REAL MONEY

Rob Rikoon

March, 2004

<u>Master Limited Partnerships</u>

Many investors are searching for ways to earn more income. Interest rates are at their lowest levels in 40 years. High earning CDs and bonds have seen their payouts come down and many investments that were earning good rates of return have been called in prematurely by their sponsors. The challenge facing people trying to live off their portfolios is how to replace the income formerly generated at 5%, 6% or 7% plus levels with currently available investments.

One common solution that I see when reviewing portfolios, often put together by "bond specialists," is the use of long term preferred stocks and bonds. This is painful to see, as one of the pitfalls of locking in the low returns that most fixed income investments now offer will only be perceived when it is too late: after interest rates rise. Long term bonds and preferred stocks will plummet in value when rates finally go up, so beware!

If there is one thing and one thing only that we can surmise from current circumstances, it is that long term rates will eventually rise. Many factors are now in place which will contribute to the shock that our financial markets will experience when large institutional traders eventually seize the opportunity to make money off of our lack of financial discipline. Unchecked, the politically motivated growth in the amount of money sloshing around the financial system, high levels of consumer borrowing, the national budget, US international trade deficits, the weak dollar and increasing credit card forfeitures all point to the bond market heading downwards due to rising interest rates.

.

Because of the precarious nature of the present economic recovery, rates may stay down longer than warranted by underlying economic conditions. This will make the medicine only more painful to swallow when it can no longer be avoided. Optimism about our ability to grow our way out of this mess seems unwarranted, given the number and types of jobs being created in our economy. When the current administration wants to classify new hamburger flipper opportunities at fast food joints as "manufacturing" jobs, you better believe there is trouble brewing.

There is a class of investment vehicles that has some exposure to rising interest rates but which may also benefit from a concurrent rise in inflation, namely, natural resource based Master Limited Partnerships.

Unlike the much ballyhooed limited partnerships of the 1980s, purveyed extensively by some now defunct brokerage firms, which eventually were closed down by the Tax Reform Act of 1986, the MLPs referred to here are publicly traded securities. This means they can be bought and sold without much fanfare and can be liquidated in just a few days. In addition, they are priced daily, much like a stock or mutual fund.

There are not that many Master Limited Partnerships around, but more are being created as the markets see the need for income oriented investments, and boy, do investment bankers hate an unfulfilled need on the part of retail consumers! MLPs differ from the older type of limited partnerships in an important way: they are not driven by the motivation of avoiding taxes, though many MLPs do have some current cash flow tax advantages.

Often, a portion, if not the majority, of the money MLPs pay out to their investors comes in the form of deferred taxable income. This is to say that some of the income is not taxed to investors because of accounting breaks the MLPs get from the government.

What is inside these mysterious boxes called MLPs? There can be different kinds of assets but generally, there is some kind of established network of pipeline or other type of distribution channel that is used to deliver natural resources to businesses and consumers. It could be natural gas, propane, even wood!

Here is how MLPs work: companies that have developed these natural resources take the most stable of their productive assets and package them up so that the public can participate in the ownership of specific properties. Why would they do such a thing? First, once the cash flow is stable, the companies want to get their money out in order to pursue higher growth investments. Second, they get a tax benefit by spinning off these portions of their companies.

In this way, earlier investors who wanted growth and were willing to take on the risk of the exploration phase are given the chance to exit at a profit so they can take their capital elsewhere. MLPs are traded at a fluctuating value, so later investors may have profits as well as income. Given the high level of investor interest in MLPs over the last 18 months, their stock prices have already appreciated somewhat because the income rate is so attractive. (I expect that future gains in stock prices will be limited over the next year.)

The current income stream of most MLPs still looks positive, and they have a record of being fairly secure. The cash paid out to investors comes from contracts that MLP organizers have with suppliers of raw materials and also with the end users of natural resources. These relationships are generally medium to long term with contract based margins for the MLP. Since the demand for energy and raw materials is fairly constant, the income distributions from MLPs are very attractive to people living off their portfolios.

What risks are associated with MLPs? As with any type of investment, it is important to be aware of the factors which could negatively impact one's portfolio. Here is a not so short list of things which could happen to a MLP that might require it to change its payout:

Reductions in demand for use of its delivery system
Damage to its physical facilities
Interest rate increase
Consumer demand fall off
Tax regulations changes
Depletion of natural resources (this could benefit some MLPs)
Bad weather (likewise, this might increase the stock price of some MLPs)

Other factors to remember when considering MLPs are that their lower volume of trading can make it less efficient to get in and out at short notice, and their tax reporting is slightly more complicated since partnerships issue K-1 as a tax reporting format instead of the more common IRS Form 1099. Investment in MLPs inside an IRA or non-profit organization portfolio could possibly raise some tax reporting issues, as there can be Unrelated Business Income (UBI) earned within the portfolio which may require extra work.

No possibility for pain, no chance for gain is what we say in the business. MLPs represent one way that investors can protect themselves against certain risks. If you have a sense that much of the economic news we read and see is infused with unreality, use of securities that represent real assets is compelling.

MLPs have their own set of positive and negatives attributes and they are a means for diversifying your portfolio. Now that many of America's largest industrial corporations earn a majority of their profits through financing, it can feel good to own a piece of the rock, or at least something attached to the rock!

Rob Rikoon is a Registered Investment Advisor and Chief Investment Officer at Rikoon-

Carret, a financial counseling firm located at 510 Don Gaspar. Contact information:

telephone - 989-3581; email- rrikoonaol.com.