Real Money Moves Into Real Assets

It was a busy week of news in Master Limited Partnerships (MLPs). Although there were several earnings announcements, perhaps most notable was the disclosure of new investments by Berkshire Hathaway (BRK), David Tepper's hedge fund Appaloosa and George Soros in much maligned Kinder Morgan (KMI). Appaloosa also disclosed holdings in KMI warrants, which expire at $40 in May 2017 so represent an exceptionally optimistic view of the company given its current price of $17.37. They also disclosed new holdings in Energy Transfer Partners (ETP) and the Alps ETF (AMLP). These purchases all took place sometime during 4Q15, coincidentally when I added personally to my MLP investments. So these three investment giants shared the disbelief of many at the continued MLP rout. Nonetheless, for those who draw comfort from the decisions of others, it was a good start to the week.

Taxes play an important role for MLP investors. Tax barriers impede many institutional investors from allocating, and most mutual funds and ETFs face a substantial drag from corporate income tax, so it's worth spending a moment on how these issues likely affected these three investors. First of all, KMI is not an MLP but is instead a C-corp, so there are no impediments to investing in them. In any event BRK is an insurance company, one of the few classes of institutional investor who can easily hold MLPs because they are taxable whereas most institutional equity investors (pension funds, endowments and foundations, sovereign wealth funds) are not.

ETP is a partnership, and Appaloosa doesn't disclose which of its funds invested. Appaloosa could hold ETP through a domestic partnership since its investors would generally be U.S. taxable. Most hedge fund money is offshore though, so holding ETP through, say, a Cayman vehicle is more problematic. When I was at JPMorgan investing offshore capital in hedge funds 10-15 years ago we used total return swaps executed with a prime broker. These provide the economic exposure to the MLP without the tax problems, but tax opinions have fluctuated on these over the years since the swap has no true purpose beyond tax management. Or Appaloosa may have created a blocker corporation to hold ETP on behalf of its offshore fund and paid taxes at that level. We can only guess, but what is clear is that they regard the potential upside as worth the cost of handling the tax issues.

The Oklahoma Teachers Retirement System evidently feels the same way about the return potential, since they recently added $250 million to their MLP exposure. As a tax-exempt U.S. institution, they may face Unrelated Business Income Tax (UBIT) through their MLP investments. Since tax-exempt institutions generally like to avoid paying taxes, UBIT represents an impediment to holding MLPs. However, they are not prohibited from making such investments, and Oklahoma Teachers may have concluded that the returns even after UBIT remain attractive, or their tax analysis may have shown that the ineligible income from MLPs falls below the threshold for a tax liability given their $14BN in funds.

In any event, all of the above shows that institutional investors are beginning to take advantage of the market dislocation in MLPs, and indeed began to do so several months ago. As we wrote in The 2015 MLP Crisis; Why and What’s Next, the comparative rigidity of the traditional investor base was exposed by the rapid exit of retail investors from MLP mutual funds and ETFs. It’s creating an opportunity. MLPs will not reclaim their place as a stable source of income anytime soon, but an asset class with double digit yields offers the potential for 30%+ one year returns assuming (1) distributions keep being paid, and (2) the constant paying of distributions leads to inflows driving yields lower by a couple of percent. Of course, the potential upside comes with the possibility of losing 10% in a week, as we’ve seen. However, it’s hard to identify another asset class that offers that kind of potential return. And it’s worth noting that investors such as Oklahoma see attractive returns even with the hurdle of potential tax expense. For investors in a RIC-compliant MLP fund that doesn’t pay tax, such as ours, it’s a simpler decision.

We are invested in BRK and KMI