



## Exchange Traded Notes (ETNs) for MLP Market Exposure: A Cautionary Tale

In this edition of our Master Limited Partnership Insight Series, we look at Exchange Traded Notes (ETNs) and some important considerations for investors who may be thinking about using them to access the MLP market.

First, a brief review of these instruments as defined by Investopedia: “ETNs are types of unsecured debt securities that track an underlying index of securities and trade on a major exchange like a stock. ETNs are a type of bond, and at maturity, the ETN will pay the return of the index it tracks. However, ETNs do not pay any interest payments like a bond. When the ETN matures, the financial institution takes out fees, then gives the investor cash based on the performance of the underlying index. Since ETNs trade on major exchanges like stocks, investors can buy and sell ETNs and make money from the difference between the purchase and sale prices, minus any fees.” Notably, ownership of an ETN does NOT reflect ownership of any underlying securities.

### Investing in ETNs Comes with Caveats

Investors in ETNs are subject to single issuer principal counter-party credit risk, not an insignificant consideration. It wasn't all that long ago when the economic crisis of 2008 caused the collapse of banking institutions such as Lehman Brothers and Bear Stearns, once considered unassailable bastions of safety, causing serious financial harm to investors in securities issued by those firms. The same dynamic that applied then - i.e. ETNs represent unsecured and uncollateralized debt obligations - remains the case today and should give investors pause. Short of default, a mere downgrade in the rating of the issuing financial institution could result in a decline in the value of its ETNs. As a result, ETN investors are in effect lending money to the issuing financial institution without being compensated for taking on this credit risk, as the ETN pays out only the return of the relevant benchmark and does not include any portion of the interest rate spread over Treasuries associated with that institution's corporate debt.

Other considerations for investors who are thinking about using ETNs involve the overall lack of transparency of these products and their complexity, particularly in terms of pricing, and of redeeming shares, which investors may wish to pursue, (as an alternative to selling shares on the exchange in adverse situations). A recent Wall Street Journal article, *ETNs (Not ETFs) Fall Out of Favor*, Oct. 4, 2020, highlighted pricing anomalies that can plague ETNs, stating: “The products also have received a black eye because of bizarre price moves that have occurred in over-the-counter trading after some ETNs were delisted from major exchanges.” Price swings of this kind may be of concern to investors seeking exposure to the returns and yield of a particular benchmark.

## Approach MLP ETNs with Caution

As we described in our recent publication [The Power of Pure: Midstream Master Limited Partnerships vs. C-Corps](#), mutual fund and ETF investors face a dilemma because funds that seek to maintain their status as Regulated Investment Companies (RICs) for tax purposes are required to limit their holdings in MLPs to less than 25%, while funds that offer “full” exposure to MLPs are organized as C-corps, and are therefore subject to federal corporate tax.

This tax drag can negatively affect the total return and yield of such funds. While ETNs can provide “full” access to the MLP market in a way that mutual funds and ETFs seeking to retain their status as Regulated Investment Companies cannot, all of the many issues regarding ETNs cited earlier apply fully for MLP investors.

## Seeking an Optimal Solution

A unique innovation by Liberty Cove Investors, *trueMLP*, can provide an alternative to MLP ETNs, and also solve the dilemma of the tradeoff between full MLP exposure and mutual fund portfolios that are able to maintain RIC legal status only by keeping MLP exposure below 25%. The *trueMLP* approach combines direct MLP investments with securities that are designed to replicate the returns of major MLP indices, such as total return swaps. Using such an approach, investors can potentially gain broad access to the returns and yield of the MLP market through a portfolio that retains its RIC status for tax purposes, while avoiding the drawbacks associated with ETN investing.

## Master Limited Partnership Investment Vehicle Comparison Matrix

	trueMLP	Direct MLP Investment	C-Corp Funds	Non-true Funds	ETN
Full MLP Exposure	Yes ✓	Yes ✓	Yes ✓	≤ 25% X	Yes ✓
Tax Reporting	Form 1099 ✓	K-1 and State (for each MLP) X	Form 1099 ✓	Form 1099 ✓	Form 1099 ✓
Unrelated Business Income (UBTI)	No ✓	Yes X	No ✓	No ✓	No ✓
Fund-Level Corporate Tax	No ✓	No ✓	Yes X	No ✓	No ✓
Single-Issuer Principal Counter-Party Credit Risk	No ✓	No ✓	No ✓	No ✓	Yes X
Premium / discount to underlying holdings	No ✓	No ✓	No ✓	No ✓	Yes X

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