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Investing in MLPs - Dispelling Common Myths (Part 2)

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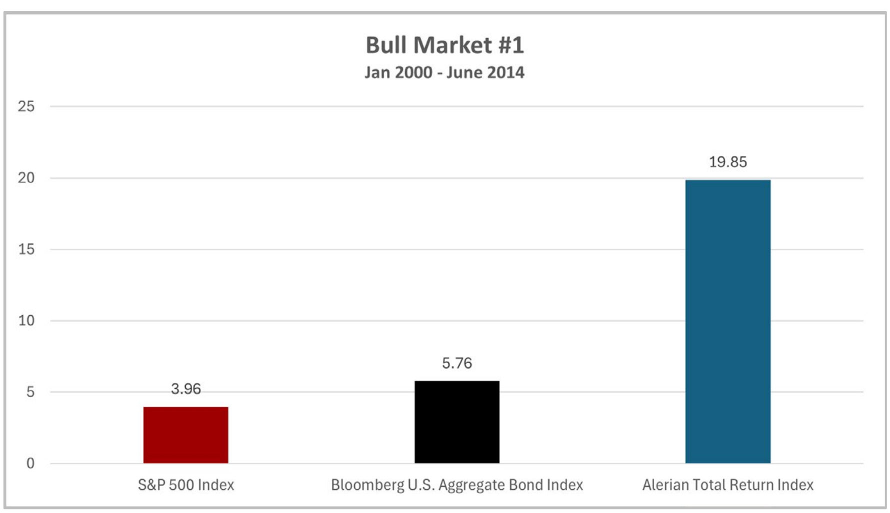
As a continuation to our publication entitled, "*Investing in MLPs – Dispelling Common Myths*" (dated April 2024), in which we provided evidence to debunk five myths of investing in MLPs, investor feedback prompted us to write about a sixth myth – MLPs underperform.

Myth 6 - MLPs Underperform

MLPs are approaching the five-year anniversary of their major historic lows (March 2020) so it is timely to review long-term MLP total returns. Lingering memories of the difficult and choppy years of 2015 through 2019, as well as the group's connection to carbon-based energy, has caused the asset class to fall off many investors' radar screens. Lack of investor interest and/or attention obscures just how well the group has done over longer time periods. Interestingly, MLP investment fundamentals today resemble the early stages of a bull market and are supportive of several more years of dynamic investment returns.

Since year-end 1999 and through June 30, 2024, MLPs have enjoyed a thirteen-and-two-quarter-year bull market, a choppy five-and-three-quarter-year bear market (i.e. interrupted by two positive years), and today's four-and-one-quarter-year bull market.

The first MLP bull market (i.e. December 31, 1999 through June 30, 2014) started quietly amidst soaring internet bubble sentiment and inflated expectations/valuations for technology stocks. Early in this period, energy was a largely ignored and boring sector with low valuations and muted expectations. Over the next thirteen-plus-years, the internet bubble burst and two large bear markets for the S&P 500 ensued. MLPs performed dynamically and went from an investment backwater to prominence as the group's connection to the domestic energy shale development boosted demand for infrastructure. Over the course of this bull market, MLP compounded annual total returns, as measured by the Alerian Total Return Index, soared to 19.85% versus the S&P 500's compound annual return of 3.96%. Over the same time interval, bond market returns, as measured by the Bloomberg U.S. Aggregate Bond Index delivered compound annual returns of 5.76%.



