Selecting a Midstream Benchmark

A Closer Look at Two New Indices

For years, the most generally accepted benchmark for master limited partnership (MLP) investors has been the Alerian MLP Index (AMZ). Launched on June 1, 2006, the AMZ established itself as the definitive benchmark for investors interested in potential opportunities in what had been a largely overlooked asset class: midstream energy infrastructure.

The MLP was in many ways the most appropriate corporate structure to house midstream energy infrastructure. Midstream comprises the processing, transportation, storage, and marketing of crude oil, natural gas, natural gas liquids (NGLs), and refined products. Generally speaking, midstream assets are capital intensive, long-lived, and provide fairly predictable, albeit relatively low margins, for the operator. By placing these assets within the tax-advantaged MLP structure, operators were able to avoid income taxes at the federal level and use that “savings” to either reinvest in the business or return those cash flows to investors in the form of a distribution, which was also tax-advantaged when compared to traditional corporate dividends.¹

Alerian’s timing on launching the AMZ was fortuitous. The Shale Revolution² was just taking hold and U.S. energy production soon began to increase after decades of declines. It soon became apparent that a large amount of capital would need to be invested in midstream energy infrastructure in order to move these incremental volumes to market. Investors valued the yields provided by MLPs and portfolio managers appreciated the relatively low correlation between MLPs and the broader market. From its launch date through 2014, the AMZ Index averaged a 14.3% total return vs. 7.9% for the S&P 500.³,⁴

With such returns, one could argue that the AMZ index became so entrenched that the terms “midstream” and “MLPs” were almost interchangeable in many investors’ minds. There were 91 “MLP/Midstream” initial public offerings (IPOs) after the launch of the AMZ until the end of 2014 that raised over $32 billion (B).³ The seemingly never-ending appetite for midstream equity unfortunately papered over many problems with the AMZ that have now become difficult to ignore, in our opinion.

¹ An MLP is a publicly-traded partnership that receives special treatment under Section 7704 of the U.S. tax code. Specifically, MLPs do not have to pay income taxes at the corporate level if 90% or more of gross income is considered qualifying.
² Shale Revolution refers to the sharp increase in United States energy production following technological advancements, which made it more economical to extract oil and gas from certain geological formations, or shale.
⁴ Past performance is not indicative of how the indices will perform in the future. 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. MLP distributions are not guaranteed and subject to change based on market or other conditions. All or a portion of MLP distributions will be considered a return of capital.
In addition, the construction of the AMZ appeared problematic. At its launch, it had a sizeable number of components whose principal business was not midstream.\(^5\) Sixteen of the 50 companies in the AMZ (comprising over 15% of the weight) were not engaged in traditional midstream operations.\(^5\) Upstream, propane, shipping, and coal MLPs were all represented in the original AMZ. The non-midstream component of the AMZ fluctuated between 10% and 15% of the index weight through 2014.\(^5\) One could argue that the presence of upstream MLPs likely exacerbated the decline in the AMZ when the price of crude oil collapsed in 2015. The AMZ fell 32.6% (vs. the Energy Select Sector SPDR ETF (XLE) down 21.5% and the S&P 500 up 1.4%) in 2015 and possibly created a lot of confusion in investors’ minds as to what they actually owned.\(^6\) Alerian’s MLP Infrastructure Index (AMZI) which is comprised of 100% midstream MLPs and is the basis for the largest MLP product in existence - the $9B Alerian MLP ETF (AMLP) - was down 31.7% in 2015 in what we believe was a “throw the baby out with the bath water” scenario.\(^5,6\)

As highlighted above, not all MLPs own midstream assets. In the same vein, there were publicly-traded entities that owned midstream assets that were not structured as MLPs. As the MLP structure became more popular with investors and began to trade at higher valuations, we saw a lot of corporations carve out their midstream assets to form MLPs in the hope of “unlocking shareholder value.” The parent corporation would maintain control of the assets by retaining ownership of the general partner (GP). As an added bonus, the GP would get an increasing share of the cash flows through the incentive distribution rights (IDRs). Several of those GPs went public as well, some of which were included in the AMZ. However, in the June 2013 rebalancing, Alerian removed all general partners from the AMZ.

According to the CFA Institute, a good composite benchmark has many of the following properties.

