SOMEBODY STOP ME!

By William H. Gross | October 24, 2024

For nearly 2 years I have been recommending MLP pipelines (Master Limited Partnership) as an attractive energy play with high yields and upside price potential. As a group this shrinking universe of stocks/partnerships has appreciated 30%+ over the past 2 years compared with 5-10% appreciation for XLE — an ETF featuring Exxon, Chevron, Williams, ONEOK, etc. The MLPs have in addition provided an average yield of 8% annually versus 3% for XLE.

Well — past is not necessarily prologue, but their outperformance may well be due to the structural characteristics of MLP pipelines and the lack of sponsorship by Wall Street firms and mutual funds. One structural key is the fact that MLPs are masquerading as stocks on the NYSE but have tax advantages as partnerships given to them by Congress in the mid-1980s.

These advantages primarily derive from the fact that the U.S. government agrees not to currently tax their dividends (just like many real estate partnerships) but will collect taxes only when sold. Huh? I'm referring not to capital gains but dividend income which is paid every tax year. As an MLP investor, you still have to pay a long-term capital gain rate for those dividends but only when you sell, which if you're a long-time investor could be 10, 20, 30 years in the future. It is this deferral (in law for 30+ years now) that makes a big difference if dividends are reinvested and allowed to compound. The compounding deferral could add as much as 1% or so over a 5–10-year average holding period, turning the 8% average to a 9-10% dividend return on your portfolio.

How has this huge tax break been undiscovered for MLPs' since the mid-1980s?

In my opinion, Wall Street research firms, while providing fundamental research, fail to even mention these tax advantages for fear of being sued if not legally explained. Not once in the past 2 years of my experience have I read a mention of MLPs' tax advantages. They do mention that investors need to fill out a special "K-1" tax form for MLPs that is complicated and messy with the implication that an investor would need a tax consultant to help them — but no mention ever of the important deferral. Instead they recommend what are known as C corp pipeline stocks like WMB, OKE, KMI…which do not have the partnership advantages of MLPs and sport much lower 4% taxable dividends. Why?

Messy K-1's and potential legal issues. Add to this the fact that if mutual funds buy them, there may (probably) be a requirement for mutual fund holders to file the same K-1 if held separately. To my knowledge very few mutual funds own MLP pipeline stocks and probably for that reason, NO SPONSORSHIP!

Most potential buyers don't want the hassle at tax time. But as Jim Carrey in "The Mask" was quoted as saying, "Somebody stop me!" I'll take the temporary hassle almost all the time versus their C corp alternatives.

Now at this point I have to admit that some C corp pipeline stocks have current advantages. Some of them are primarily gas as opposed to oil pipelines and are currently in high demand as stocks because AI service centers currently use primarily gas as an energy source. Some MLP stocks have a small gas component (ET, WES) but there is a current bias for C corp pipelines (like WMB, OKE, KMI) and they are up 20% on average in the past 2 months whereas MLP pipelines are up 3-4%. There's less AI sex appeal for MLPs. But as a long-term investment? MLPs vs. C corps are an obvious choice. PE's at 12 versus 20, yields at 8% versus 4.

Individual stock choices? Well as mentioned, there is a diminishing list due to tender offers and other reasons. Here's my available list in no particular order: WES, PAA, ET, EPD. HESM, MPLX. I currently own 30% of my portfolio in these stocks.

And oh yeah — consult your tax attorney for opinions and possible contradictions on this IO. I'm not a tax expert but sometimes a good observer in discovering structural alpha-positive investments like this that I did at PIMCO.