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AMJ – The Time Has Come

AMJ – The Basics

The JPMorgan Alerian MLP Index ETN (AMJ) is an exchange-traded note issued by JPMorgan Chase & Co. Its net asset value and cash distributions are based upon the Alerian MLP Index, by far the most widely recognized index of MLPs. Alerian MLP Index is made up of the 50 largest MLPs and constitutes over 75% of the available MLP market capitalization. At $3.3 billion, AMJ is by far the largest and most liquid MLP ETN. (An ETN is an "exchange-traded note" and unlike an ETF does not hold any actual securities.) Its expense ratio is a rather high .85%, but then, nearly all MLP ETFs and ETNs have a similar expense ratio. It has an extremely tight bid/ask spread of about .05%.

Master Limited Partnerships (MLPs) are companies that are organized as partnerships rather than corporations, and as such avoid paying corporate income tax. To qualify as an MLP, a business must generate at least 90% of its income from what the IRS deems "qualifying" sources, including the processing, storage, and transport of energy commodities. Most MLPs are oil and gas pipeline companies. They earn money by charging fees on the oil and gas moving through their pipelines. They generate a lot of stable cash flow and tend to pay out most of it in the form of cash distributions to their investors (although they aren't legally required to do so).

One advantage of the ETN structure is that as a note or debt security tied to an index, the fund issues a 1099. The MLPs themselves issue K-1s, which are more complex tax forms, often arriving late in the tax season, and sometimes requiring large investors to file returns in multiple states. In addition, MLPs may generate Unrelated Business Taxable Income (UBTI) that could be a nightmare for IRAs and tax-exempt institutions. Most investors prefer to avoid receiving K-1s.

The disadvantage of the ETN structure is that an ETN is a general obligation of the issuer and exposes investors to the credit of the issuer, in this case, JPMorgan. That is, if JPMorgan goes under, investors in its ETNs could lose all of their money just like other bondholders. The 2008 experience with Lehman Brothers made many investors leery of taking on this exposure. However, like all major banks, in the wake of the 2008 experience, JPMorgan is much more stringently regulated and has been forced to hold more capital and manage its risks more conservatively. The risk of default can be monitored and measured in real time using credit default swap rates. Currently, the CDS market charges about .4% to insure default on JPMorgan bonds for a one year term. JPMorgan's credit default swap rate is among the lowest of all major global banks.

The Strategic Case for AMJ – Why Ever Own It?

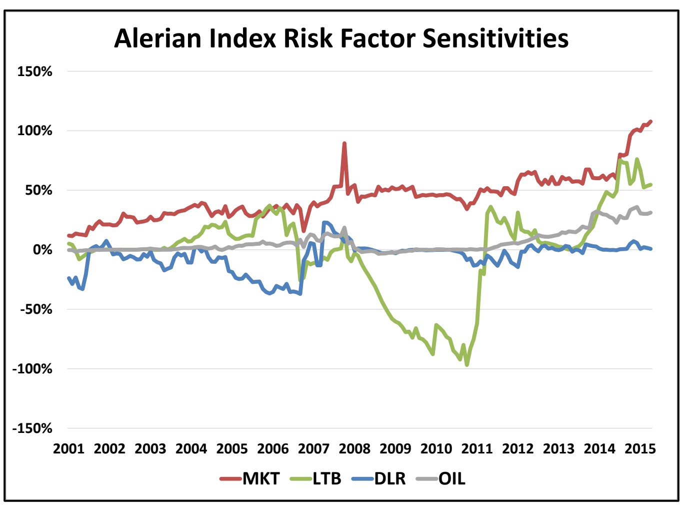
I like to invest in assets that are likely to be systematically underpriced relative to their economic benefits. MLPs are definitely in that category. The primary driver is the fact that, unlike C-corporations, MLP investors are taxed only once, not twice. The MLP itself pays no income tax—taxation occurs only when investors receive distributions. That is a major economic benefit.

MLPs are also likely to be systematically underpriced because few investors are willing to deal with the tax complexities of K-1s, particularly institutional investors. Fear of UBTI is another impediment. Fewer buyers usually means lower prices.

