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# MLP Investing:

## *Weighing The Costs And Benefits Of MLP Investment Options*

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Master Limited Partnerships (MLPs) have materially outperformed other public asset classes since 1990 as shown in Table 1. As a result, investor interest in the MLP asset class has increased and the financial sector has responded with an array of new investment options, many promising to make life easier with features like Form 1099 tax reporting and daily liquidity. 2010 saw the introduction of MLP based open-end mutual funds, a launch of the first MLP ETF, and the addition of a number of new MLP ETNS. These new products raised in aggregate over \$4.0 billion, joining the already crowded field of MLP closed-end funds with over \$10 billion in assets. This paper will examine the benefits, tax implications, and costs of these structures to help investors determine which option is most suitable for their needs.

### **Energy Infrastructure MLPs**

Master limited partnerships (MLPs) are the exchange traded securities of real businesses, with real assets, that generate real cash flow. As partnerships, publicly traded MLPs are not subject to corporate level taxation. In addition, the majority of the annual cash flow paid to investors is not taxed as ordinary income, but instead reduces the unit holder's cost basis and is subject to recapture upon sale. Most MLPs are in the energy infrastructure business and generate cash flow from the gathering, processing, transmission and storage of natural resources such as oil and natural gas, and their many byproducts. While some MLPs are exposed to commodity price fluctuations and therefore have volatile operational results, the businesses that are best suited to the MLP structure are typically referred to as "toll road businesses". These businesses collect fees for their services without taking ownership of the physical commodity.

**Table 1**  
**Performance of MLPs vs. Other Asset Classes**

<b>Asset Class</b>	<b>Total Return 1990-2010 (annualized)</b>
MLP	16.4%
REIT	10.7%
U.S. Small Cap Equities	9.2%
U.S. Large Cap Equities	8.8%
Investment Grade Bonds	7.5%
High Yield Bonds	6.1%
Municipal Bonds	6.1%
International Equities	4.2%
Treasury Bills	3.7%

*All investments involve fees. You cannot invest directly in an index. Please see additional notes and disclosures in the Appendix (p. 6).*

Eagle Global Advisors, LLC is a registered SEC investment advisor in Houston, Texas. Eagle manages in excess of \$4.4 billion for institutional and individual investors, including a focus on master limited partnerships. For more information, contact Curt Pabst, 713-952-3550; cpabst@eagleglobal.com

## MLP Investment Options

The investment appeal of the MLP asset class is easy to understand. MLPs generate bountiful cash flow, which historically has grown faster than inflation and is paid quarterly to investors. So what is the catch?

Many investors are reluctant to invest due to administrative and tax considerations. MLPs are publicly traded partnerships that trade on an exchange, but typically generate a schedule K-1 rather than a Form 1099 for tax reporting. An investor receives one K-1 for each MLP owned, so a well-diversified portfolio of 15 individual MLPs will generate 15 K-1s. In addition, most MLPs generate unrelated business taxable income (UBTI) which some IRA and other tax-exempt investors prefer to avoid. For a discussion of UBTI, please see the Appendix.

Current MLP investment options include everything from do-it-yourself portfolios to closed-end and open-end mutual funds, partnerships, separate accounts, and more recently, passively managed exchange traded funds and notes. Some benefits of publicly traded MLP investment vehicles include daily liquidity, simplified tax reporting, and in some cases, the transformation of UBTI to other income. The fundamental challenge is to determine if the benefits of these structures outweigh the costs, which include added fees and expenses, and an additional layer of taxes on the investment return.

**Table 2**  
**Key Attributes of MLP Investment Options**

	Passive Strategies		Active Strategies			
	Exchange Traded Note	Exchange Traded Fund	Closed-End Mutual Fund	Open-End Mutual Fund	Limited Partnership Fund	Separate Account
Liquidity	Daily	Daily	Daily	Daily	Typically Quarterly	Daily
Tax Reporting	1099	1099	1099	1099	Consolidated K-1	Multiple K-1s
Investment Tax Status	Taxable Note	Taxable C-Corp	Taxable C-Corp	Taxable C-Corp	Partnership Tax Status	Partnership Tax Status
Additional Corporate Level Tax Drag	No	Yes	Yes	Yes	No	No
Taxation of Distributions	Interest Income	Largely Return of Capital	Largely Return of Capital	Largely Return of Capital	Largely Return of Capital	Largely Return of Capital
Generates UBTI	No	No	No	No	Yes	Yes
Bank Credit Risk	Yes	No	No	No	No	No

