A High Income Factor Special Report

S77 INCOME:

The Secret Side of Oil

by Tom Hutchinson

It is a great irony that one of the only constants in life is change. Our environment is always evolving and morphing into something different.

Oftentimes, we don't even notice the main harbingers of change if our daily lives aren't obviously impacted.

But as investors, identifying such catalysts can be the secret to successful investing. In fact, an enormously powerful change agent is brewing in this country right now.

Beneath this slow-growth economic recovery, one of the most positive developments in generations is happening in the U.S. The United States is experiencing a massive boom in energy production.

It is a phenomenon that will provide astounding economic benefits for decades to come, creating unbelievable opportunities for investors who know where to look.

In only a few short years, one of this country's biggest problems has transformed into one of our greatest assets. Here's a glimpse of the turnaround.

The American Energy Miracle

For many decades, this country has been dependent on foreign oil for its very survival. And all along, we have rued that dependency.

From the oil embargoes and gas lines of the 1970s to the latest Middle East wars, the United States has repeatedly pledged to wean itself from its dependence on foreign energy.

But, for all the mileage and energy efficiency standards, the technological improvements and political promises, America's insatiable foreign energy dependence continued to get worse.

As demand for oil skyrocketed, U.S. production fell off a cliff. It peaked in 1970 at 9.6 million barrels per day and it declined to 5.3 million barrels per day in 2009. As a result, we went from importing just 10 percent of our oil in 1970 to an obscene 66 percent in 2007.

Every single year, hundreds of billions of dollars were being exported to pay for our massive dependence on foreign oil. Oil tycoon T. Boone Pickens warned that U.S. oil imports would facilitate the greatest transfer of wealth in human history. Our trade deficits soared to record heights during the first decade of the new millennium. Energy imports accounted for about a third of the crippling deficit.

At the same time, the global supply of energy began to dwindle as new demand from emerging markets taxed existing supplies and sent oil prices through the roof. The future looked bleak.

But that was then. In the last few years, the situation has completely changed.

New and improved technology has saved the day, unlocking vast quantities of previously irretrievable sources of oil and gas right here in the United States. This technological "miracle" has, in just a few short years, propelled the United States from being a hopelessly dependent importer of energy to being a formidable global energy-producing powerhouse.

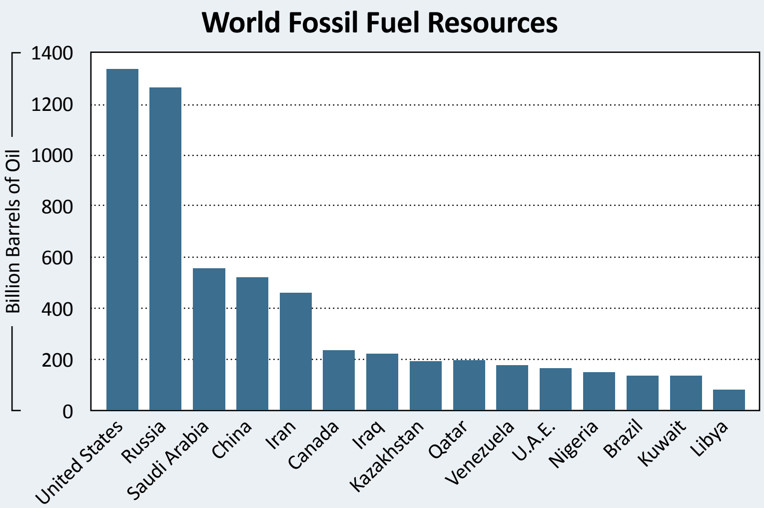
Two key technological advances are behind this incredible turnaround:

- **Horizontal drilling.**
  This is one of the most valuable technologies ever introduced in the oil and gas exploration business. Unlike a traditional drill, which bores straight down, a horizontal drill can also curve sideways below the surface. This enables a drill to go under cities and other previously unreachable places, and to tap far more from a given underground reservoir. In fact, production from a horizontal drill can exceed that of a traditional drill by as much as 15 to 20

▶ About Tom Hutchinson

I've worked in finance my entire career, from the back office of a Wall Street firm to the floor of the New York Mercantile Exchange learning how markets work. Eventually, I became a financial adviser where I met with thousands of investors and managed the portfolios of hundreds over the course of about 15 years. I left my career as a financial adviser, writing for The Motley Fool as well as StreetAuthority LLC, researching companies, industries, and markets. In The High Income Factor, I can bring you the full benefit of my years of investing experience.

