The recent surge in passive investment strategies, and corresponding decline in active investment strategies, is causing strong price correlations amongst a broad swath of equities. This dynamic has caused a large majority of stocks to rise lockstep with the market, while a few unpopular stocks have been left behind. It is these lagging assets that provide an opportunity. Overlooked and underappreciated stocks potentially offer outsized returns and low correlation to the market. Finding these ?misfits? is one way we are taking advantage of a glaring market inefficiency.

In July 2019, we recommended that investors consider a specific and underfollowed sector of REITs that pay double-digit dividends and could see reasonable price appreciation. In this article, we shed light on another underfollowed gem that also offers a high dividend yield, albeit with a vastly different fundamental profile.

The Case for MLP?s

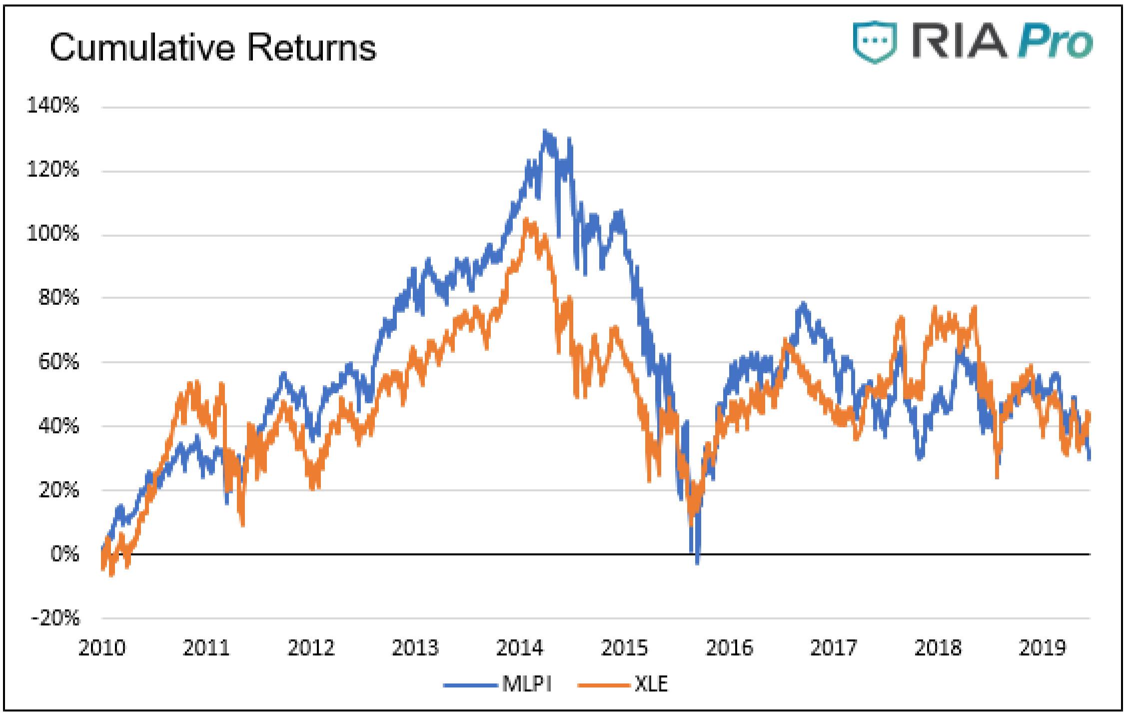
Master Limited Partnerships (MLPs) are similar in legal structure to REITs in that they pass through a large majority of income to investors. As such, many MLP?s tend to pay higher than average dividends. That is where the similarities between REITs and MLPs end.

The particular class of MLPs that interest us are called mid-stream MLPs. We like to think of these MLPs as the toll booth on the energy express. These MLPs own the pipelines that deliver energy products from the exploration fields (upstream) to the refiners and distributors (downstream). Like a toll road, these MLPs? profitability is based on the volume of cars on the road, not the value of the cars on it. In other words, mid-stream MLPs care about the volume of energy they carry, not the price of that energy. That said, low oil prices **can** reduce the volume flowing through the pipelines and, provide energy producers, refiners, and distributors leverage to renegotiate pipeline fees.

