

# THE SCOTT LETTER: CLOSED-END FUND REPORT

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*A Global View of the Closed-End Fund Industry*

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THE SCOTT LETTER is intended to educate global investors about closed-end funds. Closed-end funds can be a valuable and profitable investment tool. To learn about closed-end funds, visit our web site,

[www.CEFAdvisors.com](http://www.CEFAdvisors.com), and in particular, read our article, *What Are Closed-End Funds*. Feel free to forward this newsletter to anyone who you believe could benefit from information on

closed-end funds or global portfolios.



– George Cole Scott  
Editor-in-Chief

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## Kayne Anderson’s MLP Funds: A Tax-Advantaged Income Opportunity Interview by John Cole Scott

Master Limited Partnerships (“MLPs”) are limited partnerships that are publicly traded on a securities exchange. They combine the tax benefits of a limited partnership with the liquidity of publicly traded securities.

MLPs are limited by U.S. tax code to only apply to enterprises that engage in certain businesses, mostly pertaining to the use of natural resources, such as petroleum and natural gas extraction and transportation. To qualify for MLP status, a partnership must generate at least 90% of its income from what the Internal Revenue Service deems “qualifying” sources.

KA Fund Advisors, LLC is a subsidiary of Kayne Anderson Capital Advisors, L.P., a leading investor in both public and private energy companies with four closed-end investment companies (KYN, KYE, KMF and KED). As of September 30, 2011, Kayne Anderson and its affiliates managed assets of approximately \$12.6 billion, including \$9.6 billion in the midstream/energy sector of which \$7.0 billion was invested in MLPs and midstream companies.

Kevin McCarthy is Chairman, President and CEO of Kayne Anderson. Prior to joining Kayne Anderson in 2004, Mr. McCarthy was global head of energy at UBS Securities. In this role, he had senior responsibility for all of UBS’s energy investment banking activities, including direct responsibilities for securities underwriting and mergers/acquisitions in the MLP industry. From 1995 to 2000, Mr. McCarthy led the energy investment banking activities of Dean Witter Reynolds and then PaineWebber. He began his investment banking career in 1984. In addition to his directorships at the firm’s closed-end funds, he is also on the board of directors of Range

Resources Corporation, ProPetro Services, International Resource Partners, Direct Fuels Partners, and K-Sea Transportation Partners. Mr. McCarthy earned a B.A. in Economics and Geology from Amherst College in 1981 and an MBA in Finance from The Wharton School in 1984.

We interviewed Kevin McCarthy via phone on November 2, 2011. Monique Vo, who heads Kayne Anderson’s investor relations department, was also present on the call.

**SL:** What are the primary reasons for investors to have an interest in MLPs?

**McCarthy:** MLPs are attractive to investors who seek income and total returns



Kevin McCarthy

[price appreciation plus distributions]. In the past several years, the total return of the Alerian MLP Index has exceeded the total return from the S&P 500 as shown in Table 1 on the next page. The outperformance is especially striking for the years since the 2008 financial crisis. Many income-oriented investors invest in MLPs because their yields

are significantly higher than those of other income-producing investments such as Treasuries, municipal bonds, CDs, utilities, REITs and other fixed income securities. In addition, MLPs have consistently increased their distributions over time. The yield for the Alerian MLP index is 6.46% as of November 1, 2011.

**SL:** Is there a tax advantage to the MLP structure?

**McCarthy:** Yes, distributions from MLPs are generally tax-advantaged, generally between 80% and 90% of a MLP’s cash distributions are treated for tax purposes as “return of capital”. Return of capital reduces an investor’s cost basis, and in very simplistic terms, the taxes on the portion of the distribu-

tion treated as return of capital are generally deferred until the investor sells the investment. Of course, investors should consult their tax advisors before making any tax-related decisions.

**SL:** What about the volatility of the commodity markets? Can this impact the MLP sector?

**McCarthy:** The energy industry is often thought of as having three segments: the upstream, the midstream and the downstream. “Upstream” refers to the exploration and production (e.g., drilling) for oil and natural gas, “midstream” refers to infrastructure such as pipelines, processing plants and storage facilities, and “downstream” refers to the refining and distribution of energy commodities to industrial, commercial or residential customers. Most MLPs are found in the midstream sector. While there are differences from MLP to MLP, it would be fair to say midstream MLPs are substantially less sensitive to commodity prices than upstream companies.

**SL:** What else do you like about midstream MLPs?

**McCarthy:** Midstream assets are strategically important because they provide the backbone of our nation’s energy infrastructure. They typically have high barriers to entry; permitting costs and environmental review make certain assets very difficult to duplicate. Many MLPs have substantial fee-based revenues. This enables them to generate significant free cashflow in a variety of market conditions and allows them to consistently pay out cash distributions to their investors.

**SL:** It sounds like an interesting sector. How did Kayne Anderson begin investing in MLPs?

**McCarthy:** We began investing in MLPs through Plains All American Pipeline (PAA) in 1998, when we owned an interest in the PAA’s general partner, giving us the longest track record of any institutional investor in the MLP space.