Chart 1



The U.S. leads the world in recoverable fossil fuel supplies, just ahead of resource-rich Russia and well ahead of Saudi Arabia, China, Iran, and Canada. This powerful data helps put the country in the driver's seat as far as meeting its energy needs for years to come — reducing dependence on foreign oil in the process.

SOURCE: CRS

times, making these drills both highly efficient and cost effective.

- **Hydraulic fracturing or "fracking."** Fracking is a method of extracting oil and gas from shale rock, which pumps water into the rock to break the sediment and release gas. The development of this technology in the past decade has led to enormous gains in recoverable oil and gas reserves in vast American shale fields that previously had been untapped.

These technologies have been such a game changer that a report issued by the Congressional Research Service in 2010 estimated that this country's fossil fuel reserves (including oil, gas, and coal) are more abundant than those of any country on earth.

In fact, the CRS's study estimated that U.S. fossil fuel resources add up to more than those of Saudi Arabia, China, and Canada combined. (See Chart 1.)

By most accounts, this country has enough oil reserves for another 100 years at current consumption rates, enough natural gas for another 100 years, and enough coal for 200 years.

Such fossil fuel abundance is fortuitous, to say the least. According to a report issued by British oil and gas giant BP, global demand for energy is expected to skyrocket by more than 40 percent between now and 2035. And more than 75 percent of that consumption rate will likely be from fossil fuels, according the International Energy Agency (IEA).

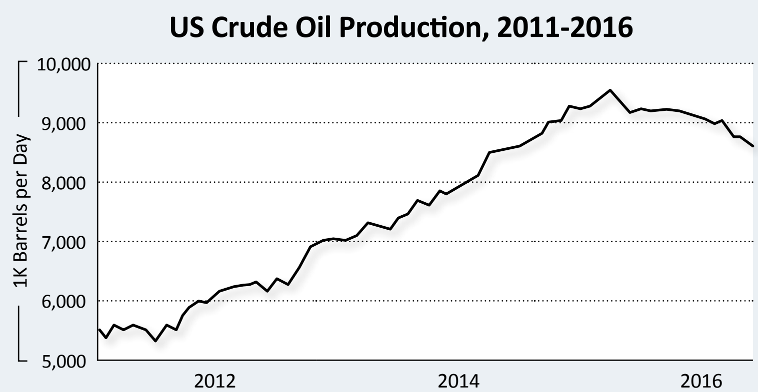
The United States is now the fastest-growing oil producer in the world. In fact, by most accounts the United States will surpass Saudi Arabia as the world's largest oil producer sometime in the next few years. The following numbers will give you an idea of the magnitude of the turnaround.

- As I noted earlier, the United States produced 5.3 million barrels per day (bpd) of oil back in 2009. By 2012, that amount had grown by more than 22 percent to 6.5 million bpd, and continued to grow to more than 7.5 million by 2013, the fastest year-over-year growth rate in U.S. history.
- Production soared 89 percent between 2008 and 2015 and 45 percent since just 2012. The country went from producing 5.475 million barrels per day in 2008 to 9.4155 million in 2015. (See Chart 2.)

And that's just oil. The rise in natural gas production also has been impressive.

