When Dealing With Energy, Be Conservative – In More Ways Than One

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When we talk about energy, we usually talk about conserving it—the energy itself. We talk about turning off our lights when we're not home, or installing tighter airproof windows to rely less on air-conditioning. We want to save electricity and gas for the whole world, while also trying to curb our personal utility bills. In short, we want to play a conservative game with as much of a safety net as we can hope for—it saves us money, and saves the company energy.

That metaphor extends beyond energy itself. Even when the conversation shifts to investments in energy companies and MLPs, the word to watch for is "safety". Most energy MLPs have this in the bag—pipelines are expanding exponentially across the United States and Canada, making natural gas and crude oil an appealing investment. But to focus exclusively on these areas disregards up-and-coming energy MLPs as inherently risky, despite maintained selected culpability and a high promise for quality returns.

What tends to happen, then, is that radical new ideas for solar, wind and nuclear energy are left wayside while larger MLPs garner bigger and bigger chunks of market growth, and investors stick to securities in pipelines and natural gas liquids. In uncertain times, people want to invest in certainty.

The Two Approaches

There are two ways to approach the dilemma, and both emphasize investment safety over all.

The first is the "bigger isn't always better," idea, which aims to reverse the problem of good ideas going unnoticed in this market structure. Miller/Howard Investments, a new MLP Index made up of 25 energy MLPs, is trying to shake up the energy sector by shifting focus away from market capitalization-weighted indexing—which encompasses pretty much every MLP Index on the market, including lofty competitors like Alerian MLP. Along with its ETN mimic, C-Tracks ETN (MLPC), there's a growing push towards indexing factors beyond cap-weight, including distribution growth, projected capex spending and distribution coverage. In other words, it's a shift back to basics.

The second approach could be described as the "slow and steady" movement, as propagated by powerhouse closed-end funds like Tortoise MLP Fund (NTG), one of the founding energy MLPs from back in 2002. Tortoise Capital Advisors approach investments with stress on current income with low volatility and as few downside risks as possible—which means tried-and-true investments in long-distance natural gas pipelines that flow between states and across international North American borders. These companies have proven to thrive in the last 10 years, with the increased production of bitumen-based fractionation and innovative gas development.

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Investing in the Inevitable Future

Tortoise is a self-described "bottom-up, fundamentals-based" MLP that leaves room for clear-minded risk assessment and heavy reliance on past-proven investment opportunities—70% of its total assets are locked into natural gas infrastructure MLP equity securities, which, given the United States' daily consumption of 19 million oil barrels and 63 billion cubic feet of natural gas, combined with the sheer continental distance of natural gas reserves from the country's most densely populated urban areas, make pipelines an undeniably alluring investment.

This is what makes Tortoise a safe bet in the energy industry. It chooses its investments based on companies' specific positions, potential commodity price risk, the stability and potential for further supply and demand, management track records and regulatory notes.

Conversely, an MLP index like Miller/Howard and C-Tracks ETN might incorporate some of Tortoise's strategies, but weigh them out with 24 other energy MLPs, including 10 specifically-chosen industry underdogs with strong promise for high yields, but who simply haven't accrued enough history to attract retail investors.

Conserving Energy Through Times of Growth

The world of energy MLPs, which

currently moderates $28 billion, is seeing more and more movement towards stability, distinguishing it within the investment universe. Energy MLPs generally risk minimal downsides and pay higher dividends because of the relatively low level of competition the companies face.

Consider the Houston-based Center Coast MLP & Infrastructure Fund (CEN), a closed-end fund MLP focused on diversified energy, refined products and natural gas pipelines. In most instances, fees are based on the quantity of the transported product, rather than the fluctuating prices of the product itself—say, the cost of gas. Pipelines, a staple for Center Coast MLP, don't often run into competition with one another, which creates a stable monetary environment. And with gas prices on the rise, interest in energy MLP investments rises in tandem with the MLP growth itself.

But it's important to keep a level head. Center Coast focuses on high-quality, midstream energy companies through a combination of operational and investment experience in MLPs. Their NAV recent history shows steady levels against fluctuations in the market price, and their four-year history is proof of a working system that has maintained consistent NAV distribution rates with modest and successful growth.

These companies are just some pieces of a larger financial puzzle. The puzzle, however, starts to look a lot less complicated when investors looking towards energy are noticing that safer MLPs are drawing in fresh money on practically a weekly basis, according to fund tracker EPFR.

At the end of the day, it's time to start thinking of investments the way we think about energy: they're both worlds where conservation leads to longer, more stable futures.

Moving Away From Cap-Weighted Indexes

This debate is ongoing. A common argument against cap-weighted indexing hinges on the disastrous technology bubble from the late 1990s and early 2000s. According to an in-house interview with Lowell Miller, president and founder of Miller/Howard, "We've seen terrible examples of weighting as a function of market cap during the technology bubble when tech stocks reached nearly 40% weight in the S&P 500 simply due to investor speculation rather than fundamentals."

When the gap widens between large-cap and small-cap MLPs, it's easy for overzealous hype to catch fire across unverifiable stocks. It becomes (as it became just over 10 years ago) impossible to accurately assess market probabilities and inflation rises exponentially.

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