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See page 7 for Analyst Certification and Important Disclosures

Industry Note

Master Limited Partnerships

Master Limited Partnership Monthly Update (October 2004)

October 6, 2004

United States

David LaBonte

SUMMARY

- In September, our composite of 19 energy-related MLPs generated a 4.9% total return, its best one-month total return of the year. For comparison, the S&P 500 Index generated a total return of 1.1% last month.
- We attribute much of this strength to the relatively high yields offered by MLPs in a yield-starved market.
- Our investment thesis continues to be that MLP performance will depend more on the direction of interest rates than on underlying business fundamentals.
- Investors should differentiate between which MLPs have good distribution growth prospects since such growth can: 1) lead to higher overall total returns, and 2) help offset the potentially adverse consequences of an eventual rise in interest rates.
- The opportunity to capture a rising income stream is the primary reason we would favor MLPs over bonds or preferred stocks.

OPINION

Figure 1. MLP Composite: Expected Total Return Potential (View Using PDF Format)

Partnership Name	Rating	Price 10/6/04	Target Price	Cur. Dist.	Proj. Dist.	Est. Dist. Yield	Return to Target	Total Return Potential	Est. Tax Deferral
Alliance Resource (ARLP)	2M	$59.50	$51.50	$2.60	$3.10	5.2%	-13.4%	-8.2%	70%
AmeriGas (APU)	2M	$29.83	$26.00	$2.20	$2.20	7.4%	-12.8%	-5.5%	80%
Buckeye (BPL)	2L	$45.00	$40.00	$2.65	$2.80	6.2%	-11.1%	-4.9%	70%
Enbridge Energy (EEP)	2H	$48.07	$46.00	$3.70	$3.70	7.7%	-4.3%	3.4%	90%
Energy Transfer (ETP)	1M	$48.70	$53.00	$3.30	$3.70	7.6%	8.8%	16.4%	95%
Enterprise Products (EPD)	1M	$23.25	$26.00	$1.49	$1.80	7.7%	11.8%	19.6%	90%
Ferrellgas (FGP)	2H	$22.08	$22.00	$2.00	$2.10	9.5%	-0.4%	9.1%	95%
Kaneb Pipe Line (KPP)	2L	$52.77	$47.00	$3.42	$3.50	6.6%	-10.9%	-4.3%	85%
Kinder Morgan (KMP)	2L	$47.65	$43.50	$2.84	$3.05	6.4%	-8.7%	-2.3%	95%
Magellan Midstream (MMP)	1L	$54.65	$56.50	$3.48	$3.95	7.2%	3.4%	10.6%	80%
Natural Resource (NRP)	1M	$42.74	$48.50	$2.40	$2.90	6.8%	13.5%	20.3%	70%
Northern Border (NBP)	2H	$46.28	$40.00	$3.20	$3.20	6.9%	-13.6%	-6.7%	95%
Pacific Energy (PPX)	1M	$28.95	$28.50	$1.95	$2.15	7.4%	-1.6%	5.9%	80%
Plains All American (PAA)	1M	$36.82	$37.00	$2.40	$2.60	7.1%	0.5%	7.6%	70%
Suburban Propane (SPH)	2M	$34.77	$32.50	$2.45	$2.55	7.3%	-6.5%	0.8%	80%
Sunoco Logistics (SXL)	2M	$39.60	$36.00	$2.35	$2.50	6.3%	-9.1%	-2.8%	80%
TC PipeLines (TCLP)	2M	$38.60	$34.00	$2.30	$2.40	6.2%	-11.9%	-5.7%	95%
TEPPCO (TPP)	2L	$42.03	$37.50	$2.65	$2.80	6.7%	-10.8%	-4.1%	90%
Valero (VLI)	2M	$57.25	$48.50	$3.20	$3.40	5.9%	-15.3%	-9.3%	80%

Near-term market volatility and short-term trading patterns may cause the Expected Total Return to become temporarily misaligned relative to the hurdle for these stocks' fundamental rating, as defined under our current system.
Source: Smith Barney

