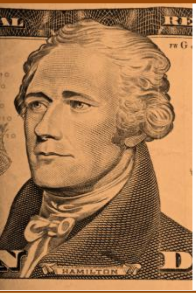

Quick Start Guide to MLP Investing

A Special Research Report from **The Dividend Hunter**

Investors Alley

By Tim Plaehn

Why Should MLPs Be in Your Portfolio?

A master limited partnership (MLP) is a company organized as a partnership with shares – called limited partner units – that trade on the stock exchanges. The attributes of many MLPs make them natural choices to be included among The Dividend Hunter recommendations. No other type of investment offers the combination of yield and dividend – called LP distributions – growth potential that can be found in the lists of MLPs and related companies.

First a word about taxes and MLPs

As the owner of MLP units, you are treated as a partner for tax purposes. The distributions you receive will be non-taxable, return of capital. You do not declare this income for taxes, but they do reduce your cost basis in the MLP units. As a partner you must declare a proportional share of the MLPs profits or losses on your tax return. You receive an IRS Schedule K-1 from the MLP which lists your partner share results. In many cases, due to write-offs the MLP can claim, you will have little or no taxable income from an MLP investment. Almost always, any amount of taxable income will be less than the distributions you received during the year. K-1s will add some extra work to your tax reporting, but all of the tax software packages can handle them without any fuss.

An Almost Guaranteed Growth Business Model

Legal restrictions limit the use of the MLP business structure to companies involved in energy or minerals production and processing. As a result, MLPs operate and/or own oil and gas wells, coal mines, pipelines, storage and processing terminals, refineries and support operations or supplies for these businesses. Each MLP tends to focus on a certain sector of energy production or infrastructure services. Historically, MLPs have grown by either developing or purchasing assets that fit into their businesses. Growth is funded by a combination of equity from new unit issuance and debt. As long as the added assets generate returns greater than the blended cost of equity and debt capital an MLP can regularly increase the distribution rate. The better MLP companies increase their distributions every quarter, with annual distribution growth rates ranging from 5% to well over 20%.

Over the last several years, corporations, such as Phillips 66, and private energy companies that own significant amounts of infrastructure assets have started to use the MLP structure as a way to monetize those assets and produce a growing income stream back to the sponsor company. A new MLP is spun-off or set up privately then listed with an IPO.

The new MLP receives enough assets to generate free cash flow to cover the initial minimum distribution rate. Then, over a period of years, the sponsor sells – called drop downs – assets on a periodic basis from itself to the MLP. The drop downs are structured and priced to guarantee that the MLP can continue to grow the distribution rate it pays to LP unit holders. The sponsor keeps a large portion of the LP units for itself and the partnership agreement also includes incentive payments to the general partner/sponsor that increase as the MLP grows and the distribution rate increases.

As a result the sponsor has a very large financial incentive to manage the MLP so that the distributions on LP units grow steadily. Individual investors get to go along for the ride as the sponsor enriches itself. With this model, all of the assets to grow the MLP exist or will be developed by the sponsor. The MLP receives assets that are already generating cash flow, typically on guaranteed fee structure contracts.

For The Dividend Hunter MLP recommendations, I work through the business models of MLPs with strong sponsor companies to find those with the best combination of current yield and growth prospects.

Should You Put MLPs in Your Retirement Account?

This section of the report was inspired by a subscriber to The Dividend Hunter asking about putting MLPs in his retirement account. Considering that many of my readers are using the dividend stocks in the portfolio to generate retirement related income and some have the option to trade within their retirement account I thought it only natural to include a discussion on this issue.

We'll start with his original question:

> "*Given that IRA investors tend to avoid the headaches that accompany MLPs and their dreaded K-1s, do you feel that ETFs that include MLPs, plus 1099 forms, might provide an alternative path with a lower yield? Just curious to learn if you favor individual equities only and do not favor ETFs in your publication.*"

The question brings up two important topics you'll want to understand about master limited partnerships (MLPs) and taxes.

K-1 Reporting Investments and Individual Retirement Accounts

There are not rules that prevent you from owning MLP units in an IRA. However, buying units with IRA money could result in your IRA earning what the IRS calls the unrelated business taxable income (UBTI). If an IRA account earns more than $1,000 in UBTI, the account becomes liable for income tax on the UBTI earnings over the $1,000 threshold. The account itself must file a tax return, which is handled by the IRA custodian. The custodian may charge up to several hundred dollars to file the return, plus the account will be debited for the UBTI tax owed.

