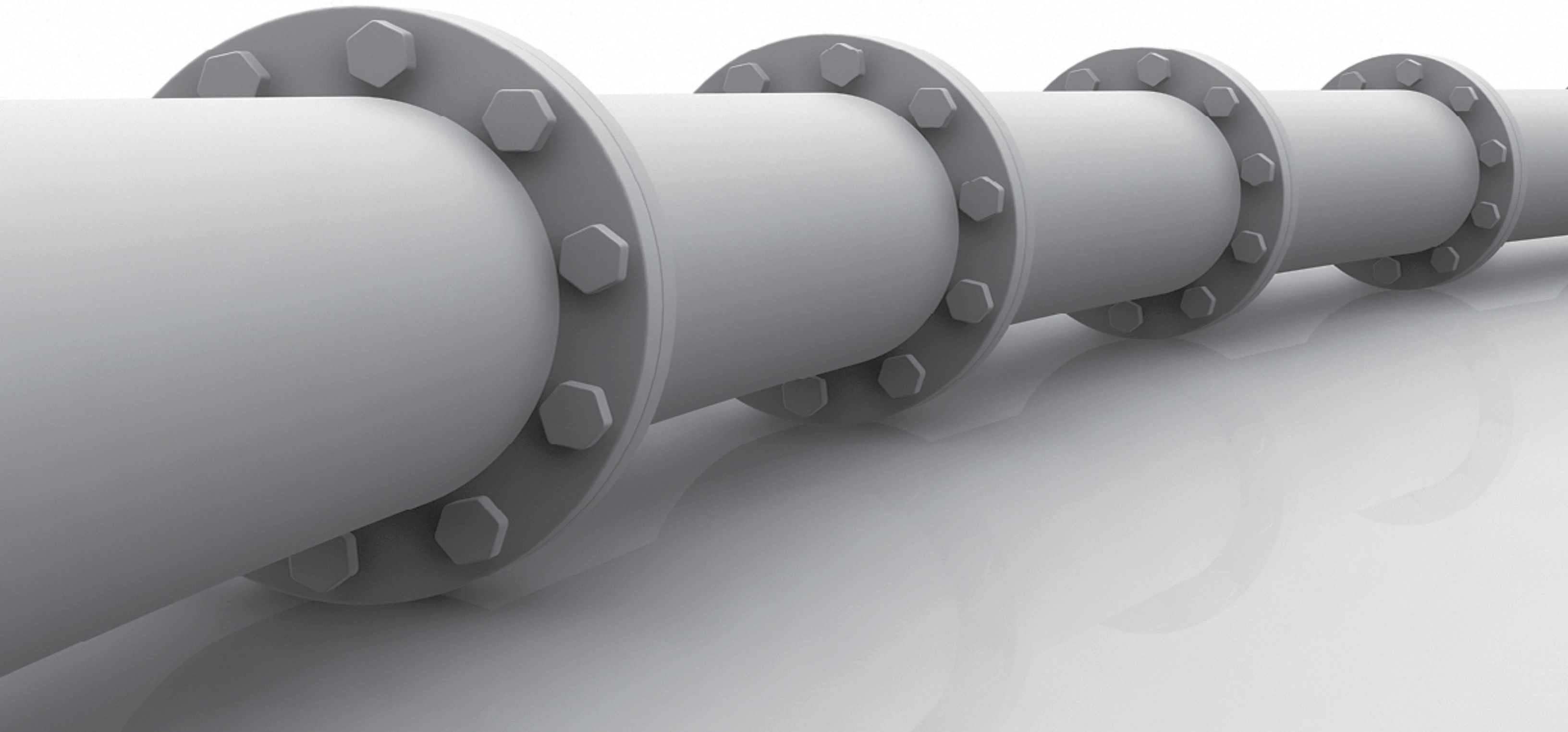
MILLER/HOWARD
STRATEGIC INDEXES

Miller/Howard MLP Fundamental Index

Q&A



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Conventional wisdom asserts that any index or benchmark should be capitalization-weighted. As an investment manager, Miller/Howard does not subscribe to the notion that bigger is necessarily better, according to Lowell Miller, president and founder of Miller/Howard Investments Inc. Recently the firm launched its first index—the **Miller/Howard MLP Fundamental Index**®* (Bloomberg ticker: **MLPMH**)—which goes beyond cap-weighted exposure to Master Limited Partnerships (MLPs). Unlike most other major indexes, the MLPMH Index seeks "to assign the right weights to fundamental factors we've identified as potential key drivers of total return performance," says Miller.