Sources: Public filings; Bloomberg

## Tax Efficient and Cost Effective MLP Investment Options

Many of the newly constructed publicly traded MLP investment options share two common characteristics: 1) ease of use and 2) fees, expenses, and tax drags that have resulted in significant underperformance. However, other approaches to MLP investing do not share those characteristics. The traditional forms of MLP investments are separately managed accounts and investment partnerships. These MLP investment options offer active management, lower expenses, and do not have a corporate level tax drag. The common characteristics of these options include the opportunity to outperform the index and tax efficiency, albeit with a greater administrative burden than their public counterparts.

### Separately Managed Accounts

A separately managed account (SMA) preserves the tax benefits of MLP investing while also facilitating active, professional management. SMA investors gain access to a diversified portfolio while retaining daily liquidity. Investors receive a K-1 for each MLP in the portfolio and pay a management fee, typically around 1.0-1.5%. The key benefits of this structure are the full flow through of MLP tax benefits, daily liquidity, professional management, and fees and expenses typically lower than the other investment options. As a tax-efficient approach, the SMA passes through the UBTI of MLPs, so tax exempt investors (including IRAs) should consult with their tax advisor before investing. In some instances, SMAs are available to investors with minimum investments around \$250,000.

### MLP Investment Partnerships

A commingled investment partnership offers the benefits of a diversified portfolio and professional management, and adds the benefit of a consolidated K-1. Instead of receiving 15 K-1s, for example, the investor receives a single K-1. As a partnership, this structure provides for the full flow through of the tax benefits of MLPs without a corporate level tax drag. Fees and expenses on this type of structure vary, but are typically well below the fees and expenses associated with closed-end funds. Investors in a partnership are typically offered quarterly liquidity and investment is limited to either Accredited Investors or Qualified Purchasers. For investors with enough investable capital to meet minimum investment requirements, this structure offers the key benefits of the full flow through of MLP tax benefits, consolidated tax reporting, and professional management.

### Publicly Traded, Actively Managed Vehicles (Closed-End and Open-End Mutual Funds)

In order to assess the value proposition of MLP focused closed-end and open-end mutual funds, it is useful to first take a look at how these vehicles convert a collection of K-1s generated by the underlying MLPs into a single 1099 tax form, and transform UBTI to another form of income. We will then examine the record of their performance relative to a benchmark.

On average, approximately 80% of annual cash flow investors receive directly from MLPs is treated as return of capital rather than ordinary income for tax purposes. Cash flow classified as return of capital is not taxed as income when it is received, but instead reduces the unit holder's cost basis. This beneficial tax characteristic is available either through investing directly in MLPs, or through a commingled pass-through vehicle, (such as a partnership), that owns a collection of MLPs.

The American Jobs Creation Act of 2004 reduced the barriers to MLP investing for registered investment companies (RICs), but also stipulated that RICs could not invest more than 25% of fund assets in publicly traded partnership securities (i.e. MLPs) without losing their preferential tax status.

The resulting choice for mutual funds: limit investment in MLPs to 25% before losing preferential tax treatment, or operate as a taxable C-corporation, and subject investors to an additional layer of taxation at the fund level. Seeking a pure play on MLPs, most closed-end and open-end mutual funds have chosen to forgo RIC treatment and instead subject their investors to an additional layer of taxation at the fund level. This creates a drag on the fund's capital gains (subject to other tax factors) that is approximately equivalent to the corporate tax rate, currently 35%. The tax drag applies to closed-end funds, open-end funds, and ETFs that choose to invest more than 25% of fund assets in MLPs.

Table 3 shows the performance history of the known MLP dedicated closed-end funds and the more recently launched MLP dedicated open-end funds with more than a six month operating history. The table excludes funds that have chosen to limit MLPs to less than 25% and register as RICS, thus avoiding the corporate level tax. All the pure play funds have underperformed the benchmark Alerian MLP index since inception, in many cases by a wide margin. This is particularly noteworthy in the case of the closed-end funds, many of which operate with leverage ranging from 10%-40%. The closed-end fund's leverage magnifies the fund's return, yet leveraged closed end funds have failed to keep up with the index in a rising market for MLPs. Among the potential causes for this consistent underperformance are the corporate level tax drag, fund fees and expenses, and security selection. Given the consistency of the underperformance across many managers, and the magnitude of the shortfall, we believe the corporate level tax drag is a significant and ongoing factor. (The excluded funds, which held less than 25% in MLPs also underperformed the benchmark).

