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In Pursuit of Value

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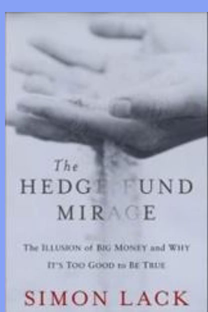


The MLP Risk Premium

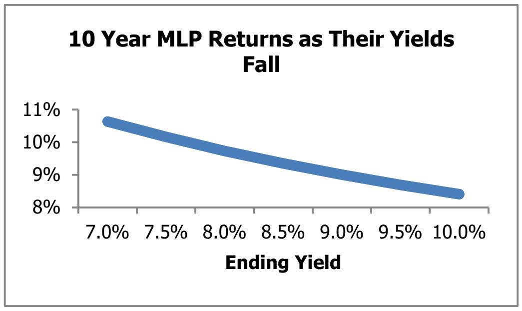
Regular readers will be familiar with examples we've used in the past of how a portfolio of stocks and cash can be used as a substitute for bonds. It turns out that with fairly reasonable assumptions the stocks/cash barbell doesn't need to hold much in stocks to have a decent chance of beating bonds. We wrote about this most recently in December's newsletter in an article titled *Cash is Not Quite Trash*. With the S&P500 yielding around 2% and high grade bonds around 3%, you could sell your high grade bonds and split the resulting proceeds 25/75 between stocks and cash to achieve the same ten-year after-tax return you would by holding the bonds.

It's another way of saying that the Equity Risk Premium, defined as the earnings yield on stocks versus bonds, is high. It's been that way for a long time, and you can debate how it will evolve. Interest rates remain extremely low for this stage of the economic cycle and that's the main reason stocks look relatively more attractive than bonds. Both assets may deliver poor returns over the next few years, but bonds are more likely to disappoint given their starting point. Since the best predictor of the return on a bond is the yield at which you buy it, paltry future returns are well advertised. You still see research using historic bond returns as the basis for their inclusion in a portfolio, usually for diversification. Why think when you can use a spreadsheet?

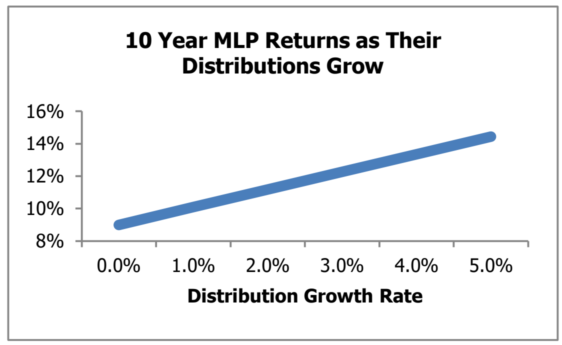
On Tuesday March 29th, Janet Yellen did what she does so well, which is to sound dovish. In the history of the Federal Reserve we have on many occasions been blessed with appropriate leaders. Cigar-chomping Paul Volcker with his imposing height was always going to vanquish inflation in the 70s and 80s. More recently, how fortunate we were to have a student of the Great Depression in Ben Bernanke at the helm during a time when we faced the very real risk of a repeat. Janet Yellen may similarly turn out to be the right person at the right time. Her dovish background is well documented. One feels that she will raise interest rates only when all other possibilities have been exhausted. The mantle of inflation hawk does not sit easily with her, and when it appears that she's been cornered by some of her FOMC colleagues into agreeing on a further step towards "normalization", she quickly moves from bird of prey to symbol of peace, soothing traders' concerns and appearing visibly more comfortable in the process. *Bonds Are Not Forever*, did not predict Janet Yellen but did forecast her behavior. Public policy continues to be run so as to be respectful of the burden of debt and to gradually erode its real value. It is good, but there's still no reason to help the process along by holding bonds.

Since most of our writing touches on Master Limited Partnerships (MLPs), this newsletter should be no different. We are hereby introducing an analog to the Equity Risk Premium, the MLP Risk Premium. Just as it's possible to show that a combination of stocks and cash can provide a good substitute for investment grade bonds, so can a combination of MLPs and cash. We used to think of MLPs as a good substitute for high yield bonds, since that was the competing asset class with which they were most highly correlated. They shared similar volatility but MLPs had outperformed over every time frame. The 2015 MLP Crash necessarily challenged this comparison; rather than being a source of stable, growing distributions for income seeking investors, MLPs nowadays represent probably the most depressed and therefore attractively valued sector available. One simple illustration is to note that investing in an equity security whose yield falls by 2% will generate a one-year return of greater than 30%. MLP yields really could fall by 2% in the year ahead – they managed as much in bouncing off the recent lows of February 11th. There can't be another asset class with anything remotely close as a potential return.

But to return to our stocks/cash substitute for bonds, if $25 in stocks stands a respectable chance of delivering what $100 will in bonds, how about MLPs with their near double-digit yields? It depends on where yields go and how much distributions grow.



The two charts reflect two sensitivities. The first assumes you invest in MLPs at 9% and shows returns with different final yields in ten years which causes a capital gain/loss, while conservatively keeping actual distributions unchanged. The second chart assumes MLP yields remain at 9% throughout the next ten years but shows total return with different distribution growth rates. Everything is pre-tax to allow for easier comparison with bonds.



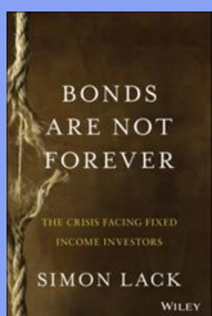
Visually, you can see that compared with 3% yielding bonds you don't need much in MLPs to get the same result, depending on your return assumptions. So MLPs at 9% assuming no drop in yields or distribution growth with dividend reinvestment over ten years would return $137 for $100 initially invested versus $34 for 3% yielding bonds, thus requiring less than a quarter of the money invested in bonds to match its return. If you assume 5% annual distribution growth, the 14% annualized return would generate $286 on $100 invested, meaning you would need just under an eighth of your bond money in MLPs to match it (figures are pre-tax). For the optimist, if MLPs grow distributions in line with the past ten years and return to the average spread to treasuries, you'll return 21% annually for the next decade (6.5X your initial investment). The 100% high grade bond portfolio return would then be matched by 6% MLPs/ 94% Cash.

In terms of the downside, over ten years even if distributions *shrank* annually at 5.5% (Alerian reports 6.8% growth over the past ten years) you'd still wind up with a 3% annual return. If prices were 50% lower in a decade but distributions had been paid throughout, you'd have earned 6.2% annually. In other words, much needs to go wrong for MLPs to do worse than bonds over a period of years. Of course, forecasting scenarios is great but the sector still fell by 58.2% from August 31, 2014 to February 11th, 2016. Given the volatility, MLPs should offer attractive returns. But if ten years is too far away, over the next twelve months as long as they maintain distributions investors are likely to drive yields lower, and 2% lower gets you a 38% one year return.

To Our Clients

At SL Advisors it's important to us that your investments with us are aligned with your financial situation and objectives. If there have been any relevant changes from your perspective or any reasonable restrictions you wish to impose, please let us know and we'll be happy to discuss appropriate modifications. Of course, anytime you have any questions or concerns don't hesitate to contact us. We value your business, and never forget the faith you have placed in us as stewards of your capital.

SL Advisors, LLC focuses on investment strategies that provide income without relying on fixed income securities.



Upcoming *Wall Street Potholes* Presentation

On Tuesday, April 5th at 12 noon I'll be giving a presentation on my new book to the New York Society of Security Analysts at the NYSSA Conference Center, 1540 Broadway, New York.