

MLPs can persevere in a rising interest rate environment

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While MLPs typically fare better than other yield-oriented securities such as real estate investment trusts (REITs) and utilities during a rising interest rate environment, it is important to remember that they are not immune. The low interest rates that were in place after the 2008 recession helped midstream MLPs (master limited partnerships) and other pipeline companies raise capital economically, enabling returns that are significantly higher than their cost of capital. That in turn supported cash distribution growth. With the strengthening U.S. economy and higher rates, investors are wondering what that could mean for their MLP investments (and to a lesser extent pipeline companies), given their attractive distribution rates. Let's take a look at both the direct and indirect effects of rising rates on MLPs and pipeline companies.

Direct effects

The direct relationship is fairly simple as it reflects how increasing interest expenses can affect variable or floating rate debt held by companies. The key mitigating factor is that MLPs have historically been very conservative in terms of their debt structure. Midstream companies, including long-haul crude oil, refined product and natural gas pipeline companies generally utilize 70 to 100 percent fixed-rate debt, making their cash flow growth and longer-term performance less sensitive to higher rates. In short, we believe the direct impact of rising rates on midstream MLPs is minimal and in our view will not significantly hinder growth.

Indirect effects

The indirect effect of higher interest rates on MLPs relates to their impact on total return. There are three main factors that can provide a buffer to rising rates: excess coverage can allow for slightly lower returns on invested capital; focus on internal growth versus external growth; and ability to pass through inflation in tariff rates or benefit from increased demand.

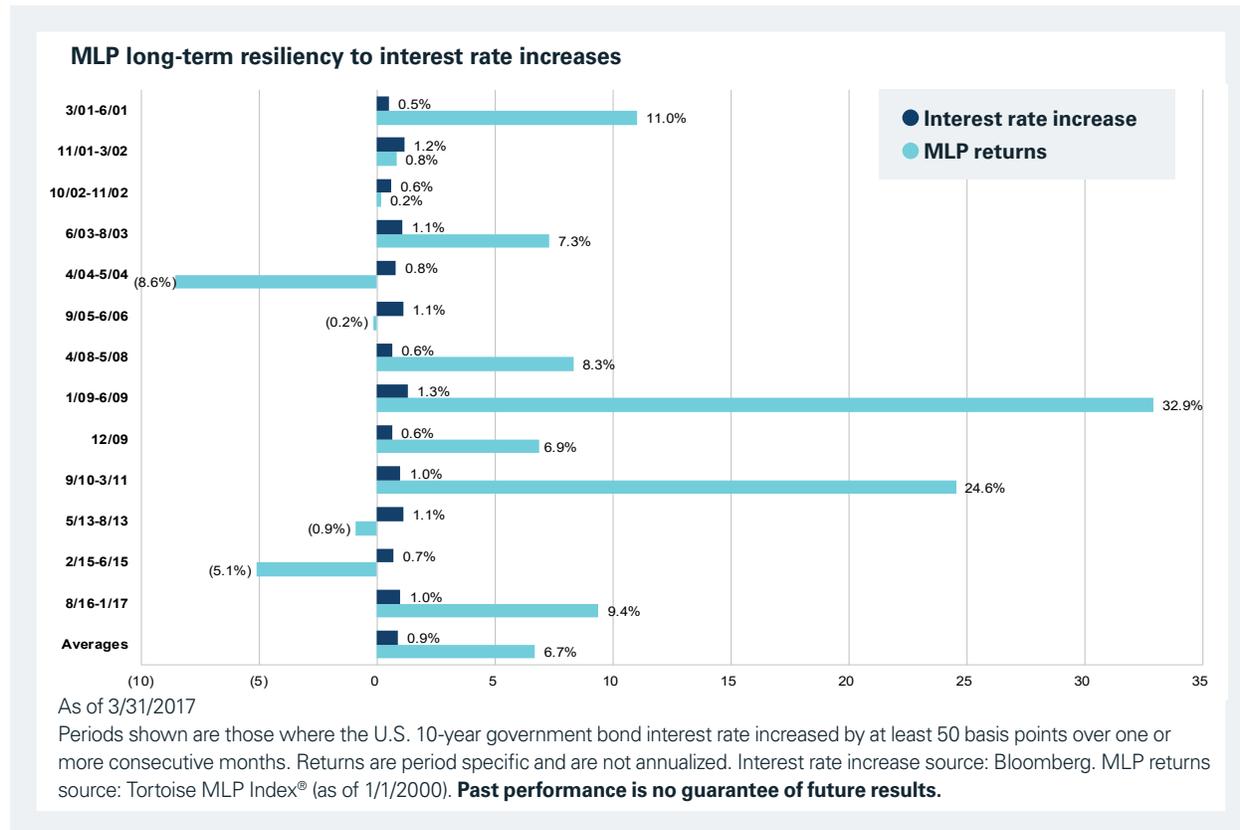
First, it's important to distinguish the catalyst for rising rates – typically either rising inflation or an improving economy. Both have potential benefits for MLPs.

- A strengthening economy helps midstream MLPs and pipeline companies transporting energy because aggregate demand increases, likely driving increased volumes transported.
- If inflation is the catalyst, though in our view this is the less likely scenario at this time, some MLP and pipeline companies can pass through the rate as it relates to liquids pipelines, which receive tariff escalators tied to the producer price index (PPI) that would push up the rate side of the equation.

We believe both catalysts for rising rates could drive improved cash flow, which could offset an increase in rising equity and debt.

History as teacher

MLPs, like all distribution-paying entities, can experience some short-term volatility during periods of rising rates. However, MLP distribution growth has historically provided positive returns over the long term during these periods. MLPs and pipeline companies' combination of attractive yield and growth potential distinguishes them from other income-oriented investments. Unlike bonds and REITs, MLPs can grow their distributions, which can help drive total return. Historically, MLP prices have experienced short-term volatility when interest rates increased, followed by a rebound and solid long-term performance. The following table reflects our analysis of the past 13 periods of one or more consecutive months with a 50 basis point or more increase in the 10-year Treasury since 2000. MLPs returned 6.7% on average during those periods, compared to the 6.6% return posted by the S&P 500[®] Index and -1.4% for the Bloomberg Barclays U.S. Aggregate Bond Index.



Looking ahead

We believe though these assets are not immune to rising interest rates, they remain an attractive long-term investment in both periods of economic growth and uncertainty. While higher rates are inevitable, we believe that over the long term, quality growth will prevail.

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