Pure play MLP open-end mutual funds were launched in early 2010. At the end of 2010, there were two issuers with a total of four new funds with aggregate assets of just over \$1 billion. Although it is early to draw decisive conclusions from such a small set of performance data, the trend is strikingly similar to that of closed-end funds, and is also likely attributable to the corporate level tax drag.

Table 3: MLP Publicly Traded Vehicles vs. the Alerian MLP Total Return Index (AMZX)  
Fund Inception Through 6/30/2011\*

	Inception Date	Cumulative Returns			Annualized Returns**		
		Fund Return since inception	Index Return for period	Difference	Fund Return since inception	Index Return for period	Difference
<b>Closed-End Funds</b>							
Tortoise Energy Infrastructure (TYG)	Feb-04	148.3%	187.6%	-39.3%	13.2%	15.5%	-2.3%
Energy Income and Growth (FEN)	Jun-04	131.8%	196.9%	-65.1%	12.7%	16.8%	-4.0%
Kayne Anderson MLP Investment (KYN)	Sep-04	92.2%	161.9%	-69.7%	10.2%	15.3%	-5.2%
Fiduciary Claymore MLP Opportunity (FMO)	Dec-04	67.9%	143.7%	-75.9%	8.3%	14.6%	-6.4%
Tortoise Energy Capital Corp. (TYE)	May-05	58.9%	127.2%	-68.3%	7.9%	14.4%	-6.5%
Kayne Andersen Energy Total Return (KYE)	Jun-05	89.9%	117.3%	-27.4%	11.3%	13.8%	-2.5%
MLP and Strategic Equity (MTP)	Jun-07	12.8%	50.5%	-37.8%	3.0%	10.7%	-7.7%
Cushing MLP Total Return (SRV)	Aug-07	-23.4%	57.6%	-81.0%	-6.7%	12.5%	-19.2%
ClearBridge Energy MLP (CEM)	Jun-10	18.5%	30.3%	-11.8%	nm	nm	nm
Tortoise MLP (NTG)	Jul-10	8.6%	20.3%	-11.8%	nm	nm	nm
<b>Open-End Funds</b>							
Steelpath MLP Alpha Fund (MLPAX)	Mar-10	15.7%	32.0%	-16.4%	nm	nm	nm
Steelpath MLP Income Fund (MLPDX)	Mar-10	19.1%	32.0%	-13.0%	nm	nm	nm
Steelpath MLP Select 40 (MLPFX)	Mar-10	17.6%	32.0%	-14.4%	nm	nm	nm
Cushing MLP Premier Fund (CSHZX)	Oct-10	6.7%	11.6%	-4.8%	nm	nm	nm

Source: Bloomberg

\* Returns include distributions received.

\*\* Annualized returns are assumed to be not meaningful if less than one year has elapsed since inception.

## Publicly Traded, Passively Managed Investment Options

### Exchange-Traded Notes (ETNs)

One option for investors seeking passive investment in MLPs is an exchange-traded note. An ETN is a publicly traded debt obligation of the issuer, usually a bank. Under the terms of the note, the investor receives the returns of the underlying index net of fees. The largest ETN by market capitalization (\$2.7 billion) was issued by J.P. Morgan and trades under the symbol AMJ. In total there are six publicly traded ETNs that are based on a variety of MLP indices and sub indices. Most are relatively new and have a small float relative to the market capitalization of MLPs. While the issuing bank guarantees the performance of the underlying MLP index (minus fees), there are several issues to consider:

1. Fees. The typical MLP based ETN issuer charges 0.85% per annum in fees. The investor receives the return of the index minus the fees.
2. Credit Risk. Investors own a note issued by a bank and are unsecured creditors of the bank. This credit risk is often referred to as counterparty risk, and the added risk does not come with the potential for additional return. If the issuing bank were to default, however, there is the potential for total loss of the investment.
3. Taxation of Distributions. Quarterly distributions paid to ETN investors are treated as interest income for tax purposes, without the tax deferral of MLPs, thereby negating a key investor benefit.

