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In Pursuit of Value

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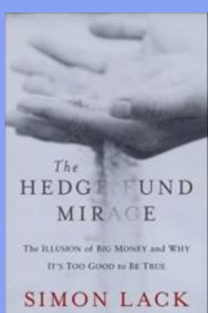


Preparing for Higher Rates

In the Summer of 2013, I published *Bonds Are Not Forever; The Crisis Facing Fixed Income Investors.* In spite of a title suggesting bond avoidance as an investment strategy, it didn't sound the alarm for a pending crash in fixed income. While that would be dramatic and is always a possibility, I didn't believe it was a serious likelihood and still don't today.

The problem with bonds remains their pygmy yields which provide scant return (especially after inflation and taxes) and little protection against negative surprises (however unlikely they may seem). You don't need to believe the Federal Reserve's $4.5 trillion balance sheet is a step on the road to currency debasement to deem present yields inadequate. Since the best predictor of your holding period return on a bond is the yield at which you buy it, returns on bonds bought now are unlikely to help anybody retire with an increased purchasing power in the future. To a substantial degree, today's fixed income investors are insensitive to return. The central banks that own significant portions of U.S. Federal debt are clearly not commercially driven. Many private investors hold bonds because of asset allocation requirements that rigidly impose some bond holdings. Some wistfully hope that future returns will be similar to those of the past, in willful denial of the Math, and others simply can't face any additional risk in public equities. 2008 remains a searing memory for many.

Bond returns in recent years have benefitted from a healthy dose of capital appreciation caused by falling yields. High yield bonds last had a losing year in 2008, and while AAA bonds haven't been as consistent, they've still managed a five year annualized return of 3.2%. The preponderance of forecasts remains for higher rates, even though this has been a persistently wrong call. Even the Federal Reserve's own projections, published four times a year and used in their deliberations on interest rates, have been too high. If the people who set rates can't predict them, what chance do the rest of us have?

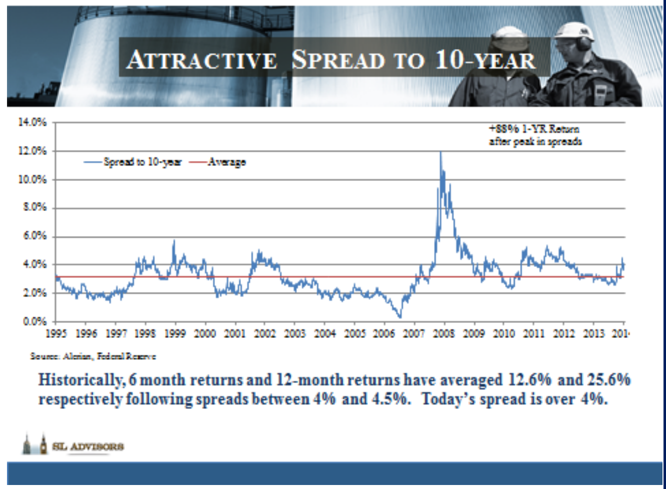
Nonetheless, even the most bullish bond investors are conceding that short term rates will rise later this year. Whether that headwind causes bond yields to simply stop falling, or to rise remains to be seen. However, one must consider the possibility that simply achieving a total return on bonds equal to the coupon (i.e. not suffering any price loss) will have to pass for success in the future. While the Fed is likely to be extremely gentle as it embarks on its first tightening since 2006, bond investors may increasingly find they're left to fend for themselves as central bank largesse recedes.

Bonds Are Not Forever made the case that income seeking investors need to look farther afield than fixed income to satisfy their need. Since 2008, the public policy response has included a steady transfer of real wealth from savers to borrowers as a time-tested solution to an economy over-burdened with debt. Although the public outcry at this financial repression has been muted, today's bond investors are passive facilitators of a steady diminution of their inflation-adjusted purchasing power. When government policy is to render bonds unattractive, thoughtful investors respond by taking their money elsewhere. The book showed how it's possible to create a balanced portfolio using the right combination of public equities (both long-only and hedged) and cash.