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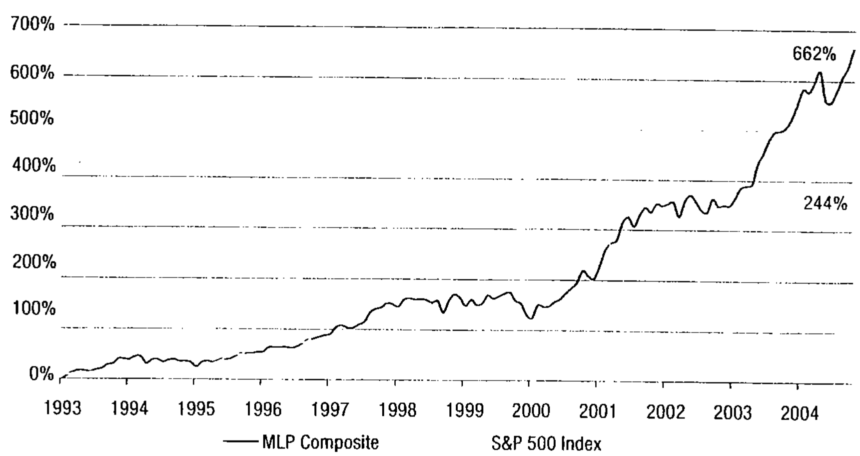
MLP COMPOSITE: PERFORMANCE REVIEW AND INVESTMENT THESIS

In September, our composite of 19 energy-related MLPs generated a 4.9% total return, its best one-month total return of the year. For comparison, the broad equity market, as measured by the S&P 500 Index, generated a total return of 1.1% last month. We attribute much of this strength to the relatively high yields offered by MLPs in a yield-starved market. Another factor that seems to have helped boost performance was an initial public offering of an MLP dedicated closed-end investment company that raised about $750 million in gross proceeds. In this regard, we suspect some investors may have tried to "front-run" some of the investment company's potential purchases.

Since experiencing a sell-off of 8.1% between April and May (compared to a decline of less than 1% for the S&P 500 Index), our composite has generated a 16.2% total return. (The equity benchmark has posted a positive total return of less than 1% during this period.) The selling pressure between April and May was largely related to the sharp upward move in interest rates during that period and concerns among investors that the Federal Reserve would continue raising interest rates to head off inflationary pressures. However, with the yield of the 10-year U.S. Treasury dropping from 4.9% to 4.2% over the past several months, investors have continued to allocate money to this unique asset class. Year to date, our composite is up 11.7% on a total return basis, which compares favorably to the 1.5% total return generated by the S&P 500 Index during the same period.

Our investment thesis continues to be that MLP performance will depend more on monetary policy and the direction of interest rates than on underlying business fundamentals. However, with interest rates seemingly reversing their upward trend in recent months and possibly heading lower, it seems that MLPs may be poised to continue their recent strong performance. Nonetheless, investors who are looking to put money to work in this group should focus on MLPs that have visible distribution growth prospects. Indeed, investors should differentiate between which MLPs have good distribution growth prospects since such growth can: 1) lead to higher overall total returns, and 2) help offset the potentially adverse consequences of an eventual rise in interest rates. The average distribution growth rate for the MLPs in our universe has historically exceeded 5% annually. Our research suggests that annual distribution increases should remain in this range. The opportunity to capture a rising income stream is the primary reason we would favor MLPs over bonds or preferred stocks, which only provide fixed income streams.

