ADVISORY RESEARCH
INVESTMENT MANAGEMENT

MLP & Energy Infrastructure Market Commentary

Third Quarter 2018

OVERVIEW

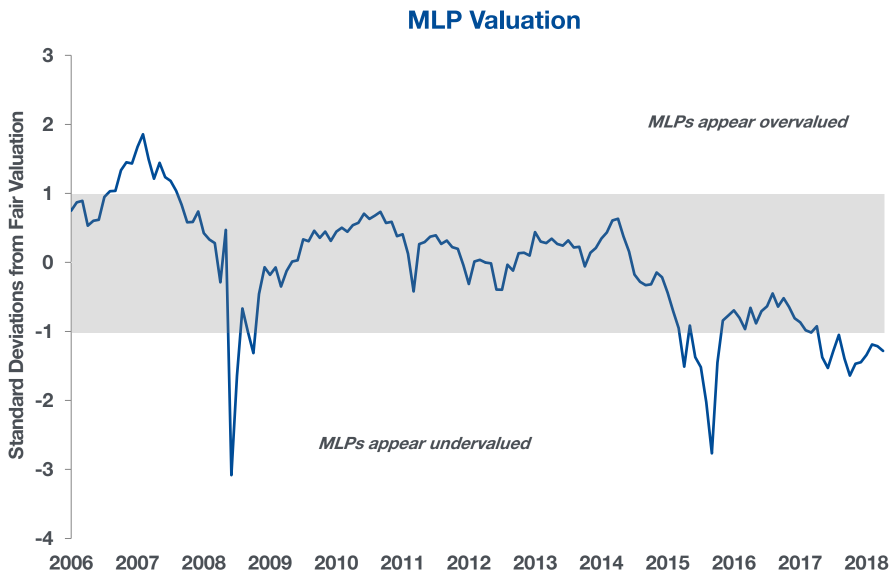
Master Limited Partnerships ("MLPs"), as represented by the Alerian MLP Index ("Index") returned 6.57% during the quarter ended September 30, 2018. The strong third quarter result brought the Index's year-to-date and one year returns to 5.90% and 4.89%, respectively.

OUTLOOK

Energy infrastructure earnings climbed to all-time highs in the third quarter. Index returns took their lead from earnings and posted their second consecutive solid quarter. Returns cooled in September and investor sentiment, possibly still scarred by the recent bear market, was negative and very fixated on potential future roadblocks. Although it is easy to point to potential problems on the horizon, the message on the ground is loud and clear. Earnings are very strong, valuations are low, and investors should expect positive total returns moving forward.

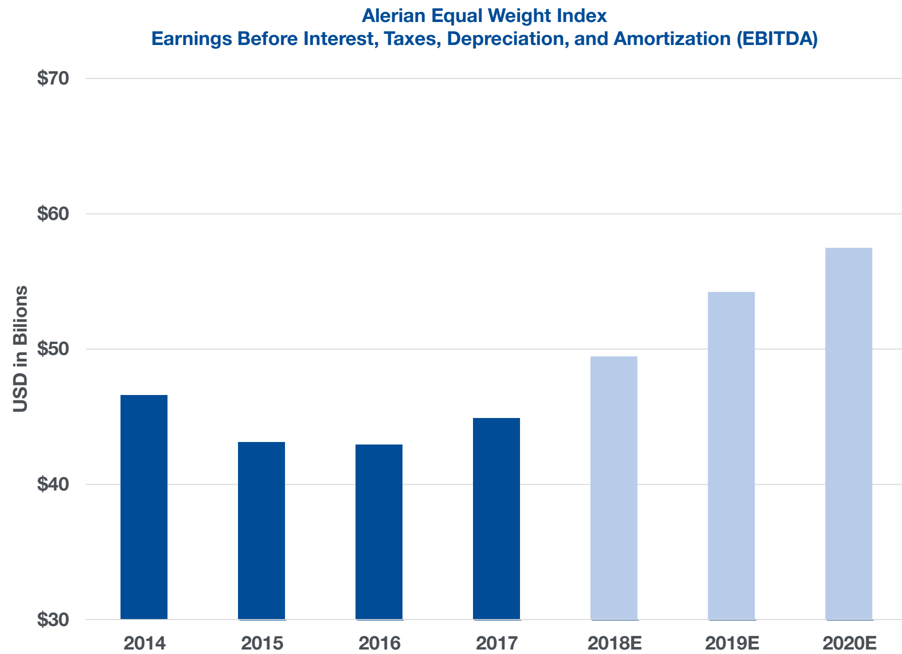
KEY ISSUES	Positive	Neutral	Negative	Comment
POLITICAL AND REGULATORY			☑	Despite the current Administration's favorable view towards domestic energy, local governments are creating an increasingly difficult operating environment
VALUATIONS	☑			MLPs remain undervalued on an absolute and relative basis versus comparable asset classes
COMMODITY PRICES	☑			Growing worldwide oil demand and higher prices should incent production; Prices for natural gas liquids have benefited from growing petrochemical demand
INTEREST RATES			☑	Rising interest rates are expected to eventually impact higher yielding securities, including MLPs, but could trigger flows into MLPs from Utilities shorter term
DISTRIBUTION GROWTH		☑		Distribution growth is expected to be in the low single digits
ENERGY INFRASTRUCTURE BUILD-OUT	☑			Growing energy exports are expected to support new infrastructure spending over the next several years.

