



Commentary

November 2009

There is still significant trepidation from investors. Using conventional wisdom, one might question why risk assets (stocks, bonds, & commodities) keep rising in the face of: higher unemployment, a weakening dollar, continuing real estate foreclosures, and more insolvent government entities. To understand what is transpiring, one needs to tune out the daily chatter on CNBC and BNN and look at the big picture. With 0% short interest rates set by the Fed, cash flow producing assets (stocks and bonds) are worth significantly more.

My parents were visiting from Connecticut over the US Thanksgiving holiday. They are your typical retirees, who are struggling to maintain their life style with dwindling assets and paltry returns on those assets. They would welcome a stable 8% return. Currently, the bank pays them 0% and they have fear of re-entering the markets. I was showing my father the yields of many of the US Master Limited Partnerships (MLP's) and some of the Canadian Income Trusts we hold in our Enhanced Income Fund.

To things simple, I did not discuss those securities on which we write options or income trusts that have not yet converted to fully taxable. I wanted to make the point of how many conservative assets are still exceptionally attractive. Here are some of the current yields of MLP's and income trusts by industry in the fund: propane distribution 12%, energy producers 12%, REIT's 10%, and pipelines 8%.

Needless to say he was astonished at these high yields given the 0% at the bank and 2% on near dated Treasuries (UST's). Like myself he also believes that we are most likely in front of a period of rising inflation and he wants protection. The cash flows from the above mentioned asset can increase with inflation where as the fixed rates from the bank or bonds will not keep up with inflation.

This conversation made me pause and reflect why these assets and all risk assets have risen significantly and will continue to rise significantly as long as the Fed keeps rates low. Pipelines are basically cash flow stable assets and should not yield 8% when the 10-year UST yields 3%. This is a 500 bps yield advantage for an asset that most likely has lower risk than UST's as it has inflation protection. I have followed MLP's over the last 15 years and can remember periods when MLP yields were below 10 year UST yields, as investors recognized MLP's offer growth and inflation protection.

So how much more might these assets appreciate given current interest rates? Let's assume that investors continue to hunt for yield and they push pipeline yields to 100 bps above the 10- year UST. That means that a pipeline yielding 8% would have to appreciate 100% to yield 4%. This makes no assumption about inflation or deflation and assumes no growth in the distribution. This just assumes the yield gets re-priced relative to the current risk free rate. Interestingly, in 2007 the 10 year UST was above 5% while these same pipeline assets yielded approximately 6%.

Remember in recent history we have never been in an environment of 0% short rates and 3.3% long rates. If one has the choice of a 0% CD or an 8% pipeline, the choice is simple. As investors regain their confidence these prices will go higher and yields will go lower. This is one of those 'gift' times in investing where you just need to look at the 'big picture' and stop following the news. All risk assets will continue to be priced relative to exceptionally low interest rates. My parents returned to CT content there is a viable option for their retirement goals.

– Derek Webb

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