- **Specified in advance.** Although this may not always be the case, firms should select a composite benchmark prior to the evaluation period.
- **Relevant.** The benchmark reflects the investment mandate, objective, or strategy of the composite.
- **Measurable.** The benchmark is quantifiable.
- **Unambiguous.** The constituents of the investable universe can be clearly identified and priced.
- **Representative of current investment opinions.** The firm has current knowledge of the investable universe.
- **Accountable.** The firm selects the benchmark and is accountable for any deviations from the benchmark.
- **Investable.** The benchmark offers a passive alternative that is a realizable and alternative opportunity genuinely open to the investor.
- **Complete.** The benchmark provides a broad representation of the sector of the market to which it pertains.

The dramatic drop in the AMZ and AMZI in 2015 accelerated a trend that actually had its roots at the absolute top of the market in August 2014: the MLP roll-up. Kinder Morgan, Inc. (NYSE: KMI) had simplified its corporate structure and eliminated its IDR burden when it announced that it intended to acquire its underlying MLPs, Kinder Morgan Energy Partners, L.P. (NYSE: KMP) and El Paso Pipeline Partners, L.P. (NYSE: EPB).\(^7\) KMP and EPB comprised roughly 10% of the AMZ Index at the time the transaction was announced.\(^5\) The Kinder roll-up was the first of many as corporations took advantage of the depressed equity values of MLPs to absorb them at cheaper evaluations.

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Roll-ups were not limited to U.S.-based companies. Canadian large capitalization (cap) names TransCanada Corporation (NYSE: TRP) and Enbridge, Inc. (NYSE: ENB) used their relatively strong equity performance during the downturn to snatch up depressed MLPs. TRP acquired the Columbia Pipeline Group (NASDAQ: CPGX) for $13B in March 2016.\(^8\) Eight months later, TRP gobbled up CPGX’s underlying MLP, Columbia Pipeline Partners, L.P. (CPPL) for another -$1B.\(^9\) In September 2016, ENB announced that it had agreed to purchase Houston-based Spectra Energy, Inc. (NYSE: SE) for $28B.\(^10\) In September 2018, ENB announced that it intended to roll-up its U.S.-based MLPs, Spectra Energy Partners, L.P. (NYSE: SEP) and Enbridge Energy Partners, L.P. (NYSE: EEP), along with the Canadian-based Enbridge Income Fund (ENF) for just under $9B.\(^11\) TRP and ENB are two of the three largest midstream companies in North America by market cap, and since they are neither U.S.-based nor structured as MLPs, they are not eligible to be included in the AMZ.

Due to the changing midstream landscape, Alerian launched two new indices in June 2018: the Alerian Midstream Energy Index (AMNA) and the Alerian U.S. Midstream Energy Index (AMUS). Alerian also revamped an existing index at the same time, the Alerian Midstream Energy Select Index (AMEI), previously known as the Alerian Energy Infrastructure Index.

AMNA and AMUS are broad indices that, in our opinion, better capture the breadth of the midstream investable universe. Notably, the two new indices are agnostic toward corporate structure and include both C-Corps and MLPs. The major distinction between the two is that the AMNA includes Canadian companies while the AMUS excludes them.

Despite the improvement over the AMZ, we believe that the AMUS is still an incomplete benchmark given that it excludes two of the largest midstream companies in North America, ENB and TRP. Though domiciled in Canada, ENB and TRP derive about 60% of their respective revenues from U.S. sources. With nearly $100B in market capitalization between these two companies alone, we are of the opinion that a benchmark that includes them as the AMNA does is more complete. In other words, the AMNA offers a more complete midstream benchmark.\(^12\)\(^13\)

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\(^12\) This statement does not constitute investment advice. Investors should evaluate their circumstances before making an investment in a fund that utilizes any of these indices. Indices are unmanaged and are not subject to fees and expenses typically associated with managed accounts or investment funds.
\(^13\) The CFA Institute defines a complete benchmark as a benchmark that provides a broad representation of the sector of the market to which it pertains.
The Alerian Midstream Energy Select Index (AMEI), previously known as the Alerian Energy Infrastructure Index, was originally introduced in 2013.\(^{14}\) The AMEI limits the weight of entities structured as MLPs to 25%, making it particularly applicable as a benchmark for funds structured as a regulated investment company (RIC) which, due to regulations, are also limited to owning 25% MLPs. Consequently, the AMEI expressly includes exposure to C-Corps (75%) but does so by artificially lowering total MLP exposure. Additionally, until the changes were implemented in June 2018, the AMEI’s construction methodology assigned larger weights to some mid cap stocks than some large cap stocks. The AMEI also included some utilities which aren’t typically considered core midstream assets.

