Dividends on Pipeline Stocks Remain High

Markets finished the strongest quarter sine 1987 yesterday, led by the energy sector. The American Energy Independence Index, which comprises North America's biggest pipeline stocks, is still down 29% for the year. Some investors are weary of years of underperformance against the broader market, combined with high volatility.

The volatility is largely a function of the investor base. In March, Closed End Funds (CEFs) that were forced to cut leverage at the lows added to the indiscriminate selling (see The Virus Infecting MLPs). Fund managers such as Kayne Anderson and Tortoise were to blame for not having the good sense to reduce risk earlier. The good news is that the consequent destruction of capital has rendered these CEFs less able to repeat, because they're now a lot smaller.

Back in March, investors had many concerns about dividend sustainability. The top ten companies, which represent over half the sector's $490BN market cap, all maintained payouts (Cheniere doesn't pay a dividend). A recurring question we get from investors is, what's the catalyst that will get stock prices higher? Putting aside higher crude oil, which usually coincides with improving sentiment, we believe the continued high dividend yields will draw in more buyers.

In Pipeline Cash Flows Will Still Double This Year, we explained how falling spending on new projects is driving cash flows higher. Covid-19 has produced few positives, but one of them is an acknowledgment by the energy industry that investing in new production and its supporting infrastructure needs to be cut. It may not be what executives want, but investors can find plenty to like about reduced spending.

In the next few weeks companies will report earnings and updated guidance. We don't expect any of the biggest pipeline companies to cut dividends. Oneok (OKE) is probably the most at risk, but since they recently completed a secondary offering of common equity it would seem odd timing for them to cut.

AMERICAN ENERGY INDEPENDENCE

Pipeline Corporations Offer Stable Dividends

Top ten midstream stocks by market cap

Sources: Company press releases; Yahoo Finance

Name	S&P Rating	Market Cap	Dividend Yield
Enbridge	BBB+	61.2	8.0%
TC Energy	BBB+	39.2	5.7%
Enterprise Products	BBB+	38.3	10.2%
Kinder Morgan	BBB	33.2	7.2%
Williams	BBB	22.3	8.7%
Energy Transfer	BBB-	18.9	17.4%
MPLX	BBB	18.0	16.9%
Pembina	BBB	13.4	7.5%
ONEOK	BBB	13.1	12.4%
Cheniere	BB	11.8	0.0%
Average		26.9	9.4%

These top ten companies have an average market cap of $27BN and an average yield of 9.4%, including Cheniere. Every three months pipeline stocks pay in dividends more than two years' worth of interest on ten year treasury notes. Energy has been too volatile, but the improving free cash flow picture that is supporting dividends contrasts positively with others. We don't know of another sector that is going to double its free cash flow this year.

Conversations with investors continue to reveal widespread caution about the overall market. The news on Covid-19 is rarely positive, and many find it difficult to maintain a constructive outlook against this backdrop. But Factset is still forecasting 2021 S&P500 earnings to be flat to 2019, fully recouping the Covid-19 drop in just one year. This, combined with low bond yields, continues to drive long term investors into stocks (see The Stock Market's Heartless Optimism and Stocks Look Past The Recession and Growing Debt).

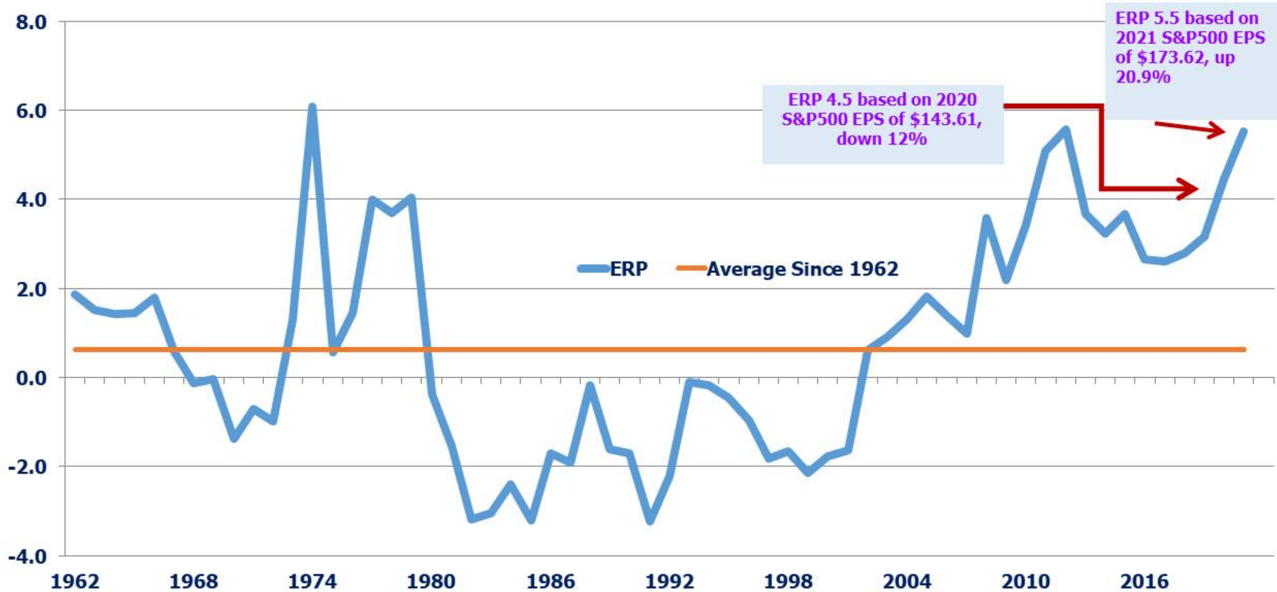
The dividend yield on the top ten pipeline stocks is a staggering five times that of the S&P500. As investors become increasingly comfortable that these are sustainable, yields will be driven down by new buying. Earnings reports in the

coming weeks will provide an important opportunity for companies to provide confirmation.