Can you explain what the Miller/Howard MLP Fundamental Index is?

Lowell Miller: The Index is a group of 25 energy Master Limited Partnerships that are weighted based on quantitative fundamental factors of publicly traded MLPs. It is a strategic index focusing on the historical drivers of total return performance for MLPs: distributions, safety of distributions, and potential growth of distributions.

What is the investment objective of the Index?

The investor in a capitalization-weighted index gets everything: the good, the bad, and the ugly stocks. We try to screen for just the good stocks. In other words, if you invest in a cap-weighted index you only get beta, the movements of the index. Our goal is to add alpha to the picture. Our Index aims to provide outstanding returns for MLP investors as well as a benchmark measurement for higher-growth MLPs. The Index is rebalanced and reconstituted quarterly, so the constituents remain fresh and up-to-date as fundamental information changes.

Given the economic backdrop, why does this MLP Fundamental Index make sense at this juncture?

Investors continue to search for higher-yielding investments. But at this point in time it's necessary for higher-yielding investments to also offer an element of growth in both distributions and their underlying businesses to overcome any potential headwinds from higher interest rates or inflation. We believe the US infrastructure area in which MLPs operate can provide both stability and growth in the years ahead.

What's the difference between investing in the Index and investing directly in MLPs?

Direct investment in MLPs is appropriate for investors with higher account values (both taxable and nontaxable investors) willing to engage in some tax management of the account. For smaller investors and nontaxable investors, an Exchange-Traded Note ("ETN") provides access to the MLP market without tax issues and paperwork compliance; there are no K-1 forms. The ETN distribution is not tax deferred. However, investors will not pay any capital gains taxes on transactions within the portfolio, nor will they be subject to depreciation recapture or ordinary income (or unrelated business income for nontaxable investors) resulting from sales within the portfolio.

As many investors have learned, IRS rules force non-ETN funds investing in MLPs—ETFs and mutual funds—to pay taxes as a corporation, which can both create a significant drag on returns and change the risk/return profile compared to the underlying MLPs that they hold.

Won't rising interest rates affect an MLP's cost structure and ultimately its ability to increase its distribution?

Almost all MLPs have long-term fixed obligations that match their revenue streams. MLPs may start with projects, perhaps at a variable rate, and term out with credit such that debt obligations remain fixed for either the life of the project or the life of the contract, which can run from 10 to 20 years. Furthermore, if interest rates rise, this gets built into the price of services. Unlike utilities, MLPs have the ability to rebid prices anytime a contract is up for renewal. Rising rates are not very threatening, in our view, though MLPs do need continuing access to capital markets in order to grow, so there is always a risk if capital markets are not functioning well.

How competitive are MLPs relative to other yield products such as bonds in a rising interest rate environment?

For MLPs, it's their historical and projected distribution growth rate that distinguishes them from other income--oriented investments because rising distributions can offset an increase in rates.

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What would the Index include specifically?

The universe from which the Index selects includes all energy-related MLPs, currently around 100 companies. From there we screen based on market capitalization, distribution cuts, and liquidity down to 50 MLPs that comprise the selection universe. Those 50 MLPs are then split into two groups based on market capitalization. The large group includes a screening of the 25 largest MLPs and the mid-cap/small-cap group includes the bottom 25 in size. Through a series of additional screens (distribution growth, projected capex spending, distribution coverage) the final portfolio of 25 MLPs is selected (15 from the group of larger MLPs equal-weighted at 5% and 10 from the group of smaller MLPs equal-weighted at 2.5%).

