1Q2015 IAC Meeting Materials

IAC Meeting – May 19 2015

Liquid Real Assets Presentation

Liquid Real Assets

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Agenda

- The role of Real Assets
- Advantages of liquid Real Assets
- Overview of:
  - Master Limited Partnerships (MLPs)
  - Real Estate Investment Trusts (REITs)

What is the Role of Real Assets?

- Low correlation with financial assets (e.g. stocks and bonds) helps diversify overall portfolio
- Provide high level of current income
- Protection against inflation
- Potential source of alpha through active management

Why Choose Liquid Real Assets?

- Provide access to hard assets through publically traded securities
- Unlike in private structures, investors can exit at their discretion and rebalance exposure
- Funds can be put to work quickly, without the J-curve of private funds
- Ability to customize exposure via separate accounts or bespoke strategies
- Lower management fees compared to private funds

Liquid Real Assets

- Master Limited Partnerships (MLPs)

MLPs

- Master Limited Partnerships (MLPs) are publically traded partnerships listed on major exchanges
- Structure was created by two tax acts:
  - Tax Reform Act of '86; created tax-free publically traded partnerships
  - Revenue Act of '87; required that 90% of income come from "qualified sources" such as natural resources
- MLPs trade in LP common units, similar to shares of common stock
- Pay no corporate-level taxes
- Typically pay out 80+% of operating cash flow as quarterly distributions

MLPs

- MLP structure has been used across many asset types:
  - Pipelines
  - Refineries
  - Cemeteries
  - Shipping
  - Sports franchises

- Approximately 120 public MLPs across the energy industry, most in midstream sector
- Market cap of asset class has grown from $8B in 1996 to over $500B today
- Daily volume: $6M in '96 to $1B today

MLPs

- MLP Structure:
  - LPs own 98% of the equity and receive quarterly cash distributions, but have no operational control and no significant voting rights
  - General Partner owns 2% of equity, but has full operational control and receives 100% of Incentive Distribution Rights (IDRs)
  - GP may be controlled by a corporate parent of a private equity sponsor
    - The SBI currently has some MLP exposure though private resource managers that function as sponsors for MLPs
  - Small number of GPs are publically traded

MLPs

- Incentive Distribution Rights (IDRs):
  - The GP indicates in advance a distribution amount
  - The GP will keep a percentage of the incremental cash flow once certain levels above the indicated distribution amount have been achieved:

	Percent of Distribution Allocated to:	
Hypothetical Distribution Tiers	**LP**	**GP**
Tier 1	98%	2%
Tier 2	85%	15%
Tier 3	75%	25%
Tier 4	50%	50%

- Typically the IDR split structure starts with the GP receiving 2% of the distributions.
- As distributions grow and targets are achieved, GPs garner a greater share of the payout.
- Most IDR agreements reach a tier in which the GP receives 50% of each incremental dollar paid to the LP unit holders. This 50/50 tier (Tier 4) is often referred to as the "high splits" tier.

Source: Wells Fargo Securities

MLPs

- MLP total return comes from a combination of current distribution yield and distribution growth
- MLPs can grow three ways:
  - Organic Growth
    - High level of investment needed to support U.S. energy industry
  - Mergers and Acquisitions
    - Consolidation expected as low-growth MLPs are acquired by stronger players
  - "Drop Down" transactions
    - MLP parent/sponsor can move assets from its balance sheet into the MLP structure
    - Allows MLP to "manufacture" growth with high level of predictability
    - Recently, "drop-down" MLPs have been top performers

MLPs

- Investors access MLPs through a variety of strategies:

	Passive Strategies		Active Strategies			
	Exchange Traded Note (ETN)	Exchange Traded Fund (ETF)	Closed-end Mutual Fund	Open-end Mutual Fund*	Limited Partnership Fund	Separately Managed Account
Liquidity	Daily	Daily	Daily	Daily	Typically monthly or quarterly	Daily
Tax Reporting	1099	1099	1099	1099	Consolidated K-1	Multiple K-1s
Investment Tax Status	Taxable Note	Taxable C Corporation	Taxable C Corporation	Taxable C Corporation	Partnership Pass-thru Tax Status	Partnership Pass-thru Tax Status
Generates UBTI	No	No	No	No	Yes	Yes

MLPs

- Other considerations:
  - Provide access to attractive segments of the energy & infrastructure sector
  - Wide variety of contract types (take-or-pay, percent of proceeds, volume based, etc.) resulting in different levels of commodity price exposure
  - MLPs rely on capital markets to finance growth; may be impacted by higher interest rates

Liquid Real Assets

- Real Estate Investment Trusts (REITS)

