Master Limited Partnerships

Your Guide to the Income-Producing MLP
Investments that are Building America's Energy Infrastructure

By David T. DeWitt, CFP, MBA

DeWitt Capital Management – Investing in MLPs Since 1991
This book is dedicated to my wife, Laura, whose perspectives and support helped keep me learning, growing, and focused.
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Disclosure

The contents of this book, including any videos presented herein, do not constitute an investment recommendation. As such, this book does not contain all information that a prospective investor may desire in evaluating an investment strategy or individual investment.

Each investor must rely on his or her examination of an investment strategy or individual investment, including the merits and risks involved in making an investment decision. Before making an investment decision, a prospective investor should consult his or her counsel, accountants, and other advisors to evaluate the merits of an investment strategy or individual investment. Additionally, any discussion of the past performance of any investment strategy or individual investment, should not be relied on as a guarantee of future performance, and no warranty of future performance is intended or implied.
I recently recorded an interview on master limited partnerships, and I am providing that interview to you as a thank you for taking the time to read this book.

To listen to the interview, please visit:

http://MasterLimitedPartnerships.com/MLP-Audio-Interview

If you would like more free resources on master limited partnerships, please visit my website, www.MasterLimitedPartnerships.com or contact me directly at dtdewitt@dewittcm.com.
Introduction

Over the last several years, energy production in the United States has undergone an incredible resurgence. After experts and industry analysts had concluded that the days of America as an energy power were numbered, technological advances and experimental drilling techniques led to massive new discoveries and kicked off years of energy production.

One part of this story of revival that often gets overlooked is the infrastructure that is required to gather, transport, store, and export the oil, gas, and natural gas liquids. This midstream segment of the energy supply chain requires billions of dollars in investment to build the facilities, lay the pipelines, and secure the transport and storage vehicles to make sure that energy is moved from the extraction point to the end user—and all the steps between.

Much of our nation’s investment in energy infrastructure comes from master limited partnerships. Master limited partnerships (MLPs) are tax-efficient, publicly-traded vehicles that earn the majority of cash flows from commodities, real estate, and energy. The U.S. government long ago realized that investment in the midstream segment was critical to our nation’s energy supply and Uncle Sam made MLPs a great way to invest in midstream assets by allowing these limited partnerships to avoid taxation at the entity level. This characteristic created a big incentive for investors in MLPs since their investment is only taxed on the distributions.

I first started investing in master limited partnerships in 1990, when there were only seven MLPs in existence. At the time, my firm focused on investing in conservative, local, and high-dividend-paying companies. By chance, I was good friends with Steve Ramsey, the CFO at the time of Buckeye Pipeline, one of the pioneering MLPs back in those days. Perhaps unsurprisingly, he suggested that I invest in Buckeye. The more I looked at the company, the more I realized that master limited partnerships like his offered an attractive structure and had the characteristics I was looking for in an investment.
Steve explained to me that Buckeye's (and other MLP's) distributions would go up over time (unlike a bond), the distributions were tax-deferred (unlike a bond), and when you passed away, your heirs received the units with the tax-deferral removed making them essentially tax-free. With all the exotic financial instruments, alternative investments, and different investment products available to investors like you and me, master limited partnerships still rise to the top in my opinion. That is why I have been investing in master limited partnerships for more than twenty years. Hopefully, by the end of this book, you will come to appreciate the incredible opportunity in master limited partnerships, just like I discovered in 1991. (By no means should this book be considered the complete discussion of MLPs, and additional information should be gathered by an investor before making a decision to invest in the product.)

As you make your way through this book, I will provide you with an extensive guide to master limited partnerships. You will understand how master limited partnerships are structured and why these partnerships formed. We devote a large portion of this book to the examination of master limited partnerships from the investor’s point of view, explaining the unique aspects of master limited partnerships such as tax efficiency, yield, and how this investment can complement your estate planning. Finally, we will cover many of the important trends that are emerging and consider the opportunities for MLP investors in the coming five to ten years and beyond.

I’ve spent nearly three decades soaking up knowledge from energy industry experts, researching master limited partnerships with my team at DeWitt Capital Management, a registered investment adviser, and putting my own money on the line in what I believe to be one of the best investments you can make in your portfolio. I appreciate you taking the time to read this book, and I am eager to share with you everything I have learned investing in master limited partnerships.

Sincerely,

David DeWitt

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Master Limited Partnerships by David DeWitt
Chapter 1 - Overview

Master limited partnerships possess several unique qualities that have drawn investors. Key qualities include a pass-through entity, stable cash flow, ownership of pipelines and other toll-road-like assets, and the ability to trade units on public stock exchanges. In this chapter, we will define master limited partnerships, provide an overview of the history and growth of the industry, and conclude with a look at the MLP sector today.

**Master Limited Partnership Fundamentals**

To begin, let’s define a master limited partnership. A master limited partnership is a publicly-traded limited partnership that derives most of its income from commodities, real estate, and energy. Master limited partnerships are most commonly associated with energy because the clear majority of MLPs invest in natural resource-related assets, especially oil and gas infrastructure. While the structure is open to real estate, the preferred investment vehicle for the real estate space is publicly traded real estate investment trusts (REITs).

The two most important features of the structure of master limited partnerships are tax efficiency and liquidity. As a pass-through entity, master limited partnerships are not taxed at the entity level. Instead, only the MLP’s unitholders are taxed on distributions. Master limited partnerships are necessarily publicly-traded, meaning that investors can buy and sell units in MLPs on the major exchanges. This public-market component is key, as it allows investors to gain the tax benefits of the master limited partnership structure without sacrificing the ability to trade shares on the public markets.

By law, a master limited partnership derives more than 90% of its cash flows from qualifying sources such as natural resources, real estate, and commodities. Master limited partnerships often generate income from energy-related sources, such as oil & gas storage and transportation. For investors, the benefits of investing through an MLP structure are the liquidity of a publicly-traded security, the regular cash distributions, and the tax benefit of being able to pass through income and avoid taxes at the entity level.
Key Features of MLPs

There are so many different investments out there, so I thought it would be helpful to highlight a few of the key features of MLPs that help to distinguish these partnerships from other securities and investment structures available to investors in today’s market.

Income: MLP owners receive cash distributions — usually paid quarterly — from the business operations of the partnership. The cash distributions have increased over time at around 6% per year, and the annual yield has averaged 6.9% since 2005.

Performance: Although the energy sector has been hit hard as of late, MLPs have outperformed the S&P 500 every year from 2000-2011. Even with the 2012 through 2015 underperformance, MLPs still have a higher total return than the S&P 500. MLPs can combine capital appreciation potential with a steady yield to deliver high total returns.

Energy Sector Experience: The U.S. is experiencing a dramatic boom in domestic oil and natural gas production due to advancements in drilling technology. MLPs are uniquely positioned to take advantage of the boom with minimal commodity price exposure. Midstream MLPs generate revenues based on volumes transported, not the price of the commodity.

Tax Advantages: Importantly, MLPs do not pay corporate tax, and the income they pay out is tax-deferred due to pipeline and infrastructure depreciation costs.

Liquidity: MLPs trade publicly on the NYSE and the NASDAQ. MLPs combine the tax advantages of a partnership with the liquidity of publicly traded securities.

Estate Planning: If MLPs unitholders leave their units to an heir, the deferred tax bill disappears. The heir receives the MLPs at a new cost basis based on the market value of the units when they are passed on.

So, in sum, master limited partnerships (MLPs) are limited partnerships that trade publicly on a securities exchange. They combine the tax benefits of a partnership (pay no corporate taxes) with the liquidity of publicly traded securities. I would now like to spend a little time on how MLPs came about and why the structure exists.
History of MLPs

The first master limited partnership was formed in 1981 when the Apache Petroleum Corporation debuted an MLP, Apache Petroleum Company. This event would mark the beginning of a vehicle that would rise in prominence over the subsequent decades all the way until today, where the master limited partnership is a widely-known, albeit sparingly used limited partnership structure.

In the beginning, most MLPs were like Apache. They were formed to invest in and develop oil and gas assets. However, the structure has since been adopted by other asset types, from casinos to financial companies to real estate. After the success of Apache’s MLP, other companies decided to form master limited partnerships for the tax advantages.

Eventually, the U.S. government grew concerned that it was losing corporate tax revenue and Congress passed a law in 1987 that limited the MLP structure to only a few sectors. Specifically, the U.S. government opened the door for master limited partnerships as they exist today with 7704(d)(1)(E) of the US tax code. This revision of the tax code set clear requirements for qualifying sources of income. The relevant text reads:

(1) IN GENERAL, Except as otherwise provided in this subsection, the term “qualifying income” means—

(A) interest,

(B) dividends,

(C) real property rents,

(D) gain from the sale or other disposition of real property (including property described in section 1221(a)(1)),

(E) income and gains derived from the exploration, development, mining or production, processing, refining, transportation (including pipelines transporting gas, oil, or products thereof), or the marketing of any mineral or natural resource (including fertilizer, geothermal energy, and timber), industrial source carbon dioxide, or the transportation or storage of any fuel described in subsection (b), (c), (d), or (e) of section 6426, or any alcohol fuel defined in section 6426(b)(4)(A) or any biodiesel fuel as
Essentially, Section 7704(d)(1)(E) specifies that qualifying income for master limited partnerships must mostly be derived from the extraction, processing or transportation of non-renewable energy sources, real estate income, or investment income. Since the regulatory changes of the late 1980s, fewer and fewer MLPs have been real estate focused.

Today’s MLPs are largely energy focused, allowing investors to supply capital to create much of the energy infrastructure (pipelines, storage, transportation, etc.) that has fueled America’s domestic energy boom.

**The Size of the MLP Industry Today**

Master limited partnerships, as an industry, have grown in the United States since the first master limited partnership formed in 1981. MLPs today control more than $400 billion in assets across over 100 MLPs. That is amazing growth since when I first started investing in MLPs back in 1991.

Investors have been showing more interest in MLPs in recent years, fueled especially by the growth in domestic oil and gas production. After more than three decades of master limited partnerships, there are now more than 100 MLPs and the market capitalization of MLPs is estimated to be at least $414 billion while other estimates are as high as $464 billion. MLPs continue to grow and are traded more than ever, with energy MLPs leading that growth.

Today, oil & gas master limited partnerships make up the overwhelming majority of the asset class. It remains to be seen whether the 2014-2016 troubles in the energy sector amid record-low oil prices will result in fewer MLPs. Personally, I believe we will continue to see the consolidation that has already taken place in the wake of the oil price collapse. I will share more on that in the final chapter, titled MLPs Today and Tomorrow.

**What MLPs Invest in Today**

When master limited partnerships debuted in the 1980s, there was a wide variety of sectors in which MLPs invested. In 1987, the U.S. Congress passed legislation that required MLPs to derive at least 90% of income from qualified sources, largely
natural resources and energy-related holdings. Today, master limited partnership investments largely concentrate in energy-related holdings.

Kevin Mahn of Forbes put together an insightful table that shows the breakdown in MLPs by industry concentration:

<table>
<thead>
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<th>MLP Industry Concentration</th>
<th>1990</th>
<th>2013</th>
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<tr>
<td>Oil and Gas Midstream and Downstream</td>
<td>10%</td>
<td>51%</td>
</tr>
<tr>
<td>Oil and Gas Exploration &amp; Production (Upstream)</td>
<td>21%</td>
<td>12%</td>
</tr>
<tr>
<td>Propane</td>
<td>0%</td>
<td>3%</td>
</tr>
<tr>
<td>Oil &amp; Gas Marine Transportation</td>
<td>1%</td>
<td>5%</td>
</tr>
<tr>
<td>Coal Leasing or Production</td>
<td>0%</td>
<td>4%</td>
</tr>
<tr>
<td>Other Natural Resources</td>
<td>5%</td>
<td>7%</td>
</tr>
<tr>
<td>Real Estate – Income Properties</td>
<td>14%</td>
<td>2%</td>
</tr>
<tr>
<td>Real Estate – Developers, Homebuilders</td>
<td>4%</td>
<td>0%</td>
</tr>
<tr>
<td>Real Estate – Mortgage Securities</td>
<td>13%</td>
<td>2%</td>
</tr>
<tr>
<td>Hotels, Motels, Restaurants</td>
<td>12%</td>
<td>0%</td>
</tr>
<tr>
<td>Investment / Financial</td>
<td>6%</td>
<td>9%</td>
</tr>
<tr>
<td>Other Businesses</td>
<td>15%</td>
<td>4%</td>
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As the table above shows, master limited partnerships are primarily investing in oil & gas. In 2013, 71% of MLPs focused on oil & gas midstream, downstream, upstream, propane, and oil & gas transportation by sea. In 1990, we can see that real estate used to be a major investment area for MLPs but now make up only about 4%.

What is driving growth?

Several factors currently drive the growth in master limited partnerships. Some include:

- The exports of natural gas in the form of liquefied natural gas (LNGs).
- The export of natural gas to Mexico for power generation.
• The export of natural gas liquids (NGLs) to South America and Asia, primarily propane and ethane.
• The increased use of ethane in petrochemical plants located primarily near Mt Belvieu on the Gulf coast.

From the supply side, we see growth drivers including:

• The Utica and Marcellus formations in the northeast (Pa, Ohio, West Virginia) providing nearly enormous supplies of natural gas and NGLs.
• The Permian Basin in Texas will drive supply mostly from oil producers.
• In Oklahoma, we continue to see supply from the South Central Oklahoma Oil Province, or SCOOP, and the Sooner Trend Anadarko Basin Canadian and Kingfisher, STACK, with its potential for liquids.
• With the recent election of Donald Trump, we could see more growth driven by the encouragement of oil and gas production, possibly the construction of the Keystone XL pipeline, and investment in America’s infrastructure.

We will dive into the various factors driving the growth of MLPs and other trends in the final chapter of this book. Before we get into that, we must break down the MLP structure and understand better how these investment vehicles work.
Chapter 2 – How MLPs are Formed and Operate

You have probably gotten the sense that I find master limited partnerships to be an exceptional vehicle for investing capital. In this chapter, I would like to walk you through how these entities are formed, how an MLP puts capital to work and manages assets, and what the relationship is between the general partner and the unit holder.