Shale gas has been the biggest driver of U.S. production over the past several years, helping

Chart 2

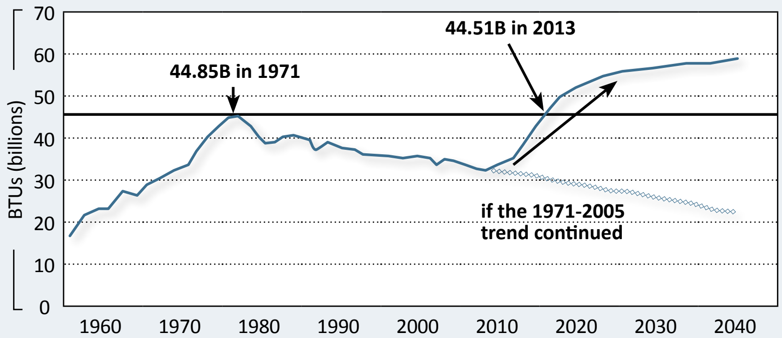


U.S. crude oil production has ratcheted up significantly in this decade, thanks to key technological advances. It's an investable trend that has transformed energy from one of the country's biggest problems to one of its most powerful assets.

SOURCE: U.S. Energy Information Administration, TradingEconomics.com

Chart 3

US Crude Oil and Natural Gas Production, 1960-2040



The shale revolution has transformed the U.S. from a country dependent on foreign sources of oil and natural gas to a major global producer. This chart shows the course we were on — and how those fortunes dramatically improved when fracking changed the game. Note that the figures from 2015 onward are estimated.

SOURCE: EIA, Carpe Diem blog

boost overall natural gas production volumes by 25 percent from 2007 to 2013.

And there's still plenty of room for growth. The EIA estimates that there are approximately 2,200 trillion cubic feet of reserves, about the same as the size of Saudi Arabia's proven oil reserves. The agency expects U.S. natural gas production will increase 44 percent between 2011 and 2040, with almost all this growth due to shale gas.

The Energy Sector Crash

The rapid expansion of U.S. energy production has been so profound that it has had a material effect on the world market. With the extra U.S. supply, the world found itself awash in oil at a time when the global economy was slowing and demand for oil was falling.

At the same time, OPEC (the Organization of the Petroleum Exporting Countries) was unwilling to cut back production and lose precious market share to the U.S. and other oil producers.

The old mechanisms to control supply and stabilize oil prices no longer applied, and oil prices went into a free fall. The price for WTI (West Texas Intermediate, the U.S. benchmark) fell from over $107 per barrel in the spring of 2014 to under $28 per barrel by February of 2016, a 13-year low. Prices have since moved well off those lows, however, and stabilized, with the per-barrel price around $44 in September 2016.

The oil price crash caused depression-like conditions in the U.S. oil and natural gas industry. Many producers have gone bankrupt and a significant number of layoffs have taken place. The carnage impacted every part of the energy sector. The SPDR Select Sector Energy ETF (XLE) — a benchmark of S&P 500 energy sector, with 37 holdings — fell from $100 per share to $57 per share in the same timeframe as the crude oil price crash.

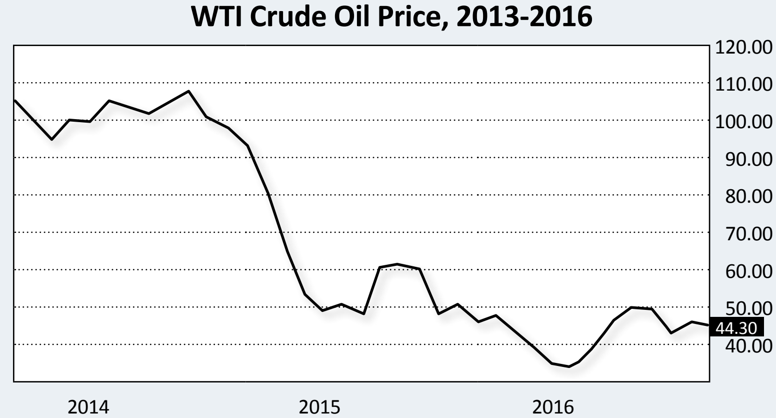
While the global energy market slowdown has caused U.S. oil and gas production to scale back somewhat from the highs of 2015, it still remains massively higher than it was just a few years ago.

As well, production should recover and resume its long-term growth trajectory in the years ahead. In fact, recent industry troubles have created a huge opportunity for investors to take advantage of the energy boom on the cheap.

