

Midstream Energy Fundamentals Remain Robust

Steve Newby, Portfolio Manager

Like most asset classes, the midstream energy (MLP) asset class has experienced increased volatility and significantly lower-than-average total returns year-to-date. While other asset classes are dealing with weak fundamentals due to a slowing economy, turmoil in the real estate markets and higher inflationary pressure, MLP fundamentals remain robust. This strength is reflected in MLPs continuing to set new quarterly records for distributable cash flow, driven primarily by improving margins, increased volume throughput (in the natural gas sector) and the commissioning of new, highly accretive growth projects. These cash flow drivers have enabled the midstream segment of the MLP asset class to increase distributions payable to investors by a weighted average of 2.5% quarter-over-quarter for the second quarter 2008 (i.e., about 10% annualized distribution growth).

Although MLPs are not immune from overall economic weakness, energy consumption, and therefore commodity transportation and storage, remain fairly resilient and defensive in depressed economic cycles. Through April 2008, natural gas consumption, increased over 4% over the comparable period in 2007 while refined product consumption, due to historically high prices, was down 3%. For midstream companies operating in refined product transportation, the consumption/volume decrease is being offset by higher transportation rates charged through Producer Price Indexed tariff escalators.

In addition to increased throughput volumes in the natural gas sector and pricing power on the refined products sector, organic growth projects are coming online and making significant impacts to distributable cash flow. Two marquee projects that recently started-up were the Independence Hub — a natural gas production platform and offshore pipeline connecting natural gas reserves located in the deepwater trend of the Gulf of Mexico with onshore processing facilities and distribution networks; and the Rockies Express Pipeline — a 1,679 mile long interstate natural gas pipeline connecting Rocky Mountain natural gas production with Midwest and East Coast distribution networks. These two projects represent a combined \$5.7 billion of growth capital expenditures and provide needed takeaway capacity for two of North America's fastest growing production basins.

Despite strong distribution growth and solid underlying business fundamentals, the Citi MLP Total Return Index was down 11.4% in the year-to-date period ended 24 July 2008 — the S&P 500 Index and the Dow Jones Utility Index were down 14.7%, and 9.3% respectively, over the same period. Weakness can partially be attributed to continued negative technical themes influencing the MLP asset class, including the forced de-leveraging of overly

aggressive investors, a general increase in risk aversion by investors, and the continued equity overhang that has been created due to high levels of equity issuance required to finance the large slate (> \$25 billion) of ongoing organic growth projects.

As in the fourth quarter of 2007 and first quarter of 2008, we continue to see signs of de-leveraging and forced selling by hedge fund and other leveraged participants as credit availability for these funds continues to tighten. It is of little surprise that the worst two months of 2008 for the MLP Indexes were in March and June — quarterly redemption months for hedge funds. During June, particularly toward month end, we witnessed several MLPs experiencing unusually high daily trading volume (three times or more of daily averages) on no substantial news. In addition to leveraged funds unwinding, general investor risk appetite continues to be severely limited as evidenced by high-yield credit spreads continuing to be erratic and approaching historically high levels. MLPs correlate about 46% to high yield credit spreads and overall levels remain high, averaging 742 basis points during the first half of 2008 vs. 287 basis points for first half of 2007. We continue to believe that a stabilization of capital markets and credit spreads will lead to improved MLP asset class performance.



As we manage the portfolio in this environment, we are mindful of several themes inherent in the asset class:

Flight to Quality — Since the credit markets began deteriorating in mid-2007, MLP investors have rotated out of high-growth, small- and mid-cap MLPs for the perceived stability and liquidity of large-cap MLPs. While a powerful trend, this creates opportunities to invest capital in multiple, high-quality MLPs with underappreciated growth profiles and attractive levels of current income.

Technical Pressures — Overly aggressive, leveraged investors are focused on unwinding their positions, thus creating attractive opportunities to deploy capital in MLPs that have solid fundamentals, but weak ownership bases. We believe that this selling pressure will continue throughout the remainder of 2008, but it will end, and when it does, investors will re-focus on fundamentals.

High Commodity Prices — While high commodity prices have been a motivating factor in the accelerated development of new basins, and thus, higher throughput volumes across midstream infrastructure assets, these high prices have led to demand destruction for crude oil and refined products, which can negatively affect certain sub-sectors of the MLP asset class. We have seen, on average, refined product pipeline volumes decrease between 3-5% during the first half of 2008. However, these volume declines have been mitigated by increases of 5% plus based upon the Producer Price Index that governs refined product pipeline pricing.

Reduced Access to the Capital Markets — Year-to-date, MLP equity issuance has totaled \$4.9 billion, representing a significant decline relative to 2007 (\$17.5 billion in total issuance). MLPs have also been forced to raise equity at wider discounts relative to 2007, indicating decreased liquidity and more risk-averse investors. This aversion creates attractive opportunities for investors to be selective and earn attractive risk premiums for providing capital.

Outlook

We expect technical pressures and heightened investor risk aversion to remain present throughout the second half of 2008. While these themes create near-term price volatility, they also create an opportunity for long-term, fundamental-based investors to deploy capital and earn above average risk-adjusted returns. Current MLP valuations, in our opinion, are highly attractive given the re-pricing of the asset class over the past year due to technical versus fundamental issues. This re-pricing has occurred while fundamentals remain strong, leaving us today at an attractive entry point with current yields in excess of 7% and annual expected growth rates in distributable cash flow also exceeding 7%.

Value can be created for investors in the asset class from: (i) core fundamental analysis and identification of attractive growth opportunities, (ii) extensive underwriting and understanding of downside risks and (iii) solid negotiating and structuring of transactions that also create value for the underlying MLP. This value can be created while also increasing diversification, as MLPs have historically shown little correlation to broader market indexes, interest rates, or commodity prices.

