



VOLATILITY IN A NICHE MARKET SEGMENT

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The last month has seen tremendous volatility in a niche segment of the market known as Master Limited Partnerships (MLPs). MLPs control important elements of the nation's infrastructure. These "mid-stream" energy companies process natural gas and oil from drilling sites, manage thousands of miles of gathering and distribution pipelines, and maintain important storage facilities. It is no exaggeration to say that without these assets we could not heat our homes, drive our cars, or power our cities.

Mid-stream MLPs offer a highly stable business model with long-lived assets and substantial cash flow. Revenues are volume sensitive and not strongly tied to the price of commodities. Whether oil is \$20 or \$120, they earn the same fee for their service. A recession would only cause a mid-single digit decrease in volumes, which would be partially offset by contractual price increases.

Despite these fundamentals, MLPs have been one of the worst performing sub-sectors of the market in the last six weeks. From September 1st through October 10th, MLPs declined over 40%, and yields rose from 7% to over 13% for the most established firms (and to over 20% for small-cap names). The selling pressure has been incredible, and the yield spread over Treasuries is unprecedented in the last twenty years.

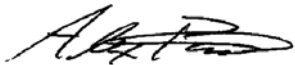
An investor must constantly strive to balance what they think they know with what the market may be telling them. The distressed yield levels of MLPs suggested that these firms were bankruptcy candidates. Every objective data point (aside from the stock prices) suggested otherwise, but claims of financial strength are irrelevant in the face of unrelenting selling.

Why own MLPs?

- 1) MLPs are critical infrastructure that as a group must be allowed to function. If the financial system truly broke down, oil and gas producers might stop supplying the market out of fear that they would not be paid. The country would grind to a halt in a matter of days. The government simply could not allow that scenario to happen. Almost every asset class appeared cheap in early October, but few were backed by as strong an asset base as MLPs.

- 2) The balance sheets and growth prospects of MLPs remain strong. No MLPs face any meaningful debt refinancing deadlines, and cash flows are growing. Growth would certainly slow down if MLPs were unable to raise capital in the coming years, but with mid-teen yields they are attractive investments.
- 3) We believe that forced sellers are dominating the market, and fearful sellers are following them off the cliff. Lehman Brothers was a significant holder of MLPs for their own account and for clients. Also, some banks had written swap agreements for foreign buyers of MLPs looking to avoid unfavorable foreign tax treatment. In September, banks raised their margin requirements on these swaps, and many clients declined to add more money to their accounts. This increased the selling pressure further as the banks were now at risk of losing their own capital on the swap.

It is impossible to predict how low a stock can fall when the seller is indifferent to price and fundamentals are irrelevant. Even with the 25% bounce off the bottom, these assets are still selling at historically low valuations and offer 50%+ upside.



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