MLPs report the amount of UBTI earned on the Schedules K-1 sent to investors holding units in an IRA. Just so you know, UBTI is not reported on a K-1 for MLPs in a regular brokerage account. Typically, an MLP owned in an IRA will report very little, if any, UBTI in the early years after units are purchased, and a growth focused MLP will not produce much UBTI for many years. My discussions with MLP investor relations departments and investors owning MLPs in their retirement accounts have shown that it is rare for an MLP owning IRA to hit the $1,000 UBTI trigger for a tax return.

The other time that UBTI can become an issue is when MLPs owned in an IRA are sold. The distributions earned over the holding period will be reported and classified as UBTI. As a result, owning a high-yield MLP in an IRA for more than a few years can trigger the UBTI tax if the units are sold.

My general opinion is to not own individual MLP units in an IRA. How much UBTI you will earn is unknown until the units are actually in your IRA and you receive a K-1. I think that a packaged investment product (fund) is the better way to get MLP sector exposure in a retirement account. The answer to which type of fund gets a little complicated, and that topic gets covered next. One last point, not all K-1 issuing companies are the same as MLPs. The finance related publicly traded partnerships may or may not generate UBTI. The investor relations managers at our portfolio holding Oaktree Capital (NYSE: OAK) have told me that OAK units will not generate UBTI in an IRA.

More Fun Tax Rules in Funds Such as ETFs, Mutual, and Closed-End Funds

Funds that focus on MLPs also must deal with negative tax issues. If an MLP focused fund has more than 25% of its assets in partnership units, the fund cannot qualify as a non-taxable, regulated investment company. The tax rules force a fund with a higher percentage of MLP assets to be organized as a corporation and to pay corporate taxes on its profits.

In practice an MLP fund tracks the accrued income taxes on the gains in its portfolio and subtracts the future tax liability from the fund's net asset value (NAV). As a result of the 35% to 40% corporate income tax bill, the NAV of a fund will lag the gains of its investments by the tax rate. For example, the Alerian MLP Infrastructure index is one of the most widely followed indicator of MLP sector returns. The index is mirrored by the **ALPS Alerian MLP ETF (NYSE: AMLP)**. Over the three years that ended on June 30, 2014 the index had recorded an average annual return of 20.83%. For the same period, the AMLP ETF produced average returns of 12.90% per year, a 38% per year under-performance compared to the index. The bottom line is that MLP index tracking ETFs are not a good investment choice.

Some MLP Focused Package Products for Your IRA Ideas

To get MLP exposure in your IRA without the potential UBTI hassles and costs, or the corporate tax hit suffered by ETFs, you have a couple of options. There exists an even dozen MLP exchange traded notes (ETNs). An ETN tracks a specified index, but does not actually own the investments tracked by the index. Instead an ETN is a debt obligation of the financial services company that issues the ETN shares. The returns of an ETN will match the selected index minus management fees of 0.80% to 0.95%, depending on the fund. Since ETN shares are not backed by any assets, there is a very small but real possibility of losses if the fund sponsor runs into financial problems or goes bankrupt.

My personal preferences for MLP packaged investments come out of the 27 closed-end funds (CEFs) covering MLPs. While a CEF faces the same corporate income tax as an ETF, there are several features of this type of fund that allows them to put up superior returns compared to the ETF indexes. Closed-end funds can use leverage, up to about 30% for stock funds. This means an MLP CEF with $100 million of assets can own $130 million of MLP units or stock shares. Also, CEF shares often trade at a discount to NAV, allowing you to own even more assets for your invested dollar.

Finally, and most important, CEFs are actively managed and the MLP space is a great hunting ground for good investment managers. The CEF advantages show up in the numbers: Through August 26 year-to-date, 10 of the MLP CEFs have outperformed the Alerian MLP index. These returns are after all fees and accrued taxes. 19 of the funds have done better than the AMLP ETF. Of course, when picking actively managed funds you need to know how to find the top performers.