Figure 2. MLP Composite vs. S&P 500 Index with Dividend Reinvested (View Using PDF Format)



Source: Smith Barney

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THE IMPACT OF CHANGING INTEREST RATES ON VALUATION

Our research indicates the statistical correlation between changes in the direction of interest rates and MLP performance is relatively low. For example, using monthly data points since the inception of our composite in 1993, we derived a correlation coefficient of 0.38 between the MLP Composite Yield and 10-year U.S. Treasury. (A correlation coefficient close to 1.0 indicates a strong positive correlation between two random variables.) We attribute this low correlation primarily to the ability of most MLPs to increase cash distributions. Not surprisingly, we believe this unique ability for growth will generally have a greater influence on valuation than changing interest rates. (The correlation is tighter today than it has been historically given the amount of capital that poured into the group last year given the unusually low interest rate environment.) Nonetheless, we are not suggesting that investors should completely disregard the prevailing interest rate environment.

We believe that analyzing the term structure of interest rates can provide insight for anticipating whether investors may be more or less likely to allocate capital to this asset class. To illustrate, we think the relative appeal of the yields offered by MLPs is likely to increase during periods of low interest rates. (In our opinion, the period of low interest rates between 2002 and 2004 is a good example of how the demand for MLPs can increase.) Conversely, we think the attractiveness of owning MLPs can become diminished during periods of strong economic growth and rising interest rates. (We believe the final two years of the stock market bubble between 1998 and 1999 highlights how investors may look elsewhere for total return.) As a result, we feel that yield spread analysis can be useful for identifying value.

MLP COMPOSITE YIELD VS. 10-YEAR U.S. TREASURY

To help identify periods of relative under- and over-valuation, we like to examine the historical relationship between the yields of our MLP Composite and 10-year U.S. Treasury. We believe that understanding a change in the historical yield spread can help identify factors that may influence future performance. In our opinion, the narrowing and widening of the yield spread is primarily explained by fluctuations in the term structure of interest rates and changes in both the specific and market-related risks associated with each MLP in our group. Specific risks relate to factors that are unique to a partnership, such as its earnings power or ability to cover its cash distribution. Market-related risks are associated with macro factors affecting the overall industry, such as the adverse consequences of a warm winter for a retail propane distribution company. We believe these risks may, from time to time, exert a greater influence on the risk premium of an MLP than the expectation regarding the general direction of interest rates.

The current spread of our MLP Composite compared to the Treasury benchmark is about 240 basis points (bps), which is 45 bps narrower than its historical average. However, the current spread between our Pipeline MLP Composite and 10-year U.S. Treasury is about 235 bps, which is 20 bps wider than its historical average. This spread suggests that the market is valuing our Pipeline MLP Composite as if the yield of the 10-year U.S. Treasury will increase to 4.4% from 4.2% over the next 12 months. (The historical spread of our Pipeline MLP Composite to the 10-year U.S. Treasury is approximately 215 bps.) Assuming that cash distributions increase as we expect over the next 12 months and the unit prices of the pipeline MLPs in our composite remain flat, the market could be valuing these MLPs as if the yield of the 10-year U.S. Treasury could rise more than 50 bps to 4.75% over the next year. This relatively large spread to the Treasury benchmark may suggest that current valuations are reasonable.

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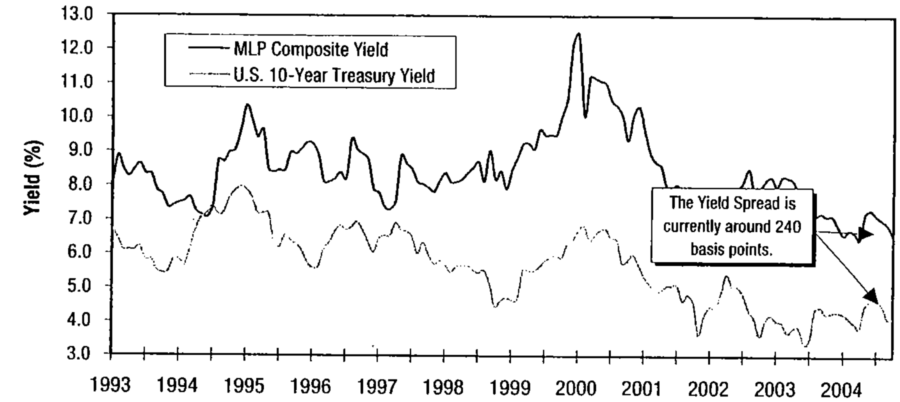
Figure 3. MLP Composite vs. 10-Year U.S. Treasury (View Using PDF Format)