In June 2018, Alerian revised the AMEI methodology to mirror that of the AMNA, with the only differences being a higher liquidity requirement\(^{15}\), a 25% cap on MLPs (same as before), and a “bad asset” test\(^{16}\) (which only pertains to RIC funds). As it regards midstream RIC-structured mutual funds, we now believe the AMEI best satisfies the benchmark guidelines as outlined by the CFA Institute. Because of these changes, we now believe that the AMEI should be the preferred benchmark for midstream RIC-structured mutual funds.

### Alerian Benchmark Comparison

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<tr>
<th>NUMBER OF CONSTITUENTS</th>
<th>AMNA</th>
<th>AMUS</th>
<th>AMEI</th>
<th>AMZ</th>
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<td>MLPs</td>
<td>44</td>
<td>44</td>
<td>21</td>
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<tr>
<td>US C-Corps</td>
<td>13</td>
<td>13</td>
<td>12</td>
<td>-</td>
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<tr>
<td>Canadians</td>
<td>9</td>
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<tr>
<td>Total</td>
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<th>WEIGHTINGS</th>
<th>AMNA</th>
<th>AMUS</th>
<th>AMEI</th>
<th>AMZ</th>
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<tr>
<td>MLPs</td>
<td>41.1%</td>
<td>54.7%</td>
<td>25.3%</td>
<td>100.0%</td>
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<td>US C-Corps</td>
<td>32.0%</td>
<td>45.3%</td>
<td>43.6%</td>
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<tr>
<td>Canadians</td>
<td>26.9%</td>
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<td>31.1%</td>
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<table>
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<tr>
<th>MARKET CAPITALIZATION</th>
<th>AMNA</th>
<th>AMUS</th>
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<th>AMZ</th>
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<tr>
<td>Market Cap ($B)</td>
<td>$636.7</td>
<td>$481.0</td>
<td>$528.0</td>
<td>$333.5</td>
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<tr>
<td>Adjusted Market Cap ($B)</td>
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<td>$283.6</td>
<td>$383.7</td>
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<table>
<thead>
<tr>
<th>CONCENTRATION</th>
<th>AMNA</th>
<th>AMUS</th>
<th>AMEI</th>
<th>AMZ</th>
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<tr>
<td>Top 5 Weight</td>
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<td>50.1%</td>
<td>38.4%</td>
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<td>Top 10 Weight</td>
<td>70.9%</td>
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<td>% of all constituents</td>
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<td>82.5%</td>
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<td>57.5%</td>
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<td>% of index weight</td>
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<td>Constituents Below 1% Weight</td>
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<td>% of index weight</td>
<td>16.5%</td>
<td>13.1%</td>
<td>7.5%</td>
<td>6.9%</td>
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</table>

Source: Alerian, Salient Capital Advisors, LLC, November 2018.

For illustrative purposes only. Past performance is not indicative of how the indices will perform in the future. 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. Figures are only as of the date shown and are subject to change. Salient does not undertake to update recipients.

\(^{14}\) Source: Alerian, December 2018.

\(^{15}\) Please refer to the Definition of Terms section of this piece for further details of the liquidity requirement.

\(^{16}\) Bad asset test refers to mandates governing regulated investment companies (RICs) that limit the total weight of “bad assets” in a fund to 50%. “Bad Asset” in this case refers to a security in a fund with a weight greater than 5% or a security in which the fund owns more than 10% of the outstanding voting securities of the issuer.
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In addition, investing in MLPs involves additional risks as compared to the risks of investing in common stock, including risks related to cash flow, dilution, and voting rights. Such companies may trade less frequently than larger companies due to their smaller capitalizations, which may result in erratic price movement or difficulty in buying or selling.

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“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.

Definitions of Terms

The Alerian MLP ETF (AMLP) is a Fund that delivers exposure to the AMZI.

Alerian MLP Index (AMZ) is a composite of some of the most prominent energy MLPs that provides investors with a comprehensive benchmark for this maturing asset class.

Alerian MLP Infrastructure Index (AMZI) is a capped, float-adjusted, capitalization-weighted composite of energy infrastructure Master Limited Partnerships that earn the majority of their cash flow from midstream activities.