While MLPs can own several other types of assets, as we saw in the last chapter, most MLPs today build and operate midstream oil and gas-related assets. In this book, we are focused mostly on midstream MLPs, i.e. the MLPs that transport, process, and store energy.

These master limited partnerships are often likened to toll roads, where drivers pay a toll to use the highway system connecting users from one state to the next. In a similar way, master limited partnerships make up the energy highway that transports fuel in all its varying stages of refinement, moving from the upstream source to the downstream distribution to the end user. Energy producers and other industry participants that rely on energy infrastructure, such as oil and gas pipelines, pay the master limited partnerships who are responsible for building, maintaining, and operating those assets for the right to use the infrastructure.

Because MLPs typically control toll-like assets, where producers pay based on the volume of oil and natural gas transported and stored, unitholders receive regular distributions from that consistent cash flow. This is one of the key hallmarks of master limited partnerships: steady cash flow that is not dependent on the price of oil or gas. In recent years, there has been more of a correlative relationship between MLPs and the price of the commodities they move, but we will get into this more recent phenomenon in the final chapter. Historically, MLPs have earned predictable and steady cash flow that have translated into quarterly distributions for investors.

MLP Structure

Before we dig into the more technical facets of the MLP such as incentive distribution rights, K-1s, or any of the other nuanced aspects, it is helpful to
understand the structure of an MLP. As we have explained above, MLPs structure as publicly-traded limited partnerships that own the operating company which in turn acquires assets. A General Partner (GP) manages the MLP and essentially runs the business. A master limited partnership forms through a multi-step process, involving much paperwork from well-paid attorneys, but it essentially boils down to:

1. The Sponsor forms the General Partner (GP);
2. The Sponsor and the GP form the limited partnership, setting up the partnership agreement that dictates the distribution levels;
3. The Sponsor invests a nominal amount of money in the limited partnership;
4. The Sponsor then contributes the qualifying assets to the master limited partnership; the assets must meet the requirements for MLPs on qualifying sources of income, per 7704(d)(1)(E);
5. The MLP now assumes the liabilities for those qualifying assets and the assets and liabilities are moved down to the operating subsidiaries;
6. In the IPO, common units (essentially public shares) are offered to the public;
7. The GP typically maintains a 2% interest in the MLP
8. The Sponsor or GP receives cash, common units, subordinated units, and incentive distribution rights (to be covered in more detail next);
9. Now that the MLP is formed, the GP works to generate cash flow and greater distributions to unit holders and the GP itself.  

The GP will sell a portion of the MLP to the public in an Initial Public Offering (IPO), and the GP owns the remainder as well as a 2% interest.

The public buys common units in the MLP while the GP holds subordinated units, giving the public preference over the GP when it comes to cash distributions. As the MLP prepares for IPO, it will submit its prospectus to the SEC and set a minimum quarterly distribution, which the public will receive first, then the GP's subordinated units. I have created a diagram to show the different entities and parties involved in a master limited partnership.

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As you can see in the diagram above, master limited partnerships have a two-tiered structure. The sponsor and shareholders own units of the publicly-traded limited partnership which have ownership of the operating entity, the vehicle that owns the operating assets and any subsidiaries.

An MLP’s partnership agreement typically requires all available cash to be distributed to unitholders. Available cash flow is the cash flow available to unitholders and the sponsor from operations in each quarter minus: cash needed to meet debt obligations, cash reserves for future distributions in the next four quarters, and other reserves set aside for regular business operations by the GP.

The public invests in MLPs largely because of the expected cash flow distributions. While MLPs are not required to deliver a guaranteed amount of cash to investors like a bond’s coupon, unit holders expect quarterly income from the MLP. MLPs trade based on a multiple of cash flow and, while the GP has some discretion over available cash flow, the sponsor is highly motivated to distribute as much cash as possible to unit holders. If an MLP’s sponsor wants to achieve a greater market
capitalization and satisfy unit holders, it will need to grow cash flows and distribute that cash to unit holders.

**Incentive Distribution Rights**

Another incentive for sponsors is the incentive distribution right (IDR). An IDR is a right of the General Partner in the MLP to a greater proportion of the limited partnership’s quarterly distributions. The IDRs provide the GP with an increasing cut of the incremental distributable cash flow from the MLP. For those who are familiar with hedge funds and private equity, it may be helpful to think of IDRs as a form of carried interest, an incentive to hit specific benchmarks that benefit the other investors, too.

An important note is that we said this is an increasing portion of the cash distributions to the GP. The cut increases according to a pre-determined schedule which motivates the GP to perform because the greater returns produced by the MLP, the greater the share of the distributions for the GP. The MLP is constructed with different targets set for when distributions percentages will change. At the outset, the unitholders will take 98% of the distributions, while the general partner only earns 2%.

While the GP starts off with a minimal cut from the initial distribution, the GP has the potential begin to earn a higher significantly higher percentage of the distribution fairly quickly. For example, upon hitting a total quarterly distribution target of $0.50, the split might shift to 85% for unitholders, and 15% for the general partner. After exceeding $0.55, the split may be 50-50. These different benchmarks shift the percentage allocations awarded to the GP according to the MLP’s distribution tiers (also known as “splits”). The distribution tiers can provide exceptional compensation for the general partner and reward it for all the hard work, the disproportionate risk in the beginning, and for the strong performance exceeding the distribution benchmarks.

For unitholders, you can see how important incentive distribution rights are because the MLP, if successful in hitting its benchmarks, will surrender a greater portion of its cash distributions to the GP. Much like hedge fund and private equity fund sponsors, MLP sponsors can reap enormous profits if the MLP outperforms.
Depreciation

There are some characteristics that make master limited partnerships unique. One such feature is depreciation. Depreciation is an expense, and it is an important expense because master limited partnerships own significant physical assets. Those assets will depreciate, and that has significant accounting consequences.

What is Depreciation?

We know depreciation in our daily lives as the decay or devaluing of goods. For example, when you buy a new car, the moment you drive a new car off the lot that asset will start depreciating. Why? The car, a physical asset that can deteriorate in quality and performance, will be worth less in the eyes of future buyers than what you valued the car when you bought it new. A new car has more appeal to a car buyer than a used one, all else equal, and so the car’s value depreciates just by the mere fact it was previously owned. Of course, it also depreciates as you drive it, adding wear and tear to the car’s interior and exterior and worsening the engine and motor performance over time.

In accounting, we view the depreciation of a company’s physical assets as an expense. The CFO of the company will spread out the estimated depreciation expense over the time between when the company purchased the asset and when the company must replace the asset. Let’s say you are the CFO of a master limited partnership. You recently purchased an oil tanker, which is considered a physical asset. You remember that the government makes an allowance for your company to spread a portion of the costs of oil tankers and other physical assets over multiple years. If Generally Acceptable Accounting Principles (GAAP) and the Internal Revenue Service (IRS) allow, then you can determine how long the oil tanker will be useful before you will replace it. You then apportion that cost to replace over the years between when you bought the tanker and when you expect to replace it. In a simplified calculation, if the oil tanker cost you $100,000 to purchase it and you know it will have a useful life of 10 years, then you can claim a $10,000 depreciation expense for the ten years from when you buy the item to when you are expected to replace it.

Why Depreciation Matters to Unit Holders

You might be thinking, “interesting, but why is a nuance of accounting important to MLPs?” I would not be digging into GAAP unless there was a good reason, and for
master limited partnerships there is: MLPs are asset-intensive businesses. When you are building a pipeline, or drilling for gas, you can expect to purchase several pieces of equipment. You can probably see where this is going; that is a large amount of heavy-duty depreciating, and that depreciation expense has a major effect of reducing the MLP’s net income, and thus reducing the MLP’s tax burden. Due to the fact MLPs are capital-intensive and because physical assets like pipelines have such a long useful life, most MLP cash distributions to unit holders are tax-deferred. Pipelines, for example, typically are useful for far longer than their rate of depreciation suggests, and that creates a healthy tax benefit for the MLP.

Return of Capital

Unit holders of an MLP benefit from this reduction in taxable income thanks to “return of capital.” A high percentage of the quarterly distributions to unitholders is treated by the IRS as a return of capital, especially in the early years you own the units. If like most MLPs, a significant percentage of the unit holder’s distribution is reported to you by the MLP as a return of capital, then you only should pay federal taxes on the portion of the distribution that is not a return of capital. Say, you receive a distribution of $100 every quarter, and after all the accounting is completed the MLP informs you that $70 of that distribution is a return of capital; then you only pay taxes on that $30 since that is ordinary income.

Other Considerations

As we recently discussed, though, this tax benefit means filing a K-1 instead of the more standard 1099 filing. The K-1 and the more comprehensive, time intensive accounting makes some people nervous because they are unfamiliar with the unique tax characteristics of master limited partnerships. Hopefully, this section helped shed some light on this topic. As always, be sure to consult your qualified tax or investment adviser on this topic and any others covered within this educational book.

General Partner

Now that you see how the general partner is incentivized, you can understand why someone would form a master limited partnership. The model allows the general partner to earn substantial compensation if the assets generate strong cash flow. So, who is the general partner? The sponsor, or GP, is typically an experienced
energy corporation that is spinning off an asset like a pipeline into a new master limited partnership. The company may have other assets that either does not qualify for the MLP structure or are not a fit because they do not produce consistent cash flow.

MLPs often make sense for a general partner that is seeking to issue public equity interests to fund a major pipeline or a similar infrastructure project that will deliver regular distributions of cash to unit holders and the GP. For the sponsor, the MLP structure offers a hybrid structure that combines the benefits of partnerships and corporations. The partnership feature allows the MLP to pass through all income, losses, and credits to its investors without paying taxes at the entity level. However, like public companies, the MLP also can offer units to the public. This model allows anyone with a brokerage account to purchase an interest in the partnership and gives these investors liquidity, unlike with a private limited partnership fund where the shares are not publicly traded, and capital might be locked up indefinitely.

There are numerous benefits to the sponsor in forming a master limited partnership, including:

- Spinning off assets to unlock value that would not otherwise be realized by investors within the larger company
- Cheaper cost of capital
- Tax benefits associated with the master limited partnership structure
- Incentive distribution rights and the ability to earn upside while investing the public’s capital
- Ability to keep ownership of assets but still spin off the assets into separate companies

**Limited Partner**

For this book, we are using limited partner and unit holder interchangeably. A unitholder is a public investor in the master limited partnership; most the equity-holders in the MLP are unit holders. These investors do not manage the MLP; they simply participate in the gains of the MLP. Unlike shareholders in public companies, limited partners rarely have voting rights and the management decisions are left to the general partner.

We will get into the benefits of investing in MLPs and owning common units in
Chapter four, but let’s briefly cover some of the benefits to limited partners:

- Participating in a high-yield security with steady distributions
- As a pass-through entity, more cash is distributed to unitholders without having to pay taxes at the entity-level
- The potential for an increase in distributions over time
- The potential for appreciation of the value of the common units
- Limited partners enjoy limited liability
- The majority of the cash distributions are issued to unitholders are shielded from tax
- Investors enjoy liquidity like that of a listed corporation
- The tax-deferred portion is not taxable until unitholder sells securities

As I stated before, these are only a handful of the benefits to owning MLPs. In chapter four we will discuss these and more reasons in greater detail.

**MLP Tax Considerations**

As I touched on in the first chapter, master limited partnerships may offer investors benefits including tax efficiency. Depreciation charges often mean that income generated by the MLP treated as a tax-free “return of capital” to the investor. For investors that are used to earning dividends, MLPs offer distributions—as we explain in this section, distributions are not dividends. When you are reporting your dividends, you simply fill out a short 1099 tax report. For MLPs, however, we have the schedule K-1 filing which is longer and more complicated than a 1099.

One challenge cited by those who are critical of the master limited partnership model is the K-1 statement. A Schedule K-1 filing is a form required by the IRS that informs the government of your share of income, deductions, and credits from a partnership. While it is only a two-page document, it is more of a hassle for investors than, say, a simple filing of your dividends earned as a shareholder of a public company.

Here’s what a K-1 filing looks like, courtesy of Uncle Sam and the good folks at the Internal Revenue Service:

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**Part I: Information About the Partnership**

- **A.** Partnership's employer identification number
- **B.** Partnership's name, address, city, state, and ZIP code
- **C.** IRS Center where partnership filed return
- **D.** Check if this is a publicly traded partnership (PTP)

**Part II: Information About the Partner**

- **E.** Partner's identifying number
- **F.** Partner's name, address, city, state, and ZIP code
- **G.** General partner or LLC member-manager
- **H.** Domestic partner
- **I.** What type of entity is this partner?
- **J.** Partner's share of profit, loss, and capital (see instructions):
  - **Profit**
  - **Loss**
  - **Capital**
- **K.** Partner's share of liabilities at year end:
  - **Noncourse**
  - **Qualified noncourse financing**
  - **Recourse**

**Part III: Partner's Share of Current Year Income, Deductions, Credits, and Other Items**

- **1.** Ordinary business income (loss)
- **2.** Net rental real estate income (loss)
- **3.** Other net rental income (loss)
- **4.** Guaranteed payments
- **5.** Interest income
- **6.** Ordinary dividends
- **7.** Qualified dividends
- **8.** Net short-term capital gain (loss)
- **9.** Net long-term capital gain (loss)
- **10.** Net section 1231 gain (loss)
- **11.** Other income (loss)
- **12.** Section 179 deduction
- **13.** Other deductions
- **14.** Self-employment earnings (loss)
- **15.** Credits
- **16.** Foreign transactions
- **17.** Alternative minimum tax (AMT) items
- **18.** Tax-exempt income and non-deductible expenses
- **19.** Distributions
- **20.** Other information

*See attached statement for additional information.*
Avoiding the K-1

Of course, we are not suggesting tax avoidance here. However, there are ways to gain exposure to MLPs while avoiding the K-1.

- Related Stock: There are certain master limited partnerships that have
listed related stocks on the public exchanges so that investors do not have to hold actual units of Enbridge Energy Partners, the master limited partnership. Instead, the investor can own shares of the related stock, Enbridge Energy Management, which has the MLP as its sole asset, essentially giving investors a chance to participate in the MLP without owning it directly and being subjected to the K-1. As the company website explains, “Enbridge Energy Management is structured as an attractive alternative to direct investment in master limited partnerships for investors without the complications associated with Schedule K-1 tax reporting. Enbridge Management shareholders receive quarterly distributions in the form of additional shares, also known as Paid-In-Kind (PIK) distributions.” (Note: as always, this is not a recommendation or opinion on the company, simply an example for explanatory purposes.)