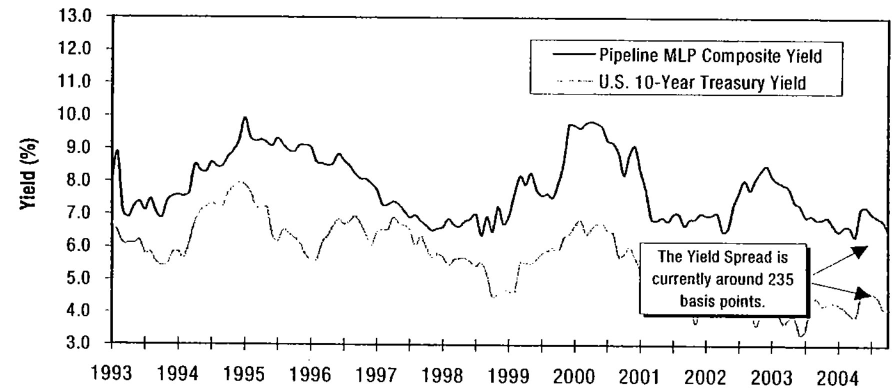
The historical yield spread between our MLP Composite and 10-Year U.S. Treasury has averaged about 285 basis points.



Source: Smith Barney

Figure 4. Pipeline MLP Composite vs. 10-Year U.S. Treasury (View Using PDF Format)

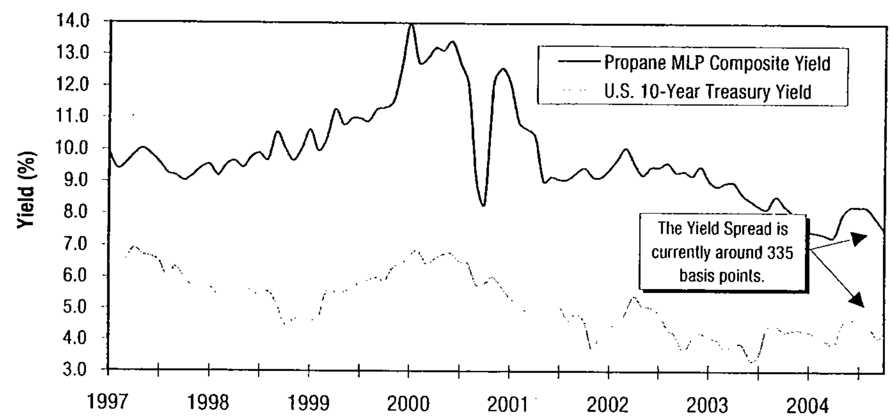
The historical yield spread between our Pipeline MLP Composite and 10-Year U.S. Treasury has averaged about 215 basis points.



Source: Smith Barney

Figure 5. Propane MLP Composite vs. 10-Year U.S. Treasury (View Using PDF Format)

The historical yield spread between our Propane MLP Composite and 10-Year U.S. Treasury has averaged about 480 basis points.



Source: Smith Barney

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Figure 6. MLP Composite Annual Total Returns, 1998A-Present (View Using PDF Format)