Alerian Midstream Energy Index (AMNA) is a capped, float-adjusted, capitalization-weighted composite of energy infrastructure Master Limited Partnerships and corporations that earn the majority of their cash flow from midstream activities.

Alerian Midstream Energy Select Index (AMEI) is a composite of North American midstream energy infrastructure companies that are engaged in activities involving energy commodities. The capped, float-adjusted, capitalization-weighted index is disseminated in real time on a price-return basis.

Alerian U.S. Midstream Energy Index (AMUS) is a capped, float-adjusted, capitalization-weighted composite of energy infrastructure Master Limited Partnerships and corporations based in the United States that earn the majority of their cash flow from midstream activities.

Basins are large-scale geologic depressions which also may contain other oil and natural gas resources.

Benchmark is typically an index, or a combination of indices, which is used by managers and clients to compare and assess a product’s philosophy, strategy, holdings, and performance.

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 Flow is the total amount of money being transferred into and out of a business, especially as affecting liquidity.

Correlation is a statistical measure of how two securities move in relation to each other. Correlation ranges between -1 and +1. Perfect positive correlation (a correlation co-efficient of +1) implies that as one security moves, either up or down, the other security will move in the same direction. Perfect negative correlation means that if one security moves in either direction the security that is perfectly correlated will move in the opposite direction. A correlation of 0 means the movements of securities have no correlation.

Crude oil is a liquid, which is extracted by producers from beneath the surface of the earth and refined into various energy products such as diesel, kerosene, and gasoline.

Distribution is money given by a company to its investors out of available cash, typically on a quarterly or monthly basis. Distributions are analogous to dividends, where distributions are issued by limited partnerships (e.g., master limited partnerships) whereas dividends are issued by corporations.

The Energy Select Sector SPDR ETF (XLE) is an exchange traded fund which seeks to replicate the returns and yield of the energy sector of the S&P 500.
Definitions of Terms (continued)

Exchange Traded Fund (ETF) is a marketable security that tracks an index, a commodity, bonds, or a basket of assets like an index fund. Unlike mutual funds, an ETF trades like a common stock on a stock exchange. ETFs experience price changes throughout the day as they are bought and sold.

General Partner (GP) is an owner of a partnership who has unlimited liability.

Incentive Distribution Rights (IDR) give a limited partnership’s general partner an increasing share in the incremental distributable cash flow the partnership generates.

Initial Public Offering (IPO) is the very first sale of stock issued by a company to the public. Prior to an IPO the company is considered private, with a relatively small number of shareholders made up primarily of early investors.

Large-capitalization (large-cap) companies are those companies with total market capitalization of greater than $10 billion.

Liquidity requirement in this case refers to a threshold of daily trading volume that companies must satisfy in order to be a constituent in the AMEI.

Margins or profit is the net income produced by a company.

Market Capitalization refers to the total dollar market value of a company’s outstanding shares.

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

Mid-capitalization (mid-cap) companies are those companies with total market capitalization of about $2 billion to $10 billion.

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

Natural Gas is a naturally occurring hydrocarbon gas mixture consisting primarily of methane, but commonly including varying amounts of other higher alkanes, and sometimes a small percentage of carbon dioxide, nitrogen, hydrogen sulfide, or helium. We use natural gas as a fuel and to make materials and chemicals.

Natural Gas Liquids (NGLs) are hydrocarbons; a hydrocarbon is a molecule composed exclusively of carbon and hydrogen. As a hydrocarbons, NGLs belong in the same family of molecules as natural gas and crude oil. Examples of NGLs include ethane, propane, butane, isobutane and pentane.

S&P 500 Total Return (TR) Index is a stock market index based on the common stock prices of 500 top publicly traded American companies. RISKS: Can be affected by general market or economic conditions.

Refined products are derivatives of crude oil after it has been processed in a refining facility. Refined products includes kerosene, gasoline, fuel oil and other liquid hydrocarbons.

Regulated investment company (RIC) is an investment company which is deemed eligible by the Internal Revenue Service (IRS) to pass through the taxes on capital gains, dividends, or interest earned through investments to individual investors.

RIC Funds is a regulated investment company, such as a mutual fund or exchanged-traded fund, that can pass-through its income to investors and avoid corporate taxation.

Upstream is the sector of the energy value chain closest to the wellhead and includes activities such as the exploration and production of energy commodities.

Valuation is the process of determining the current worth of an asset or a company.

Yield is the income return on an investment, such as the interest or dividends received.

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