



## Thought for the Week: Monday, June 28<sup>th</sup>, 2010

### Investing for Income in an Unstable Market

In recent weeks we have written about the prospects for the economy with regard to inflation/disinflation/deflation and the effect these possible paths may have on investors and DIAS portfolios.

Although Global Leaders (G20 Summit, U.S. – China discussions, etc.) are working hard to keep interest rates low, at some stage we have to assume **the following will happen:**

- Interest Rates will Rise
- Bond Prices will Fall
- Taxes on Income will Increase

One component of our investment philosophy is to **prepare our portfolios for the next financial battle** and not align them based on the battle we just had. This means that we know that interest rates may take some time to rise, but we want to be prepared for this event because the price of bonds may start falling on expectation, not reality, of interest rate policy.

With this in mind, **Global is diversifying the risk of falling bond prices in a rising interest rate economy** by investing a small portion of income portfolios in Master Limited Partnerships (MLPs).

#### MLPs can provide:

- Attractive, consistent Yield
- Price Appreciation Potential based on the operations of the partnership generating the income
- Tax Efficiency

#### What is an MLP?

An MLP is actually **a partnership company with shares that trade publicly**. It is either a Limited Partnership or an LLC choosing partnership taxation. A share is called a "Unit" and a shareholder is called a "Unit Holder." Limited Partnerships have a General partner that manages the MLP and Limited Partners that have no management role but contribute capital and receive distributions. LLCs have no General Partner and their Unit Holders have voting rights, just like normal corporate shareholders.

The most important distinction between MLPs and Corporations is the way in which their investors are taxed. Like all partnerships, **MLPs pay no corporate income tax; the partnership's income, gain (loss) and deductions are allocated amongst the partners for tax purposes**. In addition, distributions are generally considered return of capital and may therefore be taxed at a lower rate than income.

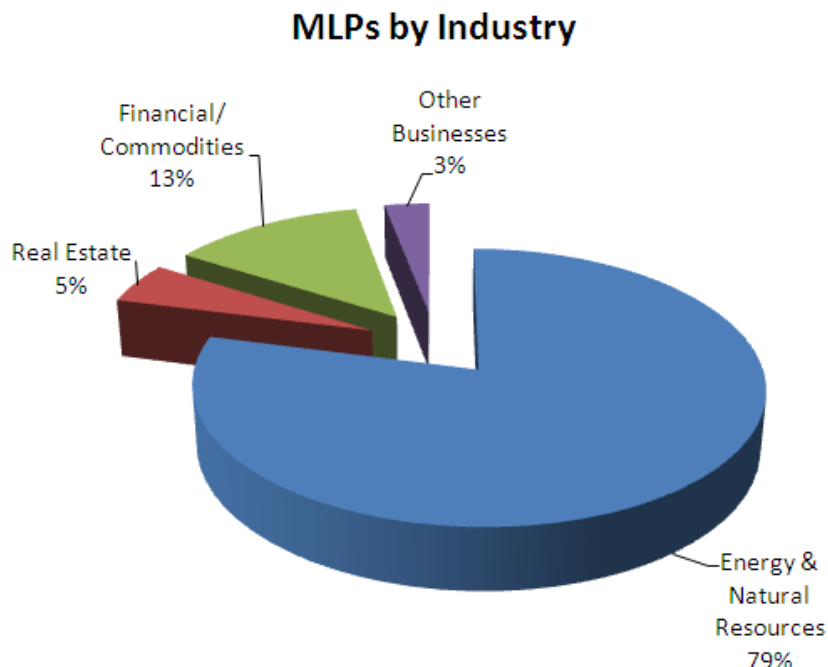
## Why do we Own MLPs?

- Because **MLPs don't pay tax**, more of its earnings can be distributed to investors. This is the basic policy of most MLPs: Distribute all earnings that are not required for operations, etc. It makes them an attractive alternative to many income-based investments.

- MLPs are generally natural resource/energy related. **They operate like Toll Booths** in that they own infrastructure and generate revenue from the movement of resources through their infrastructure. This fits well with the type of investment we are attracted to: **solid cash flow generators with franchise-type business models**.

- **Many professional investors are starting to reduce their exposure to Bonds**. This is a positive factor for MLPs as their prices should benefit from increased demand.

- In addition to providing attractive income, which may have tax benefits for some investors, **MLPs may provide capital appreciation** generally in line with economic growth and prospects for energy/natural resource usage. Given that we remain positive on the long term prospects for steady global economic growth, we expect MLP prices to be stable at worst going forward.



## What are the Negatives of MLPs?

MLPs are not immune from the regular shocks suffered by financial markets. We feel they are well positioned for the medium to long term for the following reasons:

- **Over the short term, MLP prices may be more volatile than Bond Prices:** This has been true recently; however, we feel MLP prices are better positioned for the long term than Bonds. The activities of the MLPs we invest in are the backbone of the American economy and this won't be going away anytime soon. Revenues will continue to produce high income levels and the underlying investment will stay strong. We look for an edge in our investing; we don't simply follow the crowd. Any weakness in MLP pricing is generally a good time to invest. In general, larger MLPs weather equity market weakness better than most.



- **Commodity Concerns:** Many investors feel MLP prices move with commodity prices and their distribution rates will vary in a similar manner. In fact, MLPs are fee-based companies, charging a fee for distribution. There will be short term sensitivity to the outlook for commodities but once again, this is more emotional than fundamental.
- **Credit Market Concerns:** In order to grow, many MLPs rely on access to capital markets as they distribute their earnings instead of retaining it for growth, acquisitions, etc. When credit markets close, the growth abilities of MLPs tends to recede. The larger, investment-grade MLPs we tend to invest in seem to be able to access capital fairly easily and cost effectively at the moment. We don't see this changing significantly as they have excellent balance sheets and cash flows.

**MLPs have proven more volatile than Bonds recently**, as recurring growth and economic concerns have impacted stock prices and allowed policy makers to keep interest rates low. **At some stage this trend will change** and the lower sensitivity to interest rates offered by MLPs will justify our use as a diversification method.

**In the meantime, we are comfortable receiving the levels of income MLPs produce and maintaining an investment in such solid, well financed entities.**

**This is one way we are positioned for interest rate and tax rises.**