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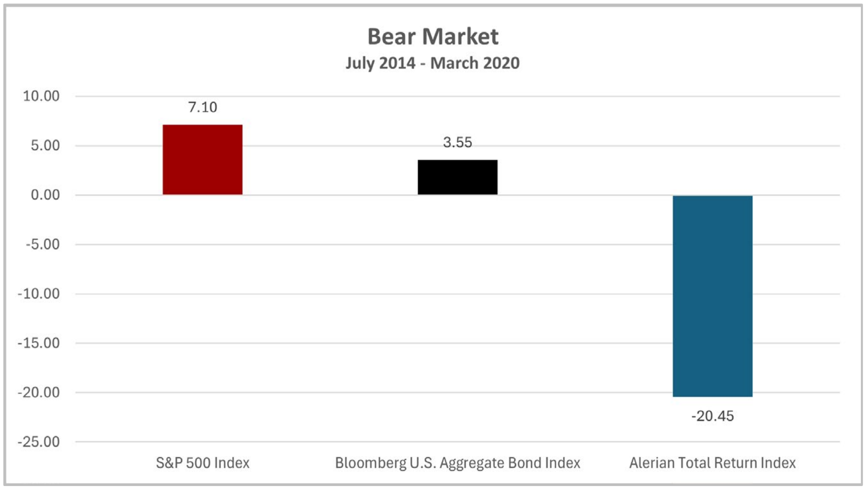
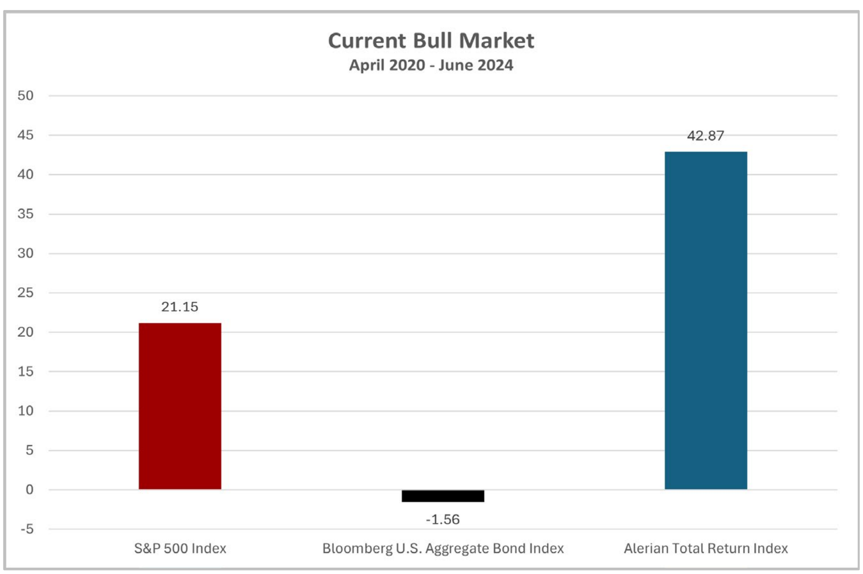
By the middle of 2014, MLPs enjoyed high valuations and widespread investment popularity. Active equity issuance, including several initial public offerings, attested to exuberant investor sentiment. MLP managements assumed capital expenditures could be externally funded and dividend policy gradually became too aggressive. When commodity prices faltered during the Saudi and Russian price wars to wrest back market share from U.S. producers, the equity markets closed to MLP new issuance. With the source of their equity capital needs closed, many MLPs were forced to cut dividends to be able to fund the equity piece of long-term capital projects. Interestingly, MLP cash flow generation remained solid and grew throughout this difficult bear market. The contracted, fee for service revenue model worked very well. Over the course of this five-and-three-quarter-year bear market (i.e. June 30, 2014 through March 31, 2024), MLP returns compounded at a miserable negative 20.45% annual rate versus 7.10% for the S&P 500 and 3.55% for the bond market.



The COVID-19 pandemic with its short-term yet severe negative impact on energy demand marked an historic low point for MLPs. Again, the MLP fee for service revenue model performed exceptionally well and cash flows held up better than the S&P 500. Still, this was lost on most investors during the first quarter of 2020. From March 31, 2020 through June 30, 2024, MLP total returns have been stellar. Over this fifty-one-month period, MLPs have generated compound annual returns of 42.87% and compare favorably to both the stock and bond market returns of 21.15% and negative 1.56%, respectively.