The Stock Market's Heartless Optimism

Last week in our local paper, the Obituaries section ran to three pages. 17 people were listed. 14 of them were over 80, and three were in their 60s. The steady drumbeat of death, economic destruction and lockdown is why the stock market looks as if it's divorced from reality. The S&P500 is only down 11.7% for the year, after being up 31% in 2019. In late March it briefly dipped below 2,200, where it registered -32% YTD. If instead it had simply spent the last four months meandering down to its present level, performance would be just moderately poor.

The stock market may not be right, but the collective outlook of investors is that we're enduring an economic blip that will pass within a year or so. Bottom-up S&P500 earnings forecasts are for next year to be higher than last year – and 2021 earnings forecasts have already been revised 12% lower since January.



The news and the mood are terrible. The stock market is heartless, but is it also irrelevant? If earnings come in as expected next year – admittedly still a big "if" since revisions continue to be down – stocks are cheap. The Equity Risk Premium (ERP – S&P500 earnings yield minus ten year treasury yield) is at the levels of the 2008 financial crisis, even following a 27% rebound from the March lows. Unless 2021 earnings are revised down substantially, the relative attraction of stocks will draw them still higher. If the market keeps rising, the resulting headlines will coincide with, and perhaps cause, a lifting of the popular mood.

What is the cold-hearted analysis that's reflected in today's valuations? What follows is not a run at amateur scientist, for which we're not qualified. It's a virus-driven upside explanation for stocks.

As much as it pains me to write this, and with deep sympathy for the many families who have lost a loved one, the fact is that not that many people are dying. In two months, 50,000 Americans have died from Coronavirus. We probably undercounted somewhat at the beginning, and it's likely the virus was killing people as early as January. We may be overcounting

now, because if a patient dies with Coronavirus it's more likely to be recorded as the cause of death even if they suffered from other, serious illnesses.

In 2018, the CDC reports 2,839,205 deaths in America. People are a bit more likely to die in the winter, but on average around 7,780 people die every day. Over the past two months, we would have expected just over 473,000 deaths anyway. The 50,000 Coronavirus-attributed deaths is, without doubt, 50,000 too many. But the demographics are by now widely known to be heavily weighted towards older people, just as in our local paper's Obituaries section. The virus is denying as full a life as all these people deserve, but its lethality for younger people overwhelmingly relies on other serious health conditions.

One bright spot is that the most recently weekly CDC figures report only 62% of "Expected Deaths from All Causes". This is partly because nobody is driving anywhere, so road deaths are down. On average, 730 people die every week in car accidents. The fortunate souls who are alive thanks to lockdown don't know who they are, but they'll be consuming products and services for many years to come.

The infection numbers are largely useless, because in the U.S. we've only tested 1.4% of the population and you generally have to be sick to get a test. 5.7% of those who tested positive have died, a catastrophically high figure. However, serology tests which look for antibodies as evidence of prior infection are implying that Coronavirus has spread much wider than as measured by reported infections. Lots of people suffer mild symptoms or even none at all (they are "asymptomatic"). Results from LA County and Santa Clara in California suggest the true infection rate is 50X higher in those regions. New York City estimates that 21% of its residents have been infected.

An infection rate fifty times higher means a fatality rate

fifty times lower. At the outset, health professionals told us that the vast majority of us weren't in mortal danger from contracting it. This seems to be true. Economically, that brings a return to new normal closer. The many constraints on our liberty and enormous economic damage have been imposed not to protect everyone, but to prevent the small percentage who will require hospitalization from overwhelming the system ('flatten the curve"). Widespread compliance has been an enormously selfless act, but this has its limits and we'll transition to more targeted means of protecting our most vulnerable citizens. Earnings forecasts dispassionately reflect that.

It also means that society will learn to live with Coronavirus long before everybody's been vaccinated. This is not a widely held view. If the fatality rate is 5%, we're all going to want a vaccine as quickly as possible. Shortening the testing period and taking some risks with side effects is a worthwhile trade-off. But if the fatality rate is less than a tenth of that, and maybe as low as the flu at 0.1%, widespread vaccination will occur at a more measured pace. Higher risk groups such as the elderly will derive more benefit, even from a vaccine that's not been subjected to normal testing. But if you're young and healthy, medical authorities will determine that the years-long testing schedule remains appropriate. A vaccine that's used prematurely would lower participation in all types of vaccination program, creating a real health catastrophe. And many people may decide for themselves to wait until the Coronavirus vaccine has been widely used safely, with no meaningful side effects. Only half the adult population gets an annual flu shot. It could be several years before a Coronavirus vaccine reaches a sizeable majority of Americans.

Most pipeline companies have maintained guidance at or close to prior levels. Cuts in growth capex more than make up for lower expected cash flow from operations, which will support

their free cash flow. Kinder Morgan raised their dividend by 5%. Other large cap companies including Enbridge, Enterprise Products, TC Energy and Williams (all members of the American Energy Independence Index) have maintained payouts, even though every company has a free pass on cutting dividends right now. Like the rest of big American business, midstream energy infrastructure companies are assessing their own outlook, and it's not as dire as the news.

The virus could take an unexpected turn. We have no scientific insight to offer on that. But today's market reflects today's facts as we know them. Rather than the stock market not reflecting reality, maybe it's telling us to be more optimistic.

We are invested in all the stocks mentioned above.

Washington-DC Based Energy Experts Offer Their Outlook

We had an opportunity to meet with a Washington-DC based independent research firm, specializing in energy policy and geopolitics last week. The following is from our notes on their discussion.

