MLPs Now Look Attractive Relative to Equities

A persistent problem for investors is constructing a balanced portfolio with an acceptable risk/return profile when Fed policy has rendered bonds an impractical component. Indeed, much of our business at SL Advisors revolves around providing solutions to this problem. High yield bonds, the closet equity refuge of many fixed income investors willing to move out along the risk spectrum somewhat, have long been bested by Master Limited Partnerships (MLPs). In fact, we've often shown clients that MLPs can be a great substitute for High Yield since it's the asset class with which they're most highly correlated whereas their returns have been much higher and are likely to remain so.

However, the use of MLPs as a fixed income substitute has not looked so clever of late. The asset class sported a -32% total return from its peak a year ago until very recently. Following a modest bounce, MLPs are now 28% off their all-time highs (including distributions), and -17% YTD. Only 2008 was a worse time to be an MLP investor, and pretty much everything was going down then whereas the broader equity indices are currently close to all-time highs. So one must concede that the case for using MLPs as a fixed income alternative has been weakened as a result of their correlation with crude oil and its concurrent 50% slide.

Although MLP prices have fallen, distributions have continued to grow. Credit Suisse recently noted that midstream MLPs had increased their distributions at 7.8% year-on-year. The yield on the Alerian Index now exceeds 7%. This set of circumstances makes MLPs now a compelling equity substitute, given the return prospects.

In constructing a portfolio, each asset class requires an expected return, volatility and co-variance with the other asset classes. These three inputs allow for a forecast portfolio return to be estimated along with the range of possible outcomes. Of course it's only as good as the inputs. In such an exercise, expected bond returns would have to be 1-3% since that's where yields are today. Public equities have a wider range of plausible returns. Given the 2% dividend yield on the S&P500 and 5% dividend growth (the fifty year average), a 7% total return (i.e. dividend yield plus growth) is an acceptable long run forecast of equity returns although reasonable people could certainly differ over this.

This is where MLPs can represent an alternative, not necessarily to the fixed income allocation since their recent volatility has weakened the case as noted, but to the equity component. The price drop in MLPs has raised their expected return, since distributions have continued to grow. The 7% yield on MLPs compares favorably with the expected return on public equities noted above without any assumed distribution growth for MLPs. Over the last ten years, MLP distributions have grown at 7.4% annually, similar to the last year. Even assuming growth of half that level, you still get a 10% total return.

For the long term investor willing to look beyond near term price gyrations, the case for using MLPs as an important component of the equities portion of a portfolio is starting to look compelling.