Dow Jones Reprints: This copy is for your personal, non-commercial use only. To order presentation-ready copies for distribution to your colleagues, clients or customers, use the Order Reprints tool at the bottom of any article or visit www.djreprints.com

- See a sample reprint in PDF format.
- Order a reprint of this article now

WEEKEND INVESTOR

How MLPs Could Still Move the Needle

By JASON ZWEIG

Oct. 31, 2014 7:46 p.m. ET

Master limited partnerships have finally come of age. In October, these typically sedate, energy-related securities showed they could behave at least as erratically as the rest of the stock market.

In the first 10 trading days of the month, the Alerian MLP Index, the leading measure of performance for these securities, fell 14%—its steepest decline since the financial crisis and nearly triple the drop in the broader S&P 500 stock index over the same period.

Then, this past Wednesday, Shell Midstream Partners went public in a $1.1 billion offering and gained 45.9%, the highest first-day return for an MLP in the past decade, according to research firm Ipreo. By month's end, the Alerian MLP index was down only about 5% and had gained 13% since Jan. 1.

The biggest attraction of MLPs, which aren't included in most major stock indexes, is that they provide steady income from handling oil and natural gas. Unlike the dividends from conventional stocks, MLPs' cash distributions generally aren't taxable until an investor sells the investment.

Does the recent wild behavior weaken the case for MLPs? Not if you are choosy and hold for the long term, say analysts and portfolio managers.

With oil prices sinking 12% in October and 25% since June, investors are worrying that some exploration-and-production companies won't be able to make money on the oil and gas they find. For MLPs in the same business, falling energy prices are "a very tough headwind," says Ethan Bellamy, a senior analyst at Robert W. Baird & Co. in Denver.

But these "upstream" MLPs make up only about 5% of the total value of the sector, suggesting that the across-the-board decline was too extreme, says Paul McPheeters, the lead portfolio manager for more than $3.5 billion in MLP investments at Atlantic Trust in Denver. Most MLPs are "midstream" firms that primarily transport or store oil or gas; a few are in the propane, coal or tanker business.

MLPs are "still expensive relative to their own history," says Tyson Halsey, who manages $12 million, mostly in MLPs, at Income Growth Advisors in Charleston, S.C. "But relative to everything else, they're probably the best thing out there."

One simple measure is the amount by which the income yield on MLPs exceeds that on 10-year Treasury notes—now about 3.2 percentage points, down from five points two years ago.

What about "everything else"? The average income on the Barclays U.S. Aggregate Bond Index is 2.2%; the dividend yield on U.S. stocks is 2%.

Bonds won't gain value unless interest rates fall more. If history is any guide, stocks might add 3% or so in annual earnings growth, plus inflation, on top of their dividend yield.

But MLPs are distributing an average of 5.5% in annual income. And that payout should be able to grow at about 7% annually in the next few years unless the price of oil "goes down and stays down" below $70 to $75 a barrel, Mr. McPheeters says. That 12%-plus expected return is attractive.

So what's not to like about MLPs?

For starters, they are vulnerable to a rise in interest rates, which would increase the yield on competing bonds, making MLPs less attractive to income-craving investors.

Mr. Halsey estimates that the average MLP would fall in price by about 10% if interest rates rose by one percentage point. Brian Kessens, a portfolio manager at Tortoise Capital Advisors in Leawood, Kan., says that MLPs historically have underperformed the overall stock market by about one percentage point during periods of rising rates.

A spike in interest rates also could jeopardize smaller MLPs that have used floating-rate debt to finance much of their growth, says Mr. Bellamy of Robert W. Baird & Co.

To steer clear of the risk that lower energy prices will crimp an MLP's profits, concentrate largely on midstream operators. Such MLPs function as tollkeepers, collecting revenue at relatively constant rates regardless of the price of oil or gas, says Simon Lack, managing partner at SL Advisors in Westfield, N.J.

Among the most stable midstream MLPs, say analysts and portfolio managers, are Energy Transfer Equity, Energy Transfer Partners, EQT Midstream Partners, Magellan Midstream Partners, Plains All American Pipeline, Plains GP Holdings and Sunoco Logistics Partners. All have manageable levels of debt, steady cash payouts and room for growth.

Finally, bear in mind that mutual funds and exchange-traded funds that specialize in MLPs are far less tax-efficient than the partnerships themselves, says Robert Gordon, president of Twenty-First Securities, a brokerage firm in New York.

Most of the income distributed by MLPs to direct owners is typically designated "return of capital" and therefore tax-deferred. You can put off paying taxes almost indefinitely on MLPs you own directly. (You may have to file annoying and potentially costly tax forms, however.)

Inside a mutual fund or ETF with at least 25% of its assets in MLPs, the same income is taxed at the 35% corporate rate.

If you bought one of these MLP funds at peak prices late this summer, Mr. Gordon says, you might be able to sell the fund now for a capital loss that could offset taxable gains elsewhere.

You could then invest the proceeds directly in a handful of MLPs and hold them permanently, letting their tax advantages accrue for decades to come—regardless of the short-term panics that might break out along the way.

—intelligentinvestor@wsj.com; twitter.com/jasonzweigwsj

Copyright 2014 Dow Jones & Company, Inc. All Rights Reserved
This copy is for your personal, non-commercial use only. Distribution and use of this material are governed by our Subscriber Agreement and by copyright law. For non-personal use or to order multiple copies, please contact Dow Jones Reprints at 1-800-843-0008 or visit www.djreprints.com