**SL:** I notice you only manage closed-end funds. What do you like about their structure for your MLP investments?

**McCarthy:** CEFs can use leverage which can enhance returns in order to overcome the 36% to 38% tax drag resulting

Table 1. Total Return of Alerian MLP Index vs. S&P 500  
As of October 31, 2011\*

	2005	2006	2007	2008	2009	2010	2011 YTD*
AMZX	6.3%	26.1%	12.7%	-36.9%	76.4%	35.9%	7.9%
Alerian MLP Index Total Return							
S&P 500 Total Return	4.9%	15.8%	5.5%	-37.0%	26.5%	15.1%	1.3%
Outperformance of AMZX over S&P 500	1.4%	10.3%	7.2%	0.1%	49.9%	20.8%	6.6%

Table 2. Kayne Anderson Closed-End Fund Structure

Structure	Fund	Inception	Focus
C-Corp	KYN	2004	Publicly-traded MLPs
RIC	KYE	2005	Diversified energy investments (MLPs, marine transportation, U.S. and Canadian income trusts, energy debt securities, midstream and other companies, and coal companies)
C-Corp	KED	2006	Privately-held MLPs
RIC	KMF	2010	Midstream companies (including MLPs and C-corporations) and energy debt securities

from tax treatment of a C-corporation. CEF distributions are treated as tax-advantaged return of capital, and they do not expose investors to counterparty risk like exchange-traded notes.

Depending on the allocation of MLPs in their portfolios, CEFs can have tax-deferred distributions. Investors receive a Form 1099-DIV instead of a Schedule K-1. This allows our investors to avoid the headache of possibly having to file state income tax returns in each state in which an MLP operates. For the larger MLPs, this could be dozens of states.

MLPs generate unrelated business taxable income (“UBTI”). If UBTI rises beyond a certain threshold in an IRA, then the IRA becomes liable for income taxes. Our closed-end funds do not generate UBTI, so they are suitable for IRAs and other tax-exempt accounts.

**SL:** What would you say is different about your MLP CEFs vs. your peer funds?

**McCarthy:** Kayne Anderson is the largest institutional investor in the MLP space. Many of our investment professionals have spent their entire careers in the MLP sector. We have access to private investments in public equity (“PIPE” deals), something that is not available to retail investors and have the highest

number of dedicated research analysts of any fund manager in the sector. We are pleased to have five former MLP CEOs on our boards of directors, a distinction that makes us unique among our peers.

**SL:** What are your MLP closed-end funds, and when were they formed?

**McCarthy:** The structures of each of the funds are shown in Table 2 above.

**SL:** I know two of your funds are C-corporations and two are regulated investment companies (“RIC”). Can you explain the difference?

**McCarthy:** KYE and KMF are each treated as RICs, meaning the funds are not subject to taxes at the entity level. KYN and KED do not qualify as RICs, because more than 25% of their portfolios consist of MLPs. For this reason, they are treated by default as taxable C-corporations.

When we formed KYN in 2004, it wasn’t possible to have a RIC that was not taxable. They changed the tax law in 2005, allowing us to create KYE and eventually KMF.

**SL:** Can you give us an overview on the tax treatment of each fund’s dividends to shareholders?

**McCarthy:** Since the fund’s inception, the majority of KYN’s distributions have

been treated as return of capital. The remainder is treated as qualified dividends.

KYN is our bread-and-butter, as it's a pure play in MLPs. Early in its history, when KED was treated as a RIC, the majority of KED's distributions were treated as ordinary income. In 2008, KED elected to be treated as a C-corporation. Since then, the majority of its distributions each year have been treated as return of capital, with the remainder being treated as qualified dividends. Business development companies sometimes describe KED as the poor-man's private equity fund, so when the market gets strong, people view it as a way to get private equity exposure.

Of all our funds, KYE's tax character has been the most variable. In the first few years, most of KYE's distributions were taxable as either qualified dividends or ordinary income. In 2008 and 2009, the majority of the distributions were treated as return of capital due to realized losses resulting from the financial crisis. In 2010, most of KYE's distribution was treated as ordinary income.

KMF went public at the end of November 2010, so the fund did not pay a distribution in 2010. It was really a thematic investment and was built around the growth in unconventional resources and infrastructure. From a risk spectrum, I would say it is very similar to KYN and more risk adverse than KYE because it doesn't have commodity exposure to C-corps.

**SL:** I have noticed that you use some covered call or option strategies in your funds. Can you clarify this for our readers?

**McCarthy:** An important part of the strategy at KYE and KMF is writing covered call options to augment the funds' income. Please note that we write calls only on equities that we already own. We also write covered call options to a lesser degree at KYN. KED does not write covered call options.

**SL:** Reviewing your four funds, I noticed KED, the private MLP fund, is well ahead of the other three year-to-date on a total return basis, while on a 90-day basis it has lagged. What was the cause of the difference in performance?

**McCarthy:** This year we announced one major transaction in KED. We sold a private MLP for \$100 million, a company in which we had only invested \$30 million. With the proceeds, we substantially increased our dividend. It was clearly a discrete event that caused the fund to perform very well when compared to the others.

**SL:** Was this the purpose in forming KED?

**McCarthy:** Our thesis in forming KED was that there was no mezzanine capital available to the midstream space as private equity tended to focus on the upstream space. If you're a public MLP, there's attractive cost of capital, but we thought about the group of companies out there too small to go public. They were 2 to 3 years away from being the size or maturity to go public but would like to have capital to help grow their business. That's why we formed KED.

*We have purposely stayed away from open-end funds, having lived through 2008.*

**SL:** Have you considered launching a mutual or open-end fund in the sector?

**McCarthy:** We have purposely stayed away from open-end funds, having lived through 2008. All the closed-end funds at that time had to manage their portfolio to stay in compliance with the Investment Company Act of 1940 leverage coverage regulations. That was difficult enough, but being faced with daily redemptions from open-end fund shareholders can become a dangerous trap in a down market.

