Market Commentary

Ain't we got all the fools in town on our side? And ain't that a big enough majority in any town?
–Mark Twain, *Huckleberry Finn*

A volatile third quarter pushed major equity indexes into negative returns for the year. As of September 30, the S&P 500 was down 5.3%, while small cap stocks were down nearly 8%. Biotech – the best performing industry through the first half of the year – gave up its gains during the third quarter. Concerns over Chinese growth and plummeting oil prices led to further declines in the Energy and Materials sectors. Developed markets outside the US fared slightly better with the MSCI EAFE Index returning -4.9%. Countries where exports of natural resources constitute a significant portion of GDP fared poorly, particularly Brazil which is down nearly 40% in US Dollar terms. MLPs reached what could only be described as panic selling toward the end of the quarter with the yields of many investment grade MLPs surpassing 2008 levels. September also marked the worst month for hedge funds since 2008, with many prominent funds now posting double digits losses for the year.

Emerging markets, most notably China, have been the primary contributor to global economic growth since the 2008 Financial Crisis. With developed markets saddled with debts from the crisis and its aftermath, emerging markets became the primary consumers of new credit. As these less developed economies need new investment in businesses and infrastructure, increased borrowing was not inherently a bad idea. However, the cycle appears to be running its course and is beginning to correct. At the end of 2008 companies domiciled in emerging markets carried approximately 70% of the average debt load of corporations in developed markets. Emerging market companies now have modestly higher debt ratios than their developed market peers. The concentration of these borrowers in the heavily cyclical natural resource, construction and manufacturing industries compounds the problem.

The global economy is currently in the process of adjusting to the end of a commodity and borrowing cycle driven by China's record setting real estate and infrastructure investment binge that began in 2009. These redeployments of capital often result in painful recessions as it takes time for job creation in new sources of growth to overtake the job losses from sectors with declining investment. So far, the developed world has remained largely immune to slowing growth in emerging markets. However, the IMF cut its forecast for global GDP growth for 2015 and 2016 to 3.1 per cent and 3.6 percent, respectively and warned that the EM slowdown poses risks to the global economy. The organization considers global growth of below three per cent to designate a recession.

Is the MLP Business Model Dead?

Swept up in the collapse of oil prices, MLPs delivered their worst performance since the collapse of Lehman Brothers. Many companies fell so far that their double-digit yields surpassed the lows of 2008. Feeding the panic in a series of articles on his blog, Brian Nelson of Valuentum Securities argued that the MLP business model is dead. Barron's and several other financial sites picked up and carried his posts.

Brian Nelson based his argument on the uncontroversial observation that because MLPs distribute most of their cash flow, they rely on external financing to grow their asset base. With some manipulation of accounting jargon, he makes the rather provocative claim that MLPs *do not generate enough traditional free cash flow to cover their cash distributions and dividends.* MLPs, he argues, must therefore borrow money to pay investors their distributions. This contention sounds alarming, implying that MLPs employ an unsound financial model that may be collapsing before our eyes.

MLPs generally cannot cover their distributions with free cash flow and do borrow money to make up the difference. However, this simply represents a rather deceptive spin on some basic accounting identities. Free cash flow consists, by definition, of operating cash flow less capital expenditures (i.e. new investments by the firm). Every company, not just MLPs, faces a choice between returning cash earned from existing operations back to shareholders through dividends (or share repurchases) and reinvesting earnings into new investments that grow the company. If a company wants to grow beyond what it can earn by reinvesting retained cash, it must raise some combination of debt and equity capital. As MLPs distribute most of the cash from existing operations, they must turn to the capital markets to fund new projects.

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The only ‘evidence’ offered in support of the unsoundness of the MLP business model consists of a table showing that for most midstream MLPs distributions exceed free cash flow. However, dividends also exceed free cash flow for a good many stocks in the S&P 500, including Exxon Mobil, Goldman Sachs, Morgan Stanley, Chevron and nearly the entire REIT and Utilities sectors. Are these companies also ‘dead business models’? Is paying dividends in excess of free cash flow bad corporate management or a sign of something more nefarious?