- Master Limited Partnership ETFs: As we will cover in Chapter four, exchange-traded funds and exchange-traded notes provide investors a vehicle by which they can track the performance of master limited partnerships.

- Master Limited Partnership Mutual Funds: Investors may avoid the K-1 by investing through a mutual fund, depending on the structure of the fund, and also have the benefit of an actively managed portfolio instead of buying the index or individually selecting stocks.

So, investors do have options when it comes to avoiding the K-1, but many MLP investors feel the benefits of owning master limited partnership units outweigh the inconvenience of a Schedule K-1 filing. However, is filing a K-1 that painful?

Navigating the K-1

Investors often dread the K-1, and we have heard multiple investment advisers concede that it is an annoyance of the structure, but K-1 filings mostly just come down to timing and understanding this rarer form of tax reporting. Indeed, some of the frustration lies not with an error by the unitholder but rather poor communication or inconsistent reporting by the partnerships. For the individual, there are many helpful guides out there and most tax preparers should be familiar with the filing and can navigate the form easily. TurboTax even has a guide to getting your K-1 submitted.

Many advocates of investing in master limited partnerships tend to view the K-1 as an inconvenient but otherwise manageable task for the benefit of higher
distributions in your portfolio. Hopefully, this overview has taken away a little of the mystique and concern over the K-1 filing. Be sure to speak with your financial advisor or tax professional for qualified advice on your personal tax situation.
Chapter 3 – What MLPs Invest In

*We access virtually every producing basin, whether for natural gas or crude oil, in the U.S. and Canada.*

- Richard Kinder, Co-Founder of Kinder Morgan

While most MLPs are energy-focused, there are differences in the various types of energy like oil, natural gas, ethane, butane, and propane amongst others. There are also other types of MLPs that have nothing to do with oil and gas. In this chapter, we will briefly examine the various assets and commodities in which MLPs invest. Like MLPs themselves, we will focus more on the most common energy-related MLPs and devote less time to the rarer MLPs with assets including real estate, financial companies or timber.

**Energy MLPs**

*Natural gas is better distributed than any other fuel in the United States. It's down every street and up every alley. There's a pipeline.*

- T. Boone Pickens, Billionaire Energy Investor

**Natural Gas**

Ethane and natural gas more broadly look to be the future of master limited partnerships, as coal and (to a lesser extent) oil decline in use and demand for gas continues to increase domestically here in the U.S. and from other countries.
As I noted in my presentation at the Deal Flow Summit in New York City, the future of master limited partnerships is not in oil (and especially not in coal), but rather in natural gas. Regulations, environmental concerns, and cheaper, cleaner alternatives have severely hampered coal production here in the U.S. This means coal will likely continue to decline as an area of investment for MLPs, as most MLPs have nothing to do with coal production or transportation.

Oil is a more complicated story as technological innovations have helped expand the discoverable oil reserves and there is still worldwide demand for oil. We are not in the business of forecasting the future of oil—many prognosticators have gone down in flames predicting the price of oil. What we will say is that natural gas is quickly emerging as a major source of growth in the U.S. energy market and master limited partnerships are well-positioned to invest capital to support the necessary infrastructure to support natural gas production, transportation, and shipping.

According to the US Energy Information Administration, from the beginning of the shale revolution to 2015 natural gas production in the lower 48 rose from 47 BCF per day to about 70 BCF per day. Natural gas liquids production (ethane, propane, butane, isobutane, natural gasoline) rose from 1.6 mm /day to 3.6 Mmb/day. Crude oil production rose from 5 Mmb/day to 8.5 Mmb/day peaking at 9.5 Mmb/day in 2015.
On the demand side, you can see how natural gas consumption has risen as a share of energy consumption in the U.S. over the last hundred years.

Source: EIA

Natural Gas Liquid, Ethane, and Propane

Natural gas liquids (NGLs) are components of natural gas, so much of the above explanation of the MLP-natural gas relationship applies to this subsection, as well. Natural gas liquids are liquids that are separated from natural gas. The process is completed in a field facility or processing plant, where the hydrocarbons are extracted from natural gas. Hydrocarbons include liquefied petroleum gasses (butanes and propane), ethane, and pentanes plus.

The EIA has produced a helpful chart showing the different hydrocarbons and their uses:
Natural gas liquids prices have fallen during the 2014-2016 turmoil in the energy markets but have since started a recovery. The recovery in natural gas liquids prices has been discussed by many MLP management teams, and they believe NGL pipelines will see strong volume growth and increased earnings over the next several years. Increased ethane pricing will drive performance from many MLPs due to numerous petrochemical facilities coming on-line that will significantly increase demand for ethane.

**Petrochemical Developments**

The expected growth in natural gas and related NGLs creates an opportunity for master limited partnerships to build the necessary infrastructure for storing, processing, and shipping natural gas and extracted hydrocarbons.

Because long-term supplies of natural gas will be abundant, so will ethane and propane. Therefore, major petrochemical plants are being built in the U.S. to produce ethylene, the building block of water bottles and trash bags amongst...
numerous other plastic products. In recent years, the shale revolution has allowed the extraction of ethane and propane in quantities that have encouraged the building of multi-billion dollar plants in the U.S.

There are numerous plants under construction in the U.S. and North America, as you can see in the map below:

![Map of major ethane-based petrochemical construction projects in North America. Source: Petrochemical Update](image)

**Natural Gas Exports**

DeWitt Capital Management focuses on MLPs that benefit from the increased production and use of natural gas (methane). On the fourth weekend of July 2016, there were over 200 million Americans estimated to have experienced temperatures over 90 degrees. That meant electrical generation had to rise to meet the need for air conditioning. Natural gas is the one fuel that represents a path forward that is both readily available and reduces carbon emissions versus the other readily available resource, coal.

**Exports to Mexico**

Exports of natural gas to Mexico is are growing quickly, tripling from 2013-2015 with expectations of doubling from 2016-2018. Liquefied natural gas is beginning
to ramp up as import facilities have been converted to export facilities!

Are MLPs Beginning to Trade Separately from Oil?

Although MLP stocks prices have traded in line with oil over the twenty-four months between 2014 and extending into 2016, that correlation was not in line with historical patterns, and it has since shown signs of separating. We noticed in 2016 that MLP prices were starting to chart their own path. Natural gas and natural gas liquids (ethane and propane) have seen a resurgence in both demand and pricing. My team and I at DeWitt Capital continually research the energy infrastructure universe to discover those companies that benefit from these trends. We believe that even in difficult times the market eventually rewards the increasing cash flow generated by these companies while investors enjoy the ample distributions they provide along the way.

The Shale Revolution

Shale gas is the gas extracted from shale formations. Shale gas has become an increasingly important contributor to American energy production. This natural gas has been trapped in shale formations which until recently has been impossible or at least uneconomical to extract. Recent advances in technology, specifically hydraulic fracturing (fracking), has allowed producers to extract and process natural gasses from shale economically. If you are wondering where the shale activity is happening in this country, the EIA has produced the following map of shale plays in the lower forty-eight:
Oil

Much like natural gas, advances in drilling techniques and technology have opened new stores of oil in America. Master limited partnerships are crucial for driving investment at all stages of the supply chain. We will discuss each stage—upstream, midstream, and downstream—in this section.

Upstream

Before a gallon of gasoline is pumped into your car or a cubic foot of natural gas is piped into your home heating system, there is a complex series of events that must first occur. This supply chain from extraction to sale to the end user is broken up into three distinct segments: upstream, midstream, and downstream.
Upstream is the segment that attracts a lot of media and investor attention, especially lately with the rise of unconventional drilling techniques minting billionaires like Harold Ham and Farris Wilks and drawing scorn from politicians and even presidential candidates like Bernie Sanders. In this post, we will discuss the upstream segment, from exploration to production to refining.

The first phase of the energy supply chain is the upstream phase, which includes the exploration, extraction and production processes.

Producers first commence with the exploration work, identifying oil, gas, or other energy deposits. Today, exploration efforts are highly scientific, engineers, geologists, and technical specialists pour over maps and survey results to find the most fertile deposits that will deliver the highest volume and highest quality energy.

Once the targets are identified, extraction phase commences wherein the producer will set about digging into the ground and extracting the energy source. It is worth noting that the extraction processes have radically changed in the last few years, as more and more producers have adopted non-conventional drilling techniques including horizontal drilling and hydraulic fracturing.

Hydraulic fracturing (fracking) is a drilling technique in which the producer injects mostly water and sand at high pressure into the ground to stimulate wells, fracture shale rocks, and ultimately free up trapped natural gas for extraction.

Horizontal drilling is a method of drilling in which an oil or gas well is turned horizontally underground to extract energy beyond what is capable only from vertical drilling.

These unconventional techniques, along with new energy discoveries and technological advancements, have unleashed vastly more domestic energy supply than was ever thought possible and spurred on the domestic energy revival that is taking place today.

After the energy is discovered and extracted, the energy must be processed and refined for more useful consumption. Oil and gas have thousands of different uses and must be refined in the processing phase so that it is consumable by end users. For example, a barrel of crude oil is not a good fuel for cars until it is refined and
processed into gasoline.

Most MLPs are focus on the midstream segment, which includes the transportation, storage, and shipping of energy, but there is some upstream master limited partnerships. Range Resources Co., for example, is a publicly-traded master limited partnership that dedicates itself to extracting and producing petroleum and natural gas.

While there are no guarantees as to how any MLP will perform, some investors view upstream investments as involving a greater degree of volatility than midstream investments. Upstream MLPs’ revenues are linked closely to energy prices while midstream MLPs may afford investors more stability in revenues because transportation and storage contracts are often structured based on volume rather than price. At the same time, investors in the upstream segment are typically looking for big discoveries or great extraction projects to compensate for the volatility and risk involved in this phase.

Because master limited partnerships are structured to make regular cash distributions to investors, most MLPs concentrate in the midstream where transportation and shipping may be more stable and predictable with long-term contracts.

**Midstream**

One of the assets most closely associated with master limited partnerships is the pipeline, a common midstream asset. MLPs own and operate many transportation-related assets, but the MLP space pumps billions of dollars into pipeline construction and management.

One might ask, why pipelines? Pipelines are a perfect fit for the master limited partnership model, but to understand why it is first important to understand minimum volume commitments. Many of these pipeline operators negotiate agreements with downstream producers that include a minimum volume commitment. That minimum volume commitment clause in the contract is intended to protect the pipeline owner from having producers completely cease shipping oil or gas through the pipelines.

In a time of low oil and gas prices, like we saw in 2015, a producer may be tempted
to stop producing or to at least curb its shipments. Without the minimum volume agreement, a pipeline could see its business dry up overnight and have no recourse to force the producer to continue shipping through the pipeline. There have been some concerns by investors that oil and gas producers, which have been distressed as a result of price declines, could successfully terminate their contracts and avoid having to fulfill the minimum volume requirements. Much of this worry had been spurred by a legal case involving the bankruptcy of Sabine Oil & Gas Corp.

Because pipelines typically charge producers under a toll-like model, charging for the use of the pipeline based on volume, a drop-in volume could mean millions of dollars in lost revenue for the pipeline operator. It is incredibly expensive to construct and maintain a pipeline, and it is a safe assumption that fewer would be built if it were not for the expectation that these are steady businesses with minimum volume agreements and thus assurances that the pipeline will have a steady flow of fuel being transported. The financiers of pipelines (such as MLPs) need to know that their major investment in building the pipeline will be paid back over time by customers shipping extracted oil and gas to refineries and end users.

For MLPs, it is even more vital to their model that pipelines earn a steady flow of revenues and that business is not interrupted by frequent swings in the commodity prices in the same way that producers may be impacted. That is because master limited partnership unitholders are often expecting regular distributions from the MLP. Many MLP investors are looking to master limited partnerships to add regular income to their portfolios, and the MLPs can only do so if their assets are producing steady cash flows.

As you can see pipelines make much sense for the master limited partnership model, and the cash flow stream helps explain why so many MLPs have been formed and why they have been so critical to the development of oil and gas pipelines in the last several years.

**Infrastructure and Master Limited Partnership**

America has enjoyed an amazing revolution in oil and gas production, thanks largely to the technological advancements in hydraulic fracturing and horizontal drilling. Once thought to be decades past Peak Oil, domestic energy production has grown remarkably in recent years, even outpacing Russia and nearly doubling Saudi Arabia’s production in 2014, as you can see in the graphic below. Master
limited partnerships are uniquely positioned to invest in infrastructure and drive the development of the necessary ports, pipelines, transportation assets, and other key infrastructure investments needed to support a burgeoning domestic oil and gas industry.

Despite the historic decline in energy prices in 2015-2016, there is still a tremendous need for infrastructure investment to support America’s energy industry. Master limited partnerships (MLPs) have been an important vehicle for capital investment in America’s energy infrastructure, and there is good reason to expect MLPs to play a big role in that infrastructure expansion in years to come, as well. As a reminder, master limited partnerships are tax-exempt publicly-traded limited partnerships that own storage tanks, pipelines, and other infrastructure-related holdings. Most master limited partnerships seek to own income-generating assets, generating cash flow that is largely passed on to the investors in the form of distributions.

The expansion of our national energy supply is critical not only to economic development but also to our national security. Our dependence on foreign governments for energy supply poses a significant threat to our national security, according to many informed voices such as Former CIA Director R. James Woolsey, who told Scientific American that America’s foreign oil dependence is a grave threat to our national security. (1) To continue on this country’s path to energy
independence, the federal government’s Quadrennial Energy Review recommended that America invest billions into its energy infrastructure. (2) Master limited partnerships are a uniquely well-suited vehicle for infrastructure investment as we will discuss below.

**Why Master Limited Partnerships Invest in Infrastructure**

Most master limited partnerships today are concentrated in oil and gas assets in the midstream and downstream segment of the market, primarily transportation, pipelines and other infrastructure assets. Master limited partnerships are focused primarily on hard assets and natural resources because of the laws Congress passed decades ago stipulating the various commodities and assets from which MLPs must derive the majority of their income.