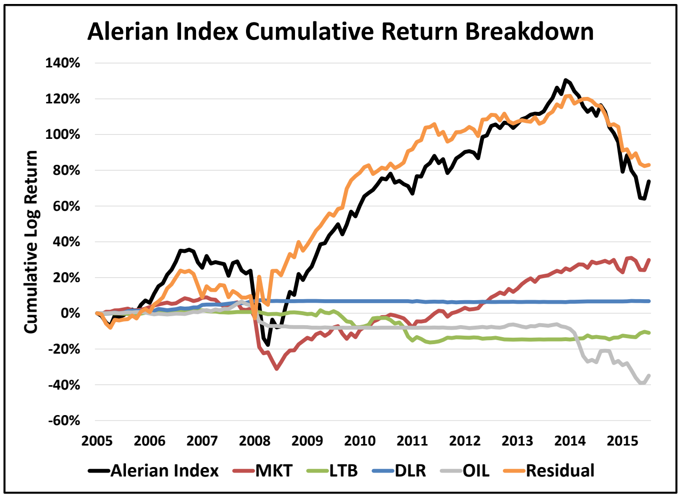
Finally, AMJ has historically had a relatively low correlation with stock market risk and bond market risk. These are the two major risks prevalent in most portfolios. Adding an investment that has a low level of sensitivity to these risk factors may help to reduce overall portfolio volatility.

AMJ tracks the returns of its benchmark index, the Alerian MLP Index, very closely. The inception date for AMJ is April 1, 2009, but I have returns for the Alerian MLP Index going back much further. This additional historical data provides a longer-term look at the historical risk sensitivities of the index (and consequently, the ETN). I measure the sensitivity of its returns to four risk factors that capture much of the risk common to most ETFs:

- Stock market risk (MKT), as measured by the S&P 500 Index
- Interest rate risk (LTB), as measured by the 10 Year Treasury Benchmark Index
- Currency risk (DLR), as measured by the U.S. Dollar Index
- Commodity risk (OIL), as measured by the West Texas Intermediate Crude Oil Index



Based upon the history of its index, while AMJ's risk sensitivities to stocks (MKT) and interest rates (LTB) have both moved up recently, this may be related to the unusual interplay of oil prices, economic outlook, and Fed policy that has affected capital markets in the recent past. Some reversion back towards more normal, and lower, levels of sensitivity to these risk factors over time is a reasonable expectation for AMJ.



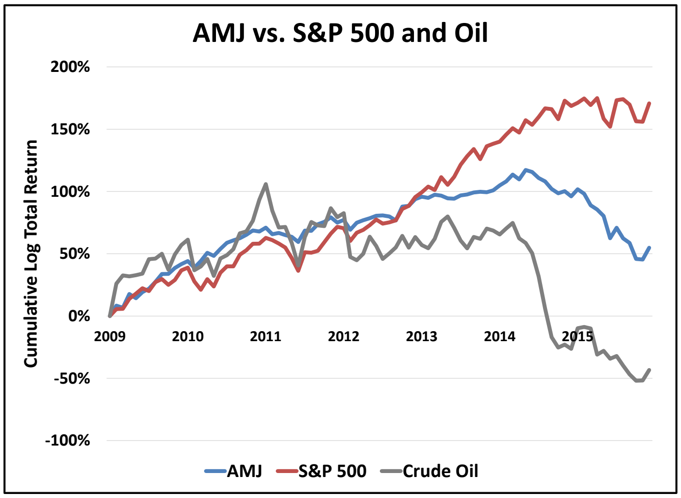
The graph above tracks the cumulative return of the Alerian Index (in black), and disaggregates it into return due to each of the four risk factor sensitivities and residual return, or what is left over after accounting for the risk effects. The Alerian Index is unusual for the very high proportion of its return being residual of risk effects, and also in the fact that three of the four risk factors play a noticeable (but not dominant) role in explaining its returns. For most ETFs, a single factor dominates. For example, the return of most equity ETFs is largely explained by its MKT sensitivity. For most debt ETFs, LTB is the dominant explanatory factor. But AMJ's overall return (black line) is largely determined by its residual return (orange line). This makes it a very good diversifier from a portfolio standpoint.

<u>The Tactical Case for AMJ – Why Now?</u>

Using the Alerian Index as a proxy for AMJ, from 2008 to 2014, investors would have been quite happy to have AMJ in their portfolios—it was generating very strong returns that were largely uncorrelated to broad risk factors. (The orange line was going up.) However, since 2014 AMJ has been in a steep decline, again most of it residual return not explained by risk factors, even as its sensitivity to those risk factors, and their power in explaining its returns, has been rising. Residual return remains unusually large, but risk factors are currently contributing a lot to AMJ's volatility.

