Indexing Midstream Energy

As you know, the midstream energy sector has undergone some major changes in recent years. With more than $20 billion in passively managed assets, we feel that it is time to review the indicies that track the sector to make sure that they still accurately represent today's midstream investing environment. Sector dynamics have shifted as many simplifications/mergers have occurred, sources of capital have changed, tax reform plans were put into effect (both broad and industry specific) and regulations continue to evolve.

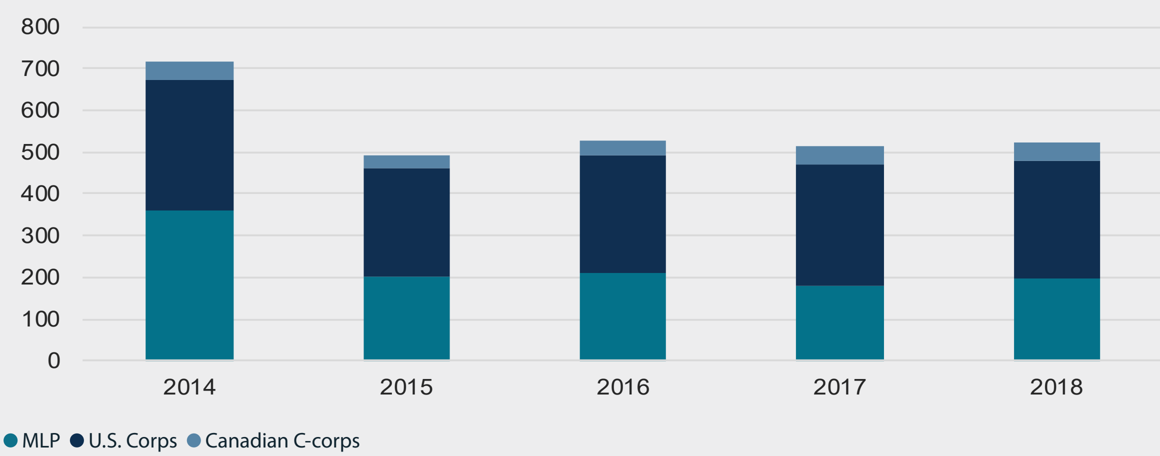
In our recent piece, "Choosing the right index for energy pipeline exposure", we highlighted how these changes have impacted the relative market caps of pipeline companies (MLPs vs. C-Corps). We also highlighted how MLP distribution cuts, either direct or those resulting from corporate actions, have negatively impacted aggregate cash flows. Historically, many investors have considered MLPs to be synonymous with midstream, but that assumption is less true today than it ever has been.

What do all the recent changes mean for passive investors in the midstream space?

Regardless of how you choose to invest in midstream energy, consolidations and simplifications have reduced the number of companies in the universe, with MLPs impacted materially more than non-MLP pipeline companies. While we still believe achieving a diversified portfolio purely through MLP exposure is possible, it's certainly much more difficult than it used to be, particularly for passive investing.

Let's look at the breakdown of the midstream energy sector as represented by the Tortoise North American Pipeline Index℠ (TNAP), which we believe is the most comprehensive representation of the midstream energy sector.

TNAP segment breakdown (billions)

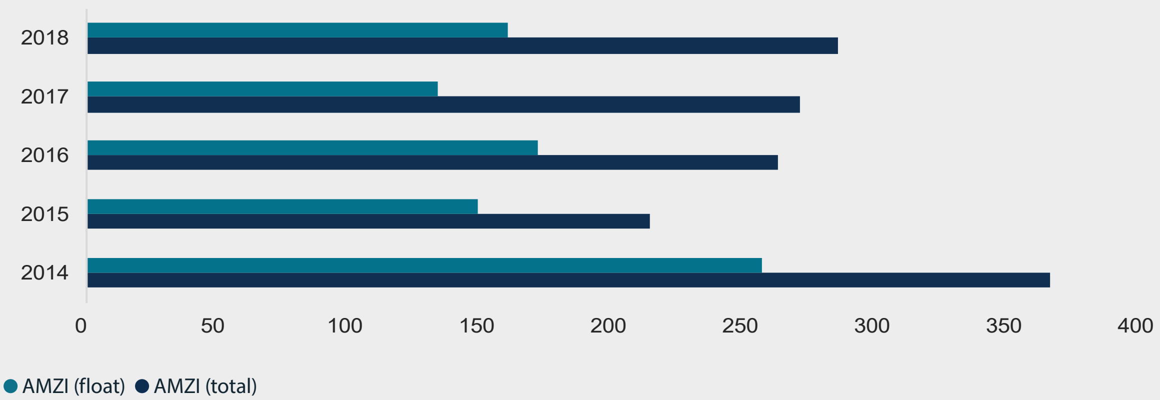


As of 9/30/18. Source: S&P Index, Bloomberg

As you can see, over the years, MLPs have dropped as a percentage of the midstream universe, while corporations have remained fairly steady.

The previous chart uses float-adjusted market cap, as a significant portion of MLP shares are privately held; the float-adjustment gives a better representation of what is actually investable. To illustrate this point, below is a chart showing the market caps of the Alerian MLP Infrastructure Index (AMZI), a popular MLP midstream index.