The Upstream Master Limited Partnership Game

There exists a broad range of activities undertaken by energy companies along the path from finding crude oil and natural gas underground to selling fuels at your corner store or using natural gas to generate electricity. The upstream energy sector is the part of the energy spectrum involved with the drilling of wells to find oil and gas and then selling those energy commodities. Upstream operations can be just one part of the business of a large integrated energy company such as ExxonMobil or Chevron. There are also pure play exploration and production companies – E&P, another term comparable to upstream – which are focused on drilling holes to find and grow their oil and gas production.

There are distinct differences between the upstream E&P companies organized as corporations and those set up as publicly traded partnerships. The corporations are most interested and operate on the "E" side. These companies measure success by how many successful wells they drill during the year. Corporate E&P companies reinvest most of their profits into drilling more new wells and rarely pay dividends.

The publicly traded master limited partnerships – MLPs – primarily stick to the "P" side, buying and owning producing wells to generate free cash flow that can be paid out as distributions to investors. The upstream MLPs currently sport yields in the 8% to 10% range making them very attractive to income focused investors. The corporate and MLP sides of the E&P business have a symbiotic relationship. The MLPs need the corporate E&P companies to cover the high costs of drilling wells, which the partnerships can then purchase to generate immediate cash flow. The corporations sell older production properties to the MLPs to raise cash to help fund their exploration and drilling operations.

At the most basic level of operations, an upstream MLP owns and operates oil and/or natural gas wells. The oil and gas is sold, expenses are paid and the remaining free cash flow is paid to investors as income distributions. The partnership structure allows these companies to pay the majority of free cash flow as tax-advantaged distributions. To stabilize the distribution rates, these MLPs use hedges such as energy futures and put options to lock in the prices received for the projected oil and gas production for the next several years. Everything about how an upstream MLP is managed focuses on the goal of maintaining those steady distribution payments. To achieve that goal each of the MLPs in the sector faces several challenges:

The rate that oil and gas comes out of a well naturally declines over time. The decline is faster in the early months after a well starts to produce and the decline rate slows as a well ages. Upstream MLPs like to invest in slow decline rate wells, but there will be some level of decline and to maintain enough distributable cash flow the companies must reinvest some revenue into projects that will sustain production. The cash used for sustaining or maintenance capex (capital expenditures) comes out of what will be the reported earnings before interest, tax, depletion and amortization (EBITDA).

Sustaining capex can be spent on drilling new wells, reworking old wells with new techniques to increase the production, or with the purchase of additional production assets.

An upstream MLP will regularly make acquisitions of energy production properties. The purpose of these purchases is to both replace declining production from current wells and to grow the total amount of oil and/or natural gas produced by the company.

Acquisitions will be funded with a combination of new debt and the issuance of new limited partner units. The additional EBITDA generated from the new assets must be enough to cover the interest on the debt, the distributions that will be paid on the new LP units and the sustaining capex needed for the assets. The money raised from debt and equity issuance and spent on new production assets is referred to as growth capex.

If an upstream MLP does a good job with what it pays for production assets, the acquisitions made over the course of a year will produce an increasing amount of distributable cash flow per unit, allowing the MLP management to grow the distributions paid to LP unit investors. However in recent years, a combination of low natural gas prices and the realization by the corporate E&P companies that the MLPs can be desperate to add production assets, has made it tough for upstream MLPs to do more than end up with enough distributable cash flow to maintain a level distribution rate. What you will find with this type of MLP are partnerships that are growing assets, market cap, enterprise value and oil and gas production, but the distributions paid to investors have remained flat. To a certain extent, the upstream MLP business model developed in the 2005-2008 era of higher natural gas prices has become stale and the old ways currently are not working well to generate growing distributions for investors.

Finally a word on taxes: under the tax rules, distributions paid by an MLP are not taxable income. Instead the distributions will be classified as return of capital and reduce your cost basis in the units you own. Investors receive an IRS Schedule K-1 that lists the investor's proportionate share of income or losses for the year. If the K-1 shows income, that will be included in your taxable income for the year and you will owe taxes. Since the upstream MLPs can claim depletion of energy assets and are always buying new assets to grow production, an investment in the units of an upstream MLP is unlikely to generate any meaningful amount of taxable income. Basically, these MLPs will be a tax free investment until you sell units and recapture the basis write down from distributions earned, or your have earned distributions in excess of your original unit cost. If you reach the point that you have earned more in distributions than you paid for the units, distributions will start to count as taxable income.

