioxide transportation business that transports carbon dioxide from producing basins in Colorado and New Mexico down to West Texas, where it's used in enhanced oil recovery. They also participate in enhanced oil recovery. That's been part of their growth success.

KINDER MORGAN

Most of those businesses have a very low amount of commodity exposure, which is what we like to see in a partnership. The businesses are fee-based, stable businesses with recurring revenues, high fixed costs and good leverage to increasing volumes. For each incremental barrel that's being transported, the value of almost all of that drops down to the bottom line to be paid out to the general partner and the limited partner in the MLP. What we are looking for in our MLP investments is for companies that can generate the kind of growth and returns in the future that Kinder Morgan has generated in the past.

How much of your portfolio is in the energy infrastructure MLP area?

At Eagle Global Advisors, our portfolio is typically 90%-100% energy infrastructure MLPs, but it's important to emphasize that we avoid MLP investments with commodity price exposure, so ***the emphasis in our strategy is on the infrastructure rather than energy.***

Explain the expected total return and how it's made up of the yield and the future growth rate.

One of the really exciting things about master limited partnerships is not just what they've delivered in the past. The historic returns have been very attractive, but the more exciting part is really the forward-looking expected rate of return. The way we calculate expected rate of return for master limited partnerships is to take the current distribution yield, which is about 11% today, then you add to that the growth in the distribution yield that can be expected in the future. Today that number is between 2% and 4%. When you add those two together, that gives you an expected rate of return of between 13%-15% from a passive portfolio approach. Our active management should boost returns even higher.

You obviously wouldn't get that every year. That's a long-term expected rate of return. It's going to fluctuate with the market. But when you look at that rate of return and you compare it to bond yields of around 4% and expected returns in the US equity market that may be somewhere in the high single digits, 13%-15% is very attractive, particularly when you look at the low correlations that the MLP market has had in terms of returns with either the equity market or the bond market. Anytime you can find an asset that has high returns and low correlations with the rest of your asset mix, that's an attractive asset to add to your total portfolio.

One of the other things that we find attractive about the MLP market for our clients is that it is relatively young and relatively inefficient. That's allowed us to have a lot of excess returns above a passive bench-mark. Our active management has added more than 5% per year above the passive benchmark over the last seven years. Looking forward, we think we should be able to continue to add value for our clients. We think we're going to add significantly above that 13%-15% return, which would make it even more attractive compared to bond yields in the 4%-5% range and equities maybe in the 8%-9% range. We think that's a very attractive thing to add to a client's investment mix.

What opportunities do Master Limited Partnership companies have for continued growth?

There are two main ways that a master limited partnership grows their distribution, and distribution increases are the key to increasing the value of the investment over time. One way is through making acquisitions. A master limited partnership company can go out and acquire an existing infrastructure asset, something that already exists and is producing cash flow. That is a traditional method that's tried and true.

The second method that master limited partnerships use to grow their businesses is to actually build the infrastructure themselves. Let's say that an MLP might have an existing pipeline and they might build an extension of that pipeline to connect to a new customer. That business is very attractive for them because usually the rates of return that the MLP can generate on what we would call organic expansion is much higher than in the acquisition market. That's mostly because there's not as much competition involved in making those organic investments as there is in pursuing acquisitions. Those are really the two key areas where we see the market going forward. Probably about 40% of the growth in the market in terms of distribution growth is going to come from organic projects and about 60% is going to come from acquisitions.

What are some of the risks associated with MLPs? How do you attempt to control investment risk?

There are a number of risks and it's certainly important for investors to realize that master limited partnerships are not Treasury bills. They do have risks. One of the key benefits that we provide to our clients is to have a diversified portfolio, which reduces the specific risks in any single partnership. There have been a number of master limited partnerships in the past that, if they haven't fully gone bankrupt, have at least gotten into significant financial distress. Partnerships typically fall into distress as a result of either taking on too much debt, or by owning or acquiring assets that do not have stable cash flows, or through a combination of these risks. We have been very successful in avoiding investments in the partnerships that became distressed.

One of the areas we focus on for our clients is to dig deep into the partnerships, to understand their businesses, to understand the debt and the volatility of the cash flows of the assets that the MLP has, as well as understanding the motivations of the management and how they're incentivized or rewarded. We also work to understand the relationship between the general partner and the related entities. It's frequently the case that a master limited partnership will have a sponsoring entity that may be another larger company, another larger energy company, typically. We understand the relationship by examining all the documents. It's important to have a professional evaluating that because there are some conflicts of interest between the general partner and the limited partner, particularly as it relates to the transfer of assets from the sponsoring company to the master limited partnership.

What is the regulatory outlook for Master Limited Partnerships?

There are two areas of regulatory risk within master limited partnerships. One is on the entity level, which is related to taxation. MLPs do have a special place in the tax code, similar to the way REITs have a special place within the tax code. That area of regulation looks very good. There's certainly movement afoot currently and has been in the recent past to make master limited partnerships available to a broader audience. For example, within the American Job Creations Act, Congress enhanced the ability of mutual funds to own master limited partnerships by making the income of master limited partnerships a qualifying source for mutual funds. That's expanded the potential buyer base for master limited partnerships. The other side of the regulatory mix is on the assets themselves. Typically, many of the assets are either regulated by a state or by federal agencies. We think that mix is stable and we think that's very beneficial. That regulatory stability allows for the cash flow expectations to be reasonably certain. In turn, that certainty enhances the ability of the companies to conduct transactions and have a very high degree of confidence as to the cash flows that they can expect to receive from the assets.

