# Thrive > Survive

## What Salient's senior investors are watching for in 2018

Outlook season is here, and for most asset management companies this means dispensing a deluge of price targets, forecasts and projections. At best, this collection of conjectures can be a convenient form of marketing: there is seldom accountability when the shots miss the mark, and if the predictions come true, authors boast about their abilities the following year. Spoiler alert: it's usually pablum, and investors don't care about it.

Salient clients know that market guesswork or airs of self-congratulation aren't our game. We don't have a crystal ball: we know that we don't know how the S&P 500 Index will perform this year; we know that we don't know the final tally of U.S. Federal Reserve interest rate increases; we know that we don't know if the European Central Bank will slow its asset purchases or by how much. Most importantly, we're not going to waste your time by pulling numbers out of a hat. We think we have assembled a terrifically smart investment team, and we focus on features and corners of the market where our insight comes alive.

Asset allocation is part of our DNA, so instead of wondering what may happen in markets, we focus our attention—and think you should, too—on what matters to markets. This year, we think the long-steady list of what matters to markets is evolving. It's changing to reflect a shift toward a higher interest rate world, a world with the potential for inflation, and as a result, the potential for volatility. These are real world, real economic drivers that should influence markets and asset prices. But because the causes (and effects!) of low volatility markets have led to a range of price-insensitive buying behaviors in everything from technology stocks to cryptocurrencies, we think investors must remain mindful of the very real behavioral drivers of market directions in the short run as well.

Beginning with Ben Hunt, our chief investment strategist, we'll follow our usual framework and identify what we believe will matter in the markets that we know well. Some are real world economic and fundamental issues; others are purely confined to markets.

We hope our 2018 outlook is valuable to you, and thank you for your interest and support.

# The Real World

**Ben Hunt, Ph.D.**
Chief Investment Strategist

First, what's our outlook for what's happening in the real world? Three related observations:

1. Global growth is accelerating. No matter the data series, there is a noticeable increase in real economic activity all around the world. Can this be derailed through a trade war or the property bubble bursting in China? Sure. But without a clear and present attack on the global growth engine, we think it keeps going in 2018 *(Figure 1)*.
2. Inflation pressures are increasing. With accelerated and ubiquitous global growth, inflation almost always follows. It's there in producer prices now (Producer Price Index), and it's starting to sneak into labor costs. Consumer prices (Consumer Price Index) are the last to feel it. But it's coming *(Figure 2)*.
3. Interest rates are going up. With increased inflation pressures, central banks may continue to tighten. That often takes the form of interest rate hikes in the U.S. and less aggressive quantitative easing in Europe and Japan. That could be, all other things being equal, a negative for both bond and stock markets (*Figure 3)*.

What works in this environment? Historically speaking, real asset strategies work, as do risk-aware and risk-balancing strategies. We are looking to thrive in 2018, not just survive.

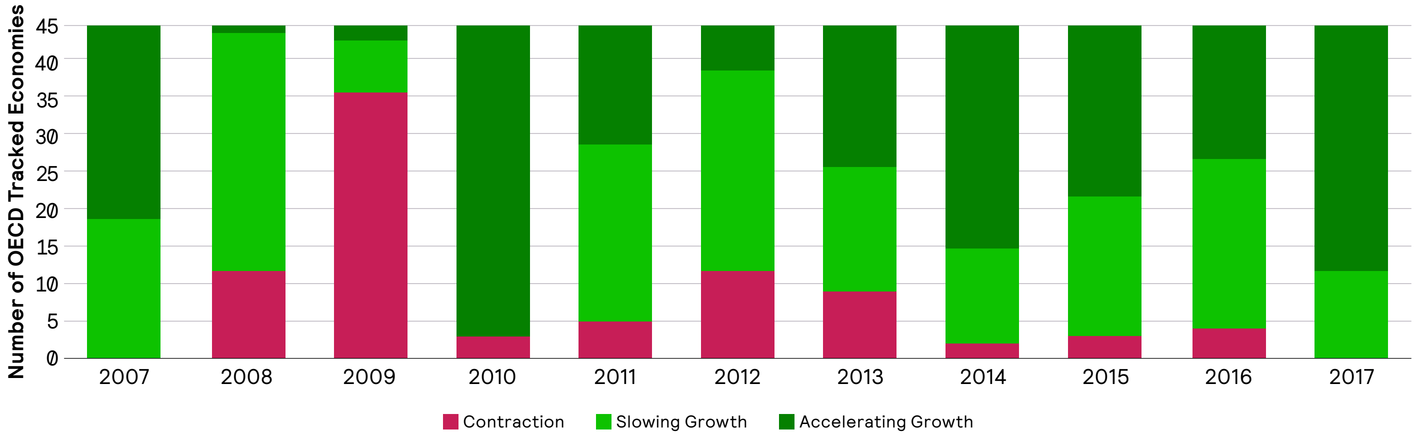
Second, what's our outlook for what's happening in markets? Two related observations follow, both connected to a great *Epsilon Theory* piece by Rusty Guinn, titled "The Myth of Market In-Itself":

1. Price-insensitive buying of anything and everything (but especially government bonds and mortgage-backed securities) from the central banks is rolling over (see previous point 3). It's still a net positive today, but it's decreasing in an accelerated way.
2. Price-insensitive buying of anything and everything (but especially stocks) from everyone else (both noninstitutional and institutional investors) is still going strong, providing a wall of money that keeps asset prices high. This dynamic may change, but it will take a lot to change it.

What's the result of these outlooks? Ultimately, we believe that there is a transmission belt between the real world and the market world, where inflation + central bank tightening = a difficult market environment, despite the structural propping up that lots of money typically provides. This situation is a slow burn but a powerful burn. It could play out over months and years, but it plays out.

FIGURE 1

## Growing in Sync

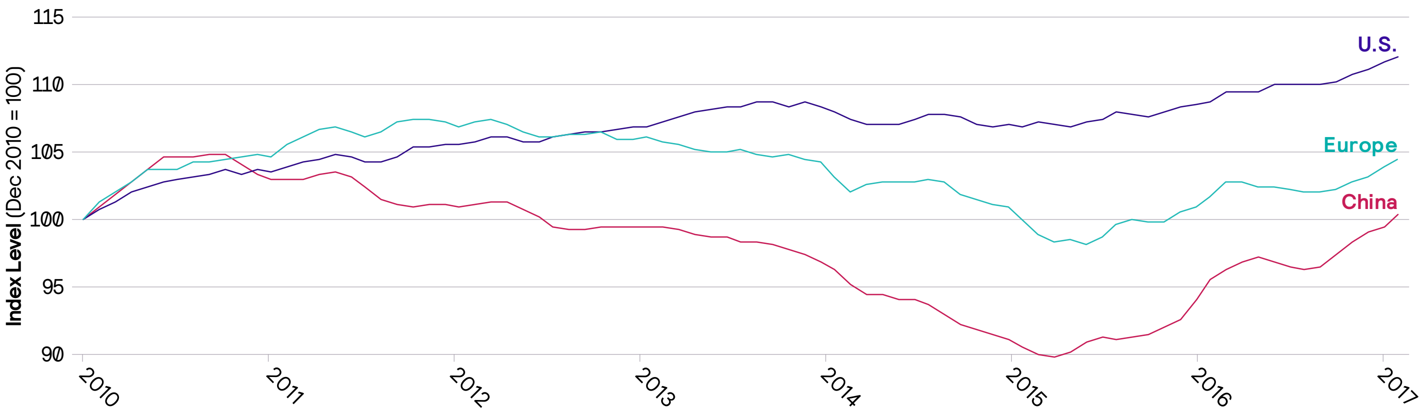



Source: Organization for Economic Cooperation and Development (OECD) via WSJ, 12/31/17
For illustrative purposes only. Past performance does not guarantee future results.