REITs

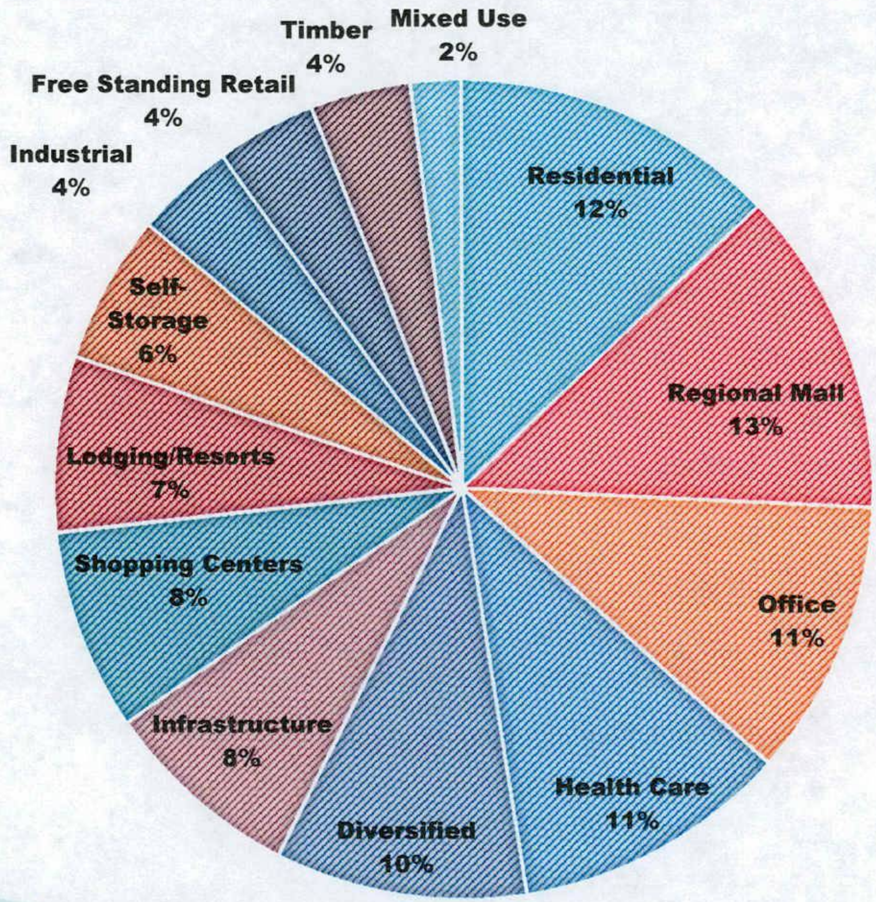
- Three main ways to invest in commercial real estate:
  - Private Real Estate funds
  - Direct property ownership
  - Real Estate Investment Trusts (REITs)
- REITs are effectively common equity in companies that own and operate real property
- REITs are significant part of both the public equity market (4%) and the overall real estate market (11%)

REITs

- REIT structure created by Real Estate Investment Trust Act of 1960
- REITs must meet several criteria
  - Pay out at least 90% of taxable income in the form of shareholder dividends each year
  - 75% of assets must be real estate related
  - 75% of gross income must come from rents, mortgage interest, or sales of property
  - Must have at least 100 shareholders
  - No more than 50% of shares can be owned by five or fewer individuals