If you're investing in dividend stocks and seeking steady, consistent income then Congratulations, you're already head and shoulders above most investors.

But what if I told you there's a way to COMPOUND that income?

That there's a tool that takes what you're going to pull in with the dividend stocks you're already holding and will pile on even MORE income. By adding this to your existing strategies, you're in essence **DOUBLING your income potential** again. What I'm talking about here is called:

30 Day Dividends

This is another one of my powerful tools that is made to not replace in any way what my regular income service, The Dividend Hunter, provides, but to complement and supplement the results you're already getting.

30 Day Dividends uses short holding periods for maximum profits and minimal risk.

You see, the focus of 30 Day Dividends will be to recommend stocks that will provide opportunities for relatively fast, attractive profits around potential dividend payouts. (And no, this is not another dividend capture strategy.)

The information you'll get from this newsletter will let you be nimble.

It will let you move fast.

It will let you bounce in and out of the market, making quick hits that pull in big profits.

How does it work?

Let me tell you how it operates.

First off it looks for investments that are considered **Special Dividends**. It finds those companies that will pay large, one-time dividends as a bonus to investors. Some stocks do this fairly regularly and there are other ways to ferret out stocks that have a high probability of paying a special dividend. There is seriously strong profit potential within these special dividend type stocks, and you can expect to earn up to 10% or more in a VERY short period of time.

The next tactic in this newsletter involves **International Stocks trading as ADRs**. You'll find that dividend-paying companies outside of the U.S. often do not follow the U.S. practice of steady quarterly dividends.

30 Day Dividends gets around that by finding and recommending companies that pay large dividends at odd times of the year. The recommendations will be to buy shares, earn the dividend and get out. The timing of the buy and sell dates will help you further maximize the profits of these trades.

The next trick up my sleeve: **Variable Dividend Payers**.

There exists a group of U.S. companies with full profit payout policies and operate in industries where profits can vary a lot from quarter to quarter and year to year. I understand the underlying factors that cause profits to swing and will recommend when to buy shares on the cheap to profit when the dividends swing again to the high side. This strategy aims to produce long term holdings where the dividend earnings are well above what you'd expect from typical dividend stocks.

Income Stock IPOs: When new REIT and MLP stocks hit the market the share prices follow a different trajectory than widely followed "hot new stock" IPOs.

What else do I show you in this newsletter? How about stocks with **Large Dividend Increases**?

I'm an expert in finding companies that are projected to significantly increase the regular dividend rate due to cash flow increases and past history of how those increases have been paid to investors.

Much of the benefit of this approach will be to pick the buy and sell timing points to maximize the returns from the upcoming or predicted dividend events. Again, not a dividend capture strategy, rather taking advantage of market actions.

For example, it may be more profitable to buy before a dividend announcement and sell on the news and price increase, rather than buying to earn the dividend itself. Much of the analysis will be price pattern recognition around dividend events.

–> Recommended stock holding periods will be a few weeks to several months, except for those that we are trying to accumulate on the cheap. This means your money isn't tied up in and exposed to the market any longer than it has to be.

I know about a couple of dozen stocks right now that can fit into these categories. Other opportunities will arise as I research stocks for the regular stock income newsletter. With the base letter the focus is on higher yielding stocks that provide a stable and predictable income along with dividend and share price increases. Special situations offer higher returns obtained by trading in and out of the selected income stocks.

That's the thinking behind what I have built into my 30 Day Dividends service.

This portfolio changing information will be delivered via email… like clockwork.

You'll hear from me often enough that you won't ever miss any big moves.

We locked in our first double digit gain in the first month and have been making money ever since.

So if you consider yourself an investor who's looking for income from stocks and willing to accept some additional risk to time the profits from increasing dividend payouts or capital appreciation from general market interest in those special payouts then this service is perfect for you.

So the question is:

Are you OK with just making just a tiny amount every month?

Or losing every month?

Or are you ready to start investing in safe income stocks that will produce quick dividend payouts and share price gains, all with the click of a button?

Delivered to your inbox like clockwork.

If you're ready to multiply your income streams, then press "add cart button" now.

Fly, Land, or Die,

Tim Plaehn
Editor
The Dividend Hunter
30 Day Dividends

All data, including equity prices and yields current as of when this report was published.

Investors Alley