Many companies are a long way from the pre-crash highs and are selling at valuations not seen since before the energy boom took hold. This creates a sort of market "hiccup" where investors can still get in at a low price in an industry that is likely to boom in the years to come. For a host of good reasons, oil and gas production will continue to thrive and grow.

Chart 4

WTI Crude Oil Price, 2013-2016



The price for West Texas Intermediate crude dropped from over $107 per barrel in the spring of 2014 to under $28 per barrel by February 2016, hitting a 13-year low. Since then, prices have somewhat stabilized, with the per-barrel price around $44 as we went to press.

SOURCE: U.S. Energy Information Administration, TradingEconomics.com

A Wide Economic Impact

The oil and gas boom has ramifications that stretch far beyond the energy industry. Energy fuels the economy. Having a cheap and abundant source of energy provides advantages that affect everything from the value of the dollar to middle-class jobs to the international balance of power.

Of course, some are skeptical about the advantages of such ramped-up fossil fuel production — those who are concerned about climate change and argue in favor of clean energy solutions.

But I believe that the economic advantages of the energy boom are simply too great not to harvest and, ultimately, this country will have no choice but to exploit the newfound bounty. Here are some of the advantages that we simply won't want to discard.

1. JOBS

Although it is hard to pinpoint exactly, it is likely that the production boom has created over a million jobs already. This is a huge benefit in an environment of persistent unemployment where such opportunities are rare. But this may be just the beginning.

Myriad job possibilities outside of the energy industry are being made possible by the boom. For example, manufacturing is starting to make a comeback in the United States as companies take advantage of access to a large supply of cheap energy in the form of natural gas.

2. INTERNATIONAL TRADE

As I mentioned earlier, energy imports accounted for as much as one-third of the skyrocketing trade deficits of last decade. Reducing the trade imbalance will have the effect of increasing U.S. competitiveness, strengthening the dollar, and creating jobs.

3. ECONOMIC GROWTH AND GOVERNMENT REVENUE

The abundance of energy has made it cheaper for certain businesses that use oil and gas to operate. A lower-cost energy source is similar to a big tax cut, leaving these businesses with more money available for expansion.

The oil boom is also providing the government with additional revenue that can help lower the deficits. Beyond the oil business taxes, the government can draw additional revenues from ancillary businesses in manufacturing and other areas that benefit from the energy boom.

Plus, there is much potential oil and gas located on federal lands. These sources have not yet been fully developed, but they can potentially not only add tax revenues but also pay royalties to the government.

S77 Income in Your Pocket

Naturally, this energy boom creates a multitude of investment opportunities, including a special one of note for income investors.

Income investors can take advantage of the little-known "S77" income streams, by investing in master limited partnerships. MLPs are traded publicly, capturing the tax benefits offered by a limited-liability partnership.

According to Section 7704 of the Revenue Reconciliation Act of 1987, for a partnership to be classified as an MLP, 90 percent of its income must be generated from real estate, natural resources, or commodities. That includes exploration, development, mining, production processing, refining, or transportation of any mineral or natural resource.

MLP designation provides a special tax loophole that was created to encourage the natural resource industry. The effect is that MLPs pay no tax at the corporate level so long as 90 percent of income is paid out to shareholders in the form of dividends.

This is a major income advantage over regular dividend-paying stocks because money otherwise lost to taxes is added to the dividend. As a result, MLPs are some of the best income-paying securities on the market. Profits go right into your pocket instead of Uncle Sam's.

While S77 companies, or MLPs, can include shippers, agricultural companies, and miners, the overwhelming majority are in the energy industry. Most of the energy MLPs are involved in what is called midstream energy, which is the middle of the process of getting oil and gas out of the ground and selling it to end users.

Midstream companies provide infrastructure support for the industry, such as piping and storing of oil and gas. The beauty of the midstream business is that these MLPs are not overly exposed to the risk posed by volatile energy prices. They simply charge a fee for the services of transporting and storing oil and gas. Such companies are like toll collectors on the energy highway and have dependable and predictable income streams.

These MLPs have the ideal business model from which to pay shareholders a regular income. In addition, many pipelines face little competition and operate near-monopolies in their area. Once these pipelines are built, they require little expense beyond routine maintenance and just continue to spit out cash.