AMZI market caps



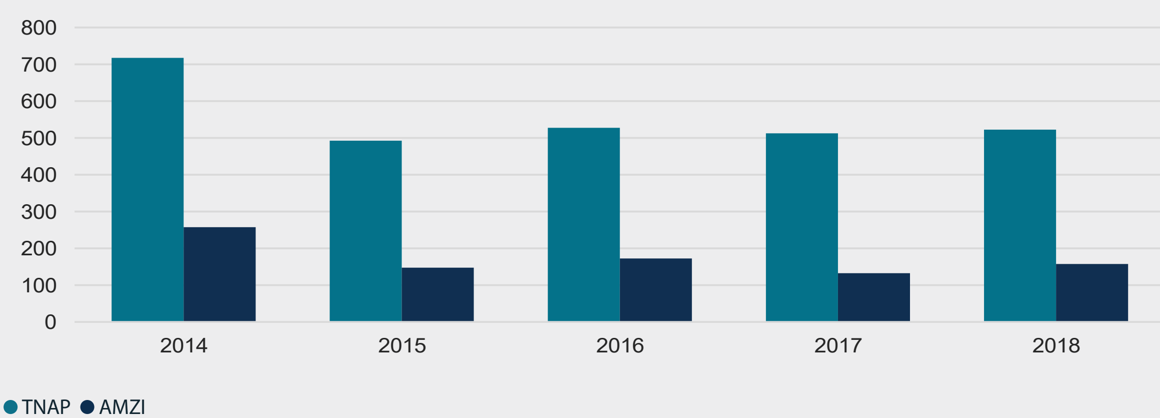
As of 9/30/2018. Source: S&P Index, Bloomberg

At the end of Q3 2018, although the total market cap of midstream MLPs was $285 billion, the actual float adjusted market cap was only $160 billion. While $160 billion may seem like a big number, it's actually a very low number for an entire asset class. The market cap of the S&P 500 is approximately $25 trillion and the market cap for XLE is over $1.2 trillion.

A quick assessment of the liquidity of the MLP asset class can further emphasize the relative size of the space in 2018. Based on existing AMZI constituents, and assuming 25% of volume is reasonable, approximately $130 million is tradeable in a single day based on the liquidity of the individual AMZI constituents. With $25 billion in passively managed MLP products and more than $10 billion in products that track AMZI, there is significant potential risk and enhanced volatility since even only 2-3% of the money coming out could very easily create a liquidity event. That further begs the following question; with all of the changes that have taken place in the midstream energy space since 2014, is it still possible to achieve a diversified and liquid portfolio?

There is more to midstream energy investing than just MLPs, and TNAP is our representation of the complete midstream universe. With 75 names in TNAP compared to only 25 names in the AMZI, investing in the broad midstream sector provides a more diversified portfolio with significantly less concentrated exposure and more market cap, as noted in the chart below.

TNAP and AMZI float adjusted market caps



As of 9/30/2018. Source: S&P Index, Bloomberg

Based on the chart, it's becoming increasingly difficult to achieve a passive diversified MLP-only portfolio. With MLPs representing roughly one-third of the total midstream market cap, asset managers are realizing that in order to provide a complete and diversified midstream portfolio, non-MLP pipeline companies must be included. Many actively managed MLP funds are expanding their mandates to allow for more non-MLP pipeline companies, and passive inflows into broader midstream ETFs are increasing.

One proof point supporting the idea that MLPs do not equal midstream, is that five of the largest ten "pure-play" midstream companies are not MLPs and thus are not included in these MLP-only indices. These names are Kinder Morgan, Inc. (KMI), Enbridge Inc. (ENB), The Williams Companies, Inc. (WMB), ONEOK, Inc. (OKE) and TransCanada Corporation (TRP). While KMI, WMB and OKE all previously had MLP relationships, consolidation and simplification transactions reorganized these companies resulting in combined entities that are not MLPs. However, we believe these companies and their high quality assets are essential components of the midstream landscape.

In addition to the benefits provided by a much larger and more diversified universe, passive midstream indices with a broader strategy have historically provided better returns, lower volatility and thus better risk-adjusted returns.

TNAPT vs. AMZIX - Indexed 5-year total returns

	TNAPT	AMZIX
Returns		
10-year	12.6%	10.0%
5-year	3.9%	-2.8%
3-year	8.0%	3.9%
1-year	7.4%	3.3%
Std. Deviation		
10-year	15.3%	19.1%
5-year	14.5%	18.5%
3-year	13.6%	18.9%
1-year	12.1%	19.1%
Sharpe Ratio		
10-year	0.86	0.60
5-year	0.34	-0.06
3-year	0.63	0.30
1-year	0.65	0.27

As of 9/30/2018. Source: S&P Index, Bloomberg

We do not recommend divesting of passive products that track MLP only indices. Some income-focused investors may be more attracted to MLP-only indices because of their higher yield, and we still firmly believe that MLPs are part of a core strategic allocation. However, it is also clear that midstream energy investing is not as simple as it was years ago. In this context, we believe a concentrated MLP position and the inclusion of a product with broader midstream exposure has historically provided investors greater diversification, lower volatility and higher total and risk-adjusted returns.

Disclosures

The characteristics provided for the index are illustrative of the characteristics of an asset class and are not indicative of the performance of any investment product. The historical data of the index prior to its inception date was calculated on the same basis on which the index is currently calculated. Past characteristics are no guarantee of future results. It is not possible to invest directly in an index.

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The Alerian MLP Index is one of the leading gauges of energy Master Limited Partnerships (MLPs). The capped, float-adjusted, capitalization-weighted index, whose constituents represent approximately 85% of total float-adjusted market capitalization, is disseminated real-time on a price-return basis (AMZ) and on a total-return basis (AMZX). The Alerian MLP Infrastructure Index is a composite of energy infrastructure Master Limited Partnerships (MLPs). The capped, float-adjusted, capitalization-weighted index, whose constituents earn the majority of their cash flow from midstream activities involving energy commodities, is disseminated real-time on a price-return basis (AMZI) and on a total-return basis (AMZIX).

For additional information on TNAP, please call 844-TR-INDEX (844-874-6339) or visit www.tortoiseadvisors.com.
For more information on AMZ or AMZI, visit www.alerian.com.