We believe investors in this structure are paying fairly high fees (0.85%) for an index, adding credit risk to their investment, and negatively altering the tax treatment of their distributions. This trade off may be worthwhile for taxable investors with small portfolios and fewer investment options, and for some tax-exempt investors who benefit from the transformation of the UBTI. Investors with larger portfolios will likely generate better returns with other structures.

### Exchange-Traded Funds (ETFs)

In August 2010, ALPS issued the first exchange-traded fund (ETF) based on an MLP index, with the ticker symbol AMLP. Like closed-end and open-end mutual funds, the ETF is structured as a taxable C-corporation and therefore imposes a corporate level tax drag, currently 35% (although timing could affect the ultimate rate). Quarterly distributions from an MLP ETF are treated similarly to the cash flow of the underlying MLP investments, meaning they are largely treated as return of capital. The stated AMLP management fee is 0.85% and additional expenses apply as detailed in the fund prospectus.

Once again, we believe investors are paying a relatively high cost for the simplicity of consolidated tax reporting. This structure does not generate income classified as UBTI, making it appealing to tax-exempt investors willing to pay a 35% tax rate on their gains in order to avoid small exposure to UBTI. Since the fund was launched August 25, 2010, it has underperformed the index by 7.6% due to the combination of fees, expenses and the corporate tax drag as shown in the table below. Investors who purchase AMLP seeking the returns of the index, may be disappointed by the abnormally high tracking error.

**Table 4**  
**Alerian MLP ETF vs. the Alerian MLP Total Return Index (AMZX)**

	Inception Date	Return since inception	Index Return for period	Difference
Alerian MLP ETF (AMLP)	08/25/10	11.9%	19.5%	-7.5%

Source: Bloomberg

## Which Option Is Best For Me?

Individual tax situations, liquidity concerns, and the ability to meet investment minimums all play a role in the decision of which MLP investment option is best for you. Individuals with lower investment thresholds may not have the required capital to meet minimum investments in private partnerships or professionally managed separate accounts. And tax exempt investors, including IRAs, should consult with tax counsel before considering an investment in MLPs. For taxable investors with substantial capital to invest, however, we believe the choices are clear.

We believe investors should identify structures that both preserve the tax benefits of investing in MLPs, and offer reasonable fees and expenses. This can be accomplished through a partnership structure, which provides the benefit of a single tax form K-1 and offers quarterly liquidity, or through a separately managed account, which provides daily liquidity but with multiple tax form K-1s. In each of these structures, lower fees and expenses, and the absence of a corporate level tax drag provide the opportunity for outperformance relative to both the benchmark and the publicly traded options. We believe this opportunity for performance is more than adequate compensation for the increased administrative burden.

**For more information on Master Limited Partnerships, please contact:**

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## Appendix

### Table 1 Source Information

Sources: MLP - Alerian 1996-2010, Eagle MLP 1990-1995; REIT - NAREIT; High Yield Bonds, Investment Grade Bonds, Municipal Bonds - Barclay's; U.S. Small Cap, U.S. Large Cap - S&P; International Equities - MSCI, Treasury Bills - Bloomberg.

Performance presentation is not intended to represent the performance of any client of Eagle Global Advisors.

Eagle MLP Index: The Eagle Master Limited Partnership (MLP) Index, is a total return index which describes the returns from investing in Master Limited Partnership units (MLPs). For additional information on the Eagle MLP Index, please go to [www.eagleglobal.com](http://www.eagleglobal.com) or contact Richard Hellmann at 713-952-3550.

### Unrelated Business Taxable Income (UBTI)

MLPs generate a modest amount of Unrelated Business Taxable Income (UBTI). UBTI in the U.S. Internal Revenue Code is the tax on unrelated business income, which comes from an activity engaged in by a tax-exempt 26 USCA 501 organization that is not related to the tax-exempt purpose of that organization. IRAs and other tax-exempt entities considering an investment in MLPs should consult their tax advisor before proceeding, as limits exist as to the amount of UBTI tax-exempt entities can receive without triggering taxes. Corporate dividends and interest income are not classified as UBTI, so the dividends paid by RICs or taxable C-corporations eliminate UBTI.