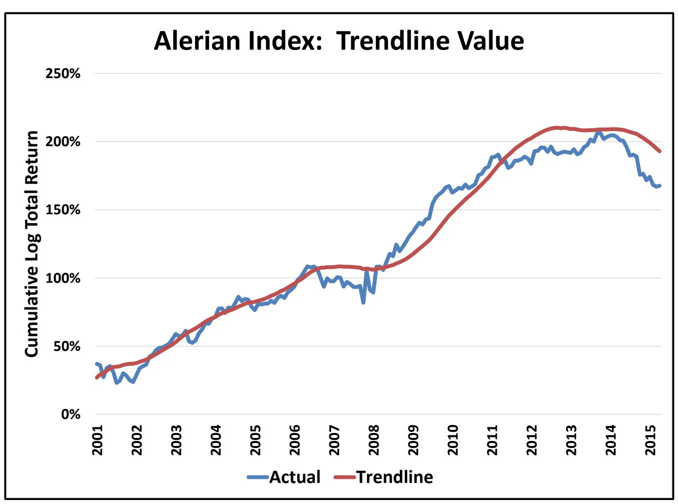
I do not like to try to catch a falling knife, and AMJ (launched April 1, 2009) has certainly been falling precipitously since 2014. It has suffered from a "triple whammy" of concerns: 1) the prospect of a slowing economy, which may reduce demand for energy, 2) falling oil prices, which may reduce the demand for energy infrastructure, and 3) fear of interest rate increases, which could increase interest expense on debt. AMJ peaked at the end of August 2014 at about

$54, and is now under $27, a decline of more than 50%. The fall in price has coincided with a 65% decline in the price of crude oil over the same time period.



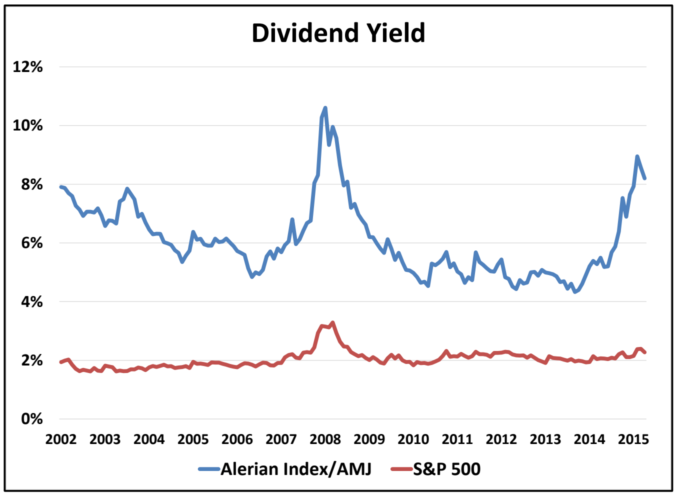
Clearly, the cumulative total return of AMJ (blue line above) has been very negative since 2014. Most MLPs have stable cash flows under long-term contracts that make their cash flow somewhat insensitive to the price of oil, yet investors have treated MLPs almost like they are in the exploration and production business. A very depressed level of cumulative total return is certainly one indication that AMJ may be attractively priced. If an ETF is significantly below its recent levels, there is reason to assume that it may be undervalued and will eventually revert back towards its historical norms.

However, my research indicates that an even better indication of the likelihood of near-term mean-reversion is the degree to which an ETF has deviated from its five-year trendline. Because this trendline is sensitive to recent twists and turns in cumulative return, significant deviations from the trendline are rare. When they occur, it is because of dramatic price swings over a fairly short time period. These patterns are often indications of a market over-reaction.

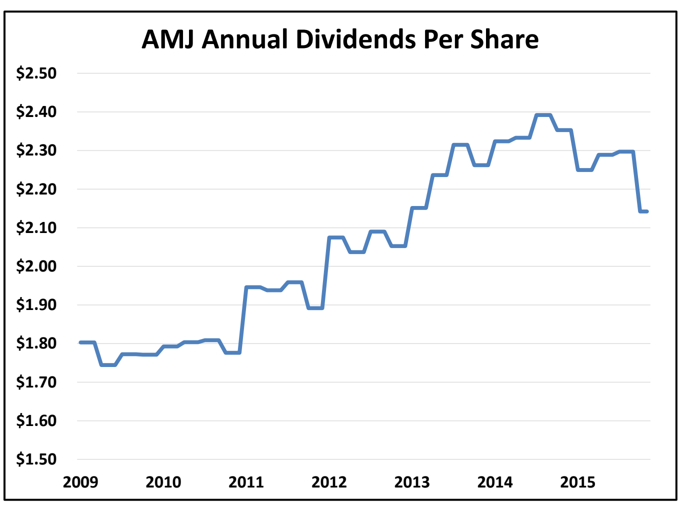


As illustrated in the graph above, AMJ is currently at a level that is significantly below trendline. While further declines are certainly possible, the value gap that has opened up the last six months is the widest it has ever been in the history of the Alerian Index.