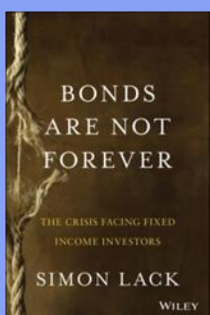
Master Limited Partnerships (MLPs) were recommended as a good substitute for High Yield Bonds, although junk bonds and REITs have both been part of the solution for many investors. Which is why the number one question for a substantial number of investment professionals concerns market performance through the new monetary policy regime. Since numbers provide context to such an enquiry, here is some historic data on asset class relationships.

Analyzing monthly returns back to 1996 (the inception of the Alerian MLP Index) reveals that in months when bonds (defined here as AAA industrial bonds) were down, High Yield and REITs were both modestly positive (+0.3% and +0.4% respectively). However, when bonds had a bad month (defined as a negative return of -1% or more, equivalent to on average a 0.15% jump in yields), HY and REITs become decidedly more rocky (-0.5% and -1.3% respectively).

By contrast, monthly MLP returns are +1.4% in the regular down market for bonds and +1.1% during the more robust type. Now it's true, MLPs have generated strong returns for many years, so these statistics are somewhat flattered by the fact that $1 invested in the Alerian Index on January 1st, 1996 was worth $16.37 by the end of last year. Even $1 invested at the end of 2008 had reached $3.82 just six years later. A more robust analysis adjusts for the strong secular performance of MLPs, by comparing returns adjusted down by their long term average. MLPs have on average returned 1.3% a month since 1996. Subtracting this long term return from their performance when bonds are falling leaves MLPs with adjusted returns of +0.1% and -0.2% respectively; not that much affected by rising rates. Their relatively low correlation with Bonds of 0.26 reflects this. In addition, distributions that regularly grow provide further protection, by contrast with bonds whose payouts are fixed at inception.



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



Gently rising rates is certainly the Fed's desired path, and the historical record suggests this need not be traumatic for MLPs. However, a bumpy ride is certainly possible. Memories of the "Taper Tantrum," triggered in May 2013 when then Fed chair Bernanke mentioned the eventual end of Quantitative Easing (QE) led to a 1% jump in bond yields. Although the ultimate phase-out of QE was far less impactful, a jump in bond yields when the Fed raises short term rates ought not to be a big surprise in spite of its widespread anticipation. Excluding 2008 for a moment, there have been four other episodes since 1996 of AAA bond yields increasing by more than 1%. Of note, the late stages of the dot.com (1999-2000) bubble saw REITs suffer an eventual 25% loss of value. MLPs lost 16% while High Yield bonds dropped as much as 12% a couple of years later during the bear market for equities.

Although 2008 probably represents the worst financial environment any of us will experience, as a measure of how bad things can get I'd note the following Peak-to-Valley falls: S&P500 (51%); High Yield (33%); REITs (68%) and MLPs (41%). Moreover, S&P dividends as well as payouts on High Yield bonds and REITs all fell, while MLPs in aggregate managed a modest distribution increase.

So where does that leave us today? Although High Yield Bonds, REITs and MLPs are to some degree regarded as substitutes for one another by income seeking investors, they offer quite different valuations. HY and REITs are close to their highs, while MLPs dropped 14% from last Summer to the end of 2014 because of the collapse in oil. Since MLP distributions have generally continued to grow, the yield on the benchmark Alerian Index recently reached 6.4% before a subsequent firming in MLPs brought the yield down somewhat. At more than 4% above the ten year treasury, MLP yields offer some potential to absorb increasing rates without suffering a substantial drop in prices. When MLP yields have been more than 4% higher than treasuries, subsequent 6 and 12 month returns have averaged +12.6% and +25.6% respectively.

Though history doesn't repeat, some think it rhymes. Income-seeking investors must consider how their yield-oriented investments are likely to perform once short term rates begin rising and long term rates at a minimum stop falling. The more attractive an asset's valuation, the better able it is to withstand the impact of rising interest rates, which will affect every asset class.