# MLP Exchange Traded Products Explained: ETNs and ETFs

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## Summary

- For investors wanting diversified MLP exposure in a passive product, it is important to understand the nuances of MLP exchange traded funds and exchange traded notes.
- In general, an MLP ETF is going to be more attractive for investors primarily wanting tax-advantaged yield.
- A key advantage of an ETN is little or no tracking error, and an ETN tends to make more sense for allocations in tax-advantaged accounts.


Investors wanting exposure to the MLP space through passive products that provide a Form 1099 have likely considered exchange traded funds (ETFs) but may be less familiar with exchange traded notes (ETNs). In some cases, an ETN may be better suited to an investor's needs or objectives than an ETF. Today's note briefly explains what ETNs are, how they compare with MLP ETFs, and how investors can determine whether an ETF or ETN is better suited for their needs.

## What are exchange traded notes (ETNs)?

ETNs are unsecured debt obligations of an issuer, which agrees to pay the investor a specified return typically based on an index. Because an ETN is providing the return on an index, there is little to no tracking error, which is a key advantage of the structure. Midstream ETNs are often based on an index of MLPs, but there are ETNs that track indexes with both MLPs and C-Corps. ETNs can also be leveraged, magnifying the return on the index in either direction by some multiple (i.e. 1.5x, 2x, or 3x).

There are nuances to ETNs that investors should understand. ETN investors are exposed to the credit risk of the issuer, so investors will want to be comfortable with the bank issuing the ETN. Additionally, MLP ETNs can provide lower income than ETFs tracking the same index because the fee for ETNs is taken out of the coupon. As notes, coupon payments are taxed at ordinary income rates, and for this reason, MLP ETNs are better suited for tax-advantaged accounts.

## How does an MLP ETN compare to an MLP ETF?

For investors wanting diversified MLP exposure in a passive product, an ETF or ETN could meet their needs, but determining which is a better fit depends on the investors' preferences and the type of account where the investment will be made. For this discussion, an MLP ETF is one that predominantly owns MLPs and is taxed as a corporation. Recall, any fund that owns more than 25% MLPs will be taxed as a corporation. There are RIC-compliant funds that own less than 25% MLPs and are not taxed at the fund level. For more information on RIC-compliant funds, see related research below.

In general, an MLP ETF is going to be more attractive for investors primarily wanting tax-advantaged yield. The distributions from MLP ETFs maintain the tax advantages of their underlying holdings, and typically, a significant portion of the MLP ETF's distributions is tax-deferred with the remainder taxed at qualified dividend rates. Because the income is tax-advantaged, it makes sense to own MLP ETFs in taxable accounts, though it is not uncommon to meet investors that own MLP ETFs in tax-exempt accounts (see last week's note for more on this topic).

When could an MLP ETN be more attractive than an MLP ETF? Assuming the investor is comfortable with the credit risk of the issuer, an ETN tends to make more sense for allocations in tax-exempt accounts because coupons are taxed at ordinary income rates. An ETN may also be more attractive if an investor is expecting significant price appreciation from the underlying index, because an ETN has little to no tracking error.

One drawback of MLP ETFs is that performance can lag the index because the fund is taxed as a corporation. MLP ETFs accrue a deferred tax liability (DTL) for capital gains and for the portion of distributions from MLPs that are considered a tax-deferred return of capital. DTL is removed from the fund's net asset value (NAV) and is assessed based on the 21% corporate tax rate, plus some amount for state taxes (typically 2-3%). When the fund is in a net deferred tax liability status, if the underlying index gains 10%, the ETF's NAV may only go up 7.6%. If an ETF is in a deferred tax asset position, the ETF may more closely track the underlying index. The graphic below summarizes the advantages and disadvantages of MLP-focused ETFs and ETNs.

| | ETN | C-Corp Funds (Predominately MLPs) |
|---|---|---|
| **Advantages** | Little/No Tracking Error | Generally Higher After-Tax Income*<br>Ownership of Underlying Securities<br>Predominate MLP Exposure |
| **Disadvantages** | Generally Lower After-Tax Income**<br>Credit Risk of Issuer | Deferred Tax Liability Mutes Gains |
| **Suitability** | Tax-Advantaged Investors<br>Total Return Investors<br>Comfortable with Issuer Credit Risk | After-Tax Yield Investors |

** Due to expense rato being taken from NAV, and income being treated as return of capital/qualified dividend*
*** Due to expense ratio being taken from coupon, and coupon being taxed as ordinary income*

## Bottom line

When weighing MLP ETFs and MLP ETNs, there are a few key points investors should keep in mind. MLP ETFs tend to be best suited for those looking to maximize tax-advantaged yield and investing in taxable accounts. Assuming an investor is comfortable with issuer credit risk, an ETN is best suited for investors wanting to minimize tracking error and investing in a tax-advantaged account.

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## Related Research:

Decisions, Decisions: Demystifying MLP Investment Options
Energy Infrastructure Investing
MLP Taxation: The Benefits and What You Need to Know

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