FIGURE 2

## Producer Price Index of Major Economies

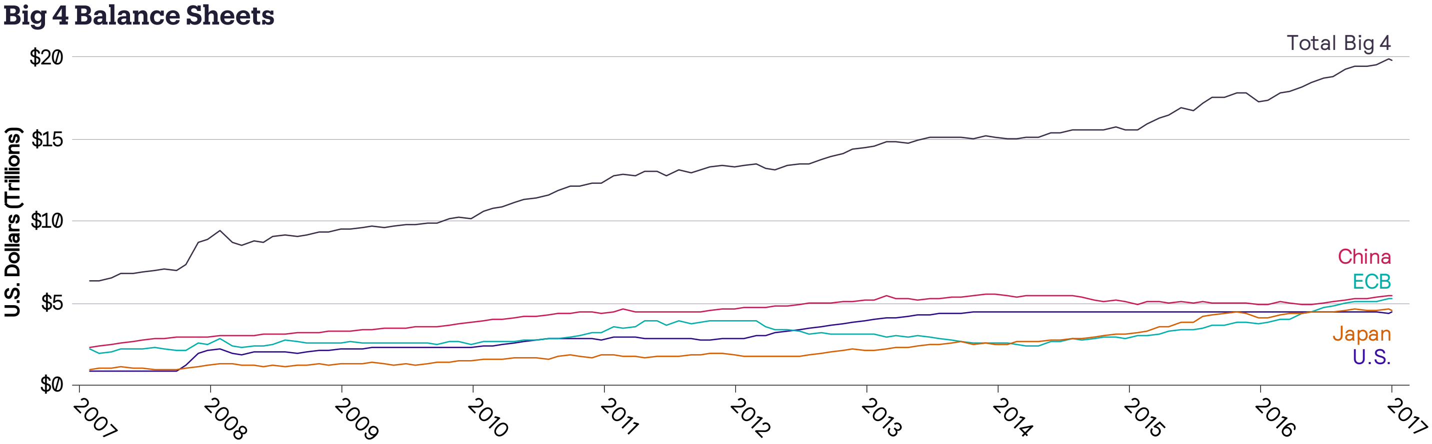
December 2010 – December 2017




Source: Bloomberg, 12/31/17
For illustrative purposes only. Past performance does not guarantee future results.

FIGURE 3

## Big 4 Balance Sheets




Source: Bloomberg, 12/31/17
For illustrative purposes only. Past performance does not guarantee future results.

**Bill Enszer**
Managing Director, Portfolio Management

## 2017 Recap

Stronger performance and fewer headlines proclaiming the death of hedge funds made for a better year for hedge funds, which generated high single-digit returns for the year. Robust global equity markets set the backdrop for double-digit returns in hedge funds with equity beta, while global macro funds struggled to produce low single-digit returns.[1] Due to the reporting lag in private equity returns, we can't say with precision how the year will finish, but with returns well into double digits through the third quarter of 2017, all signs point to another positive year of performance. Growth and buyout strategies, buoyed by a strong economy and an accommodative financing environment, led the way with the highest returns coming from emerging markets. Venture capital appears to be the laggard in private markets with returns in the single digits.[2]

## Outlook for 2018

- Despite the 2017 uptick in returns, the opportunity set for the average hedge fund still looks challenging.
- We still seek niche strategies that have the potential to deliver uncorrelated sources of return.
- Investor allocations to private equity are increasing, but performance expectations are often too high.
- Private credit remains attractive, and it's our belief that it can perform reasonably well across most economic scenarios this year.

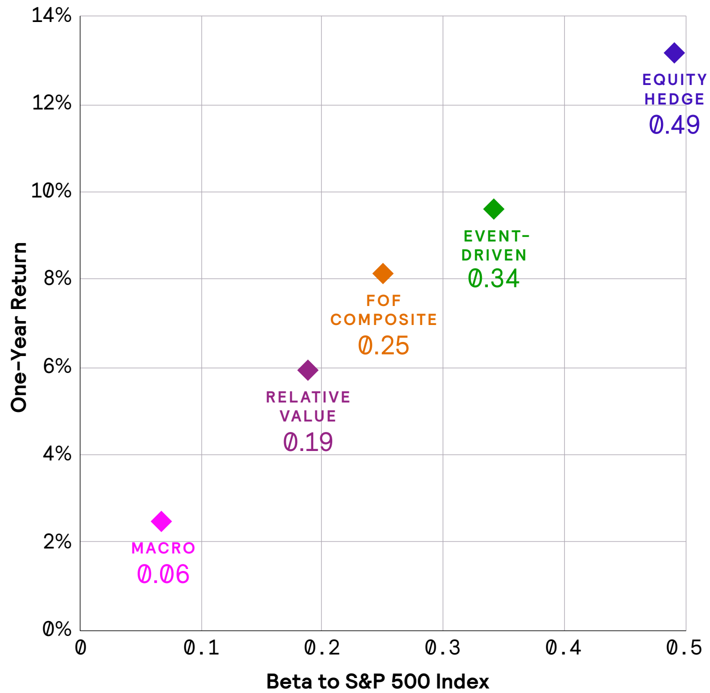
## Hedge Funds

Although returns from hedge funds were higher in 2017, our return expectations for hedge funds in aggregate remain muted. Last year's uptick was primarily attributed to the performance of beta within these portfolios, and unsurprisingly the highest returning strategies were hedge funds that historically exhibited the highest equity beta *(Figure 4)*.

Alpha, excess returns over beta, is a function of the number of independent bets within a portfolio, the breadth of those bets and the manager's edge (or ability to be right) on those bets. Returns are also intrinsically linked to the level of risk that a manager takes within a portfolio. We have no ability to force these attributes onto funds, but we understand these factors are what often drive excess returns in portfolios. It is through this lens that we try to identify compelling investment opportunities.

FIGURE 4

**One Year Return vs. Beta to S&P 500 Index**




Source: PerTrac, from 12/31/99 to 10/31/17

**Equity Hedge:** HFRI Equity Hedge (Total) Index; **Event-Driven:** HFRI Event-Driven (Total) Index; **Fund of Funds (FOF) Composite:** HFRI FOF Composite Index; **Relative Value:** HFRI Relative Value (Total) Index; **Macro:** HFRI Relative Value (Total) Index

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One of the most interesting hedge fund strategies this year is reinsurance, which is essentially insurance for insurers. For example, regardless of an insurance company's underwriting standards of individual policies, a firm writing home insurance on the Gulf Coast of Florida would find that it has significant risk from a hurricane hitting that part of the Gulf Coast. The insurance company can buy insurance for its business to protect it in such an event and the fund providing this insurance is a reinsurance provider that earns a premium for providing that protection.

While an individual reinsurance contract has risk associated with it and a certain unpredictability with its outcome, we believe a portfolio of reinsurance contracts is attractive because portfolio risk may improve as more transactions are added. There is breadth within portfolios from multiple contracts spanning different geographies and types of catastrophes, driven by independent and uncorrelated event risks. Reinsurance is not a liquid market for sourcing and trading risk, but a seasoned manager can take advantage of market inefficiencies. Moreover, reinsurance returns are uncorrelated with returns from traditional asset classes, making them an attractive strategy for an alternatives portfolio. Last year gave us plenty of activity for reinsurance events—from Hurricane Harvey to the fires in California—so we are excited to see if substantially improved pricing indeed implies a higher level of potential return this year.

