Master Limited Partnerships trade like stocks but act more like fixed income securities with tax advantages. Though they trade on exchanges like the New York Stock Exchange, Master Limited Partnerships (MLPs) trade as units, not shares. They currently pay income at annual rates of 6.5% to 7.5%.

Unlike bonds, payments may rise if the company grows. And the price of units could rise. But both of these come with the risk that income or unit price could drop if the company runs into trouble.

Many portfolios see diversification benefits from MLPs. Some MLPs that passed our screen of certain criteria carry a beta of -0.1 to +0.4. The stock market, represented by the S&P 500 index, has a beta of 1.0. The more a security's beta diverges from the market's, the greater the diversification benefits. That should translate into lower risk and/or higher returns for a portfolio.

Because MLPs throw off partnership losses, holders of MLP units typically can defer taxes on much of the yield they receive. Holders need to file a tax form K-1 to capture the details of the partnership income and losses.

Investors often want to have these investments in their taxable accounts because of tax advantages that accrue from MLPs. If an investor reaps tax benefits from an MLP, selling the units can generate taxes in the year of the sale. Over time, the income payments reduce the cost basis of the investment. When the units are sold, a portion of the gain (the difference of the selling price minus the lowered cost basis) is treated as a capital gain, and a portion is taxed as ordinary income. MLPs are not suitable for tax-deferred accounts such as IRAs because earnings above $1,000 are considered "unrelated business income," which is taxable.

As with any high-yielding instrument, the attraction of the yield paid by MLPs dips as interest rates rise. A 7% MLP dividend looks better to investors when bonds are paying 4% than when fixed income is paying 5.5%. Interest rate rises can cause MLP unit prices to fall versus other shares. Some MLPs operate in industries such as gas pipelines where transmission rates adjust for inflation. So if interest rates rise with inflation, chances are dividends paid by the MLP also will rise, protecting the units from the price effect you would expect when other rates rise.

Key factors to look for when deciding on MLPs to buy include:
Distribution coverage. Is the company generating enough cash flow to cover its promised payout? Look for a distribution ratio above 1.0.
Current payout level. MLPs carry more risk than Treasuries. They should have yields well above Treasury yields.
Growth in payout. Dividend history will tell you whether the income has grown.
Debt-capital ratio. If an MLP is deep in debt, it might not be able to maintain payout if business hits a bump.

We believe MLPs offer diversification, income and appreciation potential. If you would like to discuss them in relation to your account with us, please call at your convenience.