IPI Wealth Management, Inc.

ACCESS ETF
STRUCTURE MATTERS

By Dan Weiskopf
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Interview series: Investment Factors that drive ETF performance

The goal of this next ***Structure Matters*** series is to provide practical guidelines with how factor based investing should be monitored, measured and used. In this series, we will interview ETF portfolio managers and key decision makers who are involved in the ETF construction and the factor weightings that drive index and "real money" performance. Although the label "smart beta" is at the core of the factor question, investors in passively managed funds need to recognize that a "do nothing strategy" arguably results in the automatic acceptance of certain risks. For example, market weighted indexes overweight winners and arguably can make performance axiomatic while also potentially increasing risk. There is no free lunch!

Our belief at Access ETF Solutions is that investors need to study the factors that drive the index construction within any ETF so they understand how the engine works or run the risk of driving off course. As a tactical investor we believe that curves in the road will affect factor outcomes and portfolios need to be reviewed in the context of changes in the investment environment. Ignorance will not be forgiven if you get stuck in the mud in your new sports car when the road requires an off road vehicle.

Interview Date: April 18, 2015

In this interview I am pleased to be speaking to a relatively new member of the ETF marketplace, Jay Hatfield, the Portfolio Manager of Infrastructure Capital Advisors (ICA). Jay and his firm are the sub-advisors for the only active managed MLP ETF (AMZA) and brings backgound to the ETF market as both an operator and as a portfolio manager. He is both a Co-founder and general partner of NGL Energy Partners, a NYSE-listed MLP (NGL). Prior to forming ICA, he was portfolio manager at SAC (Now Point72 Asset Management).

We believe readers will find this interview particulalry insightful given Jay's expertise and background in the MLP space and hope his comments about factors that drive the MLP space helpful in how they view the sector.

Dan Weiskopf: Given your experience in the industry – what is your vision for how the different indexes might perform under various circumstances, i.e. consolidation, higher interest rates and energy volatility?

Jay Hatfield: We have seen some consolidation in the industry and expect the trend to continue as companies vie for attractive assets in growing basins and markets. First, we believe the trend of consolidation is positive for the overall sector and asymmetrically benefits the general partners of public MLPs whose cash flows substantially increase as the underlying MLP increases its own cash flow and share count. In addition, companies in the industry have also moved to consolidate to lower their cost of capital. Notably the Kinder Morgan (KMI) entities consolidated into one company, Enbridge Energy Partners reset its incentive distribution rights, and Williams Companies (WPZ) and Energy Transfer (ETE) consolidated their underlying MLPs.

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Second, Over time, MLPs have shown a very low correlation to treasuries, less than 10%. MLPs may experience volatility as a result of possible Fed actions later in the year, but we do not believe that it negatively impacts the long term attractiveness of the midstream MLP sector.

Third, the last Fed Funds rate tightening cycle occurred from June 2004 to June 2006 during which short term rates rose from 1.00% to 5.25%. MLPs initially fell in anticipation of the Fed's move but quickly began a sustained recovery, returning over 40% by June of 2006. Midstream MLPs are currently yielding 4.2% basis points above 10 year treasuries compared to a long term average of 2.5% - 3.0%. The prices of midstream MLPs have shown a correlation with energy prices, although the underlying cash flows of the businesses have generally not been greatly impacted.

The midstream MLP space is largely insensitive to actual commodity prices, and is more reliant on transported and stored volumes. This toll road type business model is more stable and is reflective of broader supply and demand dynamics than with volatile commodity prices. Despite lower commodity prices lately, production and demand continue to increase, and there will be a need for new energy infrastructure.

Dan Weiskopf: What 4 factors (operating fundamentals, value, technical or macro) do you as a portfolio manager monitor most closely when monitoring the MLP space?

Jay Hatfield: We monitor all of these factors in our investment process, although we place more emphasis on fundamentals and valuation criteria over technical and macro factors. Our primary focus is on the operating fundamentals of our portfolio companies and in turn their valuation relative to these fundamentals. We focus on quality businesses with good growth prospects that can generate high returns on invested capital. We seek to buy these businesses when they are priced at a discount to the growth adjusted group cash flow multiple.

While relying on fundamentals as discussed above, we also monitor technical factors to identify attractive buy and sell points within our universe. Given the retail nature of the sector, MLP market pricing can for short times become mispriced relative to fundamentals.

We monitor the macro environment to determine the level of exposure to market and commodity risk. We employ a modest amount of leverage in our fund, up to 30% of equity, and we actively monitor the valuation of the midstream MLP sector as a whole to optimize that exposure.

Dan Weiskopf: How frequently do your review these factors and potentially re-allocate or tweak the portfolio? How much turnover would you expect to have in a normal year?

Jay Hatfield: We review these factors daily and will make frequent but minor adjustments to the portfolio as appropriate. We try to keep the turnover low and anticipate that it will be approximately 30% on an annual basis. The core constituents of the portfolio will remain, although their weightings may change as the valuations and business outlooks change. There are certain tax disadvantages to short term trading in MLPs, and hence we view the majority of the portfolio as remaining relatively static over long periods of time.

Dan Weiskopf: Which of the factors do you see as the most predictive (in terms of risk, alpha in the short or long term) and how do you try to take advantage of these dynamics?

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Jay Hatfield: We look to identify and overweight high quality companies with better than average return on invested capital and resulting growth profiles at attractive valuations relative to the group. We view MLPs as a total return vehicle. Accordingly, we continuously analyze the distribution yield and the growth potential in that distribution to arrive at an expected total return. MLPs that perform best over a 12 month period tend to have attractive and achievable growth and a yield that is attractive relative to peers considering that growth.

Dan Weiskopf: Thank you Jay.

Disclosure: **For Institutional Investors Only.**

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