## Private Equity

While negative news about sluggish returns has left hedge funds feeling beat up, private equity continues to receive praise from the press and many investors. Headlines frequently tout the generalization that institutions continue to increase their allocation to alternatives, but the majority of the inflows are going to private equity as few are investing more money in hedge funds.

Digging a level deeper into the allocations to private equity reveal increasingly expensive valuations. Deal multiples across mergers and acquisitions (M&A) remained unchanged and elevated in 2017, and the average purchase multiple hovered around 10.5x earnings before interest, taxes, depreciation and amortization (EBITDA). These purchase multiples are at 10-year highs and have debt/EBITDA multiples that are approaching 6x, a half-turn higher than what we saw a year earlier. With such high valuations, private equity activity dropped last year for the first time since 2013. According to PitchBook Data, the amount of dry powder (the cash that private equity firms are sitting on) now amounts to nearly $556 billion.[3] Not surprisingly, we believe both steep valuations and idle capital could create headwinds to future private equity returns as capital may be deployed at a slower velocity and into deals at marginally attractive valuations.

Then why are institutions allocating more capital to private equity? We think that it appears to be the less bad choice in a world of tough asset allocation decisions. Stretched valuations are not limited to private equity; every asset class in the world has them to some degree, and strategists from every bank to the well-known investment management firm GMO[4] have illustrated that any future returns may likely be lower as a result. Rather than temper our expectations (or actuarial rate of return) of what a portfolio can earn over the next 10 years, all of us are trying to figure out how to make up the shortfall between what our forecasters tell us we could earn and what we need to earn. This means institutional allocators are looking at private equity and its historical performance to bridge that gap. Ultimately, we think they will be disappointed.

Academic research varies on the specific beta of private equity to public markets, but the consensus is that over the long-term, private equity has a beta of 1.5–2.5x that of the S&P 500. The higher beta seems reasonable considering private companies are typically smaller and levered. When we look at 10-year forecasts for equity markets, a rate of 2x beta to public equities won't translate to very much in terms of absolute return. It would be unfair not to mention that these studies conclude that private equity also generates alpha, although those measures have come down over time. We believe that with less returns from beta, the private equity allocator is effectively betting much more heavily that alpha will deliver returns, but in an environment with very little distress, high valuations, high debt utilization and a wall of money on the sidelines waiting to jump on the next opportunity. Private equity is still a valued part of our portfolio, but our return expectations from the segment are lower because of the headwinds facing beta and alpha. We want to remind investors of this landscape.

We find smaller deals and smaller funds across growth equity and buyout funds attractive. Throughout last year and into 2018, we favor funds in the lower middle market as the deal multiples remain at a discount to multiples typical for larger companies. We regularly see larger private equity funds growing in assets and opportunities from smaller funds that provide a steady stream of deal flow to larger players. With fewer recent exits coming from companies going public, we think investing in smaller and lower middle market funds is one way to participate in this trend. We believe that sacrificing some return by selling to a sophisticated buyer outweighs the ability to sell to both strategic and financial buyers. Also, with ample dry powder on the sidelines, we think that a smaller pool of capital can be advantageous when it comes to looking at deals that larger players are forced to ignore.

## Venture Capital

Venture capital woes dominated headlines throughout 2017 and we think this will continue. Buying into privately-held companies through discounted secondary shares—like what SoftBank is doing with Uber—is symptomatic of investor suspicion that companies with sky-high valuations will keep growing and stop hemorrhaging cash. We search for venture capitalists with a commitment to identifying more reasonable valuations and building companies with a clear exit path in a reasonable time frame.

## Private Credit

Strategies in private credit remain attractive, as low double-digit yields with limited downside are still achievable and the risk-adjusted returns remain some of the most compelling across private markets. The secured feature of these instruments, combined with their typical senior status in the capital structure, offer resiliency in a downside scenario. While more money is pumped into private credit strategies, this has compressed yields and in some cases increased risk. We are wary that some strategies, such as mezzanine investing, would perform poorly in a recession. With high valuations and an extensive use of debt, we think mezzanine investments resemble equity risk with capped upside: the value of the debt could be dramatically eroded in a restructuring and the returns are driven by the yield on the debt. Contrasting mezzanine investments with opportunities in structured credit and real estate-backed lending, the returns are comparable with less risk in a downside scenario in the latter two categories. One attractive example is the K Certificates program, which creates a structured piece of paper with double-digit yields backed by multifamily real estate loans. Multifamily K Certificates are regularly issued, structured pass-through securities backed by recently originated multifamily mortgage loans created by Freddie Mac. The loans go through a strict underwriting process, with equity capital subordinated to the loans, meaning that our paper is designed to be resilient across most economic scenarios.

# Asset Allocation Strategies

**Roberto Croce, Ph.D.**
Managing Director, Quantitative Strategies

## 2017 Recap

We began 2017 expecting to see market movements driven by fiscal policy rather than monetary policy. Despite the global political turmoil over the year, we instead witnessed a steady level of global growth, while volatility continued its decline to record lows. All major asset classes ended the year higher, corporate profits continued to move upward, momentum in the JPMorgan Global Purchasing Managers Index increased and inflation remained subdued. Our asset allocation models worked well in this environment, adding exposure to maintain constant risk and capturing large gains even with our broadly diversified portfolio.

Throughout the year, we observed that allowing portfolio risk to exceed a certain threshold below a portfolio target could be costly in a low-risk environment. Ultimately, we think actively diversifying at a consistent, yet impactful level of volatility was the most promising way of reliably achieving positive outcomes.

## Outlook for 2018:

- As always, there are things we cannot control.
  - Growth may be partially countered by a reduction in policy accommodation and the possibility for rising inflation.
  - Valuations across most markets today may cause potential return opportunities to be lower than what they were in the past.
  - Although it did not seem to matter in 2017, we think geopolitical uncertainty or an unforeseen event draws the capacity for volatility to spike dramatically.
- We will continue to focus on what we can control: risk.
  - Rather than speculate on whether or which equity markets can and will move higher, we believe an unwavering focus on risk may help many investors navigate the uncertainty to come.
  - We believe how much risk you take, where you take that risk, and how you manage that risk over time may be the primary determinants of performance this year.

We think that growth could be countered in some part by a reduction in policy accommodation and the possibility of rising inflation. In other words, it is hard to say with conviction what will happen in the coming year, so we're not going to try. However, we will highlight our thoughts in the markets in which we trade:

- **Equities:** We believe there are still opportunities for growth, particularly in emerging markets. In addition, as many equities' average current yield is higher than many global bond markets, they currently offer attractive risk-adjusted income.[5]
- **Commodities:** Commodity markets remain attractively valued, with assets currently trading at a 14% median discount to the five-year average price. Couple this favorable valuation with the likelihood that inflation accelerates amid sustained global growth, and we believe a dynamic allocation to commodities could help preserve a portfolio's potential return.[6]
- **Sovereign Debt:** This year, we think an adaptive position in sovereign debt may be critical to maximizing the benefit of diversification this asset class typically provides. Additionally, the ability to capture potential capital appreciation from rolling yields in futures markets may provide a cushion to losses incurred as global central banks turn more hawkish.
- **Credit:** Credit spreads are typically less sensitive to inflation than stocks, but volatility in credit markets can change quite rapidly. Therefore, while we maintain credit exposure in our asset class models, we stand ready to adapt to a heightened volatility environment should it unfold in the coming year.