Why should the weighting of the Index constituents deemphasize the importance of market capitalization?

This is an ongoing argument. If you believe that from an investor's standpoint the larger stock is better than the smaller stock, then you'd be more interested in traditional indexes. If you believe that an index should provide insight into how an investment might actually perform within an asset class, then you would want equal weighting so that the basis for selection looks at the fundamentals of an individual company rather than how big it is.

We've seen terrible examples of weighting as a function of market cap during the technology bubble, when tech stocks reached nearly 40% weight in the S&P 500 simply due to investor speculation rather than fundamentals.

With very few exceptions, the current MLP indexes are all cap-weighted.

One interesting effect is the concentration of existing ETFs and ETNs in large-cap stocks, meaning, they're heavily focused on the 10 largest MLPs. This can be seen when you look at the historical yield spread of large-cap MLPs versus mid-cap and small-cap MLPs, which has been widening over the past three years.

Why are the three main selection factors individually important?

First, distribution growth historically has been the most predictive factor for MLP outperformance. Distribution growth also contains within it the implication that as distributions increase prices would increase, since the instrument generating the distribution is to some extent priced on the level of the distribution. As with rental property, if you raise the rent, the property would be worth more.

Secondly, you want to be sure that the distribution is safe and that the company is not paying out more than it could really afford. We focus on EBITDA as a measure of financial stability.

Finally, the history of distribution growth is a good indicator of prospective distribution growth in the future. But you want more than that. What makes this engine run is continuing distribution growth. We seek metrics that can provide a comfort level that distributions will continue to grow in the future. The best metric is the growth of a company's capital expense. It is from these investments that a company is able to generate higher cash flow to pay distributions.

What does the final investable universe look like?

The final portfolio includes 15 stocks selected from among the 25 largest MLPs with the best current and future distribution profile, and 10 stocks from among the 25 smaller MLPs with the best current and future distribution profile. The largest stocks are equal weighted at 5% and constitute 75% of the portfolio; the smaller stocks are equal weighted at 2.5% and constitute 25% of the portfolio.

How does the M/H Fundamental Index differ from other MLP indexes out there?

The major MLP indexes—primarily the Alerian Index and the S&P MLP Index—are capitalization-weighted. The MLPMH is unlike other indexes in that it is driven by a set of factors that we believe should be key areas of investor focus. The historical experience of MLPs confirms our thinking, though no one can guarantee that the past will be prologue. However, we think it also highly logical that an investor interested in income and growth of income would look to factors of income safety and income growth—both past growth and estimated growth—rather than simply invest based on the size of a company, which is the conventional index approach.

We also treat the smaller stocks in the Index in a manner that ensures their representation in the Index returns. In a conventional index, the larger the "large" stocks become, the less meaningful the performance of the smaller stocks becomes. But we think there are investment opportunities across the capitalization spectrum to which investors would like exposure.

Can ETNs based on Alerian Indexes outperform the index they are based on?

By design, an ETN will underperform the index it is based on. It will deliver index performance minus fees. AMJ, the largest ETN, no longer creates new units, so it is now a kind of closed-end fund—with periodic discounts and premiums. In 2013 AMJ frequently deviated from its index by 3% or so, a level we think is significant. When an ETN is open-ended, the ETN should perform in line with the index (minus fees), since the ETN sponsor stands ready to create or redeem units at any time at NAV (with a small transaction cost). Any deviations of the ETN from the index should be arbitraged away because of the continuous creation and redemption feature.

Which elements of transparency are unique to the MLPMH Index?

We publish the Index constituents on our website. We provide a complete description of our universe definitions and Miller/Howard's Index rules. The Index is rebalanced quarterly, and all changes are announced at scheduled disclosures.

For more information about Miller/Howard Strategic Indexes visit: www.mhindexes.com.

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MLPMH INDEX Q&A ID 1331 PUB RIA WF OPP JMS RBC | CITI SMA1170002 1/18 | MS MSMA160728 12/18 | UBS U2016Q4_1331 12/17