On Iran, one principal, a highly decorated ex CIA officer and Iran expert, thought markets continue to underestimate the risk to oil infrastructure and production in the region. He expects tensions to increase in the months ahead, possibly leading to direct negotiations with the U.S. in 3Q20. He expects asymmetric attacks to resume once plans are approved

by Supreme Leader Khamenei, with military confrontations in Iraq but energy infrastructure targeted elsewhere in the Middle East. He placed the odds of a major escalation at 25%, most likely as a result of a miscalculation followed by a disproportionate U.S. response ("Trump likely to hit back 10X").

We would note that U.S. infrastructure assets should look relatively more attractive to investors in the scenario described above (see Gulf Tensions Back in Play).

They Also Analyze Energy Markets

On Libya, he noted that the lost output of 1 Million Barrels a Day (MMB/D) has had muted impact, because OPEC retains excess supply well in excess of that. He also thought that Saudi Arabia was willing and able to make further cuts if needed, as long as others are in compliance.

Contrary to consensus, he sees Venezuela increasing output to 0.8 MMB/D, because the current bottleneck is in marketing. The fact that the U.S. has allowed Chevron and others to continue business in Venezuela suggests a tacit acceptance of exports finding their way to market.

On Electric Vehicles (EVs), China recently cut EV subsidies but also relaxed restrictions on conventional internal combustion engine vehicles. This illustrates China's preference for economic growth over reduced greenhouse gas emissions, something we've often noted (listen to our podcast China Keeps Warming the Planet). Another expert who specializes in energy policy matters also argued that technical requirements for mandated emission reductions in

Europe render them unachievable, and that strong SUV sales will support gasoline demand.

The discussion turned to domestic politics and what changes could be expected with a Democrat in the White House (not currently anyone's forecast). By contrast with Obama's view on natural gas, which this policy expert regarded as relatively clean and a "bridge" fuel towards decades-long development of renewables, he noted that today's Democrats view natural gas as just another fossil fuel. He predicted that a Democrat president would likely impose an immediate ban on new leases on Federal land. Current Gulf of Mexico production is 2 MMB/D, and onshore from Federal land is around 1 MMB/D.

Around 1/8th of natural gas is extracted on Federal lands, but this is more easily replaced with increased production on private acreage. He also expects a new administration would rescind existing permits on Federal land, and although courts would likely disallow this, resolution could take a while. Tighter rules on methane leakage and waste prevention are likely, which would eventually impede production on private land. The granting of infrastructure permits would become highly political, with FERC likely to become partisan. No new LNG export permits should be expected.

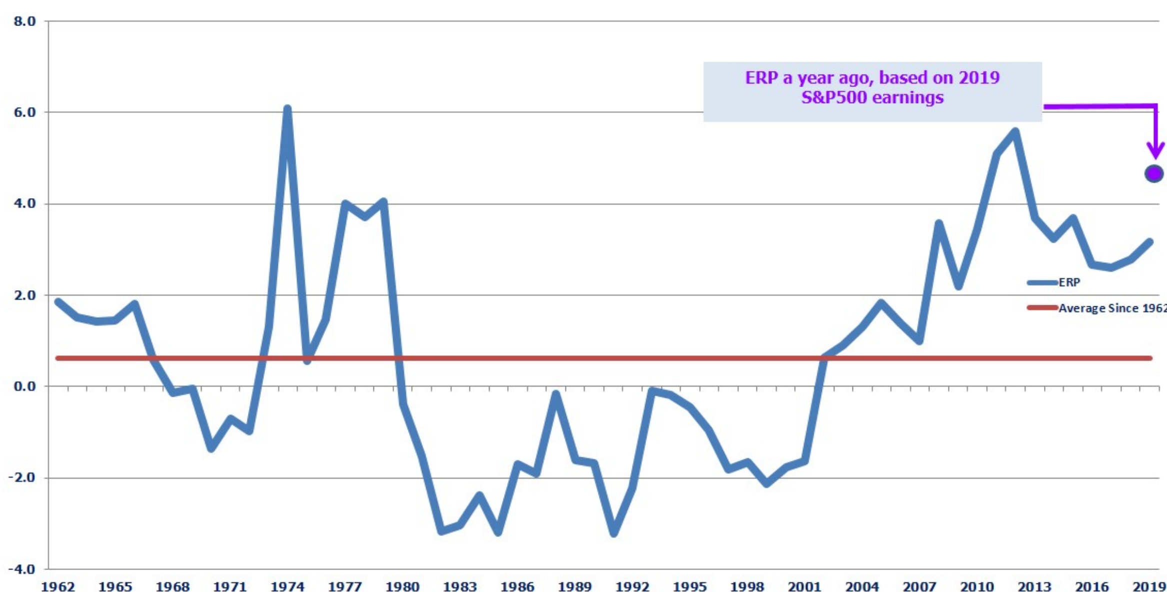
Democrat policies would likely reduce U.S. supply, exacerbating Middle East tension by increasing U.S. reliance on OPEC imports (see Energy Strengthens U.S. Foreign Policy).

Overall we felt there were several differentiated insights from the discussion and wanted to share them.

Pipeline Bond Investors Are More Bullish Than Equity Buyers

One of the most consistent bullish indicators for stocks has been the Equity Risk Premium (ERP) – the spread between the earnings yield on the S&P500 and the ten year treasury yield. At the end of last year, the S&P500's 2019 earnings yield was around 7.2% (one divided the P/E ratio, which was then 13.8). With ten year treasuries at 2.8%, the ERP was 4.4, well above the 50-year average of 0.6.

