November 6 2017

MLP WEAKNESS APPEARS OVERDONE

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KEY TAKEAWAYS

We believe that weakness in MLPs may be overdone and the group could be poised for a turnaround.

Rich yields, attractive yield spreads versus Treasuries, and the potential to play catch-up to oil are among the reasons for our optimism.

Should interest rates rise, we would expect the increase to be gradual, and therefore see rate risk as manageable for MLPs.

Master limited partnership (MLP) weakness appears overdone. The Alerian MLP Index has lost 9.3% in 2017 year to date, well behind the S&P 500 Index's 17.5% return and even the energy sector's 6.3% loss. More recent performance is particularly surprising given the 30% rally in WTI crude prices since June 21, 2017—the Alerian MLP Index has been flat over that roughly 4.5-month period, while the S&P 500 has returned 7%. In an environment where many investments look stretched, this is one that has lagged behind and could offer potentially more upside. Here we discuss several reasons the group has struggled and make the case that it may be due for a turnaround.

WHAT'S WRONG?

We see several reasons for MLPs' recent underperformance, including:

- **Distribution cuts.** Several MLPs have cut their distributions over the past three months, hurting those securities and the group on spillover concerns. These securities are generally held for their income so distribution cuts can be very damaging.
- **Slower growth.** A number of MLPs have focused more on lowering their costs of capital and deploying their capital more efficiently, contributing to reduced growth expectations. That likely translates into slower distribution growth.
- **Capital allocation.** Some investors are concerned that MLPs may have overinvested—or will overinvest—in pipeline expansions, introducing the risk of potentially costly debt or equity financings. Recent equity offerings have pressured the group.
- **Weak natural gas prices.** While oil prices have rallied sharply since June, natural gas prices rose only 3%, weighing on MLPs, which transport both commodities.
- **Legislative risk.** Some are worried that MLPs might lose their favored tax status as part of tax reform. After MLPs were left out of the House's tax reform bill that was released last week, and considering that MLPs offer a small amount of potential tax revenue, we view this as very unlikely.

Investing in MLPs involves additional risks as compared with the risks of investing in common stock, including risks related to cash flow, dilution, and voting rights. MLPs may trade less frequently than larger companies due to their smaller capitalizations, which may result in erratic price movement or difficulty in buying or selling. MLPs are subject to significant regulation and may be adversely affected by changes in the regulatory environment, including the risk that an MLP could lose its tax status as a partnership. Additional management fees and other expenses are associated with investing in MLP funds.

WHY CONSIDER THEM?

For suitable investors, we suggest maintaining modest MLP allocations, or for those without exposure, consider adding some. We think that the group may be poised for a turnaround for the following reasons:

- **Rich yields.** As of November 3, 2017, MLPs have yielded over 7% as an asset class on a trailing 12-months basis, above REIT distributions, utilities, telecommunications, and even high-yield bonds. In a still low interest rate environment, we believe that these yields should be viewed favorably even if distribution growth slows as the industry strengthens its balance sheets and focuses more on sustainable cash flow growth.
- **Attractive spreads versus Treasuries.** MLPs are yield instruments so they are often valued based on their yields relative to bonds. This means that they possess interest rate risk; but, it also means that valuations are particularly attractive in a low interest rate environment. MLPs are currently trading at a 5.7% yield advantage over Treasuries, well above the 20-year average of 3.6% [Figure 1].
- **Attractive valuations relative to high-yield energy bonds.** MLPs historically have had stronger balance sheets than high-yield corporate bonds within the energy sector. As a result, we think that they should trade with narrower yield spreads than high-yield energy bonds. When oil bottomed in the mid-$20s in early 2016, high-yield energy spreads widened out to about 18% over Treasuries, while MLP yield spreads remained under 10%. Today, MLPs look cheap relative to high-yield energy bonds with MLP yield spreads about 1.2% wider [Figure 2].

1 MLP YIELD SPREADS TO TREASURIES HIGHLIGHT ATTRACTIVE VALUATIONS

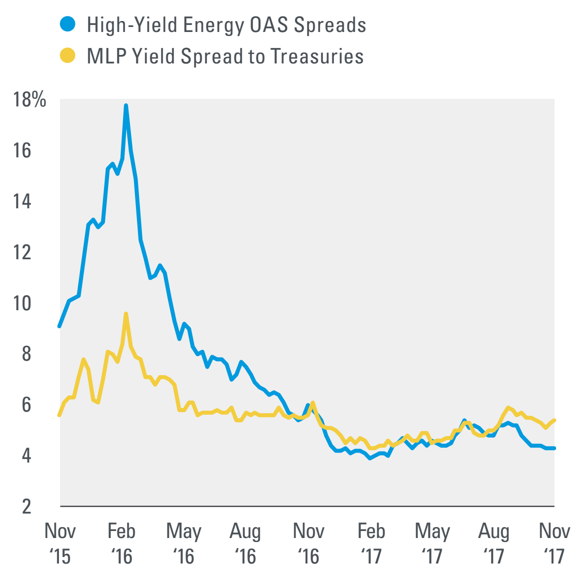
Source: LPL Research, Alerian, Bloomberg 11/03/17

Master Limited Partnerships (MLP) represented by Alerian MLP Index.

All indexes are unmanaged and cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment. All performance referenced is historical and is no guarantee of future results. Estimates may not develop as predicted.

Yield spread is the difference between yields on differing instruments, calculated by deducting the yield of one instrument from another. The higher the yield spread, the greater the difference between the yields offered by each instrument.