**SL:** I agree. The permanent capital created through the closed-end fund structure can be very helpful in protecting long-term shareholders from redemption pressures.

Expense ratios seem higher in MLP funds vs. other CEF sector funds. Why do you believe this is the case?

**McCarthy:** One reason is dealing with the tax complexities of MLPs. As mentioned earlier, an individual buying MLPs directly has to deal with K-1s and possibly filing state income tax returns in each state in which the MLP operates. This is a significant tax headache, and lots of people don't want to deal with it. In contrast, if you buy a MLP fund, you receive a Form 1099-DIV, and there is no requirement to file multiple state income tax returns. The MLP fund itself deals with all these complexities, and that comes at a cost which is passed to shareholders.

Another reason is that, compared to open-end funds, many closed-end funds bear the added cost of leverage. As mentioned before, because dedicated MLP funds are taxed as C-corporations, they pay income taxes. A very important tool to overcome this tax friction is the use of leverage to enhance returns. However, the use of leverage also adds to the expense ratio of a fund.

**SL:** Your C-corp CEFs incur a growing deferred tax liability from the non-income portion of the investment portfolio's cashflows. This liability reduces NAV over time, and some investors expect that this deferred liability will not be paid during their holding period of the fund's shares. The fund's balance sheet understates the current portfolio value due to this factor, and this can drive a MLP C-corp CEF to a premium above NAV.

To what degree is this case for your funds, and does your awareness of this inhibit your trading within the fund's portfolios?

**McCarthy:** Dedicated MLP funds simply do not qualify for pass-through treatment as RICs. A fund may qualify as a RIC only if less than 25% of its portfolio is invested in MLPs. A dedicated MLP fund typically exceeds this 25% threshold and by default has no choice but to be treated as a taxable C-corp. KYE and KMF qualify for treatment as RICs because they have diversified portfolios that are limited to a 25% allocation to MLPs taxed as partnerships. However, because KYN and KED have portfolios consisting mostly of MLPs, they are taxed as C-corps.

The deferred tax liability generally reflects taxes on net unrealized gains, which are attributable to the difference between fair market value and tax basis of the portfolio and the net tax benefit of accumulated capital or net operating losses. The return of capital portion of the distribution reduces the tax basis of the asset, creating additional deferred taxes.

Many investors believe that an undiscounted deferred tax liability overstates the liability. We believe that it is appropriate to take the net present value of the deferred tax liability based on an investor's expectations on when the taxes will be paid.

While we try to minimize our tax liability by tracking the individual basis in all our investments, we do not let the tax impact influence our decision to sell a security, because the net asset value already reflects that liability.

**SL:** How will a future rise in bond and short-term rates impact your portfolios?

**McCarthy:** Generally, yield investments trade down when rates rise which affect MLPs, just like bonds, REITs and utilities. When we looked back over time, however, we found prices go down for only a short period because the increasing dividends offset the rising rates over time.

That's something you certainly don't have with bonds because the interest rates are fixed.

**SL:** Do you feel there is too much competition for the MLP investments available to your funds?

**McCarthy:** Institutional ownership of MLPs through closed-end funds represents roughly 6% of the total MLP market cap. It's 25% to 30% if you include all institutions who own MLPs directly. We believe both these numbers are very low compared to institutional ownership of other sectors such as utilities and REITs.

**SL:** What are your thoughts as a manager on portfolio concentration?

**McCarthy:** In the MLP space consisting of approximately 75 names, a certain degree of portfolio concentration is unavoidable because the top eight names represent more than 50% of the sector's

market cap. One company alone, Enterprise Products Partners (EPD), represents 14% or one-seventh of the sector's market cap.

For each of our funds, the investment policy states that we may invest up to 15% of our total assets in any single issuer. As of September 30, 2011, the top 10 holdings of each of our funds comprise between 45% to 55% of long-term investments.

**SL:** Do you ever feel like you have to own the big names because you're a big firm?

**McCarthy:** To a limited extent you need to own the big names. The question is: "Are you underweight or overweight the index?" Let's say a MLP is 10% of the Alerian index, we need to own them. If you only own 5% rather than 10% of the MLP for a portfolio our size, that's a big underweighting difference.

***If somebody is going to be day-trading our closed-end funds, I'm not sure that I want to encourage them.***

If you look at the top 20 MLPs by market cap, there are several names that we don't own.

**SL:** Is it because of the liquidity issues that you do not invest in some of those names? Are they just too small?

**McCarthy:** In some situations, we own large positions in small MLPs and small positions in large MLPs ... or even no position at all. It depends on the investment merits regardless of whether it's a big or small company.

**SL:** Has the liquidity of the MLP sector been improving in recent years?

**McCarthy:** Some MLPs that are going public this year are in the \$120 million market cap range. The liquidity for the large cap names continues to improve every year, and some of the larger MLP names are as liquid as some large cap stocks.

**SL:** Where do you see MLPs adding value for a growth investor? How about an income investor?

**McCarthy:** Some MLPs have strong double-digit distribution growth rates with lower yields in the 4% to 6% range. Other MLPs have higher yields in the 7% to 8% range but lower growth rates. There are probably half a dozen MLPs that have forecasted dividend increases in the low-double digits. So, for a growth investor, a dividend rising at 10% to 12% a year is a real growth story.