The S&P500 is up 30% this year, and the P/E multiple has expanded to 18X next year's earnings (i.e. earnings yield of 5.5%). This has brought the ERP down to 3.6 – still favoring stocks, but not as clearly as a year ago. If treasury yields had remained at last year's levels rather than dropping almost 1%, the ERP would be even lower at 2.7.



Since stocks look cheap, bonds must be expensive. Perhaps the

biggest unanswered question facing investors today is why long term bond yields remain so low, and whether this is sustainable.

The return bond investors require over inflation, the real rate, has been in secular decline for thirty years (see Real Returns On Bonds Are Gone). Today's bond investors are willingly locking in low and negative real yields – in many cases even negative nominal yields. Two compelling explanations are (1) inflexible investment mandates, and (2) fear of another 2008 financial crisis.

U.S. pension funds have raised their fixed income allocation even while yields have fallen, a counter-intuitive response to lower expected returns (see Pension Funds Keep Interest Rates Low). Hard evidence that investors are holding additional low risk assets as protection against a crash is harder to come by, but low yields certainly support that explanation.

Bond Buyers Like Pipelines

Top Ten Pipeline Stocks, Dividend Yield vs Bond Yield

Sources: Thomson Reuters; SL Advisors

Company	Market Cap ($BN)	Dividend Yield (TTM)	Bond YTM	Maturity Date	Rating
Enbridge	$79.1	6.3%	3.7%	2049	Baa2/BBB+
Enterprise Products, LP	$61.6	6.2%	4.0%	2054	Baa1/BBB+
TC Energy	$49.0	4.4%	3.8%	2049	Baa1/BBB+
Kinder Morgan	$46.9	4.8%	4.1%	2048	Baa2/BBB
Energy Transfer, LP	$34.7	9.4%	4.8%	2049	Baa3/BBB-
ONEOK	$30.5	5.0%	4.2%	2049	Baa3/BBB
Williams Companies	$28.0	6.6%	3.9%	2048	Baa2/BBB
MPLX, LP	$27.3	10.3%	4.6%	2058	Baa2/BBB
Pembina	$19.0	4.6%	4.1%	2048	BBB
Cheniere Energy	$15.8	0.0%	5.8%	2045	B1/BB
Top Ten by Mkt Cap (Average)	$39.2BN	5.8%	4.3%	2050	

As of: 12.18.19

Lower real yields on sovereign debt are a result of investors' strong desire for bonds with negligible credit risk. But the fact that corporate bond yields are being pulled down by these same forces reveals a pricing inefficiency that equity

investors can exploit.

It's most clear at the individual issuer level, where excessive demand for debt instruments is causing some interesting distortions. The table shows long term bond yields for the ten biggest North American pipeline companies, with an average equity market capitalization of $39BN.

They're all members of the American Energy Independence Index, the broadest and most representative index of North American midstream energy infrastructure. These ten companies have outstanding bonds with maturities of 25-40 years. They are all investment grade, offering an average yield of 4.3%, which reflects a high degree of comfort with their credit risk over several decades.

By contrast, their equity dividend yields average 5.8%, 1.5% above their bond yields. And this even includes Cheniere Energy (LNG), which doesn't currently pay a dividend (although they're likely to institute one over the next couple of years).

Energy has been out of favor more or less since 2014, although stock price performance in December has been strong. These ten companies' average dividend yield is almost 3X the 1.75% yield on the S&P500, reflecting substantial wariness about their prospects. And yet, bond investors don't share the same concern.

Equity investors can earn higher yields than bond investors on the same issuer, in addition to enjoying likely earnings and dividend growth in the years ahead. Once equity prices reflect the positive outlook reflected in their long term debt, they'll re-price higher.

Based on recent performance, that revaluation may already be under way.

We are invested in all the names mentioned above.

Private Equity, Private Valuations

Last week Cowen held a two day energy conference. Presenting companies included upstream and service providers, so although there were no midstream energy infrastructure companies present it provided useful background for current operating conditions.

Baker Hughes (BKR) is one of three large diversified services companies supporting the sector, along with Schlumberger and Halliburton. BKR CFO Brian Worrell provided an upbeat outlook following their recent spinout from GE. They cleverly describe themselves as a "fullstream" company (i.e., covering upstream to downstream). Listening to Worrell, it'd be hard to remember how negative investor sentiment is within energy. Consensus estimates for BKR's 2019-21 EBITDA growth rate are 15%.

Worrell provided some interesting background on a partnership they have with AI firm C3. Predictive Asset Maintenance, one of their offerings, analyzes operating data from customer equipment to anticipate breakdowns, allowing repairs to be done pre-emptively. BKR is C3's exclusive partner in the energy sector. They have 200 customers.

Another interesting theme was the influence of Private Equity (PE) investors. Independence Contract Drilling (ICD) is a micro-cap drilling company clearly wrestling with the downturn in shale-related rig demand. One participant asked if they'd considered a sale or merger. President and CEO Anthony Gallegos noted a recent negotiation with a competing privately owned firm which foundered when the PE backer insisted their drilling rigs were worth $18MM each while ICD's stock price

placed an implicit value of only $6MM for its similar equipment.

There's plenty of evidence that PE firms assess more value in publicly traded energy sector equities than the public markets themselves. PE investments in midstream energy infrastructure have slowed down in recent months, although it's still been an active year. But there are questions about valuation.

Too Good to be True?