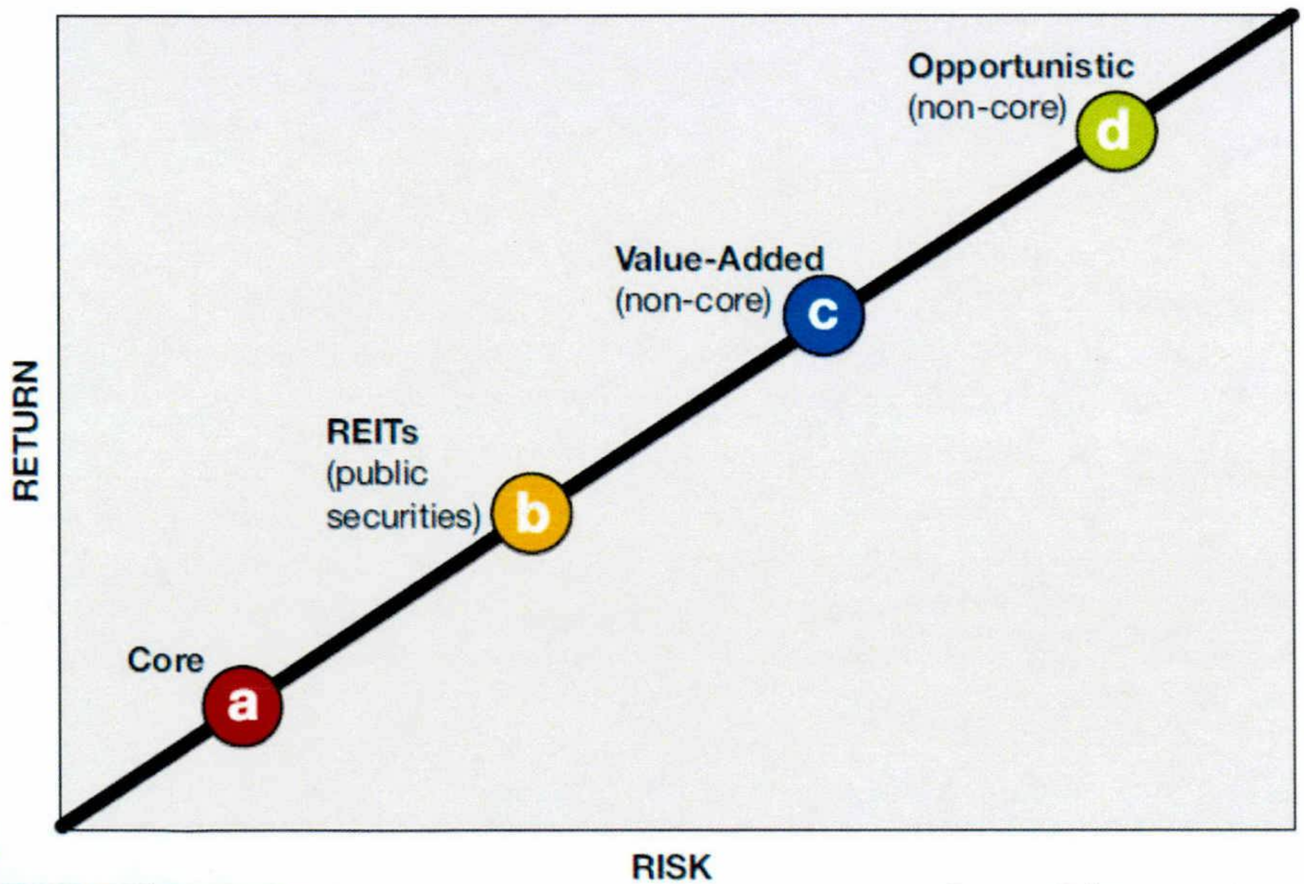
REITs

- Most REITs own specific property types. The REIT market is broken down by property sectors:



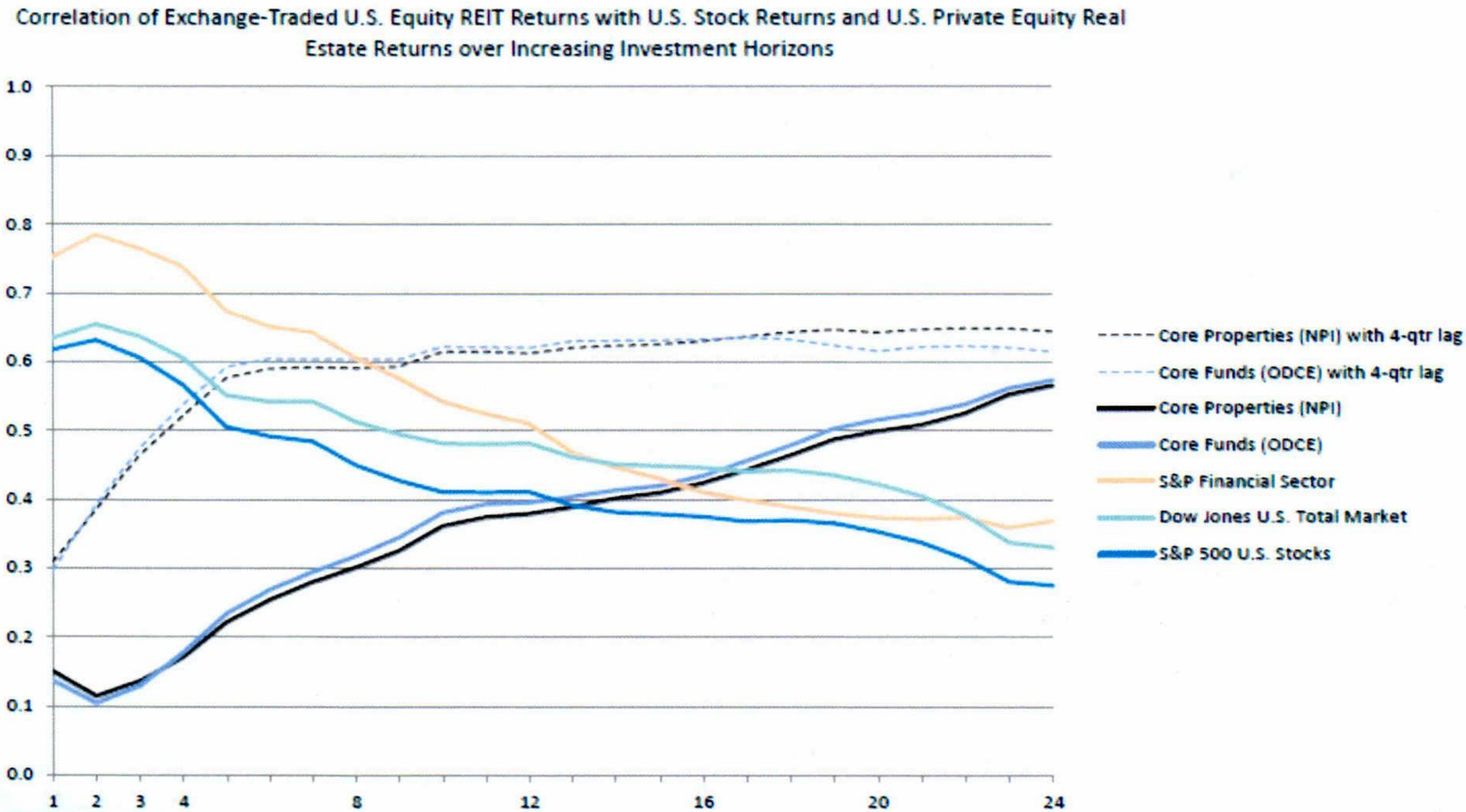
REITs

- REITs occupy a unique place in the investable real estate universe



Source: Callan

REITs



Source: NAREIT

REITs

- Listed REITs have some characteristics that may be attractive as a complement to private real estate:
  - High level of current income due to required dividend payments
  - Market is large and deep enough to provide significant liquidity
  - REITs are operated under the same regulatory and reporting requirements as other public companies

Liquid Real Assets

» Conclusion

Conclusion

- Liquid Real Assets offer competitive returns

	Last Year	Last 3 Years	Last 5 Years	Last 10 Years	Last 20 Years	Last 30 Years
NAREIT All Equity Index	**22.68**	**14.05**	**15.6**	**9.54**	**11.74**	**11.03**
Alerian MLP Index	**-2.5**	**9.2**	**13.67**	**12.98**	**--**	**--**
S&P 500	12.73	16.11	14.47	8.01	9.39	11.05
MSCI ACWI	5.97	11.35	9.57	7	7.36	--
Barclays Aggregate	5.72	3.1	4.41	4.93	6.03	7.42
NCREIF Property Index	12.72	11.47	12.75	8.38	9.69	7.89
NCREIF ODCE	12.37	11.46	13.34	5.71	7.71	5.76

Annualized returns for periods ending 3/31/2015

Conclusion

- Diversification Benefit

	S&P 500	MSCI ACWI	BC Agg	Alerian MLP	NAREIT All Equity	NCREIF ODCE	NCREIF Property Index
S&P 500	1.0						
MSCI ACWI	0.9516	1.0					
BC Agg	(0.2792)	(0.2142)	1.0				
Alerian MLP	***0.6469***	***0.6552***	***(0.1679)***	***1.0***			
NAREIT All Equity	***0.7811***	***0.7352***	***(0.0304)***	***0.4435***	***1.0***		
NCREIF ODCE	0.2055	0.1440	(0.2027)	***(0.0580)***	***0.2055***	1.0	
NCREIF Property Index	0.2600	0.2123	(0.1733)	***(0.0010)***	***0.2721***	0.9824	1.0

For 10 year period ending 3/31/2015

Conclusion

- Similar to equities on a risk-adjusted basis

	Sharpe Ratio	Standard Deviation
S&P 500	0.4	16.2%
MSCI ACWI	0.3	18.1%
BC Aggregate	1.1	3.2%
NCREIF ODCE	0.5	9.0%
NCREIF Property	1.1	6.3%
Alerian MLP	0.6	18.8%
NAREIT All Equity	0.3	25.8%

For 10 years ending 3/31/2015

Conclusion

- REITs and MLPs allow for investment in real assets via public markets
- Complement to private real assets
- Diversification of total portfolio
- The SBI should consider REITs and MLPs when making strategic allocations