The misleading part of the argument comes from comparing free cash flow to dividends. Saying that MLPs distribute cash earnings from their existing assets to their unitholders and then raise new capital to grow their asset base, means in accounting terms, exactly the same thing as stating that MLPs cannot cover their distributions with their free cash flow and therefore must borrow money and/or issue new equity to pay distributions. Again, free cash flow equals operating cash flow less new investments, so the entire argument relies merely on manipulation of accounting jargon. In reality, these decisions on dividend policy and capital structure, within certain limits, make absolutely no difference in the overall value of a firm. If a company can access the capital markets to raise new equity and debt capital to expand, then it should do so.

MLPs not without Risk - Diversification Required

However, MLPs are not without risk. Some analysts have questioned whether some companies play games with which spending gets classified as maintenance of existing assets as opposed to capital for investing in new assets. Management, particularly in those MLPs with a GP structure which get a percentage of distributable cash flow, has an incentive to overstate the amount of cash they can sustainably distribute. Labelling maintenance spending as new investment would make the company appear to generate higher cash returns on its existing assets. The cost of this policy would eventually come due as new projects would generate proportionally lower returns due to this misallocation of costs. With over twenty years of financials from many large MLPs, it should have been apparent by now if the industry did this systemically over a long period of time.

Even worse, despite being heavily regulated by the Federal Energy Regulatory Commission and state agencies, MLPs could obtain short term gains by skimping on maintenance expenditures. The recent debacle at Volkswagen demonstrates that a determined or incompetent management team can get away with deceptive and fraudulent practices for years. Outright skimping on maintenance will of course eventually result in accidents that injure people and spill petrochemicals into the environment. The safety record of the industry remains good and widespread cheating on maintenance should have also been apparent through increased accident and failure rates.

MLPs do rely on access to the often fickle capital markets to finance new projects. However, unlike REITs, MLPs are not required to make distributions to unitholders. If the public markets shut down to the issuance of new MLP debt and equity these companies would have the same options as any corporation in a similar situation: The MLP could either cease investment in new projects and distribute cash flow from current projects or suspend distributions and use the cash flow to fund new investments. Additionally, the firm could turn to alternative capital sources such as private equity or hedge funds.

Similar risks exist across all equity securities - MLPs are no exception. Diversification provides the only answer to these uncertainties. Comstock’s allocation guidelines generally limit MLPs to 20% of a portfolio’s risk assets (the total amount outside of investment grade fixed income and cash). This weight compares to the larger sector weights in the S&P 500 such as Technology or Healthcare. While MLPs have nowhere near the market capitalization of these sectors, 20% makes a reasonable limit on exposure to the idiosyncratic risks of a single industry. Beyond this limit, diversification of individual MLPs protects against a single bad management team or a particular company’s geographical or product concentration from damaging the overall portfolio.

MLPs compare positively to other stocks in many regards. We are encouraged by the amount of regulatory oversight and the fact that management owns large amounts of the partnership units directly rather than being compensated with stock options that too often incentivize a destructive short term mindset. Financial leverage remains moderate with portfolios concentrated in companies with the strongest balance sheets. The industry benefits most from increased consumption of natural gas, not high oil prices. The trend of replacing aging coal electric generation plants with cleaner and more efficient natural gas will continue. Demand for exports of natural gas will increase as new facilities come on line.

Understand the Risks of What You Own in a Volatile Market

We remain concerned about the spillover of fading emerging market growth to the developed world. As financial markets enter a period of higher volatility, knowing what you own becomes critical. How many investors got flushed out of their MLP positions at or near the bottom because they did not understand the structure or the industry when they originally purchased the securities? Comstock’s emerging market strategy has been to participate in economic growth and rising household incomes across these regions through investment strategies focused on products and services consumed by local consumers and businesses. These sectors have lower leverage ratios and more stable revenue streams. Similarly, MLPs offered participation in the technological revolution in shale oil and gas by focusing on consumption economics rather than production economics. We remain confident that both approaches will generate superior results in the long run.

- Stephen C. Browne, CFA
Chief Investment Officer
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