13 Energy Investments Yielding 6%

By Daren Fonda, Senior Writer and Investing Columnist
Fidelity Interactive Content Services
09/06/12

Master limited partnerships live in the sweet spot of America's energy boom. Here's how you can tap into these yield-rich investments.

No one likes paying tolls on the highway, but tolls provide a steady stream of income for the folks who pocket the cash. Those same tolls are the reason master limited partnerships (MLPs) can play a key role for investors looking for income in today's yield-starved markets.

MLPs are like the toll collectors of the energy world. They own and operate the country's energy pipelines, terminals and oil and gas processing plants. Many of them collect steady income from the oil and gas flowing through their pipes and other facilities. The pipelines and other infrastructure they've built act as a "wide moat" that helps protect them from competition.

But perhaps best of all for investors seeking income, MLPs, due to their partnership structures, typically pay out most of their cash flow as quarterly distributions. Many professional investors and financial advisers like MLPs because they're stable, fee-based businesses at the sweet spot of a growing industry. Energy production in the lower 48 states is booming thanks to new drilling technologies that are opening up oil and gas fields from North Dakota to the East Coast.

MLPs also tend to be more stable than other energy-related investments. That's because most MLPs don't take physical ownership of the commodity; they store, process and transport it and they get paid whether a barrel of oil costs $40 or $140. "A toll doesn't change whether you're driving a Mercedes or a Yugo, and it's the same for an MLP," says Malcom Day, head of the MLP investment committee at Eagle Global Advisors, an investment advisory firm in Houston.

Indeed, MLPs can help diversify a portfolio and smooth out returns. They don't always move in sync with the broader stock market, and they're much less volatile than other energy stocks, according to a recent report from Morgan Stanley. MLPs also tend to move independently of Treasurys and corporate bonds. The upshot: When other investments are faring poorly, MLPs may hold up better.

Granted, MLP yields have come down in recent years and remain well below levels in 2008, when they topped 11%. But yields are still on the higher side, making them especially attractive in today's low-rate environment. The benchmark Alerian MLP index, for example, currently yields 6.4%, beating rates on utilities, REITs, Treasurys and investment-grade corporate bonds.

The rewards … and the risks

The economic backdrop for MLPs looks promising as well. The natural gas industry forecasts the U.S. will need $250 billion in energy infrastructure to be built by 2035. And MLPs are at the forefront of this business, with cash flows rising for many companies as domestic production grows.

Still, MLPs may not be a good fit for all investors. For starters, they are still risky: Prices tumbled some 40% during the 2008 financial crisis as energy prices sank, and the same thing could happen in another flight to safety, says Libby Toudouze, a portfolio manager with Swank Capital, an investment advisory firm in Dallas that specializes in MLPs.

Rising interest rates also pose a risk. Many MLPs are now borrowing money at exceptionally low rates to buy assets and fund growth. But that won't last forever, and when rates do eventually rise, MLPs would face higher borrowing costs and lower profitability, says John Dowd, a Fidelity Investments portfolio manager who runs the Fidelity Select Energy Portfolio Fund (FSENX). "When financing is available and cheap, MLPs do well, but if that window closes, MLPs as a group can be hurt."

Moreover, MLPs look pricey compared to other energy-related stocks. Dowd notes MLPs trade at steep valuations compared to their cash flows, while many energy stocks look "insanely cheap." MLPs may not grow as fast as production companies. And while many MLPs are raising their distributions, investors may not see more of that money if the MLP is set up to pass a greater share of distributions to its general partners, which is often the case.

Perhaps the biggest sticking point, though, is MLPs' complex tax treatment. Because they're limited partnerships, MLPs aren't taxed at the corporate level. Instead, they pass their profits and deductions to investors, who are "limited partners" in the business and receive a K-1 statement rather than the standard 1099 form.

This can have some tax advantages since around 80% to 90% of MLP distributions are considered "return of capital." Essentially, distributions are tax-deferred until an investor sells the MLP. But that's when the tax bite can sting investors with both capital gains and ordinary income taxes. Processing multiple K-1s, moreover, can be a time-consuming and expensive accounting headache come tax time.

Ways to invest

Still, if you're willing to do some homework and have an accountant who can help come tax time, MLPs can be worth a look. Investors can buy MLPs in a mutual fund, ETF or ETN (exchange-traded note), all of which offer a way to invest in a broad basket of MLPs and help with the tax issue, since these investment products provide 1099 forms instead of K-1 statements. Options include the ALPS Alerian MLP ETF (AMLP) the JPMorgan Alerian MLP Index ETN (AMJ) and the SteelPath MLP Select 40 Fund (MLPEX), an actively managed mutual fund.