There are fundamental reasons to believe that the risk of further declines has somewhat abated. Recall the three concerns that seem to have driven AMJ's decline: 1) slowing economy, 2) falling oil prices, and 3) rising interest rates. While the rate of economic growth remains a concern, crude oil has rallied nearly 50% off its lows in the past month and the Fed recently announced a slower pace regarding future rate hikes. These developments help allay two of the concerns that have been plaguing AMJ and may portend a positive turn in market sentiment towards MLPs.



Dividend yield is another indication of value. Since 2014, AMJ's dividend yield (concatenated in the line above with the Alerian Index dividend yield) has climbed from 4.3% to 8.2%. This dramatic increase in dividend yield is reminiscent of the Crash of 2008, and provides another indication that the selling may have been overdone.



To be sure, the per share dollar amount of AMJ's dividend has declined by a little over 10% since its 2014 peak, as shown above. This reflects the fact that some of the MLPs in the Alerian Index have cut their cash distributions. And there may be some further cuts to come. Most of those reducing their distributions are "upstream" MLPs in the business of buying oil and gas fields, optimizing them, and selling their production to the market. However, upstream MLPs constitute only about 3% of the Alerian Index. While a few MLPs are "downstream" companies in the business of distributing energy products to the end customer, the vast majority of MLPs are "midstream." They store and transport energy products, mainly through pipelines. Their basic business has fairly steady cash flows that are not terribly exposed to energy prices. The 50% drop in price may well be an over-reaction.

However, there is some fear among some MLP analysts that even midstream MLPs may start to reduce their cash distributions, forcing AMJ to further reduce its dividend. Most MLP managements have traditionally considered maintaining and growing their cash distributions as somewhat sacrosanct. But MLPs rely on continued capital expenditures to grow, and most are finding their access to capital markets limited at this point: their equity prices are too low to issue stock and their debt coverage ratios are too low to get new debt financing. Some MLPs may sell off non-core assets, but that will only go so far. The big cash savings would come from reducing cash distributions.

Arguably, MLPs that reduce their distributions to invest that cash in high-return capital expenditure projects would be doing the right thing for their investors. However, the initial reaction would likely be a wave of selling out of a combination of panic and frustration, since most MLP investors are very yield-oriented and may interpret the move as a signal of lack of confidence on the part of management. For this reason, I expect further cuts to be limited.

While not without its risks, AMJ seems a compelling value. There may be more volatility ahead, but with its generous dividend yield, AMJ pays investors handsomely to be patient.

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Footnote Regarding MLP ETFs vs. MLP ETNs

In general, I believe that the older, simpler MLP ETN structure is superior to the MLP ETF structure, which is why I focus on AMJ, the oldest, largest, and most liquid MLP ETN.

However, some investors so strongly prefer to own ETFs—funds that actually own the MLPs directly—that they are willing to pay quite a lot to get one. The MLP ETFs are quite different than most other ETFs, however. Most ETFs are "1940 Act" registered investment companies "RICs." They are "flow-through" entities that simply pass along to their investors the income and realized gains or losses of the underlying portfolio, including the tax implications of the type of income and capital gains and losses incurred, whether short-term or long-term. However RICSs are required to have no more than 25% of their holdings in partnership-type investments. Consequently, unlike most other types of ETFs, MLP ETFs are C corporations that pay a corporate rate of tax on MLP cash distributions. The largest and most liquid of these MLP ETFs, Alerian MLP ETF (AMLP), staggers under a current expense ratio of 5.43%, mostly because of corporate income taxes. The fund's management fee is .85%, so the rest is a combination of corporate income taxes and corporate operating expenses. I believe it is unlikely that most investors in MLP ETFs are aware of the glaring tax problem and the resulting expenses.

Somewhat offsetting the corporate taxes that MLP ETFs must pay is the fact that investors in MLP ETFs may receive much of their dividend income (typically 70%-100%) in the form of return of capital, which is generally not subject to tax at all. However, they have the added burden of keeping track of the reduced tax basis in MLP ETFs, and once they sell their MLP ETF shares, the tax hit may be particularly painful because of the lowered tax basis.

In general, the history of MLP ETFs indicates that, unless maximizing after-tax income is the overwhelming consideration, and unless the expected holding period is extremely long, MLP ETNs are likely to be the more attractive option.

An excellent article entitled The Definitive Guide to MLP ETFs and ETNs is available from ETF.com online.

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