However, beyond the legal and tax reasons for focusing on energy, the master limited partnership model is a great fit for midstream oil and gas segment because these are mostly income-producing assets. Master limited partnerships invest in these so-called “toll road” businesses because they provide the type of regular, steady cash flow that MLP investors expect in their quarterly distributions.

**Future Infrastructure Investments**

Many people think energy infrastructure is mostly oil transportation and shipping but natural gas is a major part of our nation’s energy story, especially with the previously mentioned advances in drilling and extraction. There are still significant capital needs to develop our import and export infrastructure to support energy markets.

**Downstream**

Compared to the upstream and midstream segments, the downstream segment is considerably less relevant to master limited partnerships. For that reason, we will not devote too much time in this book to downstream assets. That is not to say that MLPs focused on the downstream do not exist, they do.
One such example was Northern Tier Energy LP, a U.S.-based downstream MLP that owned the Super American gas station and convenience store chain. The MLP has since dissolved, but there are other downstream MLPs that focus on distribution and sales to the eventual end-user of natural gas, oil, and other fuels.

Another example is AmeriGas, which is a publicly-traded MLP and the largest retail propane marketer. According to AmeriGas’s website, the MLP is the nation's largest retail propane marketer, serving approximately 2 million customers in all 50 states from approximately 2,100 distribution locations.

Sunoco LP is a growth-oriented MLP which distributes motor fuel to commercial customers, distributors, and convenience stores. The MLP also owns and operates some 850 convenience stores and retail gas stations across the country.

You can see there are numerous different downstream assets which MLPs can operate such as a portfolio of gas stations, convenience stores, and other natural gas and oil end-product distribution assets.

**Timber**

Master limited partnerships are most closely associated with fossil fuels like gas, oil, and less frequently coal. However, those are not the only natural resources in which master limited partnerships invest. A resource that at least one MLP is focused on is timber. Few master limited partnerships though are dedicated exclusively to timber because it is quite a niche space; instead, timber may be one asset carved out of a broader MLP mandate that includes other natural resources.

Compared to more typical energy assets like oil, natural gas, and minerals, timber might seem like an unusual investment. Timber is an essential resource that is used for fuel, tools, flooring, furniture, softwoods, and pulp for paper. Even in the digital age, timber continues to be a resource of high demand especially as major importers like China have an increasing need for timber and materials derived from timber.

Timber is often defined as an investment by its steady, long-term growth as a tree matures. ETF.com explains, "A tree's wood volume tends to increase 2% to 8% annually (varying by climate, species, and age). Compounding the effect of this biological growth, trees yield price gains when they grow into bigger product classes. For instance, a small tree that is only suitable for paper products may eventually grow into saw timber, where it can fetch dramatically higher prices per
ton and be used for products such as plywood or telephone poles." Depending on how the tree can be used, the value of the wood can increase, and the investor can fetch greater returns over time investing in timber.

While surely some individual investors directly own timber as part of their portfolio, there are more common ways to invest in the asset class indirectly. These include: owning shares of a timber-related company, shares of a timber-related fund, buying shares of one of a few timber ETFs out there like iShares Global Timber & Forestry ETF, or through a master limited partnership that operates timber or forest lands.

One timber master limited partnership, Olympic Resource Management, explains the asset class and why it invests in timber saying, "The timber asset class is gaining increasing acceptance among professional portfolio managers throughout the world. In 2008, over 3.4 million acres valued at nearly $5.2 billion changed hands in the U.S. alone. Investor interests outside the traditional forest products industry acquired more than half of this total. Investment managers see ownership of timberland to reduce overall portfolio risk and hedge against inflation while ensuring strong financial performance."3 (Please note, this is in no way an endorsement or recommendation of Olympic Resource Management, it was simply an MLP we landed on in our research.)

Will we see more timber master limited partnerships? Right now, timber makes up a fraction of the master limited partnership sector. Furthermore, given the limited supply of timber, it seems unlikely that this asset will suddenly emerge as a major MLP asset.

Real Estate

In the past, there were some master limited partnerships dedicated to real estate, but these MLPs have become increasingly rare for Real Estate Investment Trusts (REITs) which offers a similar publicly-traded structure. I participated in a discussion panel at the Family Office Real Estate Conference on Friday, September 30th in New York. Almost all the discussion surrounded the topics of the real estate cycle, capitalization rates (rate of return on a real estate investment property), difficulty in finding good cash flow from REITs, areas of opportunities,

3 http://www.orm.com/Timberlands/TimberAssetClass.aspx
and others. The topic of the panel discussion was finding yield in a low yield environment.

I was asked to compare Master Limited Partnerships with REITs. Among the similarities that I detailed were that both own real assets, both produce income, both require land, both are pass-through entities that return capital and pay out income, both use leverage, both rent their properties and have a history of raising rents, and both are cyclical.

A frequent sentiment at the conference expressed by many of the family offices speaking at the event was that the real estate cycle was approaching a top and that we may be in the eighth or ninth inning. Some suggested that it was time to begin cashing in. In contrast, MLPs are in the early stages of a recovery.

The Alerian MLP index peaked on August 29, 2014, at 539.85. It bottomed on February 11, 2014, with an intraday low of 199.1. At the time of this writing, the index is trading around 310, 42% off its high. Market technicians view MLPs now in an uptrend. Master Limited Partnerships were caught in a negative feedback loop from August 2014 through February 2016. Midstream MLPs are engaged in the transportation of oil (not in the ownership of oil). Most are more involved with natural gas and natural gas liquids than oil. Even though the price of oil has little-to-nothing to do with many MLPs, the prices of MLPs became directly correlated
with the price of oil. This single factor resulted in MLP prices falling to insanely low levels right along with oil.

From mid-2014 through Early 2016, investors felt anxiety because MLPs normally were compared with steady, non-volatile investments like REITs and utilities. Investors felt this was not supposed to happen. In the 1990s, when I began investing in MLPs, oil was priced in the teens and twenties, and MLPs had been steady, growing and reassuring investments. While the share price volatility of MLPs has increased due to the correlation with oil, the volatility of the underlying cash flows has not increased to nearly the same level.

Historically low interest rates over the last eight years have caused investors to search for yield outside of the traditional methods, and this has put downward pressure on the yields of REITs and utilities as these two sectors have reached near all-time high valuations. The MSCI REIT index was yielding 4.54% while the yield on the Alerian MLP index is 7.32% as of mid-2016. By comparison, the yield on the Dow Jones Utility Index is 3.53%, and the ten-year treasury is yielding 1.72%. Over the last ten years, the spread between REITs and MLPs has been 2.46 percent and is currently about 2%. The spread between utilities and MLPs has averaged 2.93% and is currently 3.8%.

The spread between the ten-year treasury and MLPs has averaged 3.96% and was at 5.6% as of 2016. However, when the ten-year yielded 6%, and the MLP index yielded 9%, there was a 50% difference. As of mid-2016, the yield on the ten-year was 1.72%, and with MLPs yielding 7.3%, there is a 325% difference in yield. This massive spread limits MLPs vulnerability in a rising rate environment. Combined with the fact that MLPs are in the early stages of their cycle and their substantial yield over the ten-year treasury, MLPs make for a compelling total return proposition.
For those who recognize that midstream MLPs are businesses that transport, store, process and distribute the natural gas and the oil we use every day, the value becomes clear. At my firm, DeWitt Capital Management, we are committed to continuing to uncover the best of these businesses while others fear to venture into the space. In a yield-starved and the politically unstable world, what better place could there be than in the vast energy infrastructure of the greatest, most profitable democracy on Earth?

**Financial and Investment Companies**

Another rare MLP user is the financial company, most notably Blackstone Group. The private equity behemoth chose to form a master limited partnership, but because the firm earns less than 90% of its income from qualifying sources it does not get to qualify as a pass-through entity. Its investors do own units instead of stock, but this is not your average energy-focused MLP.

There are other examples of financial companies that have formed as MLPs including Icahn Enterprises (the investment company founded by billionaire activist investor, Carl Icahn), AB (formerly Alliance Bernstein), and Kohlberg Kravis Roberts & Co. (the pioneering private equity investment company also known as KKR). Because of their varied investment activities and unique structure relying on carried interest, these financial companies should be treated very differently from the type of upstream and midstream energy MLPs that are most commonly associated with the master limited partnership structure.

Hopefully, this chapter has given you a good sense of the different assets that master limited partnerships hold.
Chapter 4 – How to Invest in MLPs

The chief problem with the individual investor: He or she typically buys when the market is high and thinks it's going to go up and sells when the market is low and thinks it's going to go down.

-Harry Markowitz, Nobel Memorial Prize Winning Economist

In this chapter, we will look at the different options that are available to you for investing in master limited partnerships. There are many options—from buying MLPs directly to owning an ETF to outsourcing your investment to a fund manager or SMA. I will try to take a balanced view of the pros and cons of each option and give you some insights I have gleaned from investing in master limited partnerships since 1991.

Direct Ownership

For those who have the skill, experience, and time to confidently select individual master limited partnerships, this is a way for an investor to exercise greater discretion over his portfolio as compared to a more diversified pool of MLPs through an ETF or MLP fund. The trick, as with buying any individual stock, is selecting the right MLP and holding that stock over a long enough period to earn healthy tax efficient distributions on top of the stock appreciation.

For example, an investor that held a unit of Magellan Midstream Partners LP from 2011-2016 would have seen the stock appreciate by more than 115% during that period as you can see in the chart below:
Statistics from Capital IQ and Yahoo Finance, as of February 23, 2016.

MLP Funds

If you have read this book and seen the complexities of master limited partnerships and concluded that it would be easier to just outsource the selection and management of an MLP portfolio to an experienced stock picker, much like you would a pooled equity fund, then an MLP fund might make more sense to you.

An MLP fund is a pooled investment vehicle that allows investors to spread their capital across multiple master limited partnerships, instead of investing directly into individual MLPs. We went over ETFs which are more passive vehicles.
compared to the actively-traded MLP funds in this section. These actively-managed funds are run by a portfolio management team that selects some MLPs to invest fund assets. The fund may be structured as a mutual fund, long-only fund, through a separately-managed account at an investment adviser, and even some hedge funds have started investing in MLPs.

The fund management, comprised of the portfolio manager and research team, actively manages the fund to identify undervalued MLPs, assess portfolio risk, review available research as well as conduct internal research on specific MLPs and their underlying assets, and make investments for the benefit of the limited partners in the fund. Within the broader master limited partnership sector, there are many sub-sectors (upstream, transportation, timber, etc.) and different market capitalizations. Many MLP funds will seek to spread the portfolio across multiple sub-sectors and potentially different sizes; other MLP funds may have a specific mandate to invest only in, say, small-cap infrastructure MLPs.

Of course, for the service of actively managing your capital, the fund will charge investors a fee. These fees may vary by share class, too, as the fund may provide anchor investors who commit large pools of capital with superior terms to reward their commitment and attract these larger investors.

Fees may include sales charges, annual fund operating expenses, management fees, distribution and service fees, miscellaneous expenses, deferred income tax expenses, interest expenses from borrowings, and other fees depending on how the fund is structured. While hedge funds focused on MLPs are relatively rare, the fees that hedge funds usually command are more expensive than the typical MLP fund with an annual management fee and a high portion of the profits (20% or more) going to the fund manager. Most mutual funds or other MLP funds, however, are less than 10% and some investment vehicles like SMAs can charge considerably lower fees to investors.

**Exchange-Traded Funds**

Index funds provide a broad exposure to a basket of MLPs, rather than an individual MLP. This diversification is a great benefit to investors who are unwilling or unable to buy and sell units in individual MLPs. Consider an average investor or even a sophisticated investor, with limited time to monitor the portfolio.

There are a few options available to investors seeking exposure to master limited
Master Limited Partnerships – or the energy, commodities, and infrastructure assets they acquire. One of these options is an MLP exchange-traded fund (or ETF) that holds a basket of MLPs. For those unfamiliar, an exchange-traded fund is an investment fund that trades on a stock exchange and tracks a basket of securities, an index, bonds, or commodities. Unlike a mutual fund or closed-end fund, ETFs trade on public exchanges and may have higher daily liquidity than other investments.

Benefits of a Master Limited Partnership ETF

- Greater Liquidity: As we mentioned, an MLP ETF gives investors greater liquidity than a less liquid closed-end fund since the former trades on a public exchange.

- Exposure to Energy and Natural Resources: For investors that are seeking exposure to energy, commodities, infrastructure or other MLP-holdings, then a master limited partnership ETF may be an attractive, liquid, and cost-efficient vehicle for that exposure. An MLP ETF also allows the investor the ability to invest indirectly in MLPs without actually having to select specific MLPs and actively manage individual allocations.

- Potential for Diversification: Depending on an investor’s holdings, a master limited partnership ETF may be an attractive option for diversifying from other investments in the portfolio. The liquidity of an ETF may be helpful to an investor with less liquid holdings such as a private equity fund commitment or portfolio company. Given that MLPs invest in specific assets such as commodities, natural gas, oil, etc. an investor may be able to diversify from other specific assets that make up a strong concentration of the portfolio.

Considerations for Owning a Master Limited Partnership ETF

- Tax Drag of the AMLP and Other ETFs: The largest ETF that invests in MLPs is the Alerian MLP ETF (AMLP). As the sector becomes more and more recognized, AMLP has captured a large amount of the investment dollars. It currently has more than $6.5 billion in net assets. AMLP is structured as a taxable C-Corporation which allows it to issue a 1099 tax form to investors. While the 1099 makes the ETF a much less complicated investment from a tax administration viewpoint, being classified as a taxable C-Corp means that the ETF has to pay a 35% corporate level tax.
Thus, it is important to note that in an exchange traded fund or closed-end fund, there is a tax drag as the NAV is reduced by the tax that would be paid if the portfolio were to be liquidated. This reduces performance in an up market and cushions performance in a down market by about 35% in each direction.

• ETF Expense Ratio: For MLP exchange-traded funds like the previously mentioned Alerian MLP ETF (AMLP) to invest fully in MLPs, the ETFs are structured as C-Corps, and this creates a not insignificant tax burden on investors. Morningstar, the investment research firm, first drew attention to this in 2012 cautioning investors that while the then-stated expense ratio was only 0.85%, its expense ratio was closer to 5%. This higher-than-expected expense ratio gave investors pause, especially those investors who viewed the MLP ETF as a very low-cost MLP investment vehicle.