Selected Energy Private Equity Returns

Source: Cobalt GP

Name	Vintage	Amt Closed	IRR	TVPI	DPI
Arclight Energy Partners Fund VI	2014	$5.6	12%	1.3x	0.3x
Energy Capital Partners III	2014	$5.1	10%	1.2x	0.3x
Quantum Energy Partners VI	2014	$4.5	30%	1.6x	0.4x
Energy & Minerals Group Fund III	2014	$4.0	-4%	0.9x	0.1x
Warburg Pincus Energy Fund	2014	$4.0	9%	1.2x	0.1x
First Reserve Fund XIII	2014	$3.4	11%	1.2x	0.4x
EnCap Flatrock Midstream III	2014	$3.0	17%	1.2x	0.4x
LS Power Equity Partners III	2014	$2.1	18%	1.5x	0.4x
Sheridan Production Partners III	2014	$1.5	17%	1.4x	0.5x
Energy Spectrum Partners VII	2014	$1.2	10%	1.2x	0.5x
Merit Energy Partners I	2014	$0.8	17%	1.5x	0.2x
Lime Rock Resources III	2014	$0.8	4%	1.2x	0.2x
Weighted Average			13%	1.3x	0.3x
S&P 600 Energy	12/31/2014		-16%	0.3x	0.3x

Name	Vintage	Amt Closed	IRR	TVPI	DPI
EnCap Energy Capital Fund X	2015	$6.5	11%	1.2x	0.2x
NGP Natural Resources XI	2015	$5.3	11%	1.2x	0.2x
Blackstone Energy Partners II	2015	$4.5	12%	1.2x	0.0x
Riverstone Global Energy and Power Fund	2015	$4.2	-2%	1.0x	0.2x
Energy & Minerals Group Fund IV	2015	$4.0	21%	1.5x	0.3x
Apollo Natural Resources Partners II	2015	$3.5	15%	1.2x	0.3x
EnerVest Energy Fund XIV	2015	$2.4	9%	1.3x	0.4x
Kayne Anderson Energy Fund VII	2015	$2.0	15%	1.3x	0.3x
Ridgewood Energy Oil & Gas Fund III	2015	$1.9	-32%	0.6x	0.0x
Lime Rock Partners VII	2015	$0.5	29%	1.6x	0.5x
Weighted Average			9%	1.2x	0.2x
S&P 600 Energy	12/31/2015		-8%	0.6x	0.6x

Energy-focused PE funds saw their highest inflows in 2014, when the sector peaked. This isn't surprising, since fund flows invariably follow performance. But what's odd is that fund returns since then are well ahead of the S&P600 Energy Index.

Although PE funds deploy capital over several years and likely made investments through the 2016 low, the recovery since then has been modest. It suggests that valuations are not rigorous – PE firms have a great deal of latitude in making estimates. Fees and the ability to raise subsequent funds both benefit from higher valuations.

PE energy funds continue to raise capital, supported in part

by the returns they show on prior funds. The illiquidity of private investments is supposed to generate a modest return premium, but research from Cobalt GP reveals that so far these funds are claiming to beat public markets by 15-30%. Total Value to Paid In (TVPI) suggests these fund managers have chosen well, and is the basis for their IRRs. But Distributions to Paid In (DPI) are well under 1.0X even for funds that are five years old, showing that the IRRs rely heavily on the valuations of current holdings. As cash distributions increase, the time of reckoning will arrive when investors will learn how accurate these interim IRRs have been.

On a different topic, the magazine cover contrary indicator theory posits that when a topic or person becomes mainstream, interest soon peaks. Credit friend Barry Knapp, CEO and founder of Ironsides Macroeconomics, for being first to predict that high school dropout Greta Thunberg's selection as Time's Person of the Year likely marks a peak in interest in climate change.

Equity Underwriting for Dummies; Kinder's Blunder

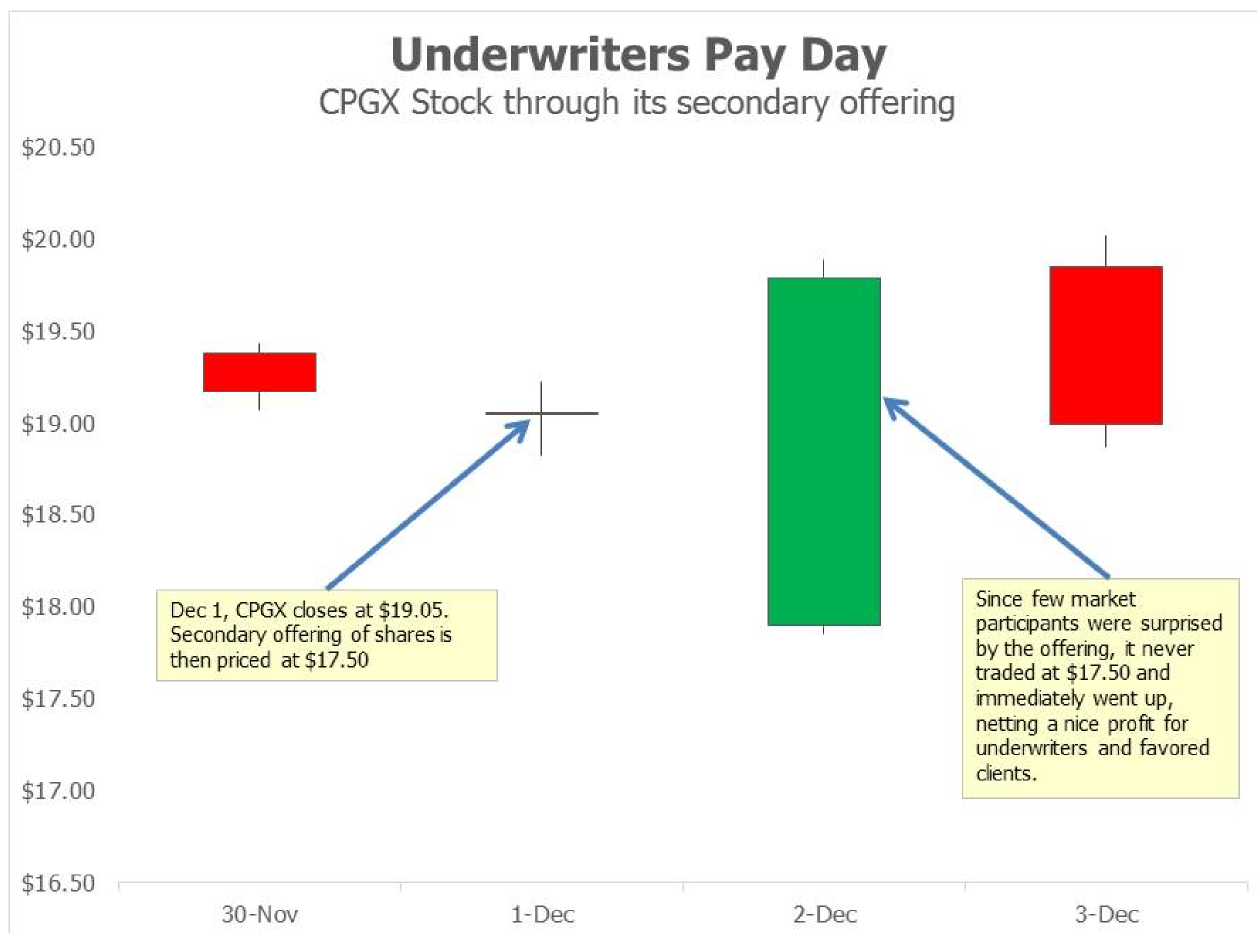
If a banker approaches the CEO of a Master Limited Partnership (MLP) with an offer to help, the CEO should run (not walk) in the other direction. The latest victim is the management of Columbia Pipeline Group Inc (CPGX). A month ago management had indicated that they'd be tapping the markets for equity via their MLP, Columbia Pipeline Partners (CPPL). This is how it's meant to work, with CPGX as the General Partner (GP) directing the MLP it controls to raise capital and invest it, sending