While ETFs and funds offer a one-stop shop, they come at a steep price. ETFs and funds that hold more than 25% of assets in MLPs must register as C-corporations, subjecting them to corporate taxes on investment gains. That means they generally hold back 35% of market gains to pay taxes — slicing about a third of any investment gains off the top.

That tax drag can sting. The Alerian MLP ETF, which tracks a slightly different index, the Alerian MLP Infrastructure index, had a total return of 11.75% over the last year versus 17.40% for the index, and the ETF has trailed the index by 6.4 percentage points since the ETF's inception in August 2010. Jeremy Held, director of research for ALPS Advisors (the ETF's sponsor), says corporate taxes can have different effects on the ETF's returns. When MLP prices are rising, the ETF would likely trail the index because the ETF would accrue deferred tax liabilities. When MLP prices fall, the ETF would likely beat the index because it would "unwind" those liabilities (the index gets no such tax benefit). ETNs, which are debt securities, don't pay corporate-level taxes and have generated higher returns. The JPMorgan Alerian ETN, for example, returned 17.78% in the last year, beating the Alerian ETF by 6.03 percentage points, according to Morningstar.

ETNs aren't tax-free, though, and have some downsides as well. Distributions are taxed as ordinary income at rates up to 35%, making ETNs best suited for a retirement account. ETN yields are also lower than the index. And because ETNs are a form of unsecured debt, there's always the risk that the issuer will default.

For investors who want an ETN, one option to consider is the Credit Suisse MLP Index ETN (MLPN). The ETN follows the Cushing 30 MLP index, which weights MLPs equally instead of by market cap like the Alerian index. Companies in the Cushing index were selected according to various measures including their growth in distributions, balance sheets and financial strength. And the index only tracks "midstream" companies, which are less sensitive to commodity prices than upstream and downstream companies. (In the energy world, upstream refers to exploration and production, midstream to processing, storage and transportation, and downstream to refining and marketing.)

"The No. 1 driver of MLP performance is growth of distributions," says Toudouze, whose firm runs the Cushing index. "If you can identify growth of distributions, you can identify growth of MLPs." The Credit Suisse ETN, which trailed the Alerian index in the last year, may be more volatile since it tracks an equal-weighted index with a smaller average market cap. Longer term, the Cushing index's performance has been better, beating the Alerian MLP Infrastructure index over the last five years and generating higher total returns since 2001, according to data from S&P.

Going solo

For investors willing to do some research, individual MLPs can provide the highest total returns. Owning MLPs individually means dealing with K-1 forms and taking a bit more risk. But a basket of five or six major companies is likely to track the Alerian index fairly closely and returns should be higher in the long run than in an ETF or fund, says George Kiraly, an adviser with LodeStar Advisory Group in Short Hills, N.J.

MLPs he's purchased for clients include Kinder Morgan Energy Partners (KMP), Boardwalk Pipeline Partners (BWP), Enterprise Products Partners (EPD), Williams Partners (WPZ) Energy Transfer Partners (ETP) and Cheniere Energy Partners (CQP). These are generally strong businesses with a long history of stable distributions, he says. They offer a good mix of exposure to pipelines, transportation, storage and processing. And their blended yield is 6.64%.

Another option is to buy shares in the five largest MLPs in the Alerian ETF: Enterprise Products Partners, Kinder Morgan Energy Partners, Magellan Midstream Partners (MMP), Plains All American Pipeline (PAA), and Oneok Partners (OKS). Combined, they account for over 41% of the ETF and a large share of its performance.

However you invest, many advisers recommend MLPs for a small portion of their client portfolios. "Yields look fabulous compared to what's out there now," says Kiraly. And unless there's a radical change in the U.S. energy industry, MLPs are likely to keep collecting tolls for years to come.

LodeStar Disclaimer

LodeStar's and/or George Kiraly's coverage and comments in this article are not intended as and should not be used to provide investment advice and do not address or account for individual investor circumstances. Investment decisions should always be made based on the client's specific financial needs and objectives, goals, time horizon, and risk tolerance. Asset classes described in this report may not be suitable for all investors. Past performance is no guarantee of future results. No forecast should be considered a guarantee either.

This article has been published for general informational purposes and is not an offer or solicitation to sell or buy any securities or commodities. Any particular investment should be analyzed based on its terms and risks as they relate to your specific circumstances and objectives.

The securities identified and described in this article do not represent all of the securities purchased, sold or recommended for client accounts. The reader should not assume that an investment in the securities identified was or will be profitable. Consult your LodeStar advisor for more information.