There are several MLPs out there that haven't grown their distribution. It's not anticipated that they will, and if they're yielding 8.5% to 9%, then they are better for income-focused investors. Depending on specific needs of an investor, there are varying types of MLP choices.

**SL:** How often do your funds report their net asset values?

**McCarthy:** We report weekly NAVs in all our funds except for KED which has always been quarterly. In the past, when people have asked us for daily NAVs, we've reminded them that it's difficult for a taxable fund to give daily NAVs because you have to recalculate your deferred taxes every day.

It's a complicated process. We want to make sure that we get it right on a weekly basis. Frankly, we invest in MLPs because of their long-term return prospects. We hope people are investing in our closed-end fund for the same reason. If somebody is going to be day-trading our closed-end funds, I'm not sure that I want to encourage them.

**SL:** How do you address the competing desire of shareholders for dividends and NAV growth?

**Vo:** Investors want the best of all worlds. They want a high yield, and they want distribution growth going forward. Luckily, MLPs have historically been able to provide this.

**McCarthy:** We remind ourselves that the name of our second fund is the Total Return Fund. We want to give investors both appreciation of net asset value plus dividends. In KYN, we've been successful

mirroring the growth of underlying dividends by increasing our distributions.

**SL:** How do you accomplish those dual goals for shareholders over time?

**McCarthy:** Distributions and NAV form a closed system. If you pay out more than net distributable income (“NDI”), the NAV will decline. That’s why total return is so important. We strive for sustainable distributions that grow over time. For this reason, we sometimes pay out slightly more or less than NDI to maintain distributions at a constant level over the long term.

**SL:** I am familiar with numerous balance sheet terms for closed-end funds. Is NDI the same as distributed or investment income?

**McCarthy:** It is a defined term that we use in all of our quarterly reports. We not only disclose the information, but how we calculate it and how we reconcile to GAAP. It’s basically what we think of as income available for distribution.

It’s not quite cashflow because there are certain adjustments to it, but we think of it as cashflow-like.

**SL:** In regards to reporting a fund’s underlying income, could you see a reason to report this monthly rather than quarterly?

**McCarthy:** Most of our investments are in MLPs which pay quarterly, so we provide NDI quarterly as it is as timely as possible for shareholders.

**SL:** How much time does your Board of Directors devote to dividend amounts or the dividend policy at its meetings?

**McCarthy:** It’s one of the biggest decisions that our Board makes. First, we spend time talking about the market, the trends, our performance and reasons why we out- or underperformed an index or competitor. We close with financial analysis of the funds and a dividend recommendation.

**SL:** Can you go into more detail on the financial analysis you use to determine the dividend policy?

**McCarthy:** Each of our funds pays quarterly distributions to its common stockholders, primarily based on the NDI generated from the fund’s portfolio. As you

may recall, NDI is the amount of income received by the fund from its investments less operating expenses, subject to certain adjustments as described in our quarterly reports.

In determining our distribution to common stockholders, our Board of Directors considers a number of factors that include, but are not limited to the NDI generated in the current quarter, expected NDI over the next 12 months and realized and unrealized gains generated by the portfolio.

In the case of KED, the Board also considers the extent to which NDI is comprised of paid-in-kind interest and distributions and the impact of potential liquidity events at its portfolio companies.

**SL:** When we analyze a CEF bond fund, we monitor the undistributed net

*... there’s difference between return of capital for tax purposes and return of capital for economic purposes.*

investment as a way of assessing a cushion or deficit for future dividend payments, which can lead to dividend increases or decreases. Does this data point have any relevance to a MLP fund?

**McCarthy:** No, because of the return of the capital, it basically shields a lot of the fund’s income.

**SL:** At CEFA, we try to distinguish between GAAP-required non-destructive return on capital (“ROC”) vs. destructive ROC. Destructive return on your principal erodes NAV. In the last three years, have any of your funds overpaid distributions or in effect, returned investor principal through dividends?

**McCarthy:** No, because we make a distribution only on the cash that comes in.

We have had adjustments to our return on capital estimates. All that does is affect our deferred taxes. It doesn’t affect any of the cash.

I used to tell people when I was a banker for MLPs that there’s difference between return of capital for tax purposes and return of capital for economic purposes. MLPs generate return of capital for tax purposes, but there’s no economic degradation of their assets. In fact, the assets are appreciating.

We try to remind people with MLPs that the return of capital is for tax purposes because of the benefits of being in a partnership. There are large depreciation deductions that individuals can take, and therefore, the cash generated from assets is far higher than the actual taxable income. That creates what’s known in tax circles as return of capital, but that’s a lot different from oil and gas drilling funds where you’re getting distributions which are real return of economic capital.

**SL:** Which of your funds trade above or below NAV, and why do you think they trade differently?

**McCarthy:** As of November 1, 2011, KYN and KYE trade above NAV. MLP CEFs often trade at premiums to NAV because they offer benefits that investors cannot easily duplicate on their own: no K-1s, no multiple state tax returns, IRA suitability, diversification,

professional management, access to private investments that are not available to retail investors and so on.

We believe that KMF trades at a discount because it is a relatively new fund (November 24, 2010 inception). We’ve noticed that seasoned MLP closed-end funds tend to trade at premiums, whereas newer funds tend to trade at discounts.

Prior to the financial crisis of 2008, KED used to trade close to NAV. During the financial crisis, KED began trading at a discount because the market valued funds with high trading volume, frequent NAV updates and transparency about portfolio holdings.

