MLP Equity Review

June 2017

COMMENTARY

Master Limited Partnerships ("MLPs"), as represented by the Alerian MLP Index ("Index") fell -6.4% during the quarter ended June 30, 2017; this compares to a 3.1% return for the S&P 500 Index over the same period. For the one-year period, MLPs returned 0.4% versus the S&P 500 return of 17.9%. It is noteworthy that while the S&P 500 is near all-time highs, MLPs remain 33.0% off of their previous highs set in August 2014.

OUTLOOK

We are very encouraged by the fact that fundamentals are improving, valuation levels are attractive, and MLPs offer investors an attractive yield that is hard to find in today's market. We continue to expect double-digit returns for MLPs in 2017 with longer-term expectations of returns in the high single digits to low double digits per annum. Recent performance has not aligned with our view as MLPs declined meaningfully during the quarter and gave up most of the gains they had earned over the 1-year period. The most immediate culprit for the lackluster performance is declining oil prices. We believe a deeper concern is the challenge in finding new buyers for MLPs. Many investors lost money investing in MLPs during the Financial Crisis of the last decade or the energy crisis of more recent years. It may take a significant amount of time and future success for MLPs to convince these skeptical investors that MLPs have a place in their portfolios. Even taking investor indifference into account we believe that the potential reward to investors significantly outweighs the risk.

Key Issues

Our current overview of the likely drivers of MLP returns is in the table below.

Key Issues	Positive	Neutral	Negative	Comment
Political and Regulatory	☑			Regulatory and policy outcomes remain uncertain; but expectations are for an improved business environment
Commodity Prices		☑		OPEC production cuts have supported commodity prices
Valuations	☑			MLPs remain cheap versus comparable asset classes
Interest Rates			☑	Interest rate increases expected to impact higher yielding securities
Distribution Growth		☑		Estimates have stabilized in the mid-single digits for MLPs
Energy Infrastructure Build-Out	☑			Expectations for increased spending in 2017 and 2018

Our key issues table is unchanged from last quarter. The good news for investors is that a solid political and regulatory environment, good valuations, and a continuing build out of U.S. infrastructure are supportive of MLP fundamentals and future returns to investors. We remain vigilant, however, on commodity prices, the level of interest rates, and MLPs' ability to grow their distributions in an environment where capital raising is more challenged.

While it is easy to focus on the current negative sentiment for crude oil prices, it is also easy to overlook the benefit of lower commodity prices to MLPs. Many MLPs are in the business of transporting commodities and are compensated on the volumes they handle, not the price of the commodity itself. The current low commodity price environment is partly due to rising U.S. supply which creates demand for the transportation services that U.S. energy infrastructure operators, mainly MLPs, offer. Lower prices also incent demand, which solidifies the need for transportation of upstream supplies.

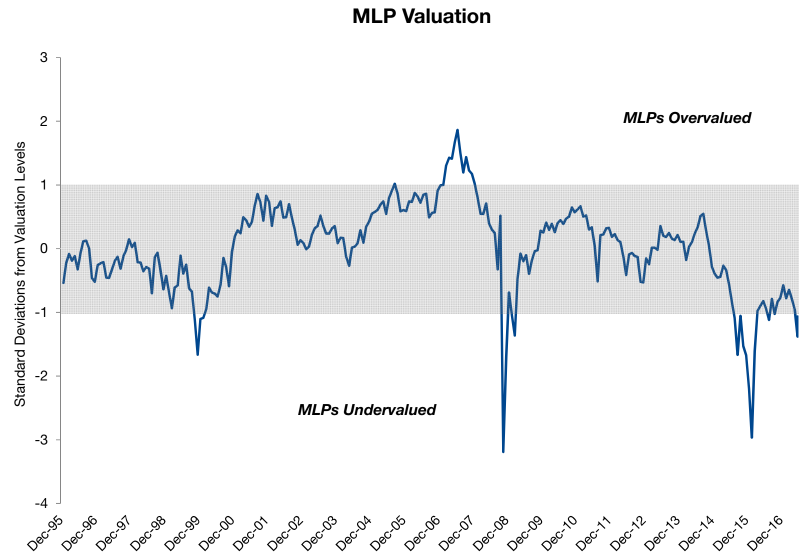
Energy production is currently growing very rapidly in the U.S. This growth is matched, in part, by demand from the global plastics market, which is growing at nearly two times the rate of global GDP as more global middle class consumers demand plastic-based products. According to a June 25th Wall Street Journal article[1], U.S. petrochemical exports are expected to hit $110 billion by 2027 compared to just $17 billion last year. The implication for MLP and energy infrastructure investors is that existing natural gas midstream assets will be exposed to growing demand, and new infrastructure may be needed as well.