half the free cashflow up to CPGX via the Incentive Distribution Rights (IDRs). They currently have $8BN in projects, notwithstanding the market's current skepticism about MLP growth prospects. To reuse the hedge fund analogy, CPGX is the hedge fund manager (i.e. earning a share of the profits and providing management) and CPPL is the hedge fund (i.e. doing as directed by the GP).

But a month later, no doubt advised by its self-serving equity underwriters Goldman Sachs and Credit Suisse, CPGX instead issued equity, thereby raising capital at the GP level rather than the MLP level. "Hedge fund manager dilutes itself by issuing equity" is not a headline as commonly viewed as "Investors pile into hedge fund". In this case, CPGX acted as the former when they ought to know better.

Goldman and Credit Suisse did what they do well, which is to ensure that CPGX stock traded down until the moment of pricing, ensuring a profit for the underwriters and favored clients at the expense of existing CPGX investors. The offering was priced at $17.50 on December 1, an 8% discount to the prior day's close and a level at which it had never previously traded. Due to strong demand the offering was upsized from 51M shares to 71.5 and the stock quickly traded up while the underwriters exercised their option to buy an additional 10.725 million shares (upsized from 7.65 million shares) on top of the 71 million originally sold. Clearly, the market was not surprised; the circumstantial evidence points strongly to the underwriters alerting clients to the offering in the preceding days and thereby softening the market. This is because only the underwriters had ***both*** the advance knowledge of the offering ***and*** the incentive to see the stock trade off in the days prior to pricing. Perhaps the equity capital markets staff use hand signals to alert their colleagues on the other side of the Chinese wall about what's coming, so as to avoid leaving any evidence of their communication. In any event, the result was a success for all

involved, except regrettably for CPGX investors whose shares were valued as high as $22 just a month earlier. Make that another win for Wall Street bankers. My book *Wall Street Potholes* will soon need a Volume 2. You can never be too cynical.



I reviewed several corporate finance blunders a few weeks ago in Investment Bankers Are Not Helping MLPs. Kinder Morgan (KMI) was part of that with their poorly handled offer of mandatory convertible securities. But on reflection, they may have committed the biggest blunder of all last year with their restructuring in August 2014. It looked clever at the time, and to our subsequent regret we liked it (see Valuing Kinder Morgan in Its new Structure). By acquiring their MLPs, Kinder Morgan Partners (KMP) and El Paso (EP), they were able to

revalue their assets to current market prices and thereby create a higher tax-deductible depreciation charge that fueled a faster growth rate in their dividend. It was pretty slick.

But in hindsight, the reasons for the restructuring were a warning. At their size, they were unable to finance enough accretive projects to continue growing their dividend at its previous rate. The hedge fund analogy is useful here, because almost every hedge fund eventually gets too big. KMI, the GP of two MLPs and in effect the hedge fund manager, should have accepted that slower growth was inevitable and been satisfied with 1) a recurring 6.8% distribution yield growing modestly at KMP, effectively its hedge fund, or 2) consolidating and financing growth from retained earnings like all the other large C-corps. Instead, they adopted a structure yielding 5% with 10% projected growth fueled by the higher depreciation charge but reliant on equity markets to provide capital to finance part of their growth. Fifteen months and a more than 50% drop later, they now have a 12% yielding security with 6-10% 2016 growth and questions swirl about their ability to finance accretive projects given that their cost of equity has doubled. Moreover, it’s no longer an MLP, and the pool of potential investors, while large, looks beyond distributable cashflow and distribution yield and to other metrics such as Enterprise Value/EBITDA, against which it didn’t look quite so cheap at the time.