Because the income of MLPs is the result of the volume of products flowing through their pipelines and not the cost of the products, their sales revenue, income, and dividend payouts are not well correlated to the price of oil or other energy products. Despite a different earnings profile than most energy companies, MLP stock prices have been strongly correlated to the energy sector. This correlation has always been positive, but the correlation is even greater today, largely due to the surge of passive investment strategies.

Passive investors tend to buy indexes and sectors containing stocks with similar traits. As passive investors become a larger part of the market, the prices of the underlying constituents? trade more in line with each other despite variances in their businesses, valuations, outlooks, and risks. As this occurs, those marginal active investors that differentiate between stocks and their associated fundamentals play a lesser role in setting prices. With this pricing dynamic, inefficiencies flourish.

The graph below compares the tight correlation of the Alerian MLP Infrastructure Index (MLPI) and the State Street Energy Sector ETF (XLE).



Data Courtesy Bloomberg

Before further discussing MLP?s, it is worth pointing out the value proposition that the entire energy sector affords investors. While MLP cash flows and dividends are not necessarily similar to those companies in the broad energy sector, given the strong correlation, we must factor in the fundamental prospects of the entire energy sector.

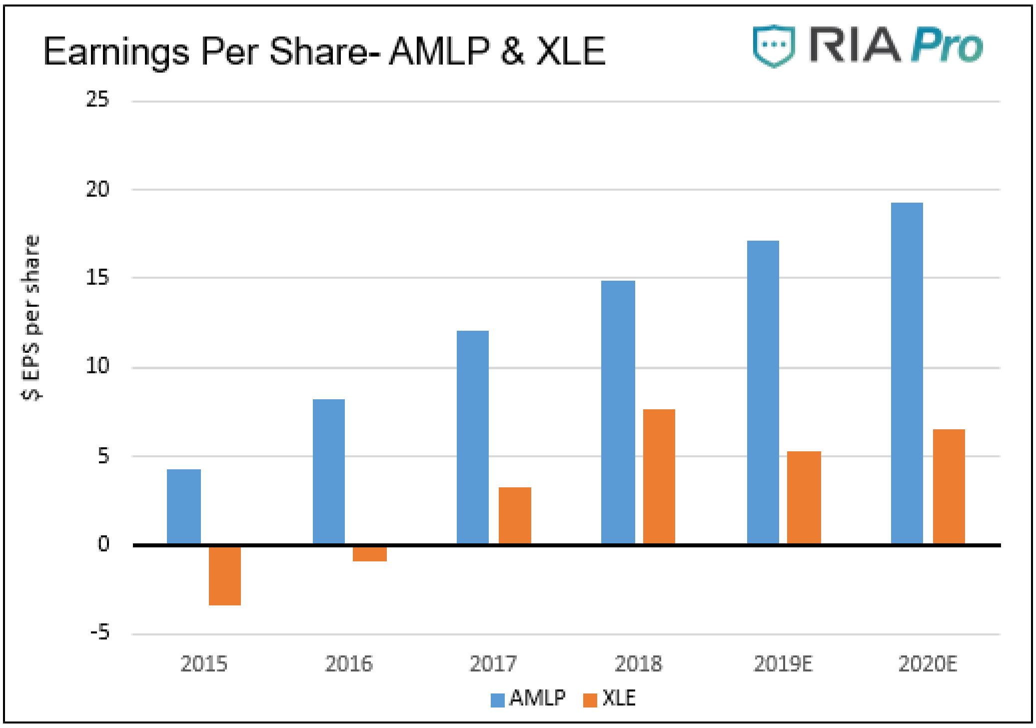
The following table compares valuation fundamentals, returns, volatility, and dividends for XLE and the S&P 500. As shown, XLE has traded poorly versus the S&P 500 despite a better value proposition. XLE also pays more than twice the dividend of the S&P 500. However, it trades with about 50% more volatility than the index.