In addition, we can confidently say that we think results that investors experience over the coming several years may be driven by the amount of risk in their portfolios, in what asset classes that risk is taken, and by how that risk is managed over time. Investors seeking positive total return may need to seek out additional investment opportunities to the extent they can tolerate risk, as it is our belief that elevated valuations make it difficult to achieve return targets without diversification.

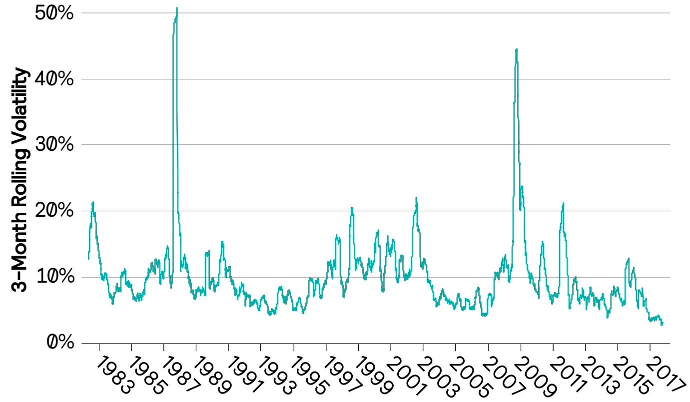
## The Importance of Risk-Targeting

Market risk can fluctuate. A lot. Some investors handle these fluctuations by holding a portfolio that, in most bad scenarios, doesn't lose more than they can tolerate. This behavior often creates several problems for an investor. First, since bad scenarios are infrequent, many investors usually take much less risk than they can tolerate, leading to less potential upside. Second, these portfolios, which are typically static, sometimes lose an unacceptable amount, causing many investors to move to cash and stay there. Doing this locks in the loss and holds them back from participating in the recovery. Last, the market typically works against static portfolios by delivering outsized compensation for risk-taking during periods of low volatility.

*Figure 5* shows the rolling volatility of a traditional and static 60/40 portfolio of U.S. stocks and bonds over a 35-year period. Risk has recently been at a record low and periods of low risk are common. The average volatility of this hypothetical portfolio was 10%; however, it remained below this level nearly two-thirds of the time. In contrast, while the portfolio's risk was only above its average less than half of the time, we find that at these points it was much higher. In other words, many investors are likely taking less risk on average than they could otherwise handle—and potentially earning less return—because they cannot tolerate the bad scenarios of a riskier portfolio. They could probably handle a little more risk (on average) if there were a way to reduce the asymmetry of the risky periods. An ability to take on higher risk on average may enable some investors to earn more return on average.

FIGURE 5

### Rolling 3-Month Volatility of a Traditional 60/40 Portfolio




Source: Salient Partners LP, as of 12/31/17

Traditional 60/40 portfolio is represented by 60% of the S&P 500 and 40% of 10-Year U.S. Treasury.

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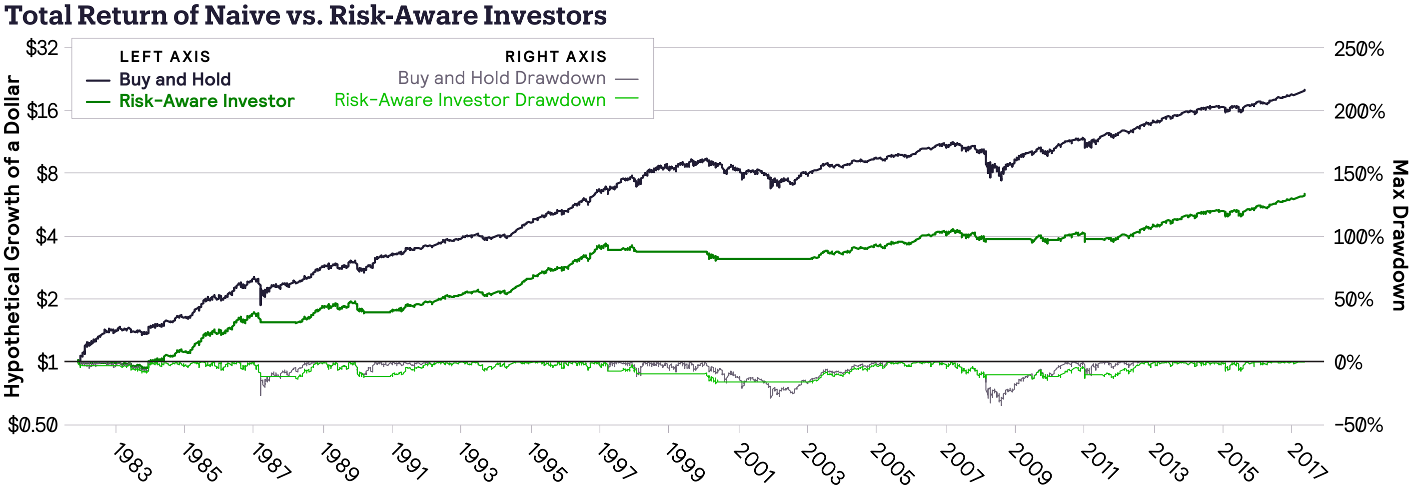
So how can an investor take on more risk on average? Let's consider the more likely experience of a risk-aware investor who moves to cash when portfolio risk rises above the 90th percentile, only reinvesting once risk returns to a more normal level. *Figure 6* illustrates just how costly it can be to deviate from a buy-and-hold tactic when risk gets high. This tactic can be quite punishing—the more aware of risk that an investor is, the more likely they are to underperform buy-and-hold in the long run. The reduction in drawdowns for the stereotypical investor was not enough to compensate for the forgone return.

FIGURE 6

### Total Return of Naive vs. Risk-Aware Investors




Source: Salient Partners LP, as of 12/31/17

The risk-aware investor represents an investor who sells his or her portfolio and holds 100% cash when its volatility is in the 90th percentile and only re-buys his or her portfolio when its volatility has returned to average. The portfolio is a traditional 60/40 portfolio and is constructed using the S&P 500 and 10-Year U.S. Treasury.

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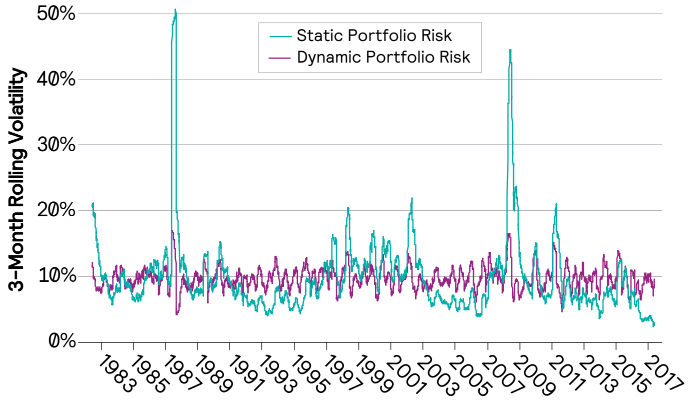
FIGURE 7

**Managing Risk: Static vs. Dynamic**




Source: Salient Partners LP, as of 12/31/17

The static portfolio maintains the portfolio weights at a 60/40 allocation. The dynamic portfolio actively shifts the portfolio weights to maintain a targeted level of 10% standard deviation. The portfolio is constructed using the S&P 500 and 10-Year U.S. Treasury.

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This loss is made particularly acute by the fact that markets tend to recover very sharply from drawdowns, which is exactly the moment, according to our analysis, that risk-aware investors typically switch to cash. Portfolios that do not dynamically manage risk may force many investors to choose between two unpleasant options: hold a portfolio that is well beyond their risk tolerance, or go to cash during drawdowns and miss out on potential gains.

