DOW THEORY FORECASTS

What is an MLP?

MLPs trade on indexes like stocks. However, they are not stocks, but partnership units. Before you buy one, read on to learn how they differ from stocks:

• On average, the MLPs in our Quadrix universe yield 7.8%, the kind of dividend that in a typical stock would start us searching for what troubles have made it so cheap. But MLPs can pay robust distributions because their corporate structure gives them tax breaks if they generate 90% of their cash flows from “qualifying sources,” such as natural resources, commodities, or real estate.

• Nearly 70 MLPs began trading in the five years ended April 2014, during which period the Internal Revenue Service broadened its interpretation of qualifying sources, opening up MLP status to companies that provide support services for drillers, and some that transport or store alternative fuels and industrial gases. The IRS suspended applications for MLP status in 2014, then in May 2015 proposed new rules that seemed to tighten the focus back toward energy companies, allowing regulators wide leeway. Since then, the IRS may have backed off on the changes, and as of yet no official rules have taken effect.

• MLP investors must go through an extra step at tax time. They will receive a K-1 form that breaks down the distributions, which may include returns of capital taxable at the individual-income rate.

• While MLPs report operating income like other companies, analysts typically gauge their operating performance using distributable cash flow, or operating cash flow minus capital spending and payments to the general partner.

• A few of the stocks we classify as MLPs aren’t partnerships, but limited liability companies that opt to be taxed like partnerships. Investors should treat them all the same way.

The curious risks of MLPs

MLPs are not technically stocks but they do trade like stocks. While we don’t recommend any MLPs on our buy lists, our Top 15 Utilities portfolio features three — **EQT Midstream** (*EQM)*, **Spectra Energy** *(SEP)*, and **Star Gas Partners** *(SGU)*.

As a group, MLPs face some risks common stocks do not:

• **Potential law changes.** For nearly two years, the Internal Revenue Service has been considering changes in what kinds of companies can obtain MLP status. While traditional energy MLPs probably won't lose their status, the uncertainty adds risk to the group.

• **Dividend cuts.** Any company that pays a dividend might choose to cut or eliminate that payment, but the problem becomes more acute with MLPs. While publicly traded partnerships are not obligated to distribute the bulk of their cash flows to investors, most do it to make the units more appealing. Such a policy benefits investors in good times, but what happens when a company that typically pays out most of its cash flows suffers a downturn in business? That problem has already manifested itself. MLPs' dividend growth has slowed, and in the most recent quarter the average MLP paid out 6% more than a year ago.

• **Interest rates.** In general, rising interest rates don't favor stocks with high yields, as the rise in rates may drive investors away from equities and toward bonds. Interest rates haven't risen enough for bonds to compete with many MLPs, but as rates keep rising, we could see investors bailing out — particularly if they perceive MLPs as especially risky.

• **Energy exposure.** Much of MLPs' revenue comes from long-term delivery or storage contracts with energy producers. Sounds like a steady revenue stream. But what happens when producers cut back, or run into financial difficulty? Such counterparty risk probably contributes to MLPs' market weakness.

• **Stampedes.** Because so many MLPs operate energy-related businesses, the whole group tends to pitch and yaw together. It's tough to diversify within the group, and a slump in one MLP often accompanies slumps in many others.