



For MLP Investing, Let's Ditch the Market Cap-Weighted Index

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Investor Spotlight



By almost any measure, the advent of the index fund has been a rip-roaring success. Indexing made it possible for hundreds of thousands of retail investors to diversify without

taking on unwanted manager risk – and the fees they charge for (generally) failing to beat their own benchmarks. And the concept and technology behind it launched the entire exchange-traded fund industry.

And indeed, indexing as we generally think of it – weighted by market capitalization - works reasonably well during normal market conditions. A market-cap-

weighted index fund, in theory, holds an equal percentage of the float of every stock in the index, through thick and thin, regardless of the financial condition of the companies it owns, and without regard to whether an given holding is overvalued or undervalued.

The problem with conventional market-cap-weighted indexing, though, comes as we approach market inflection points. Where an

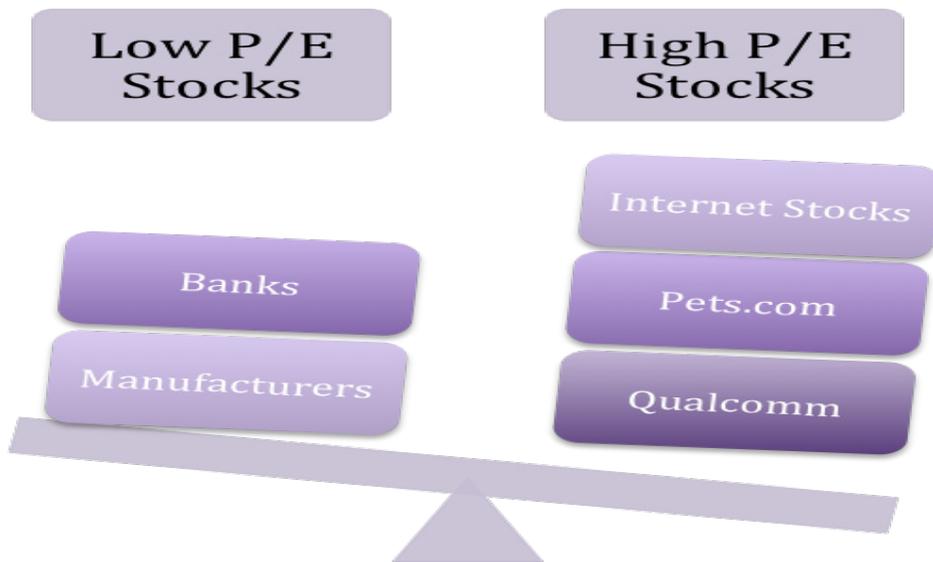


Figure 1: Equity Markets c. 1999

In normal times, a market-cap weighted index would approximate a fairly rational allocation of capital across the economy.

news.

As a result, investing TV shows became cheerleaders for already overvalued stocks. Retail money poured into indexes – the S&P 500 Index and SPDRs, the QQQ ('cubes') tracking the Nasdaq, and the indexes themselves were allocating investors money precisely to the most expensive and worst values on Wall Street, precisely because they were the worst values on Wall Street. The worse it got, the more money these financial black holes would suck up and allocate to the most overvalued companies, overvaluing them even more, inflating their prices still more, which in turn increased their weight in a market-cap-weighted index, and so on. (See figure 2). All

◀ index includes stocks based purely on the market capitalization of the company.

Here is a very basic illustration of the conceptual shortcoming of the market-cap index, as exemplified by the spectacular inflation and implosion of the Internet/technology stock bubble. The graph depicts the effect of the wildly inflated prices of such disasters as Pets.com, and even the technologically and financially sound Qualcomm, whose stock inflated far beyond any rational expectation of future market share or profitability.

In normal times, a market-cap weighted index would approximate a fairly rational allocation of capital across the economy. Each industry would have some higher P/E stocks and some lower P/E stocks, with the more volatile or riskier stocks discounted appropriately.

In 1999, though, we had precisely the opposite situation. Unproven stocks of high volatility were assigned absurdly high multiples – if they had earnings to speak of at all. If there were no earnings, sell-side analysts-too frequently on the

take -frantically tried to reinvent mathematics to justify some new paradigm – as if it were somehow rational and sustainable to price a dozen different companies as if they would each have 33 percent market share in five years.

That was obviously not going to last long. But the retail investor had no real way to assess that probability, because of the spectacular collapse of all but a few financial media outlets and their ability to skeptically report financial

