GLOBAL FINANCIAL
Private Capital
COMPREHENSIVE WEALTH MANAGEMENT

Thought for the Week: Monday, March 19th, 2012

Master Limited Partnerships: Don't let the Tax Tail Wag the Dog

For a number of years, Global Financial has invested in Master Limited Partnerships (MLPs), principally to generate attractive levels of income and potentially participate in any capital gain that may accrue from this, at times, undervalued and under-covered asset class.

This allocation has added to the diversification of our portfolios while generating excellent returns. The table below shows the main MLPs we held in 2011 and their total return (income plus capital gain/loss) for the full year:

MLPs Held in DIAS During 2011				
Symbol	**Total Return for 2011***		**Symbol**	**Total Return for 2011***
eep	13.9%		bx	3.0%
lgcy	5.6%		etp	-4.9%
line	8.5%		fgp	-19.5%
pvr	-3.0%		epd	17.8%
epb	9.1%		kmp	28.6%
paa	24.3%		oks	53.2%
gel	13.0%		wpz	35.8%
cpno	8.5%		DBC	-2.6%
mwe	34.7%		evep	77.1%
wes	42.6%			
Average Total Return for 2011:	**18.20%**			

* Total Return for full year, not the DIAS holding period

In addition to their recent outperformance of the broader investment universe, MLPs have the following features:

- As they don't pay tax at the company level, they can distribute higher dividends.
- They are generally involved in the transportation of commodities, an area of business we feel has long term stability and growth potential. This means they are also a potential hedge against inflation.
- Their oftentimes misunderstood nature can lead to periodic low valuation, opportunities for us to meet our investment goals of high quality income at discounted valuations.

Disadvantages:

Very few things in life are perfect and MLPs are not without their drawbacks:

- Their advantageous tax status results in individual investors having to carry some of the burden of tax filing. This issue can be exacerbated by CPAs who are unfamiliar with the extra work required. Although we are not qualified to provide definitive tax advice, Global Financial and your Investment Advisor are available to provide assistance in helping you deal with any tax questions relating to our investments in MLPs.
- Their valuations can move suddenly, particularly when commodity prices are volatile. We feel that the market sometimes suffers from a temporary misconception that MLPs should be priced according to the price of underlying commodities. This temporary mispricing can be an opportunity. Their business is the transmission of commodities and as such their price is largely dependent on the volume being moved and not the price of the product being moved. Think of them like pipelines or toll booths automatically collecting money every time something "passes GO."

Although we understand that the effort required in filing additional tax forms can cause consternation for investors, and less experienced CPAs; from a pure investment perspective, the above advantages significantly, and financially, outweigh the disadvantages.

That said, the undervaluation of MLPs we identified a few years ago is increasingly being recognized by the broader investment community. As a result, prices are rising to levels where we feel their investment value may be diminishing.

Background Information on Master Limited Partnerships

MLPs are unique investments that combine the tax benefits of a limited partnership (LP) with the liquidity of common stock. An MLP has a partnership structure but issues investment units that trade on an exchange, just like common stock. The modern form of an MLP is defined by the Tax Reform Act of 1986 and the Revenue Act of 1987, which outlines how companies can structure their operations to realize certain tax benefits and defines which companies are eligible. In order to qualify, a firm must earn 90% of its income through activities or interest and dividend payments relating to natural resources, commodities or real estate.

Tax Implications

The tax implications for MLPs differ significantly from corporations for both the company and its investors. There is no tax at the company level, which effectively lowers an MLP's cost of capital, as it does not suffer the problem of double taxation on dividends. Companies that are eligible to become MLPs have a strong incentive to do so because it means a cost advantage over their incorporated peers.

In an MLP, instead of paying a corporate income tax, the tax liability of the entity is passed on to its unitholders. Once a year, each investor receives a K-1 statement detailing his or her share of the partnership's net income, which is then taxed at the investor's individual tax rate.

Fortunately for investors, MLPs generally have much higher distributable cash flow than they have taxable income. This is a result of significant depreciation and other tax deductions, and is especially true of natural gas and oil pipeline and storage companies, which are the most common businesses to choose an MLP structure. Investors then receive higher cash payments than the amount upon which they are taxed, creating an efficient means of tax deferral. According to a report by Wachovia Securities, titled "Master Limited Partnerships: A Primer" (2003), the taxable income passed on to investors often is only 10-20% of the cash distribution, while the other 80-90% is deemed a return of capital and subtracted from the original cost basis of the initial investment.