

# Atherean

## Wealth Management, LLC

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Dear Atherean Wealth Management client:

Enclosed is your portfolio summary report for the quarter ending December 31, 2019, as well as an investment advisory fee statement for the first quarter of 2020. The portfolio summary report shows the holdings in your accounts as well as an overview of your portfolio asset allocation as of the close of the fourth quarter of 2019. It also provides a summary of your investment objectives, time horizon, and risk tolerance as per our records. It is important that you review this information and let us know if any of it is incorrect.

### **Equity and Fixed Income Market Performance**

Global equity markets continued their strong performance in the fourth quarter of 2019. This was a result of low interest rates and increased liquidity in the economic system due to dovish central bank policies and activities. In the U.S., the Fed resumed its asset buying program in the third quarter and kept its policy rate low throughout the year, which impacted interest rates across all maturities of the treasury yield curve. As a result, most asset class prices continued their rise despite their historically high relative valuations. In the fourth quarter of 2019 the S&P 500 index was up 9.0%, the Russell 2000 small cap index was up 9.9%, the MSCI EAFE (Europe, Australasia and Far East) index was up 7.7%, the MSCI US IM Real Estate 25/50 Index was up 0.6%, and the Barclays U.S. aggregate bond index was up 0.1% as of the end of the fourth quarter, on a total return basis. For the 2019 year the S&P 500 index was up 31.2%, the Russell 2000 small cap index was up 25.4%, the MSCI EAFE (Europe, Australasia and Far East) index was up 22.1%, the MSCI US IM Real Estate 25/50 Index was up 28.9%, and the Barclays U.S. aggregate bond index was up 8.5%, on a total return basis

### **Portfolio Management Process: Strategic Asset Allocation enhanced with undervalued opportunities**

As we have discussed in previous quarterly updates, our investment philosophy consists of a top down approach to asset allocation, enhanced by opportunistic investment in securities which we believe to be undervalued. In our last quarterly letter we described how we tend to focus on absolute valuation but have found that the portfolios which we manage tend to have a high weighting toward value stocks, which we define as stocks which are undervalued relative to their benchmark based upon a valuation metric such as price to earnings ratio or enterprise value to EBITDA ratio. We are continuously on the look out for opportunities in undervalued sectors of the U.S. economy. In the next section, we will describe an economic sector at which we have recently begun to look closely.

## **Midstream Energy Sector Investments – Tax Advantaged Bargains**

One of the sectors which we have recently been examining very closely is the midstream energy sector. This is the sector of the economy involved in the shipping and handling related to the energy sector, and companies in this sector can be thought of as “transportation companies without wheels”. Unlike the more volatile upstream energy companies, which are focused on exploration and production, the midstream energy sector is focused on toll based transportation and distribution, and its performance thus tends to not be highly correlated with oil prices. Primarily due to the Tax Reform Act of 1986, many of the companies in this sector can structure themselves as publicly traded partnerships, or “master limited partnerships”, and pass their distributions through to shareholders without the “double taxation” inherent in c corporations which pay dividends to their shareholders. Furthermore, typically large portions of the distributions paid to unit holders of master limited partnerships are treated as “return of capital” and taxation of these portions of the distributions is thus deferred until the master limited partnership units are sold. In estate planning situations such a feature can be particularly beneficial in cases where the heir receives a stepped up basis in the master limited partnership units. In such cases the portion of the distribution associated with return of capital can be effectively tax free to the unit holder.

The midstream energy sector has been out of favor for many years and its performance has disappointed investors. After over five years of essentially flat performance, the sector began to rebound slightly in the last year or so. For the 2019 year, for example, the Alerian MLP Index was up 6.6% on a total return basis. The American Energy Independence Index, which includes many Canadian as well as U.S. midstream energy companies and includes many companies structured as corporations as well as companies structured as master limited partnerships, fared much better, gaining 19.6% in 2019 on a total return basis.

Unlike many sectors of the U.S. economy, the midstream energy sector is currently significantly undervalued on a relative basis. The Enterprise Value to EBITDA ratios of many companies in the midstream energy sector are trading well below their historical averages, but perhaps more importantly many companies in the sector are trading at bargain prices with respect to the valuation of their equity using discounted free cash flow to equity models. Indeed, we expect the cash flow of many companies in this sector to increase in the coming years as the amount of capital expenditures in the sector is declining.

Due to the “Unincorporated Business Income Tax”, a tax rule which has historically prevented tax advantaged institutional investors from profitably investing in master limited partnerships on an after tax risk adjusted basis, liquidity in the market for these investments is in a large part provided by retail investors. For this reason mispricing in these instruments can exist from time to time, resulting in solid buying opportunities. We will continue to hunt for attractive opportunities in the midstream energy sector in the months to come, and will also continue to hunt for other sectors in the economy that we believe to be undervalued.

Let us know if there are any changes to your financial profile or investment objectives. If you would like to review your portfolio and/or financial plan in greater detail, have any tax planning or tax advice concerns, or have any other questions or concerns, feel free to contact us.

Sincerely,



Atherean Wealth Management, LLC