Since that time, AMLP has provided investors with greater clarity on the actual expenses associated with the AMLP. In the latest summary prospectus, the reader can understand better that because of the deferred income tax expense (4.58%) combined with the management fees (0.85%), the net expense ratio is 5.43%. The following chart shows how these fees add up beyond the basic 0.85% management fee:
So, in sum, a master limited partnership ETF is an exchange traded fund that provides investors with a liquid fund that owns a basket of MLPs or is pegged to an MLP index like the Alerian. While there are many benefits to an ETF vehicle,
investors should keep in mind the tax considerations and true expense ratio.

**Exchange Traded Notes**

Like exchange-traded funds, exchange-traded notes (ETNs) provide investors with a passive investment into MLPs. An ETN, however, is a publicly-traded debt security, rather than an equity-linked ETF. ETNs are issued by banks and trade publicly, providing investors with the total returns of all the indices including dividends, but not including the management fees or transaction costs.

Since the ETNs are notes issued by banks, there is credit risk associated with the investment. The largest ETN, the JP Morgan Alerian ETN (AMJ), has just over $3 billion in net assets. The distributions on ETNs are classified as interest income, which negates the key tax deferral benefit that is received by direct investment into MLPs. A bank issues a limited number of ETNs, which can cause the ETNs to trade at a premium to its indicative note value. Investors can incur significant losses if they sell the ETNs when the premium is no longer present. The returns of an ETN are the total returns for all the indices which reflect the performance of each index, including dividends, but do not include the management fee, the repurchase fee or any transaction costs or expenses.

**The Alerian and MLP Index**

The performance of a Master Limited Partnership (MLP) is often compared to the Alerian MLP Index, which tracks large- and mid-cap energy MLPs. Before we get into the application of the Alerian MLP Index, we should first define the Alerian and explain the index.

The Alerian MLP Index was created by Alerian, an independent provider of master limited partnership and energy infrastructure market intelligence. Alerian shares its definition of the MLP Index: “The Alerian MLP Index is the leading gauge of large- and mid-cap energy Master Limited Partnerships (MLPs). The float-adjusted, capitalization-weighted index, which includes 44 prominent companies and captures approximately 75% of available market capitalization, is disseminated real-time on a price-return basis (AMZ) and a total-return basis (AMZX).”

So, why does the Alerian matter? When an MLP’s (or MLP fund’s) performance is higher than the returns of the Alerian MLP Index, the investment has outperformed this specific sector’s benchmark; when an MLP returns less than the Alerian MLP Index over the same period, the reverse is true, and the investment has
underperformed. So, you can understand why investors are interested in the performance of the Alerian MLP Index and how specific MLPs fared relative to the Alerian. Investors who evaluate the performance of MLPs or MLP funds will likely see a chart comparing the Alerian MLP Index (or a more nuanced index such as the Alerian MLP Infrastructure Index) and other benchmarks against asset’s performance.

The Alerian MLP Index is not a perfect representation of the MLP sector, and it does not show the specific performance of any one Master Limited Partnership. Rather, this index includes 44 well-known companies in the sector and acts as a barometer of the MLP space. For observers looking for an indication of how MLPs are performing or for investors seeking a benchmark upon which to judge their investments, this is a very useful index.

Since the Alerian MLP Index is available on a real-time basis, you can see the performance of any of the indices online easily as you would other stocks, bonds, or indices. For example, if I wanted to see the performance of the Alerian MLP Index for a given month I can simply Google search for “Alerian MLP Index” or use whatever finance search you would use for another stock. If you enter AMZ on Yahoo Finance, for example, you can see that performance over the last five years, as you see below:

An example of the Alerian MLP Index performance from Yahoo! Finance over the
The Alerian MLP Index and other Alerian indices allow investors to compare the performance of the MLP asset class against other investments, MLP funds, and individual MLPs.

**Separately Managed Accounts**

Investors have several options for investing in master limited partnerships, one of these structures is the separately managed account. Separately Managed Accounts (SMAs) provide investors with the tax benefits of direct MLP ownership, along with corporate tax-free income and index outperformance, if managed by a strong portfolio manager. The SMA may be an attractive vehicle for an investor that wants a degree of customization and visibility on the MLP investments but lacks the time or sophistication to buy directly and manage those investments. SMAs are managed by a portfolio manager, and thus investors should expect to pay an annual management fee, though other expenses associated with an SMA are minimal.

For the uninitiated, a separately managed account is a custom account that is actively managed for a specific client, typically a wealthy individual. These accounts are typically managed by Registered Investment Advisers (RIAs), with a dedicated portfolio manager overseeing the accounts and making day-to-day investment decisions. The portfolio manager may be supported by analysts doing research and minimal back-office staff.

The main distinguishing quality when it comes to separately managed accounts is that an SMA is unique to the account owner, unlike a commingled fund like a mutual fund which pools accounts into one fund and invests the combined capital. By forming a separately managed account, your investment advisor can form a strategy that fits your investing objectives and needs, rather than a broad-based strategy that may suit most investors in the fund but not you. Investors that use SMAs are typically attracted to the high level of customization offered and the dedicated attention to the account by the manager.

A Separately Managed Account is one vehicle by which investors can gain access to master limited partnerships. To our knowledge, there are relatively few dedicated MLP managers offering SMAs, but that could change as investors have become more familiar with the space over the last decade or so.
The majority of MLP investors are at the retail level and invest directly in MLPs. By buying units of an MLP directly, an investor becomes a limited partner in a partnership that owns real energy infrastructure such as pipelines, storage facilities, and refineries. Many managers charge an annual management fee for SMAs, but there are no repurchase fees or other expenses and transaction costs are minimal.

The advantages of using an SMA to invest in MLPs are as follows:

1. Customized asset allocation, rather than a pooled investment fund
2. Dedicated portfolio manager monitoring your specific investment account
3. Transparency of your investments
4. Broad selection of investment options
5. Regular updates from the portfolio manager and the ability to develop a more direct relationship with the management team
6. Enjoy custom detailed reporting on the investments, market outlook, taxation and other matters of importance to the investor
7. The investor has control of the account and has direct ownership of the shares
8. Ability to transfer shares from the account without triggering a capital gains tax event
9. Potential for lower transaction costs through blending or netting proceeds in the account.
10. One point of contact for all or a good portion of their investment portfolio, rather than navigating between multiple investment managers or self-managing the portfolio and all the associated tax, reporting, etc.

Disadvantages of an MLP Separately Managed Account

The disadvantages of using a separately managed account to invest in MLPs are as follows:
1. SMAs typically have a minimum investment requirement that may limit access to smaller investors.

2. When manager sells a position, there could be some recapture positive of the tax-deferred income received. This would be true of any individually owned positive MLP.

3. Separately managed accounts may involve greater transaction costs especially when opening or closing an account than other investment vehicles.

4. Separately managed accounts may have less buying power than larger pooled funds which could potentially limit the investment manager’s ability to impact a company’s management, limit the ability to execute complex trades such as hedges or margin trading and could lead to slower transaction times or worse brokerage service compared to institutional funds.

**Overview**

There are numerous options for investors seeking to invest in master limited partnerships including a separately managed account. Today there are relatively few MLP-focused separately managed account managers compared to broader strategies such as small-cap equities or technology.

If you would like to learn more about separately managed accounts and master limited partnerships be sure to reach out to my team at DeWitt Capital Management, where we offer a number of SMA strategies to fit your needs.

**SMA vs. ETF vs. ETN**

As the asset class has grown from an $11B market cap in 1999 to a $500B market cap in 2015, many different investment vehicles have been created to give investors access to the MLP sector. Many of the exchange traded products (ETFs and ETNs) currently offered provide investors easy access to the MLP sector. That
easy access comes at a price; large tax burdens and management expenses have led to significant underperformance when compared to a Separately Managed Account investment. Another disadvantage to the passive exchange traded investment is the lack of active management. There has been significant difference in the performance within subsectors of the MLP universe. Active management allows for tactical MLP selection that leads to outperformance.

The table below gives a basic breakdown of the structure of the various investment options.

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<th>Exchange Traded Note</th>
<th>Exchange Traded Fund</th>
<th>Separately Managed Account</th>
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I hope this chapter gave you a thorough look at your options for investing in MLPs. In the next chapter, we’ll dig into why investors are investing and what the benefits are for investing in MLPs.
Chapter 5 – Why Invest in MLPs

When investors consider a master limited partnership against other investments, they may wonder what are the benefits of a master limited partnership. In this chapter, we will examine some of the factors that attract investors to master limited partnerships.

High Yield, Income, and Consistent Distributions

Compared to other asset classes, MLPs provide a significant yield. The average current yield of MLPs in February of 2016 was approximately 6.9%, yielding some 500+ bps above 10-Year Treasuries.

Fees (Tariff Rates) which generate the MLP’s Revenue and Cash Flow are historically largely insensitive to commodity prices and rely mostly on volumes processed, stored, or transported to market.

Difference Between Distributions and Dividends

It is important to note that while distributions offer investors consistent cash payments, these distributions are not the same as dividends.

Master limited partnerships do not pay out dividends. Master limited partnerships make cash distributions to their unitholders. These distributions are often made on a quarterly basis—though as we discussed in the comparison between MLPs and bonds, this is not a guaranteed schedule. Many investors mistakenly consider the quarterly cash distributions from their MLPs to be dividends, but it is an important distinction between distributions and dividends given the tax implications.

As a pass-through entity, a master limited partnership has a unique tax advantage. The advantage is that limited partnerships are not taxed at the corporate level. Dividends are taxed twice: once at the company level when the company issuing the dividends pays taxes on earnings. Then, again, at the investor level when the shareholder receives the dividend payment. This double-taxation is not ideal for investors, of course, and it is part of the motivation driving investors to buy units in MLPs and only have to pay taxes at the investor level on distributions.

The trade-off is that investors receiving these distributions must then complete a K-
1 tax filing showing their ownership in the MLP and the taxes that must be paid by the unitholder, per his/her individual tax rate. Most of the payments received by investors are tax deferred, and the taxable income will be shown in the K-1 filings distributed by the MLP to its unitholders.

MLPs also calculate these payments differently than dividends. A unitholder is paid according to distributable cash flow, which adds back depreciation. This means that unlike a dividend, the distribution per unit can be more than the net income.

So, while distributions and dividends share similar traits, it is important to remember the difference between these payments and that master limited partnerships pay out distributions, not dividends.

Similarly, master limited partnerships are sometimes confused with bonds and many people use bonds as a comparison to master limited partnerships. There is a similarity, in that master limited partnerships aim to deliver consistent distributions of income to unit holders. However, master limited partnerships are not bonds and should not be considered as such.

One of the most defining characteristics of a bond is the guaranteed interest rate to the bondholder. A bond, as you likely know, is a debt investment where the borrower typically agrees to a fixed interest rate along a set schedule. Although there are variable rate bonds, when investors use bonds as a comparison, they typically are referring to that fixed rate coupon. Master limited partnerships do strive to produce steady income distributions but the fact that master limited partnerships can and often do raise their distributions over time is very unlike a bond.

Similarly, master limited partnerships may cut their distributions in distressed situations when they need to conserve cash or where their business has been negatively affected, such as we have seen recently with the decline in oil and the pull back from many producers—a key client for MLPs. Many investors learned in the 2014 to 2016 decline in the price of oil that if you are thinking of master limited partnerships as a bond you are thinking of steady distributions that don’t change and never go down. Unfortunately for investors, there were a few MLPs where the distributions went down. They went down with the exploration and production companies that take the oil out of the ground and sell it. Those distributions went from whatever they were to nothing. The ones that are not in the exploration and production areas where the volumes declined, some of them cut their
distributions, and some of them did not, while some of them raised their distributions. So, you would have to be aware of the financial strength of the company and the geographic region in which they work because that is going to determine whether they are going to be able to pay what they are paying or at risk to have their distributions be cut.

As you have seen, the frequency and consistency of distributions makes bonds and master limited partnerships an imperfect comparison. Considering the future, one should value an MLP on its ability to pay out a dividend and increase it based on the financial strength of the MLP. An MLP with a strong balance sheet operating in areas of the country where the wells are prolific will trade at a lower yield than others.

**Growth Potential**

The domestic oil and gas boom has created significant capital expansion opportunities for MLP investors. For investors that are seeking exposure to energy, commodities, infrastructure or other MLP-holdings, then a master limited partnership may be an attractive vehicle for that exposure.

**Estate Planning & Stepped Up Cost-Basis for Heirs**

If MLPs are left to an heir, the deferred tax bill is eliminated. The heir receives the MLPs at a new cost basis based on the market value of the units when they are passed on.

MLPs pay out a tax deferred distribution that would become taxable if sold. If the MLP is held in an account with the heirs in mind, the step up in basis includes the tax that had been deferred. The heir gets a new MLP with no tax liabilities essentially turning a tax deferred asset into a tax-free asset.

At my firm, our unique value proposition for our long term clients is that we will not sell a long-term held MLP for a 90-year-old client on oxygen; the biggest firms could not possibly promise that.

**Tax Efficiency and Capital Gains**

Master limited partnerships have unique tax characteristics that are beneficial to investors. As stated previously, unlike most corporations, MLP distributions are not subject to double taxation. MLP income is taxed only at the company level and
passes through at the partnership level; thus MLPs pay no corporate income taxes. This is a big advantage for MLPs over companies which are taxed both at the company level and then upon distribution to investors.

Tax Efficiency: As noted above, Master Limited Partnerships have a unique tax advantage in that Limited Partners appreciate. A portion of the payout to the Partners can be tax-deferred, although that portion varies by distribution. The avoidance of double taxation is considered one of the key advantages to the MLP structure. Investors will receive a K-1 statement and pay individual income tax rate on their share of the partnership’s income but the investor is compensated by the cash distributions which are deferred until the MLP is sold. The high cash payments make this investment more tax efficient than it would otherwise be with the taxed income.4

Historical Performance

We have outlined some of the reasons that MLPs have grown such as changes in the regulatory environment, the tax efficient structure, and the growth of domestic energy production, but for investors the most important factor to consider is performance. Fortunately, MLPs performed impressively for much of recent history.