Partnership Name	1998	1999	2000	2001	2002	2003	YTD
Alliance Resource		-33.8%	68.8%	64.4%	-2.8%	53.3%	69.2%
AmeriGas	-0.5%	-26.2%	26.0%	48.3%	17.8%	27.9%	11.9%
Buckeye	7.7%	-2.1%	20.9%	38.9%	9.7%	26.0%	1.8%
Enbridge Energy	19.0%	-22.1%	29.9%	10.2%	9.0%	28.2%	1.4%
Energy Transfer	0.4%	-9.7%	33.0%	47.7%	4.4%	57.8%	20.0%
Enterprise Products	-31.1%	36.5%	86.7%	58.6%	-12.3%	35.4%	-0.6%
Ferrellgas	-15.2%	-17.5%	20.4%	60.4%	18.8%	29.1%	-3.2%
Kaneb Pipe Line	-0.4%	-18.2%	41.9%	40.7%	-7.7%	57.6%	7.5%
Kinder Morgan	14.4%	22.6%	46.4%	42.5%	-0.6%	50.2%	-0.3%
Magellan Midstream				102.5%	-16.8%	65.4%	15.4%
Natural Resource					3.5%	114.8%	1.6%
Northern Border	2.5%	-23.5%	50.1%	34.4%	5.7%	12.3%	23.8%
Pacific Energy					3.0%	60.7%	2.7%
Plains All American	-13.4%	-18.3%	63.0%	46.8%	2.1%	43.4%	16.8%
Suburban Propane	13.5%	2.7%	40.2%	30.2%	17.6%	22.0%	14.2%
Sunoco Logistics					24.8%	64.8%	11.6%
TC PipeLines		-28.7%	51.5%	43.6%	10.8%	34.8%	19.1%
TEPPCO	-0.8%	-15.1%	38.8%	31.3%	-0.2%	56.3%	8.6%
Valero				43.9%	6.5%	34.3%	17.2%
MLP Composite	***0.9%***	***-9.8%***	***46.9%***	***37.7%***	***2.8%***	***47.0%***	***11.7%***
S&P 500 Index	***28.6%***	***21.0%***	***-9.1%***	***-11.9%***	***-22.1%***	***28.7%***	***1.5%***

Source: Smith Barney

Figure 7. Annual Cash Distribution Growth Rates, 1998A-2004E (View Using PDF Format)

Partnership Name	1998	1999	2000	2001	2002	2003	YTD	2004 [1]
Alliance Resource		0%	0%	0%	0%	5%	24%	24%
AmeriGas	0%	0%	0%	0%	0%	0%	0%	0%
Buckeye	0%	5%	9%	4%	0%	2%	4%	4%
Enbridge Energy	10%	2%	0%	0%	3%	3%	0%	0%
Energy Transfer	0%	13%	0%	9%	4%	2%	27%	27%
Enterprise Products	0%	0%	17%	19%	10%	8%	0%	7%
Ferrellgas	0%	0%	0%	0%	0%	0%	0%	5%
Kaneb Pipe Line	0%	8%	0%	7%	5%	6%	2%	2%
Kinder Morgan	26%	15%	17%	29%	11%	8%	8%	10%
Magellan Midstream				10%	21%	16%	7%	10%
Natural Resource					0%	5%	12%	26%
Northern Border	5%	6%	15%	9%	5%	0%	0%	0%
Pacific Energy					0%	5%	0%	5%
Plains All American		7%	-4%	11%	5%	2%	9%	5%
Suburban Propane	0%	2%	5%	5%	2%	2%	4%	4%
Sunoco Logistics					0%	14%	15%	15%
TC PipeLines		0%	6%	5%	5%	5%	5%	5%
TEPPCO	13%	6%	11%	10%	4%	8%	2%	4%
Valero				0%	17%	7%	7%	7%
MLP Composite	***5.3%***	***4.2%***	***5.3%***	***7.6%***	***5.7%***	***5.2%***	***6.5%***	***8.3%***

1. Reflects our current cash distribution projections, which also factors into our 12-month price targets

Source: Smith Barney

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DOES IT MAKE SENSE TO OWN MLPS IN A RETIREMENT ACCOUNT?

Generally, all the taxable net income received by a tax-exempt investment vehicle such as an IRA, Keogh, or 401(k) plan from an MLP may be considered unrelated business taxable income (UBTI). Such income is usually subject to federal income tax if the total amount of UBTI from all partnership interests exceeds $1,000 in any taxable year. Therefore, a partner may be subject to income taxes in an otherwise tax-exempt retirement account. Investors should consult with their tax advisers regarding any retirement account investing.

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APPENDIX A-1

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