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Know the MLP pitfalls before putting money in

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Tanglewood Wealth Management, Senior Investment Officer Curtis J. Holden. (James Nielsen/ Houston Chronicle)

HOUSTON — A weakened bond market has pushed frustrated investors to buy more shares in U.S. companies, and while the nation's oil wells gush, many are parking their cash in the energy industry.

Last year, Wall Street acquired a taste for a rare vintage in the oil and gas business: the master limited partnership. Typically pipeline operators, the tax-advantaged corporate structures offer investors regular cash distributions that in some cases more than triple what investors could take home from the bond market. Investors bet $5 billion on public offerings of oil and gas MLPs in 2013**.**

But it's a complex security, and the average investor could run into unexpected pitfalls while stockpiling MLP units. Many have tapped into the securities for their high yields, without fully realizing that they are not like bonds at all, but subject to the roller coaster price fluctuations of the stock market, said Curtis Holden, a financial adviser at Houston-based Tanglewood Wealth Management.

"It makes a nice addition to the portfolio, but some investors don't fully understand there could be some downside," said Holden, who may advise clients to invest in mutual or exchange-traded funds that have invested in MLPs. "It's not like buying a certificate of deposit at the bank; it's more dynamic than that."

Given all the media attention to the North American oil and gas boom – and the demand for pipelines between U.S. shale plays and crude markets - it's easy for investors to rush into the snares of an unfamiliar energy stock.

MLPs can be unruly: A few have plummeted on the stock market in 2013, and even though they are known as having tax advantages, owning MLP units is not completely tax free for investors, Holden said.

Fuelfix spoke with Holden last week about what investors can expect when dipping into the energy industry and its most attractive offering, the MLP. Here are edited excerpts from that interview:

FuelFix: Why are pipeline MLPs so appealing to investors right now?

Holden: They make money off the volume of oil and gas moving through pipelines. They've had good growth and the ability to grow their dividends. You're probably looking at 4 to 7 percent growth in the MLPs' distributions. The 10-year Treasury bond had been sitting around 1.6 percent to 1.8 percent but recently shot up to 3 percent. There's probably money chasing the yield component, but there's also an understanding that there's more to the story than that.

FuelFix: Some say pipeline companies are a less risky investment in the energy industry than, say, oil and gas producers, because it's harder to know who will strike it rich at the well head.

Holden: That's why they like midstream MLPs. A lot of the exploration companies have made a lot of money, but the problem they deal with is they have all this new supply to the market. Gas prices are pretty low, and there are some pretty big refineries at the Gulf that have got all the crude they need. If prices were pushed down by the supply, it wouldn't be as profitable to do some of their ventures. The exploration side is a bit of a mixed bag.

FuelFix: **MLPs are known as tax-advantaged corporate structures, but what can investors in MLPs expect to pay in taxes?**

Holden: It's not completely tax free to you. The corporation is not paying a tax, but a portion of it, and you're going to pay some taxes. If you buy an individual MLP, like Kinder Morgan, you get a nice dividend payment on it, but it's different from buying, say, Exxon Mobil Corp., where your dividend payment is treated like regular income. Some income from the MLP distribution is treated as a return to capital: You don't have to immediately pay it, which is nice. But when you sell it, you'll trigger capital gains taxes.

FuelFix: Are there ways to work around the taxes?

Holden: If you buy a traditional MLP and put it in your individual retirement account, it can trigger some taxes. You don't want that. Your IRA is a vehicle you created to help avoid taxes. The advantage of buying an MLP-focused Mutual Fund is that they preserve the tax advantage feature. You can buy those in your IRA, and you don't have to worry about triggering those taxes.

FuelFix: **What are the disadvantages of buying MLP-focused Mutual Funds?**

Holden: I would caution investors about those funds because if more than 25 percent of their portfolio is pure MLP, it will trigger corporate taxes. The fund pays them, but that eats into your return. However, there are at least two mutual funds that work around that. They buy up to 20 to 25 percent in MLPs and then invest in other companies in the midstream space that are not technically MLPs. You don't want to run out there blindly and buy a mutual fund.