We think there is a better way: actively manage a dynamic portfolio's risk to a constant target. The result is a portfolio in which risk doesn't fluctuate so severely, enabling investors to stay invested. On average, these investors take the same amount of risk as a conventional investor, but they do it without facing periods of ultra-high or ultra-low risk. *Figure 7* shows the efficacy of a risk management mechanism, which adjusts portfolio weights in order to target a consistent volatility measure. In this case, it's a trailing annualized standard deviation of returns of 10%.

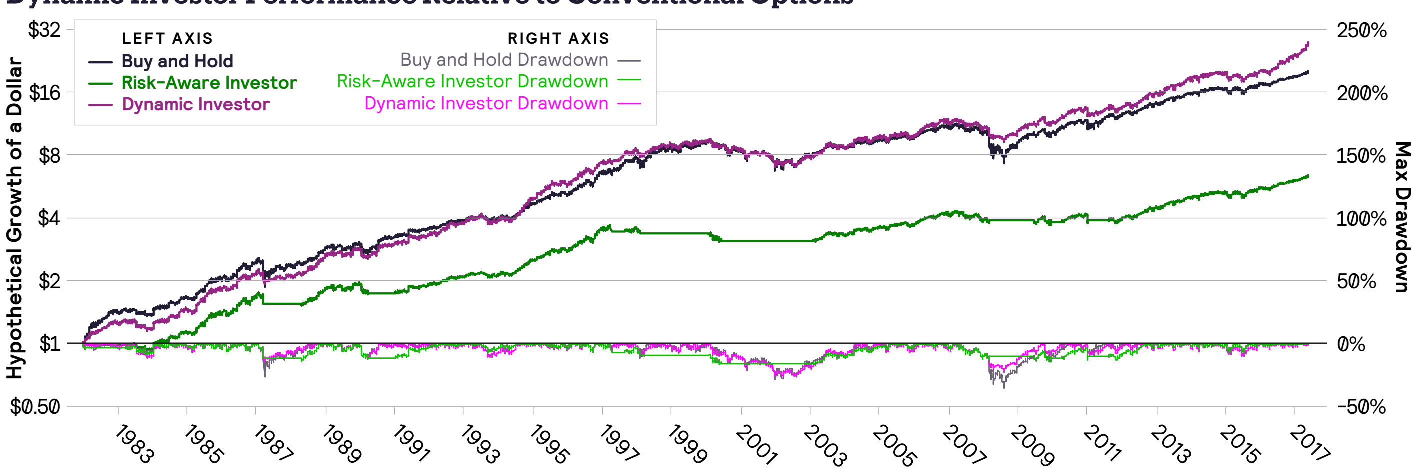
Because the amount of risk taken on average is the main determinant of return, this approach has historically delivered similar (though slightly better) returns, with a less volatile experience than that of the static portfolios. Investors who experience less volatility in their portfolios may have less emotional need to sell their securities and move to cash to capture the full potential of markets than those who do not. *Figure 8* shows a comparison of these approaches.

According to the example in *Figure 8*, a dynamic portfolio that targets a consistent level of risk has the potential to create a better outcome for investors—without the need to know exactly where markets are headed.

So, as the slow burning uncertainty of the future state of the world plays out (and is likely to do so at more normalized levels of market risk) such an eye on risk naturally shifts from trying to predict future returns to implementing an efficient and diversified approach to enhancing potential return.

FIGURE 8

**Dynamic Investor Performance Relative to Conventional Options**




Source: Salient Partners LP, as of 12/31/17

The risk-aware investor represents an investor who sells his or her portfolio and holds 100% cash when the portfolio's volatility is in the 90th percentile and only re-buys the portfolio when its volatility has returned to average. The dynamic investor represents an investor who holds onto the portfolio and dynamically allocates weights to maintain a risk target of 10%. The portfolio is constructed using the S&P 500 and 10-Year U.S. Treasury.

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**Joel Beam**
Managing Director &
Senior Portfolio Manager

## 2017 Recap

Publicly traded equity real estate investment trusts (REITs) generated a total return of 8.67% over the calendar year, as measured by the FTSE NAREIT All Equity REITs Index. This result, which trailed the sector's long-term historical average annual performance, was somewhat surprising given that the year furnished a benign interest rate environment, broadly accommodative capital markets, a strengthening backdrop for both employment and the wider economy, as well as the expectation of a lighter regulatory touch from the newly elected Trump administration. All these factors should be supportive of real estate valuations and REIT returns. But as always, composite returns obscure the fact that there was a fair amount of performance dispersion across property sectors. Specifically, data center, infrastructure and industrial REITs charted the best sector performance for the year as they continue to benefit from growth in global technology demand and the secular trend of on-demand fulfillment. On the other hand, retail REITs, both regional malls and shopping centers, delivered the market's worst returns as tenants struggled to adapt to changes in consumer preferences. Those sectors aside, many sectors produced modestly positive returns as growth began to accelerate as the year advanced, but cash flow multiples failed to expand from above-average levels. Mid-cap companies generally performed best, an interesting outcome given that large-cap businesses dominated the final three years of the previous bull market.

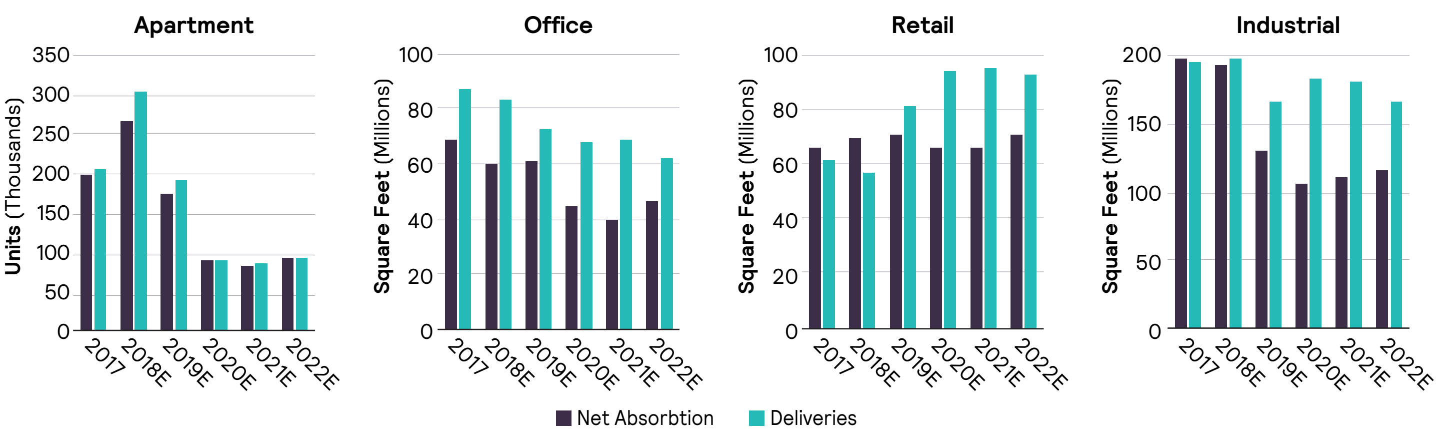
## Outlook for 2018

As we move into the new year, our strategies reflect a posture of cautious optimism. With the current real estate bull market entering its ninth year, one could reasonably conclude that the good times are nearing their end. However, we believe that deregulation, changes to the tax code and other government policies aimed at driving growth are generally constructive for property owners. Additionally, industry fundamentals such as occupancy and re-leasing spreads observed across most markets and property sectors support our positive view.