Small funds like KED that invested in small privately-held companies and reported their NAVs quarterly fell out of favor. I’m glad to say KED’s discount has narrowed to the single digits on a percentage basis.

**SL:** Do you think there are good reasons why MLP funds often trade above their net asset value?

**McCarthy:** Yes, if you're going to buy a common stock closed-end fund that owns IBM or Dell as an example, that's something that investors can easily do on their own without any friction. Individual investors don't want to own a portfolio of 30 MLPs. They don't want to have to get K-1s and file taxes in every state where their MLP does business. We think there's a good reason why MLP closed-end funds trade differently than traditional CEFs.

**SL:** I can see that point. I've been educating investors about the concept of "relative discount". This concept means that it is more important to know where a fund is trading in its own historical discount-premium trend or vs. its peers than simply being at an absolute discount or premium to NAV.

As you mentioned before, MLPs and MLP funds report a high level of "return of capital" in their cash distributions. How can investors distinguish the ROC received from the assets held by the fund (and then passed on to shareholders) from ROC taken from the fund's asset base? Can funds report this information to shareholders?

**McCarthy:** In the Statement of Operations of our quarterly reports, we show the total dividends and distributions that we receive from our portfolio investments and also the portion that is treated as return of capital.

I think your question, though, is asking about the tax character of our distributions. In other words, if a fund, say KYN, reports that a portion of its tax character consists of return of capital, does that return of capital come from KYN selling some of its assets to pay the distribution?

The answer is no, and it can be found in the NDI table in our quarterly reports. The NDI table essentially shows the inflows and outflows from the fund. It shows what comes in [in the form of distributions and other income from investments] and what goes out [in the form of fund expenses]. What's left over is NDI. As you can see

from our quarterly reports, NDI per share is very close to the distribution per share that we pay out.

**SL:** If funds encourage people to add back the deferred tax liability, how can one sell an MLP they own but no longer like, if they have a big unrealized gain? What would you say to an investor who believes the deferred tax is a real liability and a reason not to own MLP CEFs?

**McCarthy:** I believe it is a misstatement to say that fund managers encourage people to add back the deferred tax liability. We have never encouraged investors to do that. We clearly disclose and discuss the deferred tax liability for our funds that are treated as C-corporations (i.e., KYN and KED), and investors can use that information to make their investment decisions.

I would agree with the investor that a deferred tax liability is a real liability

in the current environment, and I'm happy to pay higher rates because our investors and I can sleep at night.

**SL:** What is maximum allowed leverage under law for MLP funds?

**McCarthy:** The Investment Company Act of 1940 requires investment companies to have minimum debt and total leverage [debt and preferred stock] coverage ratios of 300% and 200%, respectively. We manage our funds to provide a significant cushion above those minimum requirements. For example, our target coverage ratios for the debt test range is between 375% and 415%, depending on the fund. Our [web site](#) lists the historical asset coverage ratios for each fund.

We've been very careful in structuring our leverage. Most of it is fixed rate, so our leverage expense has little direct exposure to rising interest rates. Tranches are staggered by year to minimize refinancing risk in any one year.

**SL:** Can you give us some more details on the type of leverage you use?

**McCarthy:** All our closed-end funds use leverage to enhance returns. We typically use three types of leverage: revolving credit facilities, senior notes and mandatory redeemable preferred stock.

Our web site provides a leverage summary for each fund which includes amounts, rates and maturities. We typically keep our funds fully invested, so our assets are at work for our investors.

**SL:** What are the current costs of leverage for your funds?

**McCarthy:** As of August 31, 2011, these were the weighted average costs of leverage at our funds:

KYN:	4.55%
KYE:	4.87%
KMF:	3.79%
KED:	2.21%

**SL:** Would you say the reason KED has the lowest cost is because they got the advantage of the low cost leverage as a new fund?

**McCarthy:** No, that is an exception. The other funds are more liquid and are rated so. The notes are generally rated AAA by Fitch so we can access the insur-

*We think there's a good reason why MLP closed-end funds trade differently than traditional CEFs.*

which is why it's deducted from the NAV. While we believe it's appropriate to subtract the liability on a net present value basis, we don't think it's appropriate to ignore it.

**SL:** How has your use of leverage changed in the past few years? Where do you see your funds from a leverage perspective in a rising rate environment?

**McCarthy:** After going through the financial crisis of 2008, we now maintain larger downside cushions with regard to leverage. When the auction rate market froze up, we thought long and hard about how to refinance.

The one thing we said is we want permanent capital. We know we never want to be in a position to be forced to sell our assets because our prime brokerage goes out of business. Our interest cost will be higher than a fund using prime broker-

ance company market. KED, because it has more private securities, was set-up with basically a 3-year-revolver floating rate. It doesn't have the benefit of the other funds being fixed, but it is a committed revolver as opposed to prime brokerage.

**SL:** How does Kayne Anderson communicate with shareholders?

**McCarthy:** From time to time, we host investor calls [webcasts] to provide updates on the MLP market.

We support all of our investors, including the investment professional community, in the same way: through our web site, press releases, webcasts, MLP market updates and investor relations communications.

We file quarterly reports as if we were a 1934 Investment Act company, so our filings look like a 10-Q with full footnotes and all the financial statements. Some of our competitors surprisingly just file a schedule of investments on a quarterly basis, with no balance sheet or income statement. We try to think of anything the investor might want and give it to them.