A related point is that more U.S. energy infrastructure currently serves the natural gas markets than the crude oil market. In fact, the Department of Transportation[2] estimates that there is twice the natural gas transportation pipeline miles than crude oil and refined product pipelines, combined. When you add gathering lines and local distribution lines, the prevalence of natural gas over crude oil is ten-fold. As we look into the future it is likely that natural gas supply in the U.S. will continue to expand and provide a much larger opportunity to energy infrastructure companies compared to growth related to crude oil and refined products. While the market today appears to be buying and selling MLPs based on daily swings in crude oil prices, we suspect that the longer term value of owning MLPs will be based on a continued build out of U.S. infrastructure, mostly natural gas related, that will be driven by the abundant and relatively low cost supply available in the U.S.

Valuation

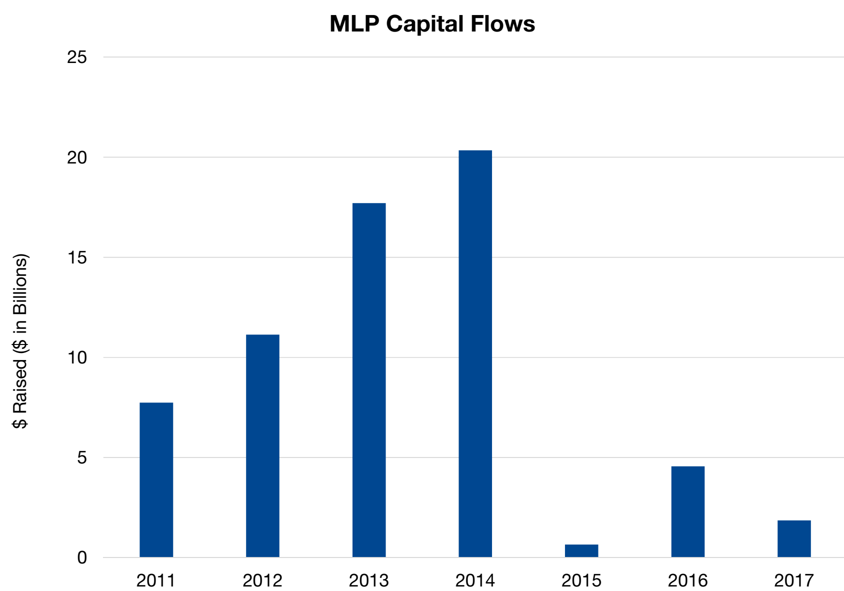
Valuation looks reasonably attractive for MLPs. MLPs are moderately undervalued in comparison to their own history. MLPs are currently 33.0% below their all-time high prices while other yield investments available to U.S. investors are near all-time highs.

MLPs sold off significantly in June. At the low on June 21st, MLPs were down approximately 16.7% on a total return basis from the most recent high prices in February 2017. The pullback was very similar in depth and duration to the pullback we witnessed in the summer of 2011. Like the pullback in 2011, we suspect that this pullback is a pause in the middle of a longer term rebound for MLPs. MLPs are equity securities and it is reasonable to expect 10% corrections approximately once a year and larger corrections approximately every 3 years. Given our improving fundamental view and the undervaluation for MLPs, we are encouraging investors to buy this dip.



Data Source: FactSet
Period: Jan 1996 - Jun 30, 2017

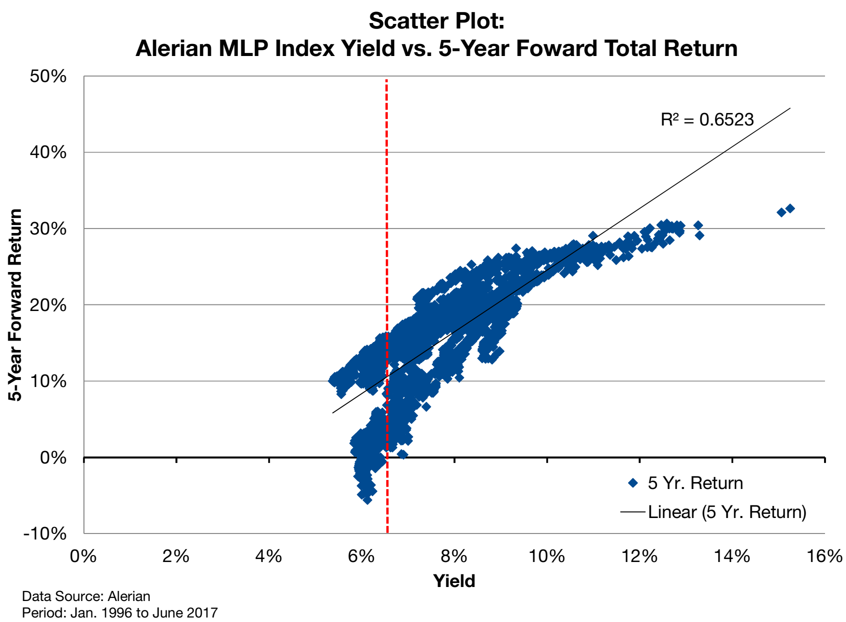
When we ask where we could be wrong in our outlook for solid returns for the remainder of 2017 and over the longer term, we point to investor demand. Most major equity market sell-offs are driven by fear of continued negative returns. We observed this with MLP investors in the financial crisis of 2008 and the more recent energy crisis where many investors decided that the MLP asset class was not meeting their expectations. This past month was very different. We have observed that the lower valuations for MLPs do not appear to be drawing in new investors or incenting existing investors to add to positions, as they had in the past. The chart below shows the estimated flow of investor capital into MLP investment products by year.