	XLE	SPY
Price /Book	1.48	3.29
Price /E (TTM)	16.56	21.53
Price/CF	6.94	13.14
Ann. Total Return 1yr	-10.69%	14.16%
Ann. Total Return 5yr	-5.13%	14.75%
Ann. Total Return 10yr	2.87%	13.54%
Ann. Vol 2014-Curr.	21.48%	13.00%
Dividend Yld.	3.70%	1.78%

The following table compares two valuation metrics and the dividend yield of the top 6 holdings of Alerian MLP ETF (AMLP) and the S&P 500. A similar value story emerges.

	AMLP (top 6)	S&P 500
EV/EBITDA	10.36	11.51
Price /E (TTM)	10.45	20.62
Dividend Yield	9.16%	1.90%

As XLE has grossly underperformed the market, so have MLPs. It is important for value investors to understand the decline in MLP?s is largely in sympathy with the gross underperformance of the energy sector and not the fundamentals of the MLP sector itself. The graph below shows the steadily rising earnings per share of the MLP sector versus the entire energy sector.

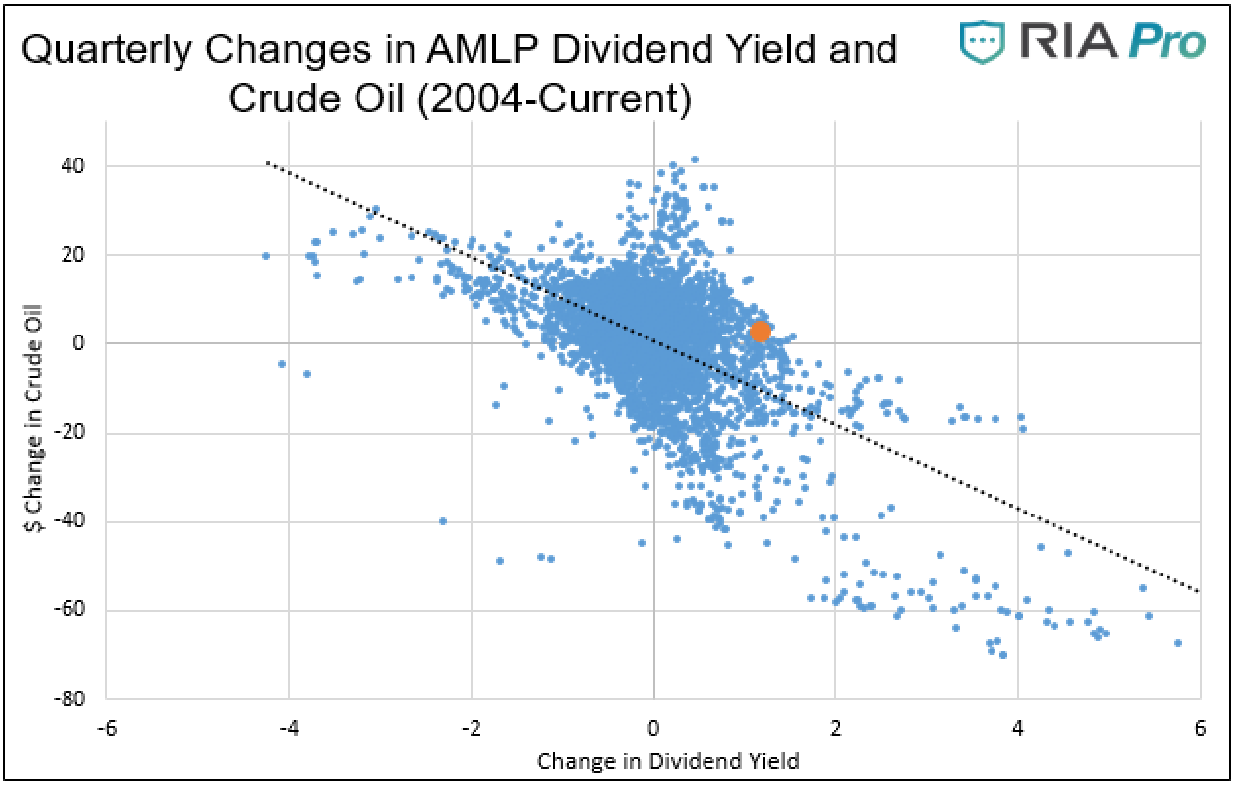


