Economic and Market Insights

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By Cindy Rapponotti, CFA®
Director of Alternative Investment Strategy

Sell-off in petro commodities looms large for global economy, but Energy Master Limited Partnerships can position you for success

While the sell-off in oil and commodities command headlines, master limited partnerships (MLPs) that invest in energy-related infrastructure supporting oil and gas production are enjoying a quiet resurgence not seen since the 1970s.

MLPs benefit from the transportation, storage or processing of a commodity, not necessarily just the underlying price of the commodity itself. The effects of temporarily plunging oil prices as of late, for example, have limited impact on the long-term returns of MLPs (see chart). A way to visualize this is to think in terms of a toll bridge – the toll booth operator gets to keep his toll fee no matter which way energy freight travels back-and-forth on his thoroughfare.

Much like a stock, MLPs are partnerships traded on major U.S. securities exchanges (NYSE or NASDAQ). Investors are attracted by MLPs' potential high yields and tax advantages, key positives for some income-sensitive investors in our low-interest rate environment. On the other hand, reaping those tax advantages takes a lot of complex paperwork, and there are certainly some other risks in MLP ownership that must be weighed.

Let's start on the plus side: MLP investing is gaining more acceptance as an asset class overall. Investors seeking income along with growth potential allocated more to this sector over the last several years. The major performance drivers for MLPs are growing U.S. energy production and, to a lesser extent, worldwide energy demand. For example, the Alerian MLP Index (AMZ), a composite of the 50 most prominent energy MLPs, was up 4.8% in 2014 following a return of 27.59% in 2013.

U.S. energy production means more volume flowing through pipelines, translating into revenue growth and higher dividends for MLPs. The attractive yields and predictable cash flows, usually paid quarterly, make MLPs something to consider for 2-4% of an overall portfolio.

Adding to the MLP momentum is the fact that the U.S. energy industry is certainly poised toward long-term growth. The United States currently produces more natural gas than any other country in the world and continued energy production capacity looks bright. Production is expected to continue to increase into 2020 according to the U.S. Energy Information Administration, particularly from offshore and shale drilling.

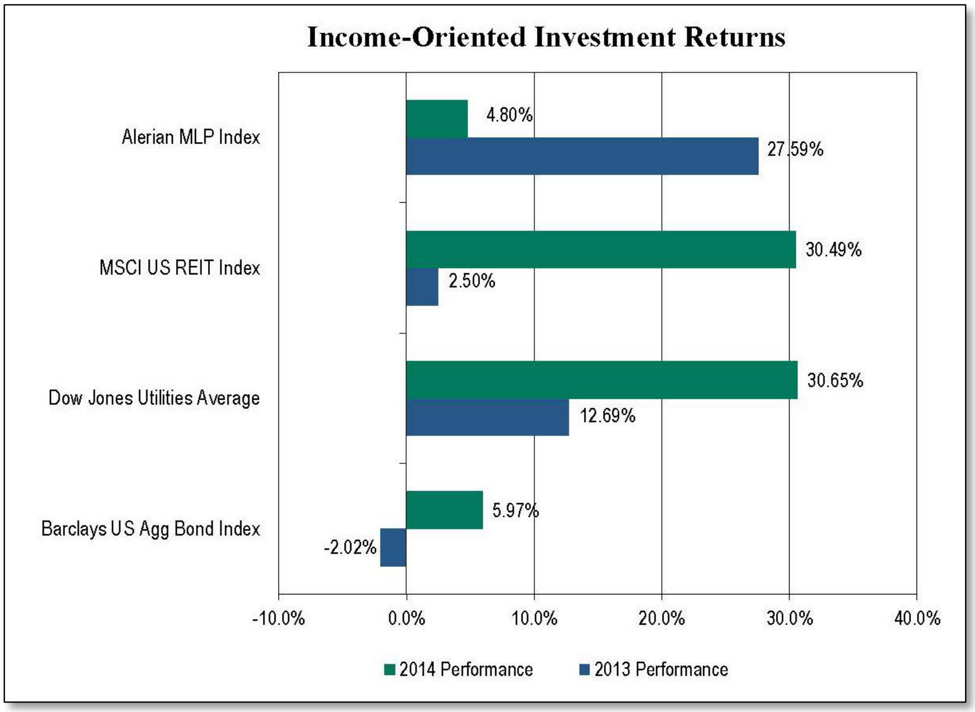
On the drawback side of the MLP equation, the aforementioned tax complexities can take their own toll. Instead of receiving a Form 1099 as investors would for stock dividends, MLP investors generally receive the more complicated Schedule K-1 form, which can often delay tax filings or add complexity in working with many advisors. You may even need to file a state income tax return in all states where the MLP operates, adding another layer of complexity. Some of these complexities can be avoided by investing in an MLP exchange traded fund, an MLP mutual fund or an exchange traded note linked to an MLP Index.

Finally, another possible unsettling aspect to MLPs is the fact that there can be changes in government fiscal policy, and the new Congress in 2015 has tax legislation on the agenda. The incentive to maintain funding of energy infrastructure in the country for energy independence is very high, and the Keystone pipeline will certainly be brought to the forefront of national debate in the first quarter of 2015.

As an investment vehicle, energy MLPs may not be for every portfolio, but they have historically provided diversification and protection from inflation. This is evidenced by their low to moderate correlations with equity market returns, minimal correlations with bond market returns, and the fact that the rates charged are regulated by the Federal Energy Regulatory Commission (FERC), which has historically called for annual increases based on the Producer Price Index (PPI). Currently, the annual adjustment is set at PPI +2.65%.

All things considered, the MLP sector as a whole continues to grow, making these investments more actively traded than ever before. MLPs range in size from approximately $200 million of market capitalization up to $60 billion. More than 100 MLPs in the sector have a combined market capitalization of $464 billion, and the trend is upward.

Many analysts expect MLP cash flows to grow more than 5% per year, providing an attractive investment on an income and total return basis. Alternative investments like energy MLPs provide diversification to a traditional portfolio of stocks and bonds. Stable but growing cash flows and low correlations with underlying oil prices can make MLPs an attractive option for many portfolios. By introducing investments that behave differently from the rest of the portfolio, investors can reduce volatility in their portfolios and potentially enhance long-term returns. Because of the complexities involved in MLPs, potential investors should always consult their investment and tax advisors when evaluating these types of investments.



Source: Bloomberg

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