Take the following chart, created by my firm, DeWitt Capital Management, using data from Bloomberg and Alerian to showcase the performance of MLPs over the last 15 years as compared to other sectors and asset classes:

As you can see, MLPs have been solid performers for many of the last 15 years even including the considerable exception of 2015—when energy prices fell to historic lows, and MLPs suffered along with other energy investments. Despite the recent energy turmoil, MLPs still have outperformed REITs, S&P Energy, Small Cap, Utilities, the S&P 500, Municipals, US Bonds, and All World sectors on an annualized return basis over the years from 1998 to 2016.

**Liquidity**

Master limited partnerships are publicly traded, unlike other energy or infrastructure investments. This allows public shareholders to buy and sell units on the public exchanges, giving these investors significant liquidity.

**Potential for Diversification**

Potential for Diversification: Depending on an investor’s holdings, a master limited partnership may be an attractive option for diversifying from other investments in the portfolio. Given that MLPs invest in specific assets such as natural gas and oil, an investor may be able to diversify from other specific assets that make up a strong concentration of the portfolio.

If, by this point, you are not convinced that master limited partnerships are a great investment, give me a call, and I would love to discuss MLPs and why I have been investing in these securities for nearly three decades.
Chapter 6 - MLPs Today and Tomorrow

In this final chapter, we look at current trends and the future of master limited partnerships.

MLPs and Oil Correlation

One concern that investors in Master Limited Partnerships may have is that because Master Limited Partnerships are often acquiring assets linked to commodities, then MLPs will have tremendous pricing exposure. For example, in 2015, oil prices fell below $30 as part of a negative price swing that hit the oil industry recently. Master limited partnerships were certainly affected at least in part by this oil price decline, as you can see by the Alerian’s decline in 2015:

During the same timeframe, you can see that crude oil prices have declined dramatically from more than $100 in 2014 to below $50 in 2016:
While two charts do not create a trend, the decline in the price of oil has certainly had an impact on the industry and its investors, including MLPs. The U.S. oil & gas industry has been dealing with a glut of supply, partly created by the domestic production boom and partly from the unwillingness of OPEC members to curb production. This oversupply has pushed down commodity prices, to the point that some producers here in the U.S. are having to scale back production or even falling into bankruptcy. With OPEC and non-OPEC producers agreeing to cut production in December 2016, the upward trend was given further support.

The majority of master limited partnerships are in the midstream segment of the energy market, investing in infrastructure, transportation, and storage. While there is some pricing exposure, especially during such a sustained down period like we saw 2014-2016, pipelines and other midstream businesses are considered less tied to the daily swings in commodity prices. This diminished sensitivity to oil prices is in stark contrast to upstream energy investments which are closely connected to the price of the commodity being extracted and what they can fetch on the market.
for their product. Many pipeline and storage companies earn their revenue through contracts based on volume as opposed to price, offering some degree of protection from a sharp dip in the price of oil or gas. As stated earlier, midstream businesses like pipeline operators are often likened to toll-road operators, charging producers to transport their oil, gas and other commodities.

Over a more sustained period, the losses incurred by upstream producers will tend to impact the midstream segment as volume will likely dip (as it did in 2015)\(^5\) when producers decide to scale back when prices make production unprofitable or less profitable than initially expected. It is hard to clearly show what is influencing investor sentiment toward MLPs and how sensitive MLP performance is to oil and gas prices and other commodities. However, the relationship certainly is not clear from a fundamentals standpoint, as most MLPs produced strong income and EBITDA during the downturn.

**Volatility**

Investors have recently been riding a wave of market volatility driven by global economic instability, interest rate decisions by the Federal Reserve, the dramatic fall in commodity prices (especially oil), and slowing growth in China. While not at the level we saw in 2008 when the Volatility Index (VIX) peaked, volatility is certainly playing a part in how today’s investors approach portfolio management and investment strategy. Volatility has even bled into master limited partnerships, which have historically been one of the more stable asset classes.

Master limited partnerships have not been especially volatile, and there have not been major price swings with the significant exception of late 2008 and the massive decline from August 2014 to February 2016. You can see the steady climb from the Alerian Index (^AMZ) below:

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Recent MLP Volatility

Even though the price of the Alerian and individual MLPs have seemed to recover in recent weeks, there are daily changes in prices that have been a cause of stress for some investors. A good example of recent volatility was a week in March seen in the chart below, particularly the 25th and 26th where we saw dramatic intraday price changes in the MLP index.
As we have hopefully shown, the type of volatility experienced in 2014-2016 was unusual in the MLP space, but it continued to occur even as prices have risen. As we move into a period of recovery, we will have to see how much volatility we can expect in the coming years. I certainly expect the volatility to wane and returns to approach historical norms.

The Search for Yield

In today’s low-yield environment, it has been difficult for investors to find investments that offer income. For many portfolios, generating income is a major component of the strategy. Yield refers to the income return on investment. Yield is a function of the investment’s income (dividend, distribution, income, interest rate) and the price of the investment. For bonds, the current yield is expressed by annual interest rate/current price of the bond. So, if the bond is trading at par at $100 and pays a 5% coupon, then the current yield is 5%. If that bond were trading at $90 though, so 10% under par value of $100, then that same 5% coupon would make for a current yield of 16.67%.

Central banks have been keeping interest rates at record lows in recent years.
Investors around the globe have flocked to the safety of bonds, pushing prices for treasury bonds and other safe-haven securities up. That combination has kept yields down for many investors as the price of bonds has stayed high, and interest rates for bondholders have not ticked up.

Analysts and investors often point to relatively high yields offered by master limited partnerships as the main reason to invest. As we have discussed elsewhere in this book, master limited partnerships distribute income to unit holders on a quarterly basis (though as you will read below, that’s not guaranteed). These distributions are typically treated as a tax-deferred return of capital, which helps lower the unitholder’s tax basis.

Yield can be calculated on a current or forward basis. Current yield is calculated by dividing the current declared quarterly distribution annualized by the current unit price of the MLP. Forward yield is calculated by taking the master limited partnership’s estimated next four quarterly distributions and dividing that by the MLP’s current unit price.

With typically high distributions, master limited partnerships can offer a considerable yield to investors, and that has attracted some in today’s low-yield investing environment.

Whereas investors are buying up bonds and keeping prices high, master limited partnerships (another traditional source of income and yield) have seen their prices fall significantly in line with the collapse in oil prices from 2014 to 2016. Since MLPs are publicly traded, the price of these investments has fallen significantly as the world digested a glut of oil and investors appeared to be tying MLPs to the fortunes of oil (though that link is debatable, as many industry experts have noted). The depressed price of master limited partnerships has had the effect of potentially increasing yields for these investments relative to prices.

The usual caveats apply, of course; not all MLPs are the same and distributions are not guaranteed. That last point is critical, as some investors have mistakenly viewed master limited partnerships as equal to bonds in providing a fixed income through their distributions the way that bonds do through the coupon. As we have noted, MLPs are not bonds, and it is important to understand that.
The Future of MLPs

Consolidation in the Industry

There was an Interstate Natural Gas Association of America (INGAA) study that was done that was very comprehensive, looking at what infrastructure is needed to be built over the next twenty years to accommodate the new sources of oil and natural gas in this country. It is essentially around twenty-five billion dollars a year that need to be invested. Now does that mean there will be more MLPs or fewer MLPs out there? I do not know, but it means MLPs will be in a growth mode, which is good for investors.

Some of these MLPs are very large, and they have a very wide footprint. They can finance or can build out the infrastructure that’s needed without a hitch. I think, however, that the overall number of MLPs may come down. This is because the ones that are on the fringe, like a sand MLP that takes sand out of the ground for purposes of fracking or the drillers that collapsed in price when oil came down, have in some cases gone from twenty dollars to twenty-five cents. This makes these MLPs prime candidates to be bought up by the larger players.

So, you may have a diminishing total number of MLPs, and I think there will be some consolidation and maybe a few new ones, but I do not think the total number will change much. I think that the build out will be done by the MLPs that are in existence today with maybe a few new ones once oil prices are a little higher.

Balance Sheets and Coverage Ratios

One aspect of being a publicly-traded entity is that MLPs are covered by analysts that issue recommendations to buy, sell, hold and offer opinions on everything in between. Two areas that analysts devote considerable attention to in regards to master limited partnerships are the coverage ratio and the balance sheet of the MLP.

MLPs and oil developed a one to one correlation when oil fell to $26 in February of 2016. Because MLPs develop projects using both equity and debt, their ability to raise money through equity ended. Therefore, they halted raising money from issuing equity and focused on completing projects with internally generated funds. In some cases, this meant halting distribution growth for a while, lowering the distribution temporarily, strengthening the balance sheet, and building the
coverage ratio meaning paying less than they could.

What this boils down to is this: MLPs have been through the fire. What did not kill them only made them stronger. I view this as like the banks that were forced to comply with stricter debt-to-equity ratios and capital reserves following the financial crisis. We now have stronger banks that are better prepared to weather the next financial crisis or economic downturn. In the same way, MLPs have now survived an exceptionally adverse environment and been forced to strengthen their balance sheets to survive, leaving the surviving MLPs better positioned for the future.

**Renewables**

Renewable energy infrastructure might be another opportunity for master limited partnerships to serve as the vehicle for infrastructure investments. There have been bills introduced in the Senate to extend the definition of master limited partnerships to include renewables, most recently the Master Limited Partnerships Parity Act introduced by Senator Chris Coons. The latest action on this bill was in 2015 when it was read twice and referred to the Senate’s Committee on Finance. We must see how that bill proceeds and whether the door is opened to master limited partnerships investing in renewables and alternatives to traditional energy sources.

I believe the future of the growth in non-renewable energy in a world of reducing carbon emissions points to the use of natural gas to replace coal and oil. Of course, the recent change in leadership in the Executive Branch may contribute to a more pro-coal regulatory approach, but there are few who seriously believe in a future built on coal.

**Natural Gas, Ethane, and Other Drivers of Growth Going Forward**

Back in the 90’s, when I bought my first MLP, Buckeye Pipeline, I have been using MLPs in my investment practice as a way of providing reliable quarterly income. The investors who owned MLPs were individuals and retired folks looking for steadily increasing income over a long-time horizon.

The United States was increasingly dependent on foreign sources of oil, and increasingly at the mercy of OPEC for supply. In the period from 2000 to 2006 the US was building LNG import terminals to bring in natural gas from overseas.
Then the shale revolution occurred. According to the US Energy Information Administration, (in the lower 48) Natural gas production rose from 47 BCF per day to about 70 Bcf/ day. Natural gas liquids production (ethane, propane, butane, isobutane, natural gasoline) rose from 1.6 mm /day to 3.6 Mmp/day. Crude oil production rose from 5 Mmb/day to 8.5 Mmb/day peaking at 9.5 Mmb/day in 2015.

While prices of all hydrocarbons started off high as the Shale revolution began, prices deteriorated as the supply grew which resulted in less profit for those who produced. However, the amount of energy infrastructure needed to transport and process the new domestic supply dramatically increased. New MLPs were created to deal with this and interest in MLPs skyrocketed.

The law of supply and demand came into effect, and the price of all energy commodities declined, and a contraction of production occurred. However, production continued at levels far above where they were before the shale revolution began.

Depending on the price of various energy commodities, certain areas of the country began to implement new technologies to decrease the cost of production significantly. This allowed many producers to make profits even at lower prices. In a book written by Rusty Brazil, one of the leading experts in Energy referred to the term the Domino Effect. The prices of natural gas fell, then natural gas liquids, then oil, as resources used to produce energy moved from the lower priced commodity to the higher priced commodity until all commodities took the hit.

As I remember my days back in college in economics 101, I learned that as prices fall, demand picks up. Demand for US produced natural gas, and natural gas liquids is growing.

Here are the trends that we will see through the end of the decade and into the 2020's:

- Demand for natural gas will continue to grow as the price of natural gas competes with coal. More electricity was produced using natural gas in 2016 than was produced by coal, a historic event. Also, the political climate encourages the switch to natural gas as it produces half the carbon dioxide as coal.
-Staying with natural gas, by far the largest supply of natural gas is coming from the northeast part of the country from two formations: The Utica and the Marcellus. The demand for natural gas is rising because we are exporting natural gas in the form of LNG (liquefied natural gas), from terminals near Mount Belvieu along the gulf coast and this trend will increase through the 2020's as foreign demand grows.
-Another area of growth that will continue to expand are imports to Mexico which are increasingly using US natural gas for electrical generation.
-Another area of growth will come from the demand for ethane, which is a natural by-product of natural gas. This also comes from the northeast as well as other areas of the country, such as the Permian in Texas. Natural gas that contains significant quantities of liquids is called wet gas. The overabundance of ethane caused the price to drop below the return gas processors could get versus what producers could get for including ethane in the natural gas system (methane), so it was included in the natural gas supply. However, major chemical plants are being built that use ethane to produce ethylene, one of the building blocks of plastic water bottles and garbage bags. When ethane is not processed, it is “rejected,” a term the industry uses. Over the next five years, ethane will be fully utilized by these new petrochemical plants presenting a tremendous opportunity for those MLPs engaged in the processing, transporting, storage, and fractionation needed to produce ethane.

Ethane and natural gas more broadly look to be the future of master limited partnerships, as coal and (to a lesser extent) oil decline in use and demand for gas continues to increase domestically here in the U.S. and from other countries.

The Future of MLP Investing

As I have repeatedly said in this book, the future of master limited partnerships is not in oil (and especially not in coal), but rather in natural gas. Regulations, environmental concerns, and cheaper, cleaner alternatives have severely hampered coal production here in the U.S. This means coal will likely continue to decline as an area of investment for MLPs, as most MLPs have nothing to do with coal production or transportation.

Oil is a more complicated story as technological innovations have helped expand the discoverable oil reserves and there is still worldwide demand for oil. We are
not in the business of forecasting the future of oil—many prognosticators have gone down in flames predicting the price of oil. What we will say is that natural gas is quickly emerging as a major source of growth in the U.S. energy market and master limited partnerships are well-positioned to invest capital to support the necessary infrastructure to support natural gas production, transportation, and shipping.

Natural gas and its associated products such as propane and ethane will continue to grow in our estimation, creating the need for further infrastructure investment to support the production and exportation of these fuels. In future posts, we will look at the possible impact of renewables on the master limited partnership space and what role MLPs will have in the development of clean energy and renewable resources.