Data Source: Estimated from Bloomberg, U.S. Capital, Fin Searches
Period: January 2011 to June 2017

This chart reflects investors' excitement about MLPs from 2011-2014 and the relatively muted post-crisis capital flows from 2015-2017. As we have noted over the past two years, the MLP asset class will likely struggle to regain the luster it had prior to 2014. Many investors who left the asset class will not be back anytime soon. New investors considering the asset class will likely be attracted by the significant yield, but will be concerned by the exceptional level of volatility over the past 10 years. Even with the concern that attracting buyers to the MLP asset class may be harder for the next few years, we strongly believe that patient investors willing to look past the recent volatility will benefit from their investment in MLPs.

Over the past year we have consistently stated our belief that the current market presents an attractive entry point for long-term investors. The shorter-term remains uncertain as the market continues to get comfortable with a “lower for longer” crude oil price environment. The following chart shows daily observations of five-year forward total returns versus the then current Index yield. The striking observation is that when the Index is yielding 6.4% or higher, it has never posted a negative five-year total return. Amazingly, over 99 percent of the time, the Index returns better than the yield, suggesting distribution growth or improving valuations. The Index exited the second quarter with a yield of 7.1%. Past performance is no indicator of future performance, and the current energy environment is different from past periods in many ways. However, we continue to believe that long-term investors will be rewarded for putting money to work in energy infrastructure securities at current valuations.



Portfolio Positioning

Our largest relative overweight in our portfolios is in energy infrastructure entities engaged in gathering and processing natural gas and natural gas liquids. Processors take the raw gas stream from production wells and isolate the various components into batches that can then be sent to their end users. Historically, the majority of these entities had revenue that was contractually tied to the price of oil and expenses associated with the price of natural gas. Natural gas liquids that were removed from the production stream typically traded as a percentage of the price of a barrel of crude oil rather than the price of their associated natural gas volumes. As oil prices climbed to historic highs before the financial crisis and then again after the recovery, producers looked to capture more of the upside in commodity prices and contracts shifted over time to be based upon the volume processed, not the dollar value of the volume processed. These contracts are referred to as fee-based; the compensation is a fee for a service provided. On the margin, these contracts are exposed to crude oil prices at the extremes as production will be altered and volumes will contract. Today, producers have reduced the cost of their operating model through improved efficiency, technology, and drilling the best locations in well understood areas of producing basins. The result is that production volumes are more resilient at current prices, and are actually growing and therefore more predictable going forward. Although gathering and processing securities have recovered greatly from the February 2016 crude oil lows, we believe there is still room for improved valuation. In our view, the market is not appropriately valuing the more fee-based cash flows these entities currently experience. Our research shows that the percentage of direct commodity sensitive cash flows in the MLP space has declined from nearly 30% five years ago to less than 10% more recently. Recent drilling activity and improved demand for natural gas and natural gas liquids, as discussed earlier, should push volumes higher and improve performance for this group of midstream players.

Another area of interest for us is investing in diversified MLPs that have growth opportunities across the energy value chain, regardless of what particular part of the cycle we are in. For example, if crude oil is out of favor but natural gas demand is high, a diversified MLP will have opportunities a crude oil midstream player may not. Furthermore, diversified players whose assets stretch from upstream to downstream, as opposed to one or the other, should have opportunities even if supply or demand is weak. Because the Index is dominated by several large-cap diversified MLPs, we think there are opportunities among growing, smaller-cap MLPs that have recently diversified. These MLPs, in our view, are not being valued for their fundamental optionality the way larger-cap diversified MLPs are. Valuations on these smaller-cap names are meaningfully discounted and present another way to play offense in a challenging market.

ATTRIBUTION

In a very volatile quarter there was weakness across the board, with most sectors posting negative returns. Marine Transportation continues to demonstrate sensitivity to crude oil prices, and was the weakest performing group during the period. Large caps proved to be somewhat defensive, but still lost ground. Small caps were hit hard by the lack of investor interest and presumed short-selling, down almost double the loss of the Index. One interesting trend was that the market seemed to prefer those MLPs that had demonstrated distribution growth over the last-twelve months. However, there was no discernable trend when looking at growth expectations for the next twelve months. A positive sign for future MLP returns will be when the market begins to reward future growth expectations. We last saw this shift, from a backward looking market to a forward looking market, in 2013. The ensuing period was a very positive one for MLP investors.

Source:

1. Christopher M. Matthews, “The Shale Revolution’s Staggering Impact in Just One Word: Plastics,” Wall Street Journal, June 25, 2017
2. United States Department of Transportation, Bureau of Transportation Statistics, Table 1-10: U.S. Oil and Gas Pipeline Mileage