Despite an overall healthy diagnosis, the current favorable lending environment, coupled with the fact that large amounts of private capital dedicated to real estate remain uninvested, compels us to pay particular attention to near-term delivery and absorption metrics. As the charts illustrate, we anticipate that several property sectors could face supply headwinds in 2018 and beyond. As a direct consequence of these potential imbalances, we anticipate that some property types may witness deceleration with regard to "same-store" net operating income growth in the years ahead. Whereas other investors may view the current landscape with trepidation, we greet it with enthusiasm. Historically, a bull market can often mask a cavalier approach to underwriting real estate, but when the opportunity set is constrained, there is no substitute for rigorous, bottom-up, fundamental analysis in generating potential above-average, long-term returns.

FIGURE 9

**Real Estate Net Absorbtion vs. Deliveries**




Source: CoStar Group, Inc., as of 12/31/17
For illustrative purposes only. Past performance does not guarantee future results.

Filtering the aforementioned view through our value-oriented lens, we endeavor to own REITs that have very healthy coverage ratios, muted valuation multiples, higher implied cap rates and management teams that are skilled at generating late-cycle value. While it may be tempting to make directional calls on individual sectors, we tend to shy away from such bold proclamations and instead focus our efforts on determining where expectations are misaligned with reasonable assumptions, hoping that the market will reward our disciplined approach over time. We have increased exposure to out-of-favor sectors such as shopping centers and health care, and we have attempted to dampen portfolio duration by increasing our exposure to shorter-lease asset classes such as hotels. Finally, we continue to bias our portfolios toward REITs located in areas where supply and demand characteristics differ from the national outlook or provide insulation from near-term pressures.

In summary, we enter the year:

1. Cautiously optimistic amidst late-cycle economic acceleration;
2. Cognizant of the implications that tax reform and other government policies may have on landlords;
3. Anticipating positive—although slowing—operating performance for recent high-growth sectors;
4. Favoring companies with healthy coverage ratios, appropriate growth expectations, well-insulated properties and experienced management teams.

## Risks to Our 2018 Outlook

With both growth rates and interest rates low but increasing, we continue to believe a broad resetting of real estate valuations remains the largest risk to our 2018 outlook. On the back of positive performance since the 2008–09 financial crisis, sector-wide valuations appear closer to fair than not, and growth expectations have not yet moderated enough to make REITs look inexpensive.

FIGURE 10

### Current Valuation Metrics for Equity REITs

| Premium-to-NAV | Implied Cap Rate |
|---|---|
| 0.10% | 5.90% |
| **Current Yield** | **P / 18E AFFO** |
| 4.00% | 19.9x |

Source: FactSet Consensus Estimates, as of 12/31/17

For illustrative purposes only.
Past performance does not guarantee future results.

We are true believers in the wisdom of property investing and have confidence in its long-term return potential. Real estate is a diverse asset class; companies, even those within the same subsectors, can differ markedly from each other. We believe that the performance dispersion we saw this past year will continue to persist, which may provide skilled active managers the opportunity set from which to outperform the overall indices.

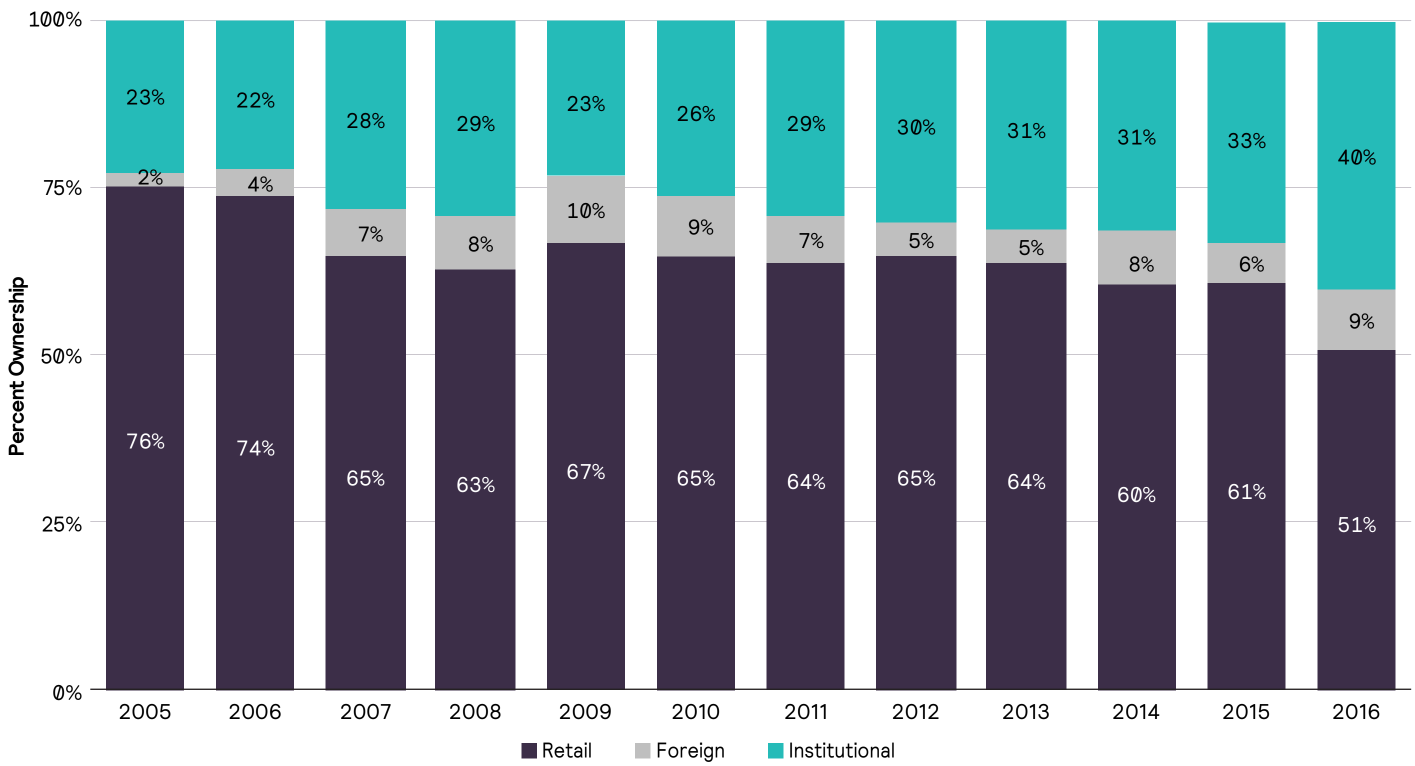
**Gregory A. Reid**
President, Salient MLP Complex

## 2017 Recap

Last year was an inflection point for midstream energy infrastructure. We saw a small number of high-profile distribution cuts, while Enterprise Product Partners, L.P. (EPD) slowed future distribution growth.[7] On the whole, these decisions by company management were not enthusiastically received by the marketplace, which sold down the midstream sector. Asset prices were further depressed following a rash of early tax-loss selling. Despite this environment, we have seen long-term, value-oriented investors, particularly institutions, getting more involved. Since 2006, the space has witnessed an uptick in allocations from institutional investors, and we're experiencing increased interest in our products from institutions and institutional consultants. In addition to distribution yield and growth, these investors are paying close attention to cash or earnings multiples and to value companies. In turn, we believe that the growing influence of institutions may encourage corporate managers to place greater emphasis on cash and earnings growth, spurring overall healthier corporate practices.