**Vo:** Just to give an example of our transparency. When we come to an agreement on our revolving credit facility or sell senior notes, we publish the credit agreement on our web site, so anybody can take a look at all the terms and conditions.

**SL:** Interesting. Glad you place such a high priority on transparency.

Do you participate in CEF conferences, The Investment Company Institute or The CEF Association to communicate and connect with investors?

**McCarthy:** Rightly or wrongly, we think of ourselves as MLP guys, not closed-end fund guys.

We belong to MLP associations. We go to every MLP conference but not others. Every time we do a deal, we have a discussion with underwriters over whether the people who buy our securities are closed-end fund investors or MLP investors.

**SL:** In our experience, there's a lot of crossover with individuals who buy closed-end funds and MLPs.

**McCarthy:** Exactly, that's why no one wins that argument.

**SL:** How do you track the activist activity in your funds? We noticed that back in 2010 a Karpus/Bulldog Group encouraged your funds to redeem some preferred shares.

**McCarthy:** The vast majority of our funds' shares are held by retail investors. We haven't needed to track activist activity.

**SL:** Please highlight a recent change in the portfolio and why you made the changes.

**McCarthy:** We hate the increased volatility we see in the overall markets and in the MLP space, but our view is that as long as we have volatility, we're going to make money from it. What we saw in August 2011 was a really turbulent month for MLPs which generally trade rationally.

*Every time we do a deal, we have a discussion ... over whether the people who buy our securities are closed-end fund investors or MLP investors.*

Consider if you have two MLPs with different prospects. One expects flat distributions for the next three years, and another expects to grow distributions at 7% to 8% over the same time period. Normally the grower would trade at 5% yield, and the flat one would trade it 7% yield. During the August disruption, you could have bought either company at a 7% yield. We sold the company with no growth, and we used the proceeds to buy the one with high growth. We got the exact same yield but a much better forward-looking total return.

**SL:** Would you say your turnover ratio is an accurate way to understand your funds?

**McCarthy:** No, not always. If you raise assets during a secondary offering,

the additional funds that you spend from the new capital counts as turnover.

**SL:** Is there any guidance you would like to give on activity in the portfolios that may be different than the turnover ratios people see publicly reported?

**McCarthy:** As an example, the quarter ending August 2011, our turnover ratio, especially KYN and KYE, was substantially higher than it has been historically, because we were taking advantage of the volatility by doing rotation trades. I don't know the exact figures, but I wouldn't be surprised if we did a year's worth of normal trading during August as it was a target-rich environment.

**SL:** There has been substantial merger and acquisition ("M&A") activity in the MLP sector this year. Can you put the activity into a context and let us know if it is unusual?

**McCarthy:** M&A activity in 2010 and 2011 has been the best we've ever seen in the MLP space. Prior to the financial crisis, the highest level was \$27 billion of M&A activity in 2007. During the financial crisis, M&A virtually shut down with only \$8 billion in 2008. M&A activity recovered to \$20 billion in 2009 with activity in the past two years, \$48 billion in 2010 and \$32 billion year-to-date in 2011, surpassing the previous high from 2007. We believe this

activity has been spurred by attractive opportunities to build infrastructure to support unconventional resources.

**SL:** What are your comments and outlook for the MLP sector in the next three to six months?

**McCarthy:** The past few months have been marked by extreme volatility in the financial markets. There was no shortage of factors weighing on markets including: the health of the global economy, the potential for a "double dip" recession, the U.S. debt ceiling stalemate, the U.S. credit downgrade and European debt concerns. The resulting volatility was dramatic, and MLPs were no exception. After the market's relative high on July 22, the Alerian MLP Index declined by -15.4%

and the S&P 500 declined by 18.3%. Since those lows, the markets have recovered very nicely. As of October 31, 2011, MLPs are up +2.6% for the year on a price basis [not a total return basis], outperforming the S&P 500 which is down 0.3% for the year.

Despite the increased volatility, we continue to believe that fundamentals in the MLP space remain strong. One of the best measures of this, in our opinion, is distribution growth trends. After their second quarters this year, 39 MLPs announced an increase in their quarterly distribution compared to 35 in each of the prior two quarters. The average annualized increase also grew to 6.3% versus 5.6% in the prior quarter. MLPs just kicked off their distribution announcements for the third quarter, and the quarter is off to a very good start. Several MLPs have announced distribution increases. Kayne Anderson expects 2011 distribution growth for the space to be around 6% and distributions to grow by a similar percentage in 2012.

**SL:** How about the future of oil and gas prices?

**McCarthy:** In the past few months, natural gas prices trended lower in spite of higher demand from warmer-than-normal summer weather in much of the country. The principal reason for the decline was the unprecedented increase in supply as the result of rising shale production. While low prices hurt natural gas producers, these prices have been driven by excess supply, which actually helps the midstream MLPs.

Shale gas production continues to grow in spite of low natural gas prices for two reasons. First, many producers have contractual incentives to drill in order to hold leases or to meet investment obligations. Second, other producers have a strong economic incentive to aggressively develop shales that are rich in natural gas liquids.

As a result, many analysts are becoming increasingly bearish on natural gas prices for 2012 and don't see gas prices recovering to normalized levels before 2013 or 2014. I'd like to emphasize that midstream MLPs with natural gas gather-

ing assets are benefitting from increased production levels. Additionally, midstream MLPs with natural gas processing and fractionation assets are benefitting from the price differential between NGL and natural gas.