2 HIGH-YIELD ENERGY SPREADS HAVE NARROWED BEYOND MLP YIELD SPREADS



Source: LPL Research, Alerian, Bloomberg 11/03/17

Master Limited Partnerships (MLP) represented by Alerian MLP Index.

Indexed to 100 at 11/01/16.

High-yield energy is represented by the Bloomberg Barclays US Corporate High Yield Energy Sector OAS Index.

Option-adjusted spreads (OAS) represent the difference between the index yield and the yield of a comparable maturity Treasury.

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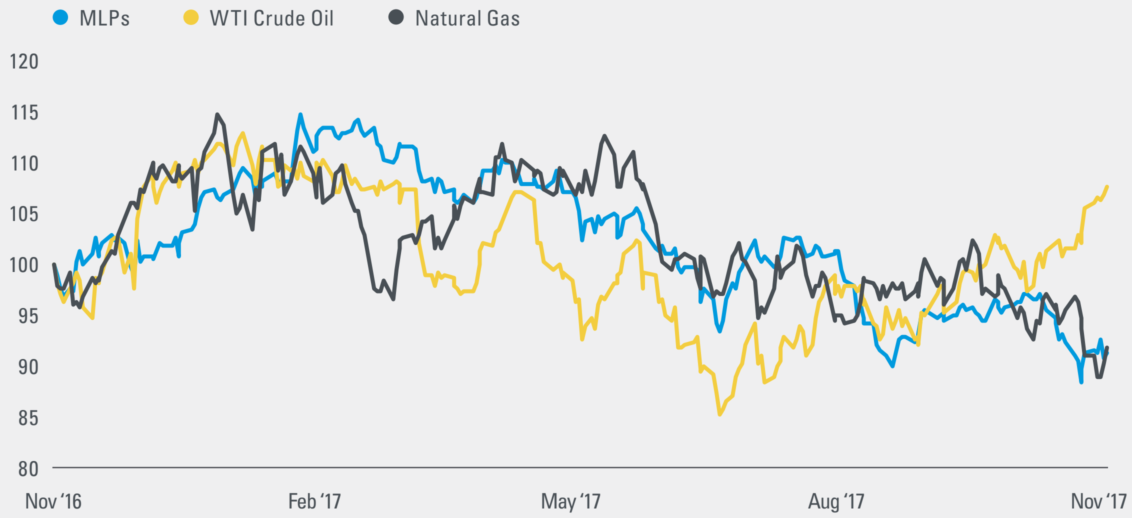
- **Potential to play catch up to oil.** Widespread skepticism that oil prices may be able to break much above the mid-$50s has likely contributed to MLPs' recent struggles, even though pipelines' fortunes are driven more by volumes than prices. Still, the lack of MLP response to the recent oil rally is surprising and suggests a potential opportunity for the group to play some catch up [Figure 3]. Weakness in natural gas prices is an overlooked factor in the group's struggles, but MLPs have historically exhibited higher correlations to oil.
- **Deregulation efforts are ongoing.** The Affordable Care Act experience illustrated how difficult it is to get major laws passed in the current divisive political environment. But regulations, notably of the environmental variety, can be changed with the stroke of the president's pen. Accordingly, pipeline construction projects that were rejected or delayed by the Obama administration appear likely to gain approval from the Trump administration, buoying MLPs' growth prospects (currently there are over $20 billion worth of these projects). The regulatory environment is also becoming more supportive of oil and natural gas exports.

INTEREST RATE RISK

Beyond a collapse in energy prices, a spike in interest rates may be the biggest risk MLPs face. Because MLPs are equity income vehicles, they possess some bond-like characteristics in how they trade. In addition, many MLPs depend on their ability to borrow and to carry debt. That means that MLP performance should generally be better when interest rates fall (or when Treasuries rally).

3 MLPS HAVE THE OPPORTUNITY TO PLAY CATCH UP TO OIL



Source: LPL Research, Alerian, Bloomberg 11/03/17

Master Limited Partnerships (MLP) represented by Alerian MLP Index.

Performance indexed to 100 as of 11/01/17.

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Should interest rates rise, we would expect the increase to be gradual and therefore see this risk as manageable for MLPs.

After tracking interest rates relatively closely for much of the past two decades, the group has underperformed since the oil downturn began in late 2014, even when interest rates were falling. This interest rate disconnect may mean that the group is in a better position to withstand higher interest rates should they materialize.

CONCLUSION

We believe that weakness in MLPs may be overdone and that the group could be poised for a turnaround. Although some of the challenges noted above may continue to weigh on the group in the near term, we expect the value of MLPs to be increasingly recognized by the market over time. ■

INDEX DESCRIPTIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Alerian MLP Index is a composite of the 50 most prominent energy Master Limited Partnerships that provides investors with an unbiased, comprehensive benchmark for this emerging asset class. The index, which is calculated using a float-adjusted, capitalization-weighted methodology, is disseminated in real time on a price-return basis (NYSE: AMZ) and on a total-return basis (NYSE: AMZX).

The Bloomberg Barclays U.S. Corporate High Yield Energy Index covers the universe of fixed rate, non-investment grade debt. Eurobonds and debt issues from countries designated as emerging markets (sovereign rating of Baa1/BBB+/BBB+ and below using the middle of Moody's, S&P, and Fitch) are excluded, but Canadian and global bonds (SEC registered) of issuers in non-EMG countries are included. Original issue zeroes, step-up coupon structures, 144-As and pay-in-kind bonds (PIKs, as of October 1, 2009) are also included.

RES 9208 1017 | Tracking #1-664257 (Exp. 11/18)