It’s no doubt a better investment today than it was in August 2014, and it remains a modest holding of ours although substantially less than in the past as we’ve switched into more attractive names. But the MLP-GP structure, with its close comparison to the hedge fund-hedge fund manager, is how Rich Kinder became a billionaire. Incentive distribution rights, the mechanism by which KMI earned roughly half the free cashflow from KMP and (more recently) EP, are similar to a hedge fund manager’s 20% incentive fee. Rich Kinder was smart enough to figure that out, but not smart enough to

recognize when it's time to stop accessing the secondary market for financing. The largest MLP, Enterprise Products (EPD), funds its growth from internally generated cashflow rather than issuing equity and has 1.3x coverage on its distribution. Perhaps that's why EPD unitholders have fared better.

Size is the enemy of performance in hedge funds and, at times, in MLPs. Shame on Rich Kinder for not realizing it and instead letting the investment bankers talk him into the value destroying structure. He bet faster growth would drive down the yield on KMI, making it an acquisition currency of less leveraged businesses in a downturn, which would in turn reduce KMI's leverage. The strategy has backfired. KMI no longer gets credit for the dividend, which leads to questions about its sustainability. While it's covered by cashflow and they don't need to issue new equity until 2H16 since doing the mandatory convertible, if KMI still yields >10% in late 2016 it'll make more sense for them to cut the dividend and thereby reduce or eliminate their need for additional equity. KMI has made the mistake of many hedge fund managers and investors, thinking they can grow indefinitely. Although some commentators are worried about pressure on pipeline tariffs from stressed E&P companies, there's a stronger case for tariff *increases* since the cost of equity for pipeline owners (i.e. MLPs) has risen.

Hedge fund managers don't buy their hedge funds, and MLP GPs shouldn't buy their MLPs. Management at Targa Resources (TRGP) should take note (see Targa Resources Needs an Activist).

We are invested in CPGX, EPD, KMI and TRGP.

Bridgewater Reassesses Flight to Quality

If you stop to think about it there are several analogies for the Fed's "tapering", under which they gradually relax the support which has been underpinning the bond market. Maybe it's the parent who creeps out of the young child's bedroom at night believing they're finally asleep, only to be halted by renewed cries from the little one. Maybe it's Jenga, a game played with wooden blocks where players alternate turns of removing one without causing the structure to collapse. Or perhaps the magician who dramatically whips the tablecloth smartly off the table while leaving the place settings unmoved.

Whatever imagery does it for you, somewhere within the investment horizon of most people the Fed will make their move. Which is why a Bloomberg article on Bridgewater's $80BN All Weather fund caught my attention earlier today. It seems that in recent weeks Ray Dalio substantially reduced their exposure to Fixed Income. Apparently not in reaction to the weak bond market of the second quarter, but instead as a result of many months of analysis which concluded bonds were no longer as attractive in a portfolio that's expected to generate positive, uncorrelated returns most of the time.

The classic justification for holding bonds is the diversification they provide to a heavy weighting in equities. It's worked more often than not, but we may just be heading into a period of time that will test conventional wisdom. To start with, yields on high grade and government bonds are unattractive on a buy and hold basis. It'll be hard to finish ahead of taxes and inflation with yields of 2-3%. The idea that bonds will rally during times of equity market stress, thus mitigating the inevitable mark to market swings of a conventionally allocated portfolio only seems to justify bonds

if you'd actually sell them when they're bid up through a flight to quality. Few investors do, and the ownership of bonds for the temporary sugar high that turmoil may bring seems less interesting when the long term prospects are poor. Watch for creative explanations from financial advisors to defend clients' bond holdings in the future.

But the other side of things is that stocks and bonds may at times be highly correlated on the downside. If the Fed's attempts to at least slow the growth of its $3.5 trillion balance sheet awake the sleeping child, or perhaps even result in a smashed dinner set all over the floor, weaker stocks may be accompanied if not even caused by weaker bonds. The flight to quality may not work.

We believe the most likely outcome is one of very measured, non-threatening reductions in Quantitative Easing and a further very long interval until short term rates rise. This is what the Fed has told us to expect. But that's just a forecast, and we could be wrong. However, if we do find ourselves in a substantially weaker equity market caused by the Fed's lack of manual dexterity, we at least won't have compounded the error by owning bonds as well.

Skating Where the Puck Was

This is the title of a "mini-book" by William Bernstein. I just came across a review of it by Larry Swedroe. I haven't yet read Mr. Bernstein's book (I just ordered it this morning) but Swedroe's review caught my attention. It looks as if a three factor analysis of hedge fund returns has arrived at the same conclusion I did in my book – that hedge funds used to be great, that early investors did well, and that the industry

today is overcapitalized.

David Hsieh, Professor of Finance at Duke's Fuqua School of Business suggested that alpha is finite, and that's why today's hedge fund investors will continue to be disappointed. Makes perfect sense to me. So now we have some real academics weighing in on the debate, as opposed to the pseudo-variety hired and paid for by AIMA in London. Mediocre returns delivered at great expense continue, providing additional support for the critics.

Hewlett Packard Shoots Their Other Foot

Hewlett Packard (HPQ), a company that is earning records for large and expensive strategic errors, plummeted to new depths of incompetence today with their $8.8 BN write down of Autonomy, a software company they acquired in 2011. The list of enormous acquisitions about which nothing much positive subsequently emerged is shockingly long: Compaq in May 2002 for $25 BN; P&G IT in 2003 for $3BN; Mercury Interactive in 2006 for $4.5BN; Opsware in 2007 for $1.6BN; Electronic Data Systems in 2008 for $13.9BN; 3Com for $2.7BN, Palm for $1.2BN, 3PAR for $2.35BN and ArcSight for $1.5BN all in 2010; Autonomy for $11BN in 2011. And these are just the $1Bn or greater deals. $66.75BN in acquisitions over the past ten years and the company's market cap is less than half of that. None of today's board members have served since 2002, but several joined in 2009 since when HPQ has spent $18.75BN including on the ill-fated Autonomy deal. Among those board members who have been around long enough to be responsible are G Kennedy Thompson and John Hammergren (both since 2005), and

Marc Andreessen and Rajiv Gupta (both since 2009). There are only eleven board members including CEO Meg Whitman, and she was on the Board when they bought Autonomy prior to becoming CEO.