**SL:** What is NGL? It is an industry term I am not familiar with.

**McCarthy:** Natural Gas Liquid. Three years ago, nobody would have heard it, but now it's interesting as someone on Wall Street is putting out an NGL report. You can tell it is a hot sector because one of the MLP IPO's last year called themselves NGL Partners. It's becoming more mainstream but worth clarifying for your readers.

**SL:** What do you expect to happen in the mid-to-long term for MLPs?

**McCarthy:** Generally, we believe that new energy infrastructure development will be a catalyst for distribution growth in the MLP sector. Production in unconven-

*I would emphasize how important experience is for making investment decisions.*

tional basins – such as the Marcellus Shale in Pennsylvania, the Eagle Ford Shale and Barnett Shale in Texas and the Haynesville Shale in Louisiana – will drive the construction of new energy infrastructure to transport energy products to major population centers. We believe that MLPs are the most direct way to capitalize on this trend.

Another factor that will drive MLP returns is the continuation of a robust NGL market. Due to high prices and the current supply/demand imbalance, NGL volumes are expected to grow as energy and power companies reallocate rigs to drill in liquids-rich areas, as opposed to drilling for natural gas. Many gathering and processing MLPs have announced plans to increase capacity for fractionation or separation of NGLs into individual products such as ethane, propane, butane, and

natural gasoline. Other MLPs have announced projects for processing plants and pipelines to handle these NGLs.

Significant amounts of capital are being spent by energy companies to develop unconventional reserves like the shale plays we mentioned earlier. In fact, major oil companies, foreign oil companies and national oil companies have spent more than \$100 billion in the past 18 months to acquire these types of reserves. This trend is very important for MLPs, as development of these new reserves will require substantial amounts of new midstream infrastructure. An energy industry group estimates that up to \$250 billion will need to be spent between now and the year 2035 to build the necessary midstream assets to develop these reserves. We believe this will provide attractive investment opportunities for MLPs and help drive future distribution growth.

Rising interest rates are a potential risk for MLP investors. However, MLPs are less risky than other fixed income investments, because MLPs have the ability to grow their distributions to offset rising interest rates.

**SL:** What is the one thing you would like our readers to consider in closing?

**McCarthy:** I would emphasize how important experience is for making investment decisions. With 27 years of experience in the MLP sector, I've lived through multiple investment cycles, fads, and "hot" themes. I think that perspective helps in making sound investment decisions.

I believe that Kayne Anderson's expertise in energy is superior to that of our competitors, as we are a leading investor in MLPs as well as the upstream energy space.

**SL:** Thank you for your time. I appreciate you being so helpful and diligent. We have learned a lot and are glad to share it with our clients and *Scott Letter* readers. ■

**Disclosure:** Closed-End Fund Advisors, its clients, family members or principals currently do not hold any shares in a Kayne Anderson closed-end fund or are affiliated with the firm in any capacity.

## Book Review of *The Quest: Energy Security and the Remaking of the Modern World* by Daniel Yergin

Dr. Yergin's first book, *The Prize*, published in 1991, is one of the few books that is essential reading. It works as a secret history of the 20th century, revealing how often oil – or the lack of it – has been a decisive factor of world affairs. It is inspiring in its narrative drive.

Yet, in the two decades since *The Prize*, a series of events has transformed the world of energy: break-up of the Soviet Union, the rise of China, the 9/11 attacks, the invasion of Afghanistan and Iraq and the emergence of climate change as a policy issue. It is a cause for celebration that Dr. Yergin has returned with his perspective on a very different landscape. If *The Quest* does not quite reach the heights attained by its predecessor, it is, nonetheless, another piece of required reading.

The new book covers a shorter time period but a broader field. It begins exactly where *The Prize* left off – with Iraqi forces in Kuwait and the disintegration of the Soviet Union about to become visible. Its first 341 pages continue the story of oil and gas up to the present, with references to the June 2011 OPEC meeting and the upheavals of the Arab spring.

Thereafter, the approach changes. Yergin rewinds the tape, going back into the past several times to tell the stories of other aspects of energy: electricity generation, climate change, renewable power and the checkered history of the electric car.

The effect is to make *The Quest* feel like four or five books in one, without the lineal narrative thrust of *The Prize*. If the earlier book is novelistic, *The Quest* is more like a handbook or primer.

That said, it is impossible to think of a better introduction to the essentials of energy in the 21st century. In its lucid, easy prose, the 800 pages flow freely. There are some vivid character sketches such as Marion King Hubbert, the brilliant, abusive originator of the theory of “peak oil” (the idea that the world is at or close to

the maximum rate of oil production it will ever reach).

Above all, the value of *The Quest* is its clarity and fair-mindedness of Yergin's thought. On the U.S.-led invasion of Iraq, he makes the most persuasive case I have seen as to why it was a difficult but unavoidable strategic necessity. He then with equally economical precision sets out the hubris and lack of planning that doomed Iraq to the tragedy that followed.

On climate change, he properly recognizes the complexity of the science, while leaving the reader no doubt about the weight of scientific opinion.

Yergin is an admirer and supporter of the oil and gas industry and serves as a consultant to the industry through Cambridge Energy Associates. His verdicts often echo what one might call enlightened industry opinion. He is incredulous of “peak oil” theory and that certain fossil fuels will play a central role in our energy system for decades to come.

He is more excited about the potential of shale gas, produced from rocks that were previously uneconomical due to the controversial practice of “fracking” (the injecting of water, sand and chemicals into a rock a mile down to fracture it, releasing the gas). He acknowledges there is likely to be “much argument” about the safety and regulation of the industry. [We will review new developments about “fracking” in the next *Scott Letter*.]