Conclusion

It has been a great pleasure writing this book and explaining to you, the reader, why master limited partnerships are not only a great investment but a necessary investment in our nation’s infrastructure. I have devoted my career to investing in master limited partnerships and yet I am always gaining new insights that help refine and improve my understanding of energy and the new sources of growth that continually crop up in the United States.

If you are interested in continuing the conversation, I invite you to contact me using the information below my signature. I look forward to meeting you and discussing master limited partnerships and how they can work for you.

David DeWitt

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Appendix

MLP Data – A Free List of Master Limited Partnerships

I have seen a number of lists of master limited partnerships for sale, and I receive requests for lists all the time. So, I decided to share this expanding list of master limited partnerships courtesy of Alerian showing the Energy Publicly Traded Partnership Universe.

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Variable Distribution Partnerships

| USD Partners LP                     |
| Valero Energy Partners LP           |
| Vanguard Natural Resources LLC      |
| VTTI Energy Partners LP             |
| Western Gas Partners LP             |
| Westlake Chemical Partners          |
| Westmoreland Resource Partners LP   |
| Western Refining Logistics LP       |
| World Point Terminals LP            |
| Williams Partners LP                |

Variable Distribution Partnerships

| Alon USA Partners LP                |
| CVR Refining LP                     |
| Dorchester Minerals LP              |
| Emerge Energy Services LP           |
| OCI Partners LP                     |
| Terra Nitrogen Co LP                |
| CVR Partners LP                     |
| Viper Energy Partners LP            |

Variable Distribution Partnerships

| Alon USA Partners LP                |
| CVR Refining LP                     |
| Dorchester Minerals LP              |
| Emerge Energy Services LP           |
| OCI Partners LP                     |
| Terra Nitrogen Co LP                |
| CVR Partners LP                     |
| Viper Energy Partners LP            |

Variable Distribution Partnerships

| Schedule K-1 Issuing GPs            |
| Allianc Holdings GP LP             |
| Atlas Energy Group LLC             |
| EQT GP Holdings LP                 |
| Energy Transfer Equity LP          |
| NuStar GP Holdings LLC             |
| Western Gas Equity Partners LP     |

Variable Distribution Partnerships

| Schedule K-1 Issuing GPs            |
| Allianc Holdings GP LP             |
| Atlas Energy Group LLC             |
| EQT GP Holdings LP                 |
| Energy Transfer Equity LP          |
| NuStar GP Holdings LLC             |
| Western Gas Equity Partners LP     |

Variable Distribution Partnerships

| US Midstream C Corps (Pass-Thru)   |
| EnLink Midstream LLC               |
| Plains GP Holdings LP              |
| Tallgrass Energy GP LP             |

Variable Distribution Partnerships

| US Midstream C Corps (Pass-Thru)   |
| EnLink Midstream LLC               |
| Plains GP Holdings LP              |
| Tallgrass Energy GP LP             |

Variable Distribution Partnerships

| Other Unit Classes                 |
| Cheniere Energy Partners LP Holdings LLC |
| Enbridge Energy Management LLC     |

Variable Distribution Partnerships

| Other Unit Classes                 |
| Cheniere Energy Partners LP Holdings LLC |
| Enbridge Energy Management LLC     |

Variable Distribution Partnerships

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<td>BIM, CDG, EPO, GPR, HPL, KLP, NAP, RIGP, SDL, SOM, and TTTI are publicly traded limited partnerships taxed as a C-Corporations for U.S. federal income tax purposes</td>
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Author Interview Transcript – Include Transcript of Interview with David

We wanted to share an interview with this book’s author David DeWitt. David has spent more than two decades investing in master limited partnerships and has
accumulated a wealth of knowledge in this space.

For this interview, David expounds on a range of subjects from how MLPs first started, to what he and his team look for in an MLP investment, to how he tracks the market for events and trading opportunities. If you have ever wanted to learn about master limited partnerships, this is a great introduction to the industry from someone who knows it very well. You can also listen to this interview here: http://MasterLimitedPartnerships.com/MLP-Audio-Interview/

Interview - David DeWitt

[00:00:00]

Interviewer: Welcome to our interview series on master limited partnerships. Today we are pleased to be joined by David T. DeWitt, president and portfolio manager at DeWitt Capital Management. David has been investing in energy-related master limited partnerships for more than twenty-five years now. Thank you for your time, David.

David DeWitt: Well, I'm happy to be here.

Interviewer: Great. Can you please introduce yourself and how you started investing in master limited partnerships?

David DeWitt: Oh sure. When I first started investing, I had a penchant towards investing in local area companies in the region around Philadelphia. I felt that investing locally was good because it allowed me to visit the management of the companies easily and understand them early on before they were widely understood, and by being close geographically I believed it just gave me a better chance of getting a deeper understanding of the company, its management, its goals, and its chances for success. And there were a lot of high-tech companies in the region back in the 1990s and I needed to balance that risk with either bonds or a bond alternative.

This led me to invest in conservative, local high dividend paying
companies and it just so happened that one of my good friends happened to be the CFO of Buckeye Pipeline back in 1990. And when I told him of my endeavor to invest locally, he suggested that I invest in Buckeye. He said that the distributions would go up over time (unlike a bond), and the distributions were tax-deferred (unlike a bond), and in the event that you passed away with it in your estate, your heirs have got all the tax deferral eliminated and basically all that distribution would’ve been turned in tax-free. So I began investing in MLP’s in 1991 starting with Buckeye.

Interviewer: OK, well, that’s a pretty good in with the CFO of Buckeye. I’m sure that gave you some kind of insight and knowledge into the space. Speaking of which, how has the MLP space changed since you began your career in the industry, since that time you first started investing in master limited partnerships. Have you seen any big changes recently?

David DeWitt: Yes, I have. When I first started investing in MLP’s there was only seven of them in existence. And the only one that I knew about, obviously, at the time, was Buckeye. But there were six others and nobody I spoke to about them back in those days had ever heard of them. I thought Buckeye was great but back then it was a very, very small universe. Back then the price of MLP’s barely budged except to rise slowly as they increased their distributions.

When interest rates went up or the stock market went down, it didn’t make any difference. That was because they were basically owned by people in retirement, they just wanted the distribution, they weren’t looking at the overall market, there was no institutional holdings like there are today. Although they could be considered interest rate sensitive, I remember when rates moved up back in the ‘90s and government bonds would go down, then municipals would go down, REITS and utilities fell, and MLP’s barely budged – or, if they did, they would just drop slightly.

MLP’s were stable and uncorrelated with the market. MLP’s back then were generally the turnpike variety in which MLP’s charged a fee, either a market-based fee or regulated by the federal energy regulatory commission to transport oil and gas or to store it or to
process it. They were truly stable, money-making machines. Now today, there are over 120 MLP’s engaged in all sorts of businesses that do not fit the model that I originally invested in. Today we have MLP’s who transport oil and gas over long distances – that’s more similar to what I started with.

[00:05:01]

And then ones that transport over short distances, like the ones that connect from one pipeline to another. And then we have gathering and processing which operate in areas of drilling and are sensitive to volumes of the amount of oil and gas that is coming out of the ground. Then there’s storage and terminals shipping, there’s MLP’s that dig sand out of the ground for the process of fracking, there’s chemicals, drilling, and more. So there’s just a much wider variety of MLP’s and that’s one of the major shifts.

And I have to tell you that the volatility in the MLP space increased as more exchanged traded funds and institutions and hedge funds got involved. It changed the stability of the price of the MLP’s, so it’s completely unlike what it was when I first started.

**Interviewer:** Yeah, it must’ve been pretty amazing to witness how it changed from seven master limited partnerships to the universe we have now. I’ll get into the size of the MLP universe in a minute but a lot of people are talking about changing interest rate environment. Going forward, do you think master limited partnerships will be sensitive to that or not?

**David DeWitt:** Well, that’s a very good question. And you know we get that often, that question, if interest rates go up what’s going to happen to the price of MLP’s. We’ve done studies and looked back at what happens when interest rates go up in the past. And here’s what happened, interest rates were rising up until 2007, 2008 and in that time MLP’s had hit their highest price up until that point. So, higher interest rates usually means higher economic activity, probably more volume of oil and natural gas liquids going through the pipeline, and that generally gives them a healthier outlook. So far we haven’t seen much correlation between MLP’s and interest
rates. We have seen correlations between MLP’s and oil.

Interviewer: Certainly, and we’ll get into that as well in a couple minutes, but just getting back to the size of the MLP universe. Do you foresee an expansion or contraction in the number of MLP’s, obviously we’ve seen a lot of growth in the number of MLP’s since when you started investing – do you see that growth continuing?

David DeWitt: Here’s what’s going to happen. There was an ING study that was done that was very comprehensive, looking at what infrastructure is needed to be built over the next twenty years to accommodate the new sources of oil and natural gas in this country. And it’s essentially around twenty-five billion dollars a year that needs to be invested. Now does that mean there’ll be more MLP’s or less MLP’s out there? I think we probably have enough MLP’s.

Some of these MLP’s are very large and they have a very wide footprint and can finance or can build out the infrastructure that’s needed, but I think the overall number actually may come down because the ones that are on the fringe like a sand MLP that takes sand out of the ground for purposes of fracking, or the drillers that basically collapsed in price when oil came down, they might have gone from twenty dollars to twenty-five cents.

So you may have a diminishing number of total MLP’s but I think there’ll be some consolidation and maybe a few new ones but I don’t think the total number will change much. I think that the build out will be done by the MLP’s that are in existence today with maybe a few new ones once oil prices are a little higher.

Interviewer: And given your sentiments you expressed there, I guess it’s not surprising that you focused on the midstream segment of MLP’s. Can you describe here, just for the audience, why you invest in that area, as opposed to the drillers or sand or some of the upstream assets?

David DeWitt: Yes, I can explain that, and why we do that. OK so, what you have with a midstream MLP is an entity that’s engaged in the movement, the processing, the storage of either oil, natural gas, or
natural gas liquids. So, as long we’re going to need oil, natural gas, and natural gas liquids, we’re going to be moving it around, we’re going to be storing it, we’re going to be processing it, that’s just an ongoing, repeatable business that would grow with population and just be a steady, ongoing business. Because it’s not drilling, it’s not like you’re looking for anything.

You’re simply taking what you have and moving it somewhere or processing it. So, it’s an ongoing business that doesn’t rely on commodity prices, I mean it can be affected by commodity prices, but it’s still an ongoing business, a stable, ongoing cash distribution business.

[00:09:56]

Interviewer: I often hear MLPs compared to toll road type businesses. Can you explain a little bit about the contracts? I know an important point is volume-based contracts versus the more price sensitive contracts you can negotiate.

David DeWitt: Sure. Some pipelines have minimum volume contracts so that when the amount of oil or natural gas going through the pipeline goes below a certain level they’re still going to get paid at the minimum rate, and that is OK in a situation where your counter party is Exxon or Shell but it isn’t so great when your counter party is a producer that’s heading into bankruptcy. So we’re careful when we’re looking at minimum value commitments to make sure that these are with stable, good companies.

And we’ve been in a situation where this primarily affects oil because when oil drilling declines then maybe those minimum volume contracts might come into effect. And we also look at the length of the contract as well, what the term is. We also look at where the contract is geographically located so for instance, if the gathering and processing pipelines are coming out of an area where there is no other alternative then whether you have a minimum volume contract or you don’t, it could have some difference but the fact of the matter is they still have to use your pipelines to get the oil or natural gas out of that area, they don’t
have an alternative, so you almost have a monopolistic position in that situation – we like that.

Interviewer:  OK, well that’s good to know. I think counter party risk is huge whether you’re dealing with a minimum volume contract or pretty much anything in this business. It’s obviously a concern with some of the distressed situations you have there on the extraction side.

David DeWitt: I want to give you an example of what I was just talking about where you are geographically located; it is essential that you have a gathering and processing pipeline where there is no alternative. There was a case in 2006 where a major gathering and processing company was facing a situation where the driller was falling into bankruptcy. Private equity came in and said, we are going to take over the company and we’re going to renegotiate the contract, and there was a bankruptcy court judge involved – it didn’t get that far. But what happened was because of the monopolistic position of the midstream company, they got a ten-year contract that I believe was just as good as the one they had before. There really was no alternative for them. So again, being the only player in town is what we’re looking for.

Interviewer:  Yeah, that makes a lot of sense. Anytime you can get a good position like that I’m sure it’s pretty attractive for you as an MLP investor. Toward that point, how does an MLP investor go about evaluating an MLP? Can you take us through your process and what maybe other investors might look for when considering a master limited partnership specifically?

David DeWitt: Sure. Well, there is a lot of factors. From a financial perspective, when you look at the numbers, you would want to invest in an MLP that, well there’s a couple of terms I’ll have to define. One is distributable cash flow and the other one is distribution. So if an MLP earns two dollars but distributes one dollar, we would like that one because there’s a whole dollar of cushion there in case there’s a bump in the road.

So we want to look at the distributable cash flow versus what they’re actually paying out, and a one-to-one correlation is they
are paying out what they could at a one-to-one ratio. We’re looking for ones that have a higher ratio, that have a better cushion than just one. And then the second thing you would look at, particularly now, or at any time, is you want to make sure they are well within their covenants they have with their lending institutions so that they don’t bump into any kind of restriction that would cause them to have to curtail their distribution.

[00:15:00]

So if debt-to-EBITDA restriction was set at five, we’d want to be in at three-and-a-half to four. We would like the MLP to be able to finance the bulk of its building out of the pipeline networks, to be able to be self-funded if they had to be. The MLP structure, historically, has been they would sell stock and sell some bonds and pay out five percent but invest in a project that would return fifteen percent. So that’s the general model of MLP’s. When things get tight and tough then you want to be able to see they have the financial leverage and wherewithal to be able to finance their projects internally without affecting their distribution.

Interviewer: How are you and your Portfolio Manager tracking the market and looking at different situations? Are you checking it daily or what’s your process there?

David DeWitt: We’re checking it daily, we’re constantly looking at news flow, we’re constantly looking at reports coming out of the company, SEC filings, attending conferences where management is speaking or speaking directly to the company ourselves.