When you write a check for $11BN and subsequently find you were ripped off, you can't seriously blame anyone but yourselves. Pointing the finger at the former management of Autonomy or the auditor just further confirms that none of these people should be managing anybody's money but their own. For our part, while we're thankful to have never been investors, we're going to add the HPQ Rule to our investment process that rejects any investment in a company with one of these value destroyers on its board of directors.

How We'll Painlessly Avoid The Fiscal Cliff

The Fiscal Cliff is forecast to represent 2.9% of GDP drag in 2013 if nothing is done, according to the Congressional Budget Office (CBO). Although it was originally intended as a mechanism to force Congressional compromise around bringing the Federal budget under control, with less than seven weeks until the automatic tax hikes and spending cuts take effect the focus is now clearly on simply avoiding the blunt instrument of fiscal policy that it represents.

The CBO's analysis breaks down the different pieces of the Cliff and calculates the impact of each on GDP. Assessing the likelihood of compromise on each one provides an interesting perspective on the likely resolution.

1) Raise Taxes on the Rich – this has received the most

attention by far. The President wants to raise taxes on those single tax filers making more than $200,000 and joint filers making more than $250,000. The Republicans will likely agree to higher taxes in some form. That will be one consequence of their poor showing in the election. "Rich" may eventually be defined as income above $500,000 or even higher, but it really doesn't matter. That's because the CBO estimates that even if tax rates for this group were restored to their "pre-Bush" level and investment income was all taxed as ordinary income, the entire impact would be to slow GDP by 0.1%. The optics matter because the "shared sacrifice" that must ultimately include entitlement reform can only occur in conjunction with some sacrifice from the 2% or 1% (depending on the definition of "Rich"). The Republicans have already indicated some flexibility on their opposition to new taxes so while it will grab headlines, wherever they ultimately settle on this issue it won't impact the economy much.

2) Allow the temporary reduction in the payroll tax and emergency unemployment benefits to lapse. This is probably going to happen – neither party has expressed much interest in extending these. The CBO believes this is worth 0.7% to 2013 GDP.

So now we have 0.8% of fiscal drag already imposed on the economy, as well as the effects of Hurricane Sandy (estimated to cost 0.5% during the current quarter). Let's look at the remaining components of the Cliff as measured by the CBO.

3) Restore the pre-Bush tax rates on everybody else. This is worth 1.3%. The Republicans are against this, and the President has focused on raising taxes on the rich. How hard are the Democrats really going to push to raise taxes on the middle class under these circumstance? It's likely both sides will agree to defer this item.

4) Automatic cuts in Defence, 0.4%. A complete non-starter.

5) Automatic cuts in non-Defence Discretionary spending, 0.4%. There's some room for symbolic cuts to remain, by way of demonstrating resolve, but it's unlikely to be close to this figure.

The beauty of the Cliff is Congress created it and Congress can alter it. Neither side is likely to find much benefit in causing more GDP drag than the 0.8% or so illustrated above. So having decided they've done enough, or made a "down payment" as John Boehner has said, the Cliff will be avoided. The announced settlement will include a commitment to a broad-based overhaul of the budget and perhaps tax reform, to be negotiated in 2013. Will they include another Fiscal Cliff by way of forcing Congressional action? Possibly, although the President will undoubtedly push back on that.

Under different circumstances during these negotiations the President and Congressional leaders would be maintaining a watchful eye on the bond market for its approval of fiscal discipline, and to a lesser degree the rating agencies. Except that, as a barometer of such things the Bond market no longer works. The Federal Reserve is by far the biggest buyer of bonds and since they're not economically motivated interest rates won't be allowed to respond by voting on the outcome. Perhaps the most powerful visible incentive on budget makers to negotiate difficult compromises will be silent at this time. As such, the motivating features for both sides will be contemplating the visible cost of fiscal drag through tough decisions without the benefit of lower borrowing costs for the government or the penalty of higher costs if action is insufficient.

Equity investors are enduring a difficult time right now, and that may continue through year-end. However, it seems likely that a fairly modest GDP headwind and catastrophe avoided will be where we ultimately wind up. We can all wring our hands about the long term cost of such an approach, but take the world as you find it.

We continue to own solid businesses with good prospects and strong balance sheets that will be around no matter what happens, because we're probably going to see another can kicked down the road. We like Microsoft (MSFT) whose cashflow generation continues and is priced at an attractive less than 7X FY June 2013 EPS ex-cash; Berkshire Hathaway (BRK-B), which at under $85 is close to levels at which they could buy back stock (as much as 10% above $76.29 book value, or $83.92). We recently added to Kraft Foods Group (KRFT) which yields almost 4.5% and will comfortably cover its $2 dividend with $2.60 of EPS next year. Following a good earnings report we sold Energizer Holdings (ENR) since the battery business is shrinking by a startling 7% per annum and they're likely to have to cut pricing to stay competitive which will hurt their margins. And we maintain an investment in the Gold Miners ETF (GDX) since reflation is where central banks are going and Europe is demonstrating the futility of too much fiscal discipline too soon.

Timing is invariably difficult, but it's possible to see a negotiated solution that can turn out fine even if it once again delays the day of reckoning.