Valuation is still attractive even after strong second and third quarter returns. Our view of current valuation is below.



Period: 12/31/06 – 09/30/18. Source: FactSet Research Systems. Composite valuation based on both relative and absolute valuation metrics. Valuations and long-term return expectations do not represent or predict the performance of any particular investment. Standard deviation is a measure of volatility, which shows how much variation exists from the average return.

Our positive outlook is also based on the continued build out of U.S. energy infrastructure supported by increasing domestic energy production and increasing demand, particularly in the form of exports. Growth from this infrastructure build out is translating into record earnings for many energy infrastructure entities in our investment universe. We expect these earnings increases to continue as shown in the chart below.



Data as of 9/30/18. Source: Advisory Research, FactSet Research Systems. Note: Data is based on annual observation using the current Alerian MLP Equal Weight Index constituents. Numbers are sell-side estimates sourced from the FactSet Research Systems estimates database. The data used for each security is the Consensus Median Estimate.

The improving e [illegible]. After a double-digit total return in the second quarter, the MLP Index posted another respectable positive return in the third quarter. We expect results for investors to remain positive, particularly relative to other higher-yielding assets.

In September, returns took a negative turn. It seems reasonable to expect occasional pullbacks during a strong recovery. We expect that September's weak returns will be viewed as a pause, not an end to this rebound. There were a couple of items that likely contributed to the weakness. Those include a tricky political and regulatory environment as we approach the November elections, rising interest rates, and self-inflicted wounds by MLP sponsors and management teams.

The political and regulatory issues are notable enough that we have changed the rating on that key issue from neutral to negative. During the second and third quarters, investors spent considerable energy digesting the Federal Energy Regulatory Commission's (FERC) bad, and then not so bad, rulings in regards to pipelines tied to MLPs. In September, investors shifted focus to Colorado ballot Proposition 112. The proposal, if implemented as written, would have a negative impact on Colorado drilling activity and long-term production. While some respected observers believe that Proposition 112 has even odds of passing, it is worth noting that there is another Colorado ballot initiative (Amendment 74) that would require property owners be compensated for any reduction in property value caused by state laws or regulations. In addition, the Colorado Legislature has the authority to make changes to Proposition 112, if passed. While opposition by environmental groups will likely continue, we believe that Colorado will remain a significant producer of energy for the foreseeable future.

Rising interest rates, which we have noted as a concern for some time, have gained the focus of investors twice this year. While rising rates are perceived to have a negative impact on yield-oriented asset classes, the table below illustrates that MLPs generally outperform bonds when interest rates are rising. We expect that will be the case this time as well.

MLP Returns
in Previous Rising Rate Environments

Period		Total Return	
From	To	MLPs	10 Yr Treasury
3/17/2008	6/13/2008	9.9%	-6.7%
12/18/2008	4/5/2010	67.7%	-8.8%
10/8/2010	2/8/2011	9.7%	-9.6%
9/22/2011	3/19/2012	20.5%	-4.3%
7/24/2012	12/31/2013	19.1%	-6.6%
7/8/2016	9/28/2018	1.3%	-4.7%
Average		**21.3%**	**-6.8%**

Data as of 9/28/18. Source: FactSet Research Systems. MLPs represent the Alerian MLP Index. Interest Rate cycles based on daily data for US Treasury Bond - 10 Yr. Returns for periods less than 1 year are unannualized.

Governance remains a concern. During the quarter, several MLP sponsors/general partners announced that they were planning to buy in all of their units from their limited partners. In most cases, these transactions offered minimal upside to the limited partners and little leverage for limited partners to ensure fair value for their units. Worse yet, we have seen several of these buy-in offers come soon after significant distribution cut announcements, which have the effect of lowering the value of the limited partnership units making the buy-in more attractive for the sponsor. While many MLP sponsors have treated their limited partners very well over many years, the unfriendly actions of the few will force other MLPs to improve their governance going forward.

While the concerns over political, interest rate, and governance issues are important, we believe they are being assigned too much weight in today's market. We are choosing to focus on the growing earnings and cheap valuations for our energy infrastructure universe. We believe the future return outlook remains strong.

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Investing involves risk, including the possible loss of principal. Past performance is not indicative of future results. An investment in MLP units involves risks that differ from a similar investment in equity securities, such as common stock, of a corporation. Holders of MLP units have the rights typically afforded to limited partners in a limited partnership. As compared to common shareholders of a corporation, holders of MLP units have more limited control and limited rights to vote on matters affecting the partnership. There are certain tax risks associated with an investment in MLP units. Additionally, conflicts of interest may exist between common unit holders, subordinated unit holders and the general partner of an MLP; for example, a conflict may arise as a result of incentive distribution payments.

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