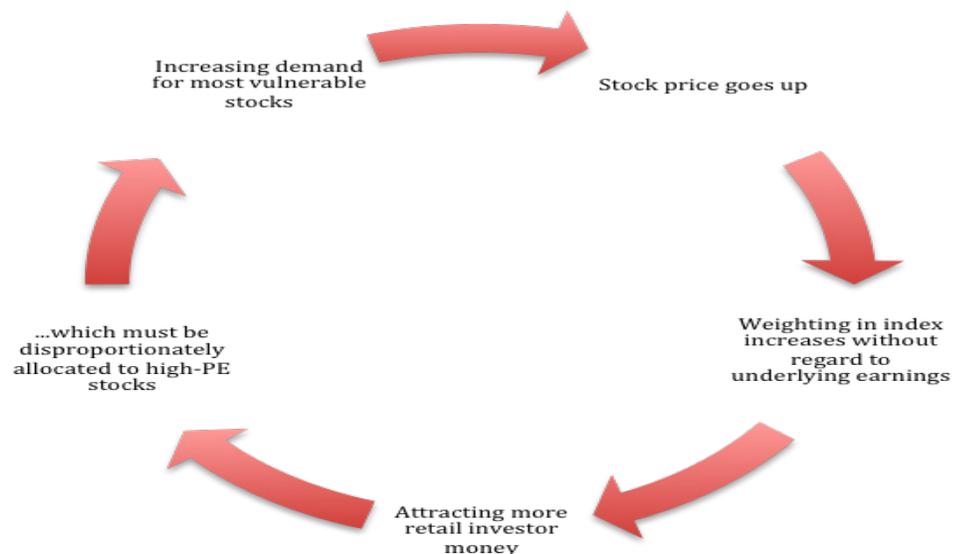


Figure 2: The Vicious Cycle of Market Cap Weighting while in a Bubble

◀ the while, the much better value stocks – those paying dividends in 1999, for example, were left grossly underbought, because market-cap-weighting rules caused overpriced companies to continue stealing all the oxygen from the much better deals at the bottom end of the indexes.

The broad stock markets of 1999 were big enough, kind of, to absorb the massive capital inflows to high-P/E, low-earnings stocks, though even then we had massive distortion within the indexes.

By 1999 and early 2000, we had the absurd situation where technology accounted for just 10 percent of the real earnings in the S&P 500, but represented 40 percent of the S&P 500 index. The Nasdaq 100 was even more off-kilter. The market had become unhinged – and the effect was being magnified even more within market cap-weighted indexes.

But what happens in an investment milieu that has perhaps a few score reasonable investable companies, each much smaller than even stocks in the midcap index? In this case, a pure market-cap-related

It is possible for a manager to make many millions of dollars in stupid investments.

index would cause even more problems. One such market is the Master Limited Partnership arena.

At least one investment company specializing in this market, though, has rejected the market-cap weighting system for passive investing. Instead, Miller/Howard Investments is looking to avoid the tendency of market-cap-weighted indexes to be massively efficient at market inflection points by adopting the less-widely-known fundamentals-based index approach. Introduced in August of 2013, The Miller/Howard MLP Fundamental Index is comprised of 25 energy Master Limited Partnerships focuses on metrics they believe are likely to drive future returns, such as dividend/distribution growth, EBITDA, distribution coverage, projected

capex spending (that is, projected capital investment), and use those factors to calculate how the index should be allocated.

While traditional market cap weighted index efforts within the MLP world will invariably focus on the biggest ten MLPs or so, the Miller/Howard fundamentals gives the little guy – the MLPs still in the earlier and growthier stages – a chance for representation in a passively managed fund.

If market-cap weighted indexes function like the House of Representatives, dominated by big population states like California, New York, Pennsylvania, Ohio and Florida, think of a fundamentals-based index like the Senate: Rhode Island and Alaska have the same pull in the upper house of the legislative branch as California and New York.

Dividends are Key

“Distribution growth has historically been the most predictive factor for MLP growth performance,” explained fund manager Lowell Miller in an interview with his own marketing team last year. “Secondly, you want to be sure that the distribution is safe and the company isn’t paying out more than it can really afford.” Hence the EBITDA focus.

“Finally, the history of distribution growth is a good indicator of prospective distribution growth in the future. But you want more than that. What makes this engine run is continuing distribution growth. We seek metrics that provide a comfort level that distributions will continue to grow in the future. The best metric is the growth of a company’s capital expense. It is from these investments that a company is able to generate higher cash flow to pay distributions,” Miller says. ▶



Figure 3: MLP Capex investment and distribution growth, not market cap, drive MLP returns.

◀ Outlook

While most MLPs are structured to provide income, thanks to certain tax advantages accruing to K-1 income, the fundamentals-based index pushes the center of gravity towards smaller, up-and-coming MLPs. The prospects for capital growth, then, may be greater for MLPs in this fund, as compared to cap-weighted indexes.

Investors may see greater short-term price volatility, because of the presence of the smaller and less liquid MLPs. However, the illiquidity of the smaller MLPs

may be part of the charm: Illiquid securities tend to have to offer a sweeter yield on investment than more mature securities in order to compensate for their illiquidity. If illiquidity is no big deal to you, that's an opportunity.

At least one academic paper, Jan Olof Andersson writing for his Masters' thesis at the University of Stockholm, bears out this analysis – at least in Sweden, and characterizes fundamentals-based investing as a “high-risk/high return” strategy in his excellent paper, Irrational Indexation.

Nevertheless, Warren Buffett's famous counterargument to Modern Portfolio Theory approaches to risk management seem to be applicable here: If you have two investors – one buying dollars for 90 cents each and one buying dollars for 50 cents each – and you tried to assess their risk exposure, Modern Portfolio Theory would hold that it's the guy with the 90 cent dollars that had the safer portfolio.

The reality is that the investor buying the cheaper assets is much, much safer, in the long run. ■