Yet, while his views on all of these points can be challenged, and no doubt will be, his judgment is hard to refute. Yergin has been criticized for being excessively harsh on Hugo Chavez, the demagogic and increasingly auto critic Venezuelan president. From an oil expert's perspective, however, the wreckage created by Chavez's policies on that country's once dynamic industry makes it increasingly difficult to avoid being angered and saddened by his record in office.

As the presses roll, the world of energy is still in flux. The consequences of the

Arab uprising are still unfolding, the backlash against environmental and other regulations in the U.S. is gathering pace, and China's commitment to “clean” energy, such as wind and solar power and electric cars, may be wavering.

Yergin ends his discussions with an honest but frustrating observation that it is “too early” to know how it will turn out. Dated as soon as it hit the shelves, *The Quest* is a definitive guide on how we got to where we are.

*The Prize* has acquired totemic status among those who work in the energy industry. New reporters starting out on the beat are given copies by their seasoned colleagues like infantrymen being presented Bibles before going to the front.

It is hard to see *The Quest* being loved in quite the same way. Yet, it is sure to prove every bit as valuable. ■

Source: Ed Crooks, *Financial Times*

### About the Author

Daniel Yergin is one of the most influential voices on energy in the world and a highly respected authority on international politics and economics. He is chairman of HIS Cambridge Energy Associates (CERA). HIS Energy, a leading source of oil and gas information, acquired CERA in 2004 and is the preeminent knowledge advisor to the world's energy industry and to financial institutions and governments.

### Editor's Note

We have just read this highly informative book. We obtained our hardback copy at half price from Amazon.com. It is available in both hardback and paperback (the latter for \$14.99) as well as in electronic format from Amazon.com/Kindle. The book may also be found in many public libraries.

We will explore these energy challenges in our next interview in December with Doug Ober, Chairman of Adams Express and Petroleum & Resources for the February 2011 *Scott Letter*.

## Portfolio Manager's Review

We expect a continuation of weak markets in Europe, which is now sliding into recession, but the odds are against a European financial meltdown. According to *The Kiplinger Letter*, the U.S. will feel the impact but won't crumble, hanging onto a 2% GDP growth in 2012. Credit tightening may cause some contraction as U.S. banks have stakes in European banks. Consumer confidence is improving, boosting vendors' holiday spirits. Auto parts and services are expected to benefit as the average age of cars grow. Oil is expected to end 2011 around \$95 a barrel. We expect markets to remain volatile but plan to use this volatility to make strategic changes in client portfolios.

According to data in our November 25, 2011 CEF Universe report, the average equity CEF is trading at a -7.16% discount with a 7.7% distribution yield and a -8.9% year-to-date market price return. Taxable bond CEFs trade at -1.81% discount with a 8.3% distribution yield and +1.5% year-to-date market price return. National municipal bond CEFs trade at +1.38% premium, a 6.4% distribution yield and a +16.5% year-to-date market price return. The S&P 500 is down -6.14% year-to-date.

### Manager's Review: Diversified Growth, Growth & Income and International Equity Models

Since October 1, we have made significant changes to these portfolios. We added to H&Q Life Sciences (HQL), as they have been our best performer for these models. We also own a significant number of shares in H&Q Healthcare (HQH). These funds can perform well, especially when the stock market declines.

Other changes have included purchases of global debt funds, which have been acting well in this environment. We have been selling some of our weaker real estate funds, especially those that have dropped so much that their distributions are suspect.

We have eliminated our shares in Asia Pacific (APB) because it will not be able to

pay a distribution this year and has been acting poorly, despite its superb long-term record. We added to our emerging market exposure with purchases of Templeton Emerging Markets (EMF) from the proceeds of APB.

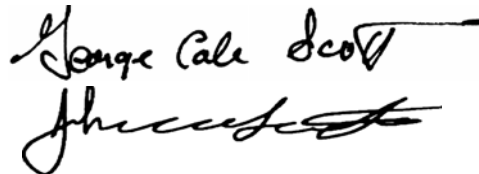
### Manager's Review: Hybrid Income, Foundation/Balanced and Conservative Diversified Models

We increased our exposure to Adams Express (ADX) when it traded at a -15.5% discount in the recent weak markets. We also added exposure to First Trust Enhanced Equity & Income (FFA) and Western Asset Global High Income (EHI).

For the Hybrid Income model, we purchased the senior loan funds, Avenue Income Credit Strategy (ACP) and Highland Credit Strategies (HCF), sold JH Tax Advantaged Global (HTY) and benefited from the tender offer in LMP Capital & Income (SCD). We are disappointed with the performance in Alpine Global Premier Property (AWP) and Advent Claymore Global Convertible (AGC) but believe they will recover and maintain their current dividend policy.

For the Foundation/Balanced model, we added to Lazard Global Total Return & Income (LGI) on market weakness. We added shares of Templeton Global Income (GIM) at a small discount to NAV and purchased shares of a new fund, ASA Gold & Precious Metals (ASA).

For the Conservative model, we added ING Prime Rate Trust (PPR) and Bancroft Fund (BCV), and for taxable accounts we swapped Pioneer Municipal High Income (MHI) for EV Municipal Bond (EIM). We also added to the model's various ETF selections, increasing exposure to alternative and low correlation asset classes. ■



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