We do have conversations about what is a good MLP to invest in and one side might say, “I want the one with the highest coverage ratio, the one that’s going to raise its distribution the fastest.” The other party might say, “Well I want the one that has the highest distribution because they’re easily covering that distribution and the market just doesn’t recognize the value.” So, that is the primary conversation we’re having.

Is it that they’re going to raise their distribution very fast or are
they going to raise it more slowly but the distribution is solid and the market just doesn’t recognize the value for that. So we’re constantly talking about these issues. And then when we come to an agreement, we’ll either buy it or we won’t.

Interviewer: I understand.

So what’s one of the biggest false assumptions that people might get wrong when they think about the master limited partnership space or maybe just some misconceptions that you see?

David DeWitt: The biggest misconceptions are that all MLP’s are equal and that MLP’s are like bonds. If two MLP’s each yield seven percent, one of them may be raising it at seven percent per year. When people think of MLP’s they can’t just look at the distribution, they have to look at what’s behind it and how quickly they can raise it. And I guess this goes back to when we evaluate MLP’s, the compounded annual growth rate that’s projected – I forgot to even mention that, that is key.

How quickly are they going to be able to raise that distribution because the bulk of the return from investing in MLP’s comes based on the rate at which they can consistently raise that distribution. So if you look back over time, a high-yielding one won’t move up in value as fast as one that yields less but raises distribution faster. It’s kind of like, would you rather have a million dollars today or a penny and double that every day for thirty days? Don’t get thrown off by the distribution yield it’s more important to look at how quickly it’s growing.

Interviewer: And you mentioned that they’re not bonds, and can you touch on some of the misconceptions associated with comparing it to a bond?

David DeWitt: Oh sure. First of all, the fact that they’re raising their distributions over time means the distribution is variable so that fundamentally is very un-bond-like. The second thing is, and I think we learned that in 2014 to 2016 decline in the price of oil is that if you’re
thinking of it as a bond you’re thinking of steady distributions that don’t change and never go down. Well, there were a bunch of MLP’s where the distributions went down. They went down with the gathering of processors that take the oil out of the ground and sell it, those distributions went from whatever they were to nothing. The ones that aren’t gathering and processing in areas where the volumes declined, some of them cut their distributions and some of them did not and some of them raised their distributions. So you have to be aware of the financial strength of the company and the geographic region in which they work because that is going to determine whether or not they are going to be able to pay what they’re paying or at risk to have their distributions be cut.

Interviewer: Sure, that’s good to know. I was wondering if you could touch on one point that you’d raised earlier in the interview which is the estate planning benefit and the taxes from it. Could you explain that for somebody who’s maybe thinking about this and the estate planning consequences of it?

[00:19:50]

David DeWitt: Yeah, I’ll give you an example of where this worked very well. Let’s say, just as an example, somebody’s seventy-five years old and they have a portfolio of corporate bonds let’s say, and they’re getting an eight percent yield and it’s fully taxable and they’re going to get the eight percent yield for as long as they live, fully taxable. Well, in that case, if you were to switch from your bond portfolio to an MLP portfolio, you could very conservatively get the same seven percent.

Very likely it will rise five or six percent or maybe four or five percent per year, eighty percent of that distribution you get will be non-taxable and you could continue to receive these increasing distributions that are mostly non-taxable until you reach your great reward. And let’s say now your kids inherit this portfolio, all the taxes that were deferred when it’s passed to the estate are eliminated. So you could live, mostly tax-sheltered, and preserve your estate for your children, and they pay no tax.
So that is a key consideration and why one might want to invest in an individual MLP that does pay out this tax deferred distribution for the estate tax benefit. And I experienced this personally because I invested heavily in MLP’s for my mom and when she passed on there was no tax to pay and yet, if she had sold them there would have been tax to pay.

Interviewer: That leads into my next question which is, what are the tax implications more broadly for an MLP investment? And can you talk about a pass through entity and why that feature is so important and some of the background there?

David DeWitt: Yes. OK so, an MLP is a master limited partnership, so people who buy master limited partnerships are in a partnership so there’s no tax at any corporate level, every partner is taxed at his own level. So the depreciation of the pipeline, the depreciation of the storage terminal, that passes through to the individual which then shelters the current income from tax, so you get the tax deferred part there.

Because there’s no corporate tax there’s more money that gets passed through to the investor, so instead of paying a thirty-five percent corporate income tax or forty percent, there is no tax so the investor gets all the money. So some of the tax considerations there are that if you hold an MLP for a long time and get, let’s say twenty years of tax deferred distributions, you got to remember it’s tax deferred – when you sell it, you’re going to have to pay the tax and the tax is going to be at ordinary income tax rates. So you have an increasing liability as time goes on if you think you’re to need to sell it and you have to be aware of that. Most of the management that we do with MLP’s is in the early years because over a few years that tax liability is small, over time it grows and so at some point you say, I’m just going to hold onto them because why sell them, lose the income, and pay the tax stuff. You have to be aware of the tax liability, and it can get more complicated than that because there are also passive loses that can develop that can offset some of that tax liability but I would refer you to an accountant to get into those details.
Interviewer: OK well that’s a good at least general knowledge on the MLP space and of course we want to refer out to any kind of expert that plays into the space all day as a CPA or tax advisor or something like that, but that’s definitely helpful for anyone kind of wondering about the broader tax implications. Given that MLP’s are largely invested in energy-related assets, what’s the relationship between MLP’s and commodity prices specifically oil and gas, the biggest categories? Is it different depending on upstream, midstream, downstream? I’m sure there’s a lot of pricing consequence there.

David DeWitt: That’s a great question. There has been and there exists a correlation with the MLP price and the price of oil – whether that is justified or not really depends on what sector of the industry the MLP is engaged in. So, for example, if you’re in the business of drilling for oil and you’re an MLP then the correlation should be very high because you’re dependent on the price of oil for making any money.

If you’re, on the other hand, a natural gas long-haul pipeline, where you’re transporting natural gas from say Marcellus to an electric utility, there should be no correlation. If you’re a shipper there should be no correlation. If you are moving oil to a refinery and then moving out refined petroleum products and increasing your business, it shouldn’t really matter what the price of oil is but the reality is that the price of MLP’s and oil have been correlated, whether there is a fundamental reason for that correlation or not they have been correlated. So, I don’t think that correlation will go away.

I think people just think that MLP’s are energy and if oil goes down then MLP’s go down. That’s the way life is these days. It didn’t used to be that way, back when I started it wasn’t like that, but it’s like that now. And it’s crazier now because you have hedge funds investing and leveraging up and closed-end funds that leverage up and when oil prices go down the price goes down the MLP’s are forced sellers and you have all of this insanity happening that never existed when I started.
Interviewer: Yeah, I’m sure it has changed that way. It seems like a lot of institutional money coming in and a lot of, like you said, closed-end funds coming in and it’s definitely affecting the market compared to early on when it was mostly retirees and people looking for the income.

David DeWitt: Right.

Interviewer: So where’s the bleeding edge of where MLP’s are going? For example, we know about U.S. exportation of LNG but what else do people not know about MLP’s that is maybe not mainstream yet? Anything you’re looking for going forward?

David DeWitt: OK, everything you don’t know about MLP’s, well there’s probably quite a bit. Everything you wanted to know about MLP’s but were afraid to ask, let’s put it that way.

Interviewer: Yeah.

David DeWitt: OK. Well, I guess the first thing you mentioned was LNG exports. So yes, in the Gulf of Mexico through Cheniere, the United States has begun to ship out natural gas. As they expand that then that will continue to expand, and that takes a lot of the natural gas out of the market because those are major ships that take that out. So that’s an expanding market for natural gas. The next thing people may not be aware of is that we’re shipping a lot of natural gas and natural gas liquids to Mexico.

They’re increasingly wanting to use natural gas to electric power generation and pipelines are being built into Mexico, that’s also a growth area in the business. The other overlooked area is that propane distribution is increasing. Propane is considered a natural gas liquid. There’s big demand for propane in South America and Africa and that’s a growing part of the business. The next part of the business that’s growing is ethane. Ethane is the smallest molecule next to methane which is considered natural gas.

Ethane is the next smallest molecule. And a lot of times if the ethane isn’t being used for something like making plastics it just goes into natural gas steam and that’s when they call it’s being
rejected. But there are large chemical plants being built in the gulf coast and some that will be built possibly, in Ohio for instance, that are multi-billion dollar conglomerations of chemical facilities using ethane to make ethylene or propylene or propane and these are going to use a lot of ethane so ethane production, ethane separation, ethane pipes are going to be a big business over the next five to ten years.

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Another thing I guess that people should think about is to focus more on the natural gas side of it because natural gas is going to be the fuel of choice for decades. It’s going to be increasingly used for electrical generation. Oil, over a longer period of time, the United States can boost up oil production but it’s not going to be like natural gas. Natural gas, you could have hundreds of years of natural gas. Oil is a little more time sensitive, it’s not going to be as long-lasting as natural gas.

Interviewer: Yeah that’s definitely good to keep in mind. I know that a big reason for capital that’s been invested in MLP’s over the last decade or so is the need for capital to finance infrastructure, supporting our domestic oil and gas boom. Do you think there’s still a need for that infrastructure investment here in the U.S.? Do you feel like there’s still a capital need there?

David DeWitt: Yes, absolutely. So if you look at Pennsylvania, Ohio, West Virginia, there’s two formations. One is the Marcellus, the other is the Utica. The Utica is actually underneath the Marcellus formation. This area of the country basically is just going to continue to grow, it will represent the ability to produce an enormous percentage of the natural gas used in this country.

Ten years ago, natural gas production was declining and we were actually building facilities to import natural gas, those facilities are now being reconstructed to export natural gas. And the natural gas that was coming up from the Gulf of Mexico is going to be flowing down from Marcellis, down from Utica, and it’s going to go west and it’s going to go south and it’s going to go north. That
infrastructure was never built because traditionally the United States was getting its natural gas from the lower states and the Gulf of Mexico. So there could be twenty-five billion dollars a year of investment needed to reconstruct and get to natural gas liquids, and oil, that are in areas that they didn’t before have any infrastructure. So yeah, there’s going to continue to be a big need for infrastructure build out.

Interviewer: OK, well that’s exciting for the MLP space. What I wanted to get into next is just, what do you see as the future for the master limited partnership industry? Do you see investors maybe grabbing hold of the MLP structure more? Or more focus on the gas side of the equation rather than crude oil? Is there anything you see as a future trend?

David DeWitt: Well the future trend is going to be natural gas primarily for export, for electrical generation, as a fuel of choice, for a clean environment and the build out has to continue. We’re going to see less coal. There are coal MLP’s and as these coal plants are retired they’re going to be replaced by natural gas. So if you’re investing for the long haul and you want to invest in an MLP that will continue to grow its distribution, well you invest in an MLP that transports natural gas to electric utilities or for export because that’s going to be growing for as long as we can look out into the future.

And in terms of oil production and transportation of oil, that can be more sensitive to the price of oil so that if oil is at forty, the amount of oil that’s going to be produced is going to decline but if it goes back to eighty then it’s going to increase. So there’s going to be more variability in oil.

You didn’t ask me this, but I think the price for oil has to be commensurate with what’s going to sustain the Mideast and their social structures and that’s closer to eighty than it is to forty. So oil will also be a great place to invest in but it’ll build more variables over short periods of time.

Interviewer: Sure, that makes sense. How has the perception of master limited
partnerships changed specifically in the last couple years? This was a point you wanted to address and a point you and I have discussed at length. Can you give us a little bit of your opinion on this?

David DeWitt: Yeah, MLP’s have been given a big black eye. From 2014 to 2016 because of this correlation with the price of oil the price of MLP’s collapsed. So the perception that they are stable, that they always increase their distribution or at least hold them steady, those perceptions have changed. So how should people see them?

I think people have to look at master limited partnerships at an individual basis as to whether or not each individual MLP is capable of sustaining distribution and raising it.

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But we had such a violent decline in the price oil and whether it was justified or not, the price of MLP’s came down and that hurt their ability to use their equity to finance new production and investment in new production. So I think people have to look at them more on the equity side than as a bond. These are companies, they’re equities--they’re MLP’s, sure—but they’re equities. And you look at ratios and distribution ratios and coverage ratios and building and raising distribution and earnings and look at it more how you would an equity.

Interviewer: That makes sense. Is there anything else you wanted to cover?

David DeWitt: I think that the increased consumption of ethane will be a major feature over the next three or four years, exports of LNG will be a major feature, exports to Mexico, propane to Mexico into South America and Africa, those are all going to be growth areas for the MLP market space. I think that people, if they dig down deep, and they look at the bulk of the midstream MLP’s they’re going to find solid distributions, solid earnings, the ability to increase those distributions, and over time I think they’re going to make a good return. Because once people understand what they’re invested in they’re not going to just all of a sudden, when an oil price moves
and drops, they shouldn’t just automatically assume that that’s bad – it is for some but for most it isn’t really.

Interviewer: Sounds like you have a little bit more nuanced view on this than maybe some of the headlines or some of the institutional capital that’s coming in there.

David DeWitt: I mean I could get you the perfect example of this correlation of oil that shouldn’t exist. One of the shipping companies that has nothing to do with oil, in terms of the price of oil, was expressing frustration on a conference call because even though their earnings are going up, revenues are going up, distributions are going up, if the price of oil went up ten percent their stock went up ten percent, if the price of oil went down ten percent their stock went down ten percent. So their stock price had nothing to do with actually how the company was performing.

So once people dig into it and look at, is the company performing or is the company not performing and is the price of oil coming down or going up, should it make any difference at all, and you get past all of that and you look at what’s actually happening and what actual distributions are earning and what their cash flow really is. And I think people are going to gradually wake up and say, “Wait a minute, these are great buys.” And more and more people will slowly begin to trust them a little bit more, because they have to be looked at individually.

Interviewer: Well I think that’s good advice and a good place to probably wrap this up and at least for today. Thank you David DeWitt for participating in this. David DeWitt is the president and portfolio manager at DeWitt Capital Management. He has been investing in energy-related assets mass limited partnerships for more than twenty-five years now. Thank you so much for being with us, David.

David DeWitt: My pleasure.
About the Author

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PRESIDENT & PORTFOLIO MANAGER

David has been in the securities and investment business since 1983. DeWitt Capital Management, a registered investment adviser, was formed in 1990 for the purpose of researching and investing in Philadelphia area publicly traded companies.

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