Data Courtesy Bloomberg

Illustrating the Value Proposition

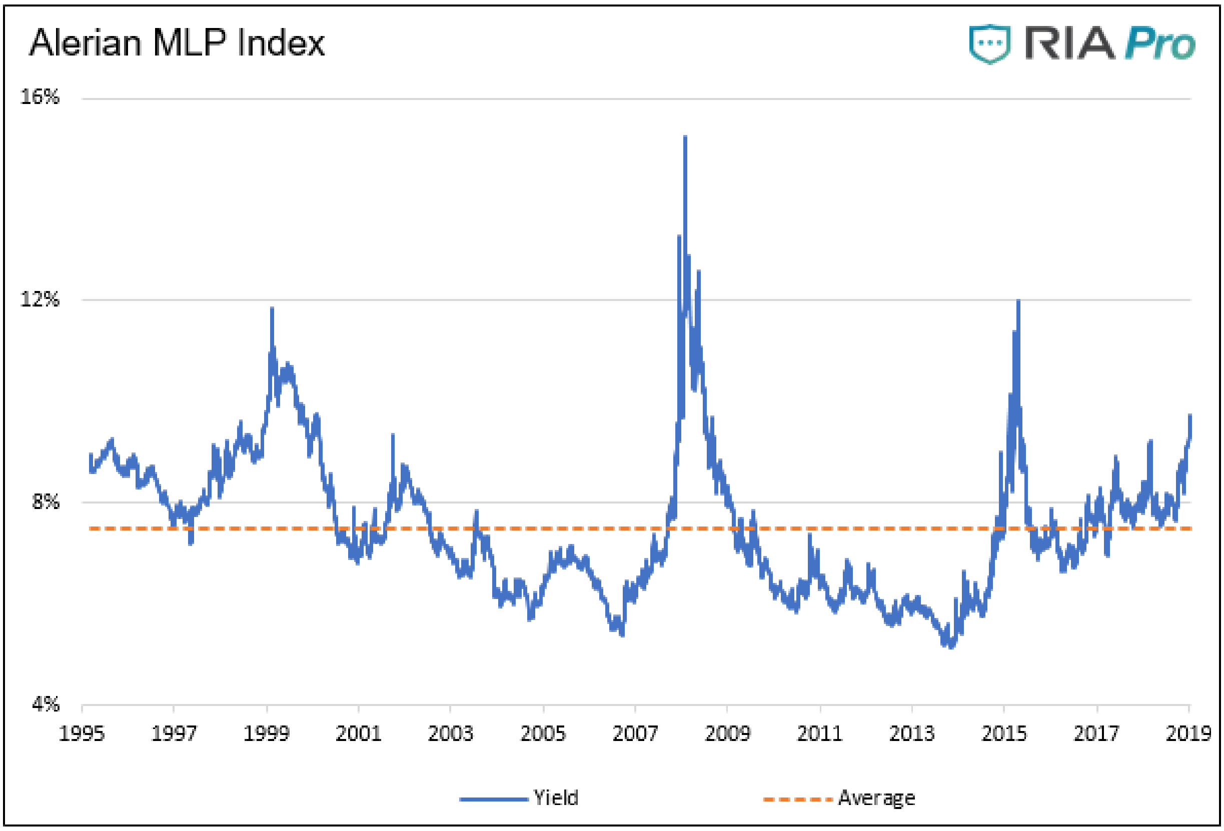
The following graphs help better define the value of owning MLPs at current valuations.

The scatter graph below compares 60-day changes to the price of oil with 60-day changes in AMLP?s dividend yield. At current levels (the orange dot) either oil should be $10.30 lower given AMLP?s current dividend yield, or the dividend yield should be 1.14% lower based on current oil prices. **A decline in the dividend yield to the norm, assuming the dividend payout is unchanged, would result in a price increase of 13.17% for AMLP.** Alternatively if oil declined about 20% in value, the current AMLP dividend yield would then be fairly priced. We consider this a significant margin of safety should the price of oil fall, as it likely would if the U.S. enters a recession in the near future.