FIGURE 11

**MLP Investor Base Shifting to Institutional Ownership**




Sources: PricewaterhouseCoopers LLP, Partnership reports and Wells Fargo Securities, LLC, as of 10/31/17
For illustrative purposes only. Past performance does not guarantee future results.

FIGURE 12

### Valuation Metrics

(Enterprise Value/EBITDA)

| | Current | Average Since 2006 | Premium (Discount) | 2010-2014 Average | Premium (Discount) |
|---|---|---|---|---|---|
| **MLPs** | 10.7x | 13.7x | -21% | 12.7x | -15% |
| **Midstream C-Corps** | 12.0x | 15.1x | -21% | 13.5x | -11% |
| **Exploration & Production** | 8.4x | 6.7x | 25% | 5.9x | 42% |
| **Refiners** | 7.6x | 5.4x | 41% | 5.1x | 49% |
| **Integrated Exploration & Production** | 7.0x | 5.3x | 32% | 4.8x | 46% |
| **Oilfield Services** | 8.9x | 7.8x | 14% | 7.1x | 26% |
| **S&P Utilities** | 10.5x | 8.7x | 21% | 8.0x | 31% |
| **REITs** | 17.7x | 16.6x | 7% | 15.1x | 17% |
| **S&P 500** | 11.3x | 9.2x | 23% | 8.5x | 33% |

Source: Wells Fargo Securities, LLC., Bloomberg, 11/30/17

For illustrative purposes only. Past performance does not guarantee future results. The indices reflect the reinvestment of dividends and income and do not reflect deductions for fees, expenses or taxes. The indices are unmanaged and are not available for direct investment.

What's driving institutions to invest now? Among yielding assets, master limited partnerships (MLP) and midstream valuations remain markedly inexpensive *(Figure 12)*, representing, in our opinion, a potentially meaningful current opportunity for total return. In the context of a climbing price for crude oil, robust energy demand, healthy domestic supply growth and improving fundamentals, including lower leverage and higher coverage, the Alerian MLP Index (AMZ) is still negative—down over 6.5% as of December 31, 2017.[8]

Unlike in 2015 when the high cost of capital, production cuts and credit pressures hampered the ability of companies to fund growth and pay out distributions or dividends,[9] the valuations (EV/EBITDA) for midstream companies are inexpensive at the same time that fundamentals are relatively strong and appear to be getting stronger. This dynamic suggests that MLP valuations are dislocated. In fact, the only times that valuations have been worse over the last 10 years are during the 2008–09 financial crisis and the crude oil price collapse of 2014–2015.

Despite lagging performance, the midstream space is still growing, with a preponderance of MLP and midstream companies issuing distribution growth guidance that ranges from mid-to-high single digits over the next year. MLP yields, calculated as the weighted average current yield of AMZ constituents, average more than 7%.[10] We believe that the real and growing cash flows make the midstream sector particularly appealing during a rising interest rate and inflationary environment.

Other items we'll be watching in 2018 are volumes, tax reform and improving corporate governance.

## Outlook for 2018

- Domestic energy volumes are forecasted to grow, supporting midstream fundamentals.[11]
- Tax reform, as passed, appears to be net positive for midstream and MLP investors who will generally pay lower rates on pass-through income.[12, 13]
- Further consolidation of general partners (GPs) and limited partners (LPs) will increase transparency and visibility of cash flows.
- Capital discipline will be a distinguishing factor among midstream companies in 2018.

Expanding on these points, domestic energy volumes, which are a primary driver of midstream revenues, continue to grow. We believe that as the swing producer, the U.S. has the potential to further ramp up domestic energy volumes in response to growth in global demand. In fact, the Energy Information Administration continues to forecast U.S. production growth through the end of 2018.[14]

Tax reform, as signed by President Trump on December 22, 2017, contains advantages for midstream companies, as the lower corporate tax rate would benefit C corporation midstream companies. MLPs would further benefit from the lower pass-through tax rate.[15]

Finally, just as we've seen over the past three years with Targa Resources Corp. (TRGP), The Williams Companies, Inc. (WMB), Plains All American Pipeline, LP (PAA) and ONEOK, Inc. (OKE), we would expect more GP incentive distribution rights (IDR) buyouts this year.[16] Over time, as MLP distributions grow, the GP is entitled to receive more cash flow from the MLP. For those MLPs whose GPs take a large percentage of the distribution, cost of capital starts to become a real burden. Buying out the IDR is one way to improve the cost of capital at the MLP level while further aligning the interests of the GP and the MLP.

In 2018, we believe it will be important for midstream companies to express capital discipline when growing their businesses. Increased buildout in premier basins could put downward pressure on margins, which could be a headwind against a company's ability to generate income over and above the cost of capital. The mismatch between capital needs and capital supply will be an important mile marker as well. Retail investors have stepped away from MLPs and for a variety of reasons. The question is whether they will come back to MLPs this year, or, if not, whether there is enough institutional capital to fill the gap. Too much spending, and not enough equity capital could strain returns.

Fundamentals are healthy and are generally improving. Good governance and capital discipline are priorities for many companies. And macroeconomics, including domestic supply and global demand growth, are supportive of midstream valuations. We are optimistic about what 2018 has in store for midstream energy infrastructure.

1. Hedge Fund Research, Strategic Financial Solutions, PerTrac, as of 12/31/17
2. Cambridge Associates, as of 12/31/17
3. As of 12/31/17
4. GMO is a global Boston-based investment management firm that provides sophisticated clients with asset management solutions. Jeremy Grantham is the founder and chief investment strategist of GMO, well-known for its investment knowledge and research.
5. Bloomberg, as of 12/31/17
6. Ibid.
7. Enterprise Products Partners, L.P., Enterprise Declares Quarterly Distribution Increase, October 12, 2017.
8. Alerian, January 2018.
9. All or a portion of MLP distributions will be considered a return of capital.
10. Bloomberg, 12/31/17. MLP distributions are not guaranteed and subject to change based on market or other conditions.
11. Energy Information Administration (EIA), January 2018.
12. Congressional bill: http://bit.ly/2Gnhb95
13. Salient Capital Advisors, L.P. does not offer tax advice. Please contact your tax professional for advice regarding your specific situation.
14. Reuters, "EIA raises 2018 U.S. oil output forecast to highest on record," December 12, 2017, http://reut.rs/2n8hg8N
15. Salient Capital Advisors, L.P. does not offer tax advice. Please contact your tax professional for advice regarding your specific situation.
16. Targa, Investor Presentation, November 3, 2015, http://bit.ly/2n9A0EZ; Williams, Press Release, May 13, 2015, http://bit.ly/2BtCCBW , Plains All American Pipeline, Press Release, July 11, 2016, http://bit.ly/2F9tc0z; ONEOK, FAQ, June 30, 2017, http://bit.ly/2E5TGAE

**Definition of Terms**

**Adjusted Funds from Operations (AFFO)** refers to a computation made by analysts and investors to measure a real estate company's cash flow generated by operations. (NAREIT)

**Alerian MLP Index (AMZ)** is a composite of some of the most prominent energy MLPs that provides investors with a comprehensive benchmark for this emerging asset class. RISKS: Discussed throughout this material – include tax related risks due to their partnership status, unlike the other asset classes discussed, as well as possible higher volatility than the majority of the other asset classes discussed. "Alerian MLP Index", "Alerian MLP Total Return Index", "AMZ" and "AMZX" are trademarks of Alerian and their use is granted under a license from Alerian.