Returns on oil and gas infrastructure MLPs had been phenomenal prior to the oil price crash. Now many of the companies are cheap again. Here's a look at three outstanding individual investments currently available.

Opportunity No. 1: Magellan Midstream Partners (MMP)

Magellan is primarily involved in the piping and storage of refined petroleum products (gasoline, jet fuel, heating oil). The partnership in fact has the longest pipeline system for refined petroleum in the country and is connected to about 50 percent of all refining capacity in the United States.

The brilliance of the business is that 85 percent of funds from operations are fee-based. That means Magellan mostly just collects fees for the service of transporting and storing petroleum products and is not overly exposed to volatile commodity prices and the energy market.

As well, the overwhelming majority of these services are contracted with long-term commitments and minimum throughput levels and automatic inflation adjustments.

Basically, the MLP generates cash due to the fact that lots of gasoline, diesel, and crude oil continue to slosh around the country. The amount of throughput should only grow in the years ahead.

The results prove that this is one of the very best MLPs on the market. MMP has provided a stunning performance, delivering results well in excess of its industry peers in both good times and bad.

Magellan also has invested heavily in new infrastructure over the past few years to accommodate the growing demand and is starting to reap the benefits. Also of note, the company has been one of the most operationally resilient and financially sound of all midstream companies, with an investment-grade credit rating and a fantastic track record.

MMP has provided an average annual return of about 16 percent per year for the past 15 years and held up the best of all its peers during the recent sector downturn. The partnership has grown the distribution at a compound annual growth rate over 10 percent since 2001, and management is targeting similar growth in the years ahead.

PICK AT A GLANCE

MAGELLAN MIDSTREAM PARTNERS

SYMBOL: MMP
TRADES ON: NYSE
MARKET CAP: $15.54 billion
52-WEEK RANGE: $54.51–$77.45
P/E: 18.29
DIVIDEND YIELD: 4.83%

*Data as of September 15, 2016

Opportunity No. 2: Enterprise Product Partners LP (EPD)

Based in Houston, Enterprise is one of the largest midstream energy companies in North America. Its services include operating pipelines, storage facilities, processing plants and export facilities. The services accommodate natural gas liquids (NGLs), natural gas, crude oil and refined petroleum products.

Like Magellan, the overwhelming majority of revenues generated (80 percent) are fee-based for services rendered and are not subject to volatile commodity prices. Even after a falloff in revenues during the oil crash, the partnership maintains strong investment-grade debt ratings, with revenues covering roughly 1.4 times the distribution.

Enterprise Partners generates most of its earnings servicing NGLs. This is a business with a huge future. The U.S. in the years ahead will export its cheap natural gas — in liquid form — overseas. NGL export facilities in the U.S. are opening up for the first time, and thus unlocking these potentially enormous foreign markets in the years to come.

Enterprise is vigorously investing in future cash flows, with $5.6 billion in capital growth projects currently under construction. These projects will be coming on line and adding to distributable cash flow going forward.

With such strong cash flow backing, the stellar 6.15 percent yield is very well supported and likely to grow going forward.

Like Magellan, Enterprise has an added advantage beyond the tax advantage of other MLPS. The company pays no incentive distribution rights (IDRs) to the General Partner, which can take up as much as 50 percent of distributable cash flow in a typical MLP.

Reliable and predictable cash flows combined with strong credit and an investor friendly structure have led to 48 consecutive quarters of distribution growth. A cheap valuation in the middle of the U.S. energy boom makes Enterprise Partners an excellent investment for income-oriented investors.

PICK AT A GLANCE

ENTERPRISE PRODUCTS PARTNERS LP

SYMBOL: EPD
TRADES ON: NYSE
MARKET CAP: $54.3 billion
52-WEEK RANGE: $19.00–$30.11
P/E: 20.73
DIVIDEND YIELD: 6.15%

*Data as of September 15, 2016

Opportunity No. 3: Williams Partners (WPZ)

Williams Partners is one of the largest natural-gas infrastructure companies based in the United States. The partnership owns interests in three major interstate natural gas pipelines that, combined, connect to about 30 percent of all U.S. natural gas supply and access the largest, fastest-growing shale regions.