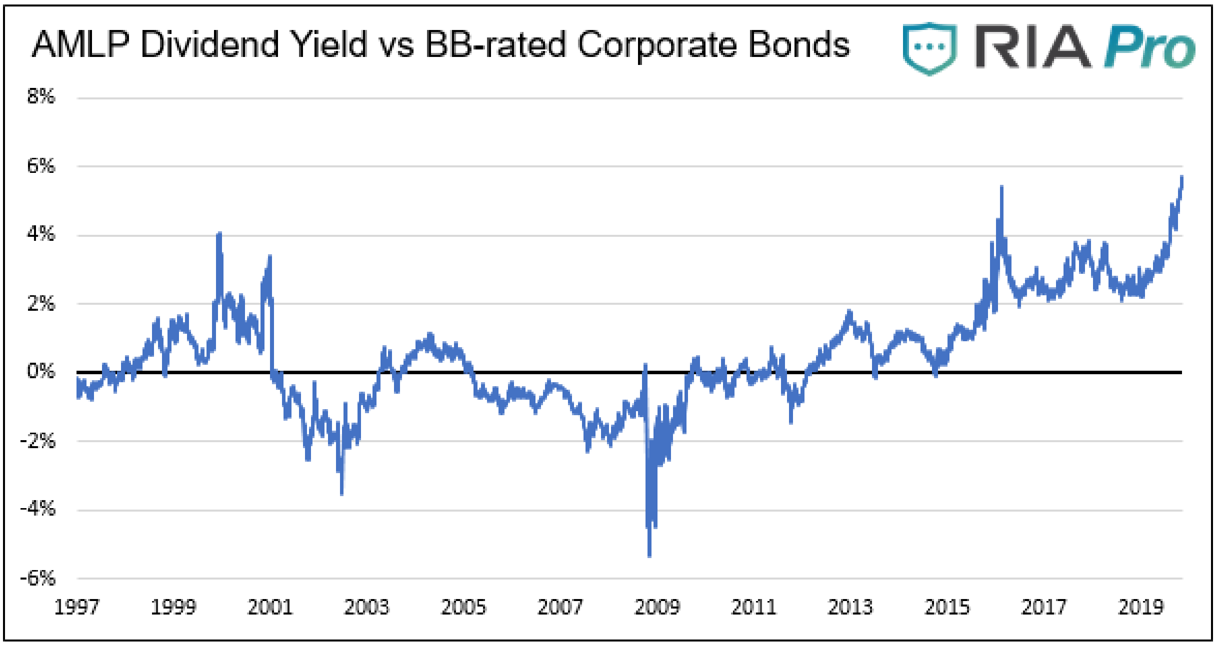
Data Courtesy Alerian and Bloomberg

The graph below highlights that AMLP?s dividend yield is historically high, albeit below three short term spikes occurring over the last 25 years. In all three cases oil fell precipitously due to a recession or a sharp slowdown of global growth.