One other risk element that I should point out is that there is interest rate risk for master limited partnerships in that they are income producing securities. As such, they do tend to be affected by significant changes in interest rates. A lot of investors have been concerned about that in the past when we've seen the Federal Reserve tightening monetary policy. That is an area that investors should be aware can cause short-term dislocations or negative returns in shorter time periods as interest rates rise. MLPs at the margin are competing for investors' dollars with other income products such as bonds and REITs, and so higher overall levels of interest rates will tend to have an impact. What's nice about the master limited partnerships is that as they grow their distributions, they tend to overcome these rises in interest rates to generate positive returns. But if you do see a sharp rise in interest rates such as we saw in 1994, that will tend to have a negative impact on the MLP market in the short run.

When do MLPs perform strongly? Do MLPs have down years?

Those two things are actually somewhat related. Typically we see the strongest years for MLPs immediately following down years. The MLPs themselves continue to increase their cash flows and investors tend to come back to that growing cash flow as a very attractive feature. The Index that we track did have negative years in 1994, as I mentioned, primarily caused by increases in interest rates. The market was also slightly negative (pretty close to zero) in both 1998 and 1999, and that was an era, as you may recall, when investors were much more focused on metrics such as page views and click-throughs. The general bubble psychology that took place in the investment market at that time created a significant lack of enthusiasm for these types of assets, which are more of your classic old economy, cash producing, very stable types of investments.

The third period where we saw slightly negative returns was in 2002, when the energy merchants as well as the equity market as a whole were under a lot of stress in the post- Enron era. What that did was create an environment where the MLPs were poised to have very high performance in 2003 because essentially all of the increases in cash flows in 2002 were ignored by the market, so there was some catching up to do in 2003 for all the good work that had been done by the companies in 2002. That's one of the things that we try to remind investors of. The underlying businesses are very stable and they are growing. By and large, the companies do a tremendous job of growing their businesses in a fairly predictable manner, but the part that is very hard to predict is the market psychology and what people are willing to pay for the cash distributions and growth. That's really where we see the negative returns come in, when the market psychology becomes negative in the short run, whether it's because of interest rate fears or because of Enron-related questions. But those periods are usually the best periods to buy. As is true for probably most asset classes, when everyone's afraid, that's when you get some of your best opportunities.

In what way is the portfolio approach for investing in MLPs distinctive at Eagle Global Advisors when compared to other companies that invest in MLPs?

It's a very new area. There's a very, very small number of fiduciary companies such as Eagle Global Advisors that offer a dedicated MLP investment style. What sets us apart from some of our competitors is not only our strategy and our very strong track record but also our location in Houston, in the MLP nerve center. This is not only where the majority of the companies are located, but the accounting and legal teams that work with these master limited partnerships are also located in Houston. That gives us a unique opportunity to rub shoulders with the companies and their staff. That gives us a little better insight into what they're doing.

We think the other investment companies do a fine job. There are so many investors out there who can benefit from having a master limited partnership in their portfolios, and so few companies that know anything about it and that can offer a master limited partnership based investment strategy. We think it's really a case where there are a lot more potential investors than there are people who can offer the service today.

What advice would you give to potential investors who are looking to invest in MLPs? Is this a good time to get into this market?

Yes, I think it's a good time. Obviously you have to do your homework, as with any investment. The financial crisis has depressed valuations for all MLPs, but these depressed valuations present an opportunity. MLPs are trading at some of the lowest absolute valuations ever. Some of the MLPs do not have the necessary business models or access to capital to make it through this crisis, but for the MLPs with stable businesses and good balance sheets I think that today's prices will prove to be fantastic buying opportunities. Investors who come into the master limited partnership really need to be looking for long-term companies that can produce returns consistently going forward and really not focus too much on the one week, one month, one quarter type of information. MLPs typically are not managed for their earnings. They're managed for their cash flow and so their earnings can be very volatile from quarter to quarter. Investors should know that in advance and not be overly concerned about either particularly high or low earnings relative to analyst expectations.

Within the master limited partnerships, the cash distribution is king and that's a good thing to focus on. Where's that cash coming from and how is the company going to grow it in the future? That's what we do for our clients. We focus on how the cash is being generated by each of these companies. How stable and solid is that cash distribution and where is the growth in that cash distribution going to come from? We've done a very good job of being able to buy undervalued MLP companies based on their ability to grow their distribution that the market pricing was not reflecting. I think any discussion of master limited partnerships should at least involve a disclaimer about the taxation of ownership of master limited partnerships. An investor who owns a master limited partnership will receive a K-1 from that partnership at the end of the year, which is different from receiving a 1099. It's a slightly more complicated tax form, so really anyone who's considering it should consider the tax implications prior to making an investment. There are special tax issues for tax-exempt investors in master limited partnerships. That would include IRAs, for example. These tax issues are really one of the reasons that the master limited partnership is kind of an underappreciated market or relatively unknown.

There are a lot of investors like pension funds that are not significant investors in the MLP market because it does cause some tax complications for them, but we like that and our clients like it because it really makes the returns better for the people who are willing to deal with those tax complications. We would definitely advise anyone to make sure they understand the tax consequences before they make an investment.

Note: Opinions and recommendations are as of 4/1/2009.