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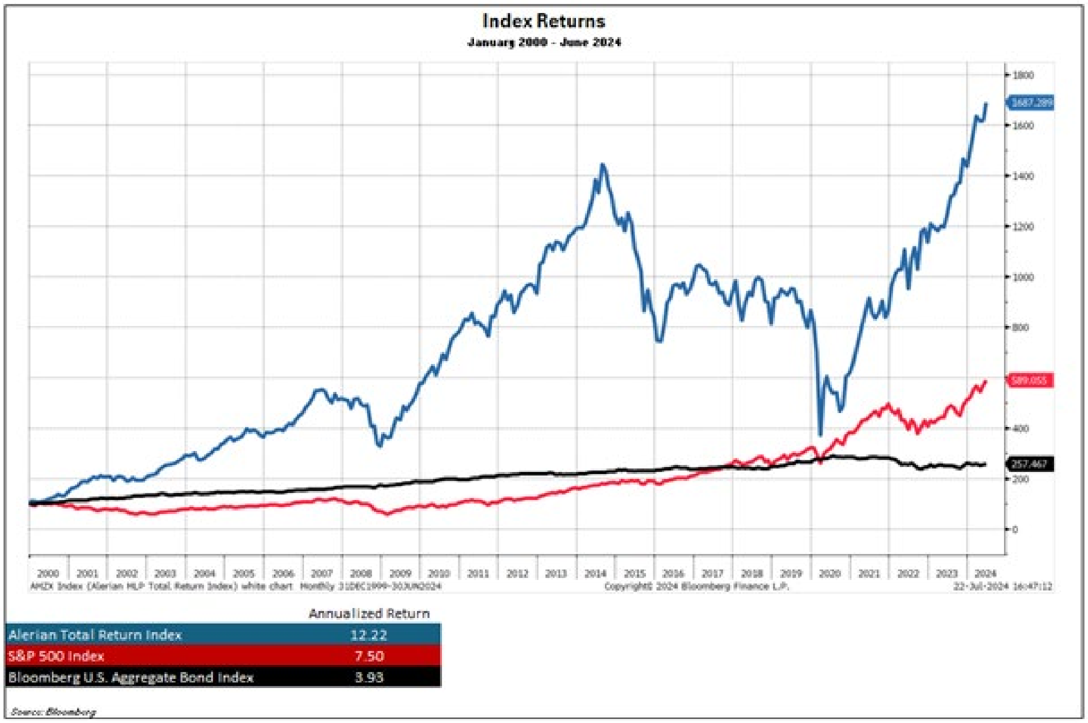
There have been multiple drivers of this resurgence in MLP performance. Deep undervaluation, combined with a renewed commitment by MLP management teams to capital discipline was key. MLPs no longer rely on external sources of equity capital to fund their capital expenditures. Dividends are well covered by cash flows, especially versus historical norms. Dividend growth has resumed, but at more sustainable rates. Finally, balance sheets have become much stronger with less reliance on debt.

In the context of the entire twenty-three-and-two-quarter-year measurement period, MLPs have (perhaps surprisingly to some) performed very well. The group has generated a compound annual rate of return of 12.22% versus 7.50% for stocks and 3.93% for bonds. When compounded for more than twenty-years, there is a staggering difference in the cumulative return for this period. It has been a more volatile path for MLPs than it should have been because of the self-inflicted lack of capital discipline and dependence on external equity capital. However, the recent few years have seen a return to the lower volatility the group showed in the early years of this time period.



Most importantly, when we look to the future, we are encouraged by several factors that are not typically present at a bull market's end. Specifically, the following items stand out to us:

- MLPs are inexpensive relative to the overall market and are trading at a discount of over 20% to their long-term average valuation,
- MLP capital expenditures have declined significantly and are focused on higher return projects,
- The lower Capex needs have made MLPs self-financing, eliminating the need for equity capital and allowing for debt paydown, and
- MLPs are generating 7% dividend yields that are well covered and growing more than 4% per year.

This combination of attractive valuations, better capital discipline and a growing return of cash flow to shareholders leads us to believe the industry is poised to continue delivering double-digit long-term returns as it has for over twenty years.

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