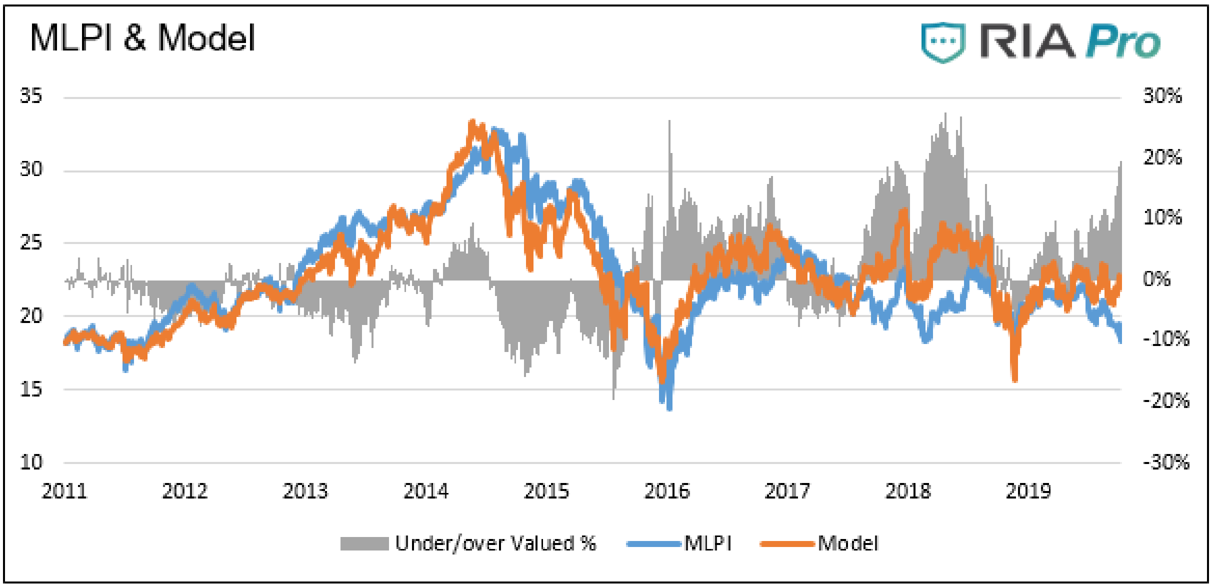
Data Courtesy Alerian and Bloomberg

Due to their high dividend yields and volatility, MLP?s are frequently compared to higher-yielding, lower-rated corporate debt securities. The graph below shows that the spread of AMLP?s dividend yield to the yield on junk-rated BB corporate bonds is the largest in at least 25 years. The current spread is 5.66%, which is 5.18% above the average since 1995.



Data Courtesy Alerian and St. Louis Federal Reserve

To help us better quantify the pricing of MLPs, we created a two-factor model. This model forecasts the price of MLPI based on changes to the price of XLE and the yield of U.S. Ten-year Treasury Notes. The model below has an R-squared of .76, meaning 76% of the price change of MLPI is attributable to the price changes of energy stocks and Treasury yields. Currently the model shows that MLPI is 20% undervalued (gray bars). **The last two times MLPI was undervalued by over 20%, its price rose 49% (2016) and 15% (2018) in the following three months.**



The following summarizes some of the more important pros and cons of investing in MLPs.

Pros

- Dividend yields are very high on an absolute basis and versus other higher-yielding securities
- Valuations are cheap
- Earnings are growing in a dependable trend
- Balance sheets are in good shape
- Potential for stock buybacks as balance sheets improve and stock prices offer value

Cons

- Strong correlation to oil prices and energy stocks
- ?Peak oil demand? ? electric cars/solar
- Sensitivity to global trade, economy, and broad asset prices
- Political uncertainty/green movement
- High volatility

Summary

The stronger the market influence that passive investors have, the greater the potential for market dislocations. Simply, as individual stock prices become more correlated with markets and each other, specific out of favor companies are punished. We believe this explains why MLP?s have traded so poorly and why they are so cheap today.

We urge caution as buying MLPs in today?s environment is a ?catching the falling knife? trade. AMLP has fallen nearly 25% over the last few months and may continue to fall further, especially as tax selling occurs over the coming weeks. It has also been in a longer-term downtrend since 2017. We are unlikely to call the market bottom in MLPs and therefore intend to scale into a larger position over time. We will likely buy our first set of shares opportunistically over the next few weeks or possibly in early 2020. Readers will be alerted at the time. We may possibly use leveraged MLP funds in addition to AMLP.

It is worth noting this position is a small part of our portfolio and fits within the construct of the entire portfolio. While the value proposition is great, we must remain cognizant of the current price trend, the risks of owning MLPs, and how this investment changes our exposure to equities and interest rates.

This article focuses predominately on the current pricing and value proposition. We suggest that if you are interested in MLPs, read more on MLP legal structures, their tax treatment, and specific risks they entail.

AMLP does not require investors to file a K-1 tax form. Many ETFs and all individual MLPs have this requirement.

**MLPI and AMLP were used in this article as a proxy for MLPs. They are both extremely correlated to each other. Usage was based on the data needed.*