



Adviser Soapbox

The Canroy Alternatives

Joseph Tatusko, Westport Resources 11.03.06, 5:25 PM ET

Master limited partnerships (MLPs) and royalty income trusts have been greatly appealing to income-oriented investors over the last couple of years. With generous cash distributions that have averaged 7% to 12% per annum, other long-term investors might also consider the benefits certain of these investments could bring to their portfolios--in particular the MLPs.

MLPs as a group have provided excellent returns to patient investors combined with the added benefits of relatively low price volatility and low correlation to the major U.S. equity indices. MLPs may also find some near-term support from income-seeking investors given the turmoil in Canadian income trusts, which experienced sharp declines following the unexpected announcement on Oct. 31 by Canada's ruling Conservative party to begin taxing existing income trusts in 2011.

The Westport Resources Management MLP Index through Sept. 30, 2006 earned a 5-year annualized total return of 15.5% and a 10-year annualized total return of 17.3%, significantly outperforming the S&P 500's total returns of 7.0% and 8.6% over the same time periods, respectively. The returns have been excellent, but let's spend a moment examining some of the other factors to consider when determining whether MLPs or income trusts have a place in your portfolio.

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MLPs typically own and manage U.S. energy-related infrastructure involving the storage and transportation of crude oil, natural gas and refined products, as well as the gathering and processing of natural gas. The main assets, such as pipelines, storage tanks and barges, are intended to provide stable, predictable cash flows to support, and hopefully, grow future distributions to unit holders. Stable cash flows and reliable distributions greatly reduce the price volatility observed when analyzing MLPs.

Energy-related income trusts, by contrast, participate in the riskier business of exploration and production (E&P) of crude oil and natural gas. Most are Canadian in origin, but there are several U.S. royalty income trusts as well. The last several years have seen a large rise in the number of Canadian income trusts in other sectors besides energy, such as hydro-electric power generation, trucking, other resources (coal, iron ore) and even restaurant chains. Companies had been choosing the trust structure mainly to benefit from not having to pay corporate income tax. Bell Canada's recent intention to transition to an income trust and avoid paying corporate income tax was the final straw for the Canadian ruling party, causing the elimination of corporate income tax exclusion.

There are important distinctions in the structures underlying MLPs and income trusts, particularly with respect to tax treatment. MLPs in reality are partnerships with a managing general partner and limited partners. Unlike shareholders of corporations, partners face potential liability issues.

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Most MLP units trade on a recognized exchange such as the New York Stock Exchange, which provides price transparency and ready liquidity. MLP units can be bought or sold with relative ease, which distinguishes MLPs from their early ancestors dating back to the 1980s when many problems surfaced with limited partnerships. Income trusts are comprised of assets assigned to a dedicated trust (of which you, the shareholder or unitholder, own a portion), as well as the future cash flow stream associated with those assets.

Taxes are an important factor to consider, particularly for MLPs. One of the key attractions of MLPs and income trusts is that they do not pay income tax (this is being phased out for the Canadian trusts), and most of their free cash flow is required to be distributed quarterly or monthly to the unitholders. This avoids double taxation of the distributions. A large portion, if not all, of an MLP's cash distribution is considered a return of capital, and taxes are deferred until the units are sold by the investor. If held longer than one year, most of the accumulated distributions are taxed at the prevailing federal long-term capital gains rate, which is currently 15%. The portion attributed to the recapture of depreciation is taxed as ordinary income.

MLP investors receive a partnership K-1 statement at the end of the year, which adds to tax preparation time and effort. Besides added effort at tax time, MLPs should not be placed in qualified accounts, meaning they are not appropriate for IRAs. Distributions received in qualified accounts can have the unintended effect of being taxable in the current year.

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Income trusts from a tax perspective do not share this added complexity. Most of them qualify for the 15% Federal tax rate that applies to corporate dividends. As a matter of course, we recommend you consult with your tax adviser for further assistance.

Here are several MLPs worth considering when doing your own research. We maintain a favorable long-term outlook on the following MLPs based on criteria such as distribution coverage and growth history, stable free cash flow, debt levels, commodity exposure, geographic concentrations and relative valuation based on discounted cash flows.

Name	Description	Current yield
Atlas Pipeline Partners (APL)	Natural gas gathering & pipeline	7.20%
Energy Transfer Partners (ETP)	Natural gas gathering & pipeline; retail propane distribution	6.06%
Enterprise Products Partners (EPD)	Natural gas pipelines	6.57%
Inergy LP (NRGY)	Propane distribution	7.55%
Magellan Midstream Partners (MMP)	Refined products transportation & storage	6.37%
MarkWest Energy Partners (MWE)	Natural gas gathering & pipeline; crude oil pipeline	7.32%
Sunoco Logistics Partners (SXL)	Crude oil & refined products storage & pipelines	6.75%

Yields calculated as of November 3, 2006

Kinder Morgan Partners is one MLP we view with some wariness at the moment. The general partner, Kinder Morgan, Inc. has proposed a leveraged buyout, which will greatly increase the company's debt level and interest expense. KMP is the main cash producing asset for KMI and already receives generous distributions from KMP. As a cautionary note, our sense is this transaction has the potential to restrain distribution growth for the limited partners given the general partner's future debt service needs.

We would advise that any new investment in the income trusts be done with extreme caution for the time being. The Tory government has proposed that existing trusts pay corporate taxes beginning 2011, which means distributions will likely be reduced substantially from generous 10% to 15% yields earned today. An effective 20% corporate cash tax rate in 2011 was quickly factored into trust values the day following the unexpected announcement.

In the short-term, the Canadian trusts will continue to pay generous distributions to the extent access to capital for normal operations does not become an issue. Nevertheless, value and selective opportunities remain, primarily among oil and gas income trusts that have low payout ratios. The trusts' oil and gas reserves have obvious value, and the tax law change may provide the impetus for consolidation and private equity activity in the Canadian oil patch. But beware of the risks and expect heightened volatility within this energy sub-sector.

Tax issues aside, important characteristics in assessing the income trusts include the mix between crude oil and natural gas production, proven and remaining life of reserves, free cash flow, capital expenditure plans, debt service, payout ratios, performance history and netbacks (the difference between revenue and all the costs of production per barrel of oil equivalent).

Joseph Tatusko is a portfolio manager at Westport Resources in Westport, Conn. Clients of Westport Resources may be invested in master limited partnerships mentioned above. [Click here for further disclosures.](#)

Excerpted from the October issue of DRIP Investor. [Click here for more information and analysis of direct purchase and dividend reinvestment plans from editor Chuck Carlson.](#)

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