The Enormous Misunderstanding About MLP Funds and Taxes

Inspiration for these posts often comes from conversations I’ve had with investors during the prior week. For a great many investors, the decision to invest in an MLP mutual fund or ETF goes something like this:

1) MLPs have generated attractive historical returns over (choose your time period) number of years

2) The yield on the Alerian Index is around 6%, which looks good.

3) But MLPs generate K-1s, which I don’t understand and my accountant hates

4) However, there are mutual funds and ETFs which invest in MLPs but give you a conventional 1099

5) I should invest in one of them

What this analysis misses is the heavy tax burden these funds endure, which sharply reduces the returns to investors. The conversion of K-1s received by the fund into 1099s received by the ultimate investor comes at the price of a 35% corporate income tax on those returns. So you’re going to receive 65% of what the fund actually receives on its investments.

There are many examples; let’s look at the Mainstay Cushing MLP Premier Fund (CSHAX), whose Fact Sheet reveals an expense ratio of 6.97% to 7.72% (depending on the share Class). They call it a “Gross” ratio (which is an apt name because it is pretty gross) to highlight that most of the expenses do NOT go to the manager. They go to the U.S. Treasury instead. These expenses are still borne by the investor though. CSHAX has returned between 5.7% and 7.1% (depending on share class) since inception in October 2010, compared with 9.4% for the Alerian Index. In fact, it correctly doesn't compare its performance with the benchmark nor seek to achieve an equivalent return. It can't.

Goldman's MLP Energy Infrastructure Fund (GMLPX) has an expense ratio of 3.16% to 3.56%. Most of the MLP funds out there pay substantial taxes. Although MLP returns have been good – for example, the Alerian Index has returned 14.28% per annum over the five year period through April 2015 – the investors drawn to the sector by this history and the attractive prospects are unlikely to earn close to the returns of the index by investing through funds like these because of the tax drag.

Now that a few years of performance have revealed how poorly these funds do against the benchmark, the reality of the huge tax drag is becoming apparent to many investors.

It's worth looking carefully at the MLP funds you own to see if you're contributing substantial chunks of return to the U.S. Treasury. Not all funds are structured in this way. And those that are not subject to corporate income tax only need to earn 65% of the pre-tax return of the funds that are subject to the tax to do just as well for their investors. It shouldn't be hard to do substantially better.