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WHAT HAPPENED TO MLPS?

A follow-up interview conducted on October 15, 2014 by Cecilia L. Gondor, closed-end fund industry consultant, with the portfolio managers of the Duff & Phelps Select Energy MLP Fund, Inc. (NYSE: DSE): David D. Grumhaus, Jr., Senior Portfolio Manager; Charles Georgas, CFA, Portfolio Manager and Senior Analyst; and Kyle West, CFA, Junior Equity Analyst.*

After a five-year run of popularity, the surprise 11.4% correction in the share prices of master limited partnerships (MLPs) over less than a one-week period sent shock waves through the sector and investors running for the exits. What exactly was behind the early October panic and has the selling been overdone? For answers, I turned once again to the DSE investment team.

Q. Gentlemen, thank you for speaking with me on short notice and in the midst of this pronounced sell-off. Let's start with the question on everyone's mind; what touched off this surprise sell-off in MLPs?

A. There is no question that the biggest driver is the decline in oil prices. Brent and West Texas Intermediate (WTI) crude have fallen sharply since summer. For instance, Brent peaked at $115 a barrel on June 20 and closed below $84, as we speak. An oil analyst we spoke with today noted that the decline was even faster and more severe than in 2008 and 2009.

Q. Is there typically a strong correlation between oil and MLP prices?

A. The correlation is historically low, around 0.4, but it has been a lot higher over the past month. Outside of the upstream MLPs, which sell oil so they have direct exposure to oil prices, most other MLPs – especially the midstreams – are only impacted when oil prices are low enough that drilling is curtailed and pipeline volumes are cut. Even the upstream MLPs are insulated as most employ hedging strategies precisely for that reason. For instance, a large majority of the upstream MLPs in DSE's portfolio are heavily hedged, by as much as 80%, which will insulate them this year and in 2015, reducing or negating any near-term effect. Many other MLPs also have fee-based revenue and minimum volume contracts, which guarantee payment for a certain volume, even if usage is below capacity.

This means that MLP revenue should hold up, in spite of declining oil prices. At this point in time, we believe the fundamental effect of the drop in oil prices is de minimus, however, the psychological effect is clearly extreme.

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**Read the previous interview with the DSE team, "How Kinder Morgan's Reorganization Impacts Closed-End MLP Funds," available in the closed-end fund section of Virtus.com.*

continued

Q. At what oil price will MLPs start to feel an impact?

A. Oil production should not be significantly affected until oil prices fall into the $70's, and even then, prices will need to stay at that level for a long time before production is cut back. There are significant costs to laying off rigs, cutting workers, decreasing drilling, and reducing production; most companies take the longer-term view in making decisions related to their drilling and production programs.

We would expect marginal producers to be the first to curtail production, and that would be expected if oil prices stay below $75 per barrel.

Q. What has fueled the psychological effect that you mentioned is dominating the market?

A. Despite growing institutional ownership, one must remember that MLPs remain a liquidity-constrained sector. We believe what we witnessed was a combination of selling by hedge funds rapidly reducing exposure, retail investors panicking over price drops, open-end funds and ETFs meeting redemptions, and closed-end funds reducing their leverage. Watching MLP prices intraday, it was clear there were periods of forced selling. There were three to four times over the five-day period when we saw big gap-downs in MLP prices as investors were seemingly selling with no regard to price.

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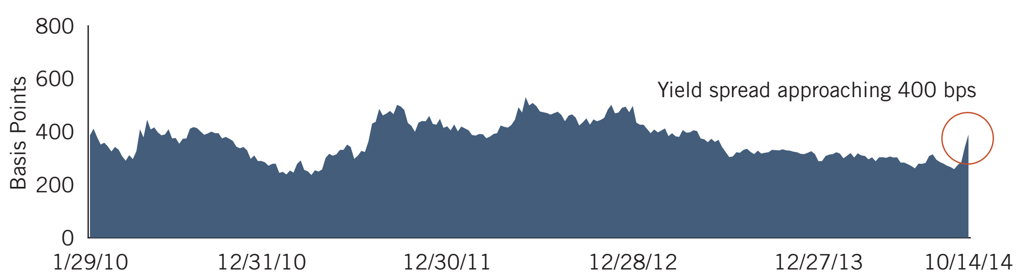
Q. MLPs have had an extended run of positive performance; can you put the recent decline into perspective?

A. This has been a pretty historic sell-down, in terms of both the amount and speed of the drop! The Alerian MLP Index fell from 532 at the beginning of October to 457 in just two weeks; it opened the year at 463. As we speak, it closed slightly above that level at 475. Over the past five years, we have seen only four other periods when MLPs corrected more than 10%, and none happened this quickly.

Q. Are MLPs now considered cheap?

A. One valuation factor we watch closely is the yield spread between MLPs and the 10-year U.S. Treasury. Historically, the average spread has been around 330 basis points. About two weeks ago, the yield spread was 280 basis points; today it is about 400 basis points. So MLPs have gone from being a little expensive to looking pretty cheap.

YIELD SPREAD BETWEEN ALERIAN MLP INDEX (AMZ) AND 10-YEAR U.S. TREASURY



Source: Duff & Phelps Investment Management Co. and Alerian.com. ***Past performance is not indicative of future results.***

Q. How have MLP yields been affected by the correction?

A. The yield on the Alerian MLP Index was as low as 5.1% before the correction; now it is back above 6% while the dividends have not changed. As stated earlier, we do not believe MLP distributions are at risk this year or next.

Q. Discounts of closed-end funds that invest in MLPs have been widening since the end of last year. To what do you attribute that?

A. Looking back, even just a few weeks ago, the dominant fear was rising interest rates and a crowding out of MLP yields. This seems to have been the driving factor behind the gradual widening of closed-end fund discount levels for the group. Of course, ironically, interest rates have done the opposite and fallen dramatically. There has also been a steady stream of MLP closed-end funds brought to market, so investors have an expanding number of names to choose from. Last month during the offering period for the second Goldman Sachs MLP closed-end fund, which raised $1.4 billion, we saw a lot of selling of existing funds to buy the new issue. In some ways, that large offering also created a false sense of security that a lot of money would be put to work in the sector once that deal closed on September 25.

Q. Closed-end fund retail investors tend to make tax-motivated trades at year-end. How do you expect MLP funds to react this year?

A. We don't think this will be a huge issue. Despite the recent price drops, most retail investors probably have unrealized gains rather than losses in these holdings. Furthermore, distributions paid by MLP funds are largely comprised of return of capital, which reduce the holder's cost basis so when investors sell, they are more likely to realize a gain than a loss. Ultimately, MLPs are really a product that investors tend to buy and hold.

Q. In light of the recent decline, what is your current outlook for MLPs?

A. MLPs have been a great performing sector, the fundamentals are strong, and yields are even more attractive now. While we think most of the damage has already been done to oil prices, that's not to say that prices for oil and MLPs won't bounce around. Down the line, oil will stabilize and that stability will allow MLPs to begin trading based on fundamentals once again.

The features that attracted investors to MLPs in the first place – yield, growth and exposure to the U.S. energy renaissance – are still there. We believe that if you look back six months from now, you will remark that this was a great time to add to exposure.

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