Most of the discussion so far has focused on the oil boom, but make no mistake about it, natural gas is coming on strong after being down and out in recent years. Huge increases in production had created a glut in the fuel, and prices crashed. The recent fall in oil prices has also crimped demand for natural gas. But these are short-term factors. Things will change in a big way.

The energy boom has made the U.S. the world's largest producer of natural gas. Natural gas has the supreme advantage of being the cleanest burning fossil fuel and is the energy source of the future. In fact, natural gas is forecast to be the fastest-growing energy source worldwide over the next 20 years.

Demand for natural gas is sure to grow in the U.S., but there is a huge story outside our shores. This country is developing an ability to export our cheap and abundant natural gas overseas in liquid for the first time ever. An enormous export market is on the cusp of exploding and Williams is right there. Its TransCo pipeline services the Northeast (from which 80 percent of North American demand growth is estimated to come through 2025) to the Gulf Coast, where LNG export facilities are being built.

Williams is slated to invest an additional $5 billion in 2016 and 2017 in more growth projects. The stock pays a huge 9.29 percent yield, and

Your S77 Monthly Income Stream

To conclude this special report, I wanted to share this chart outlining the 2016 payments of the three master limited partnerships highlighted in this special issue. Using a $100,000 investment spread equally across the three picks, you can see the income generated after just one year.

Ticker	Current Yield	Jan.	Feb.	Mar.	Apr.	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.	Total Annual Income
MMP	4.83%	—	$402.62	—	$402.62	—	—	$402.62	—	—	$402.62	—	—	$1,610.48
EPD	6.15%	$512.40	—	—	$512.40	—	—	$512.40	—	—	$512.40	—	—	$2,049.60
WPZ	9.29%	—	$773.50	—	—	$773.50	—	—	$773.50	—	—	$773.50	—	$3,094.00
Total		**$512.40**	**$1,176.12**	**$0.00**	**$915.02**	**$773.50**	**$0.00**	**$915.02**	**$773.50**	**$0.00**	**$915.02**	**$773.50**	**$0.00**	**$6,754.08**

Notes: Income assumes $100,000 invested equally across all six positions. Total annual income provides a 5.9% yield.

Williams intends to maintain the current payout through 2017 and then begin to raise it in 2018.

PICK AT A GLANCE

WILLIAMS PARTNERS

SYMBOL: WPZ
TRADES ON: NYSE
MARKET CAP: $21.38 billion
52-WEEK RANGE: $12.69–$36.39
P/E: -9.69
DIVIDEND YIELD: 9.29%

*Data as of September 15, 2016

Closing Thoughts

The United States has long been dependent on foreign oil for its survival, although we have rued it every step of the way. From the oil embargoes and gas lines of the 1970s to the latest Middle East wars, the United States has repeatedly pledged to wean from its dependence on foreign energy.

Yet, the country's insatiable foreign energy dependence continued to get worse. We went from importing just 10 percent our oil in 1970 to an insane 66 percent in 2007.

Over the past decade, our trade deficits soared to record heights while the value of the dollar plunged to new lows. Energy imports accounted for about a third of the crippling deficit.

At the same time, the global supply of energy began to dwindle as new demand from emerging markets taxed supplies and sent oil prices soaring. The future looked bleak.

But that was last decade. Now, new technology has saved the day, unlocking vast quantities of previously irretrievable sources of oil and gas right here in the United States. This technological "miracle" has, in just a few short years, propelled the United States from being a hopelessly dependent importer of energy to being a formidable global energy-producing powerhouse.

It's in this new paradigm that energy has become an extremely attractive investment. Specifically, so-called "S77" income streams, which investors can capture via investments in master limited partnerships, have come to the forefront.

In this special report, I've outlined three MLPs that, in my opinion, stand above the rest. My hope is you take a closer look at each as you build your own nest egg.

Sincerely,

Tom Hutchinson
Editor, High Income Factor

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