**Alpha** is the excess return of a fund relative to the return of its benchmark index's return.

**Beta** is a measure of the volatility, or systematic risk, of a security or a portfolio in comparison to the market as a whole. A beta of 1 indicates that the security's price will move with the market. A beta of less than 1 means that the security will be less volatile than the market. A beta of greater than 1 indicates that the security's price will be more volatile than the market.

**Breadth** is a technique used in technical analysis that attempts to gauge the direction of the overall market by analyzing the number of companies advancing relative to the number declining.

**C corporation (C-corp)** is a legal structure that businesses can choose to organize themselves under to limit their owners' legal and financial liabilities.

**Cash flows** are incomings and outgoings of cash, representing the operating activities of an organization. In accounting, cash flow is the difference in amount of cash available at the beginning of a period (opening balance) and the amount at the end of that period (closing balance).

**Commodity** is a basic good used in commerce such as grains, gold, beef, oil and natural gas that is interchangeable with other commodities of the same type.

**Consumer Price Index (CPI)** is the measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living.

**Correlation** is a statistical measure of how two securities move in relation to each other.

**Coverage ratio** is a measure of a company's ability to meet its financial obligations. In broad terms, the higher the coverage ratio, the better the ability of the enterprise to fulfill its obligations to its lenders.

**Debt/EBITDA** is a measure of a company's ability to pay off its incurred debt.

**Distribution coverage** is the metric that gives a sense of an MLP's ability to make its distributions every quarter, which is simply an MLP's distributable cash flow divided by the total amount of distributions it paid out. A value of 1 is the ability to cover the distribution and a value >1 is considered over-coverage.

**Distribution yield** is a measurement of cash flow paid by an exchange-traded fund (ETF), real estate investment trust (REIT) or another type of income-paying vehicle.

**Drawdown** is the gradual decline in the price of a security or other investment between its high and low over a given time period.

**Duration** is a measure of the sensitivity of the price of a fixed-income investment to a change in interest rates and is expressed as a number of years.

**EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization)** is a standard measure of profitability and reflects a company's financial health.

**Energy Information Administration (EIA)** collects, analyzes and disseminates independent and impartial energy information to promote sound policymaking, efficient markets and public understanding of energy and its interaction with the economy and the environment.

**Enterprise Value to EBITDA multiple** is a ratio used to determine the value of a company. The enterprise multiple looks at a firm as a potential acquirer would, because it takes debt into account. Enterprise Multiple = Enterprise Value/EBITDA.

**FTSE NAREIT All Equity REITs Index** is a free-float-adjusted market capitalization weighted index that includes all tax qualified REITs listed in the New York Stock Exchange, American Stock Exchange and NASDAQ National Market.

**Futures** are financial contracts that obligate the buyer to purchase an asset (or the seller to sell an asset), such as a physical commodity or a financial instrument, at a predetermined future date and price.

**General partnership (GP)** is an arrangement by which partners conducting a business jointly have unlimited liability, which means their personal assets are liable to the partnership's obligations.

**HFRI Equity Hedge (Total) Index** is an index where investment managers maintain both long and short positions primarily in equity and equity derivative securities.

**HFRI Event-Driven (Total) Index** is an index where investment managers maintain positions in companies currently or prospectively involved in corporate transactions of a wide variety including but not limited to mergers, restructurings, financial distress, tender offers, shareholder buybacks, debt exchanges, security issuance or other capital structure adjustments.

**HFRI Fund of Funds (FOF) Composite Index** invests with multiple managers through funds or managed accounts. The strategy designs a diversified portfolio of managers with the objective of significantly lowering the risk (volatility) of investing with an individual manager.

**HFRI Macro (Total) Index** is an index where investment managers which trade a broad range of strategies in which the investment process is predicated on movements in underlying economic variables and the impact these have on equity, fixed income, hard currency and commodity markets.

**HFRI Relative Value (Total) Index** is an index where investment managers maintain positions in which the investment thesis is predicated on realization of a valuation discrepancy in the relationship between multiple securities.

**Implied cap rate** is the net operating income of a REIT divided by the sum of the REIT's equity market capitalization and its total outstanding debt.

**Incentive distribution rights (IDRs)** are incentive plans designed to give general partners in a limited partnership increasing shares of the distributable cash flow generated by the partnership, as per-unit distribution increases to the limited partners.

**JPMorgan Global Purchasing Managers Index (PMI)** measures the health of the manufacturing sector and is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment.

**Leverage** is the use of borrowed capital for an investment, expecting the profits made to be greater than the interest payable.

**Limited partnership (LP)** exists when two or more partners unite to jointly conduct a business in which one or more of the partners is liable only to the extent of the amount of money that partner has invested.

**Master limited partnerships (MLPs)** are publicly traded limited partnerships and limited liability companies that are treated as partnerships for federal income tax purposes.

**Mezzanine investment** is any subordinated debt or preferred equity instrument that represents a claim on a company's assets which is senior only to that of the common shares.

**Midstream sector** involves the transportation, storage and wholesale marketing of crude or refined petroleum products.

**Momentum** is the rate of acceleration of a security's price or volume.

**Monetary policy** refers to the actions of a central bank, currency board or other regulatory committee that determine the size and rate of growth of the money supply, including an increase in interest rates or changing the amount of money banks need to keep in bank reserves.

**Mortgage-backed security (MBS)** is a type of asset-backed security that is secured by a mortgage or collection of mortgages.

**Multifamily K certificates** are regularly-issued, structured pass-through securities backed by recently originated multifamily mortgage loans.

**Multiple of Invested Capital ("MOIC" or "multiple")** is calculated for each investment by adding the distributions plus the current Net Asset Value ("NAV") divided by the invested capital. This multiple reflects the value created relative to capital invested. It is useful to explain the wealth created or destroyed by the investment. A multiple that is greater than 1.0x implies that value has been created. Wealth in this calculation includes realized and unrealized gains or losses on the investment but does not take into account the time it took to generate that value.

**Pass-through income** is sent from a pass-through entity to its owners. The income is not taxed at the corporate level — it is only taxed at the individual owners' level. A pass-through entity is a special business structure that is used to reduce the effects of double taxation.

**Premium to net asset value (NAV)** is a pricing situation that occurs when the value of an exchange-traded investment fund or closed-end fund is trading at a premium to its daily reported accounting NAV. Funds trading at a premium will have a higher price than their comparable NAV.

**Price-earnings (P/E)** ratio is a measure of the price paid for a share of stock relative to the annual income or profit earned by the company per share. A higher P/E ratio means that investors are paying more for each unit of income.

**Producer Price Index (PPI)** measures the average change over time in the selling prices received by domestic producers for their output. The prices included in the PPI are from the first commercial transaction for many products and some services.

**Reinsurance**, also known as insurance for insurers or stop-loss insurance, is the practice of insurers transferring portions of risk portfolios to other parties by some form of agreement to reduce the likelihood of having to pay a large obligation resulting from an insurance claim.

**S&P 500 Index** is an unmanaged, capitalization-weighted index comprising publicly traded common stocks issued by companies in various industries. The S&P 500 Index is widely recognized as the leading broad-based measurement of changes in conditions of the U.S. equities market.

**Standard deviation** measures the degree to which a fund's return varies from its previous returns or from the average of all similar funds.

**U.S. Treasurys** are marketable U.S. government debt securities with fixed interest rates and maturities.

**Valuation** is the process of determining the value of an asset or company based on earnings and the market value of assets.

**Volatility** is a statistical measure of the dispersion of returns for a given security or market index.

**Yield** is the interest or dividends received from a security and is usually expressed annually as a percentage based on the investment's cost or on the U.S. government's debt obligations.

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