Investment Case for Alternative Income with High-Income Pass-Through Securities

Executive Summary

After years of effectively zero percent bond yields, interest rates have been rising at an unprecedented pace to stave off inflation. After initially believing that the inflation spurred by pandemic stimulus and supply chain constraints was "transitory," the Federal Open Market Committee (FOMC) embarked upon the most aggressive tightening cycle in history. Over the last year, policy rates have moved from zero in March 2022 to the current level of 4.75%. The good news for investors is that thanks to a heavily inverted yield curve, short-term cash instruments are now paying more attractive yields. The bad news is that even though there is evidence that inflation has been tamed to below 6%, it has had a crippling effect on bond returns and the banking system, leaving many bond investors and financial institutions with huge unrealized losses thanks to the worst bond market returns in 40 years. This has been a wake-up call for investors relying on fixed income exposure to hedge or smooth their equity holdings.

The diversification premise of the 60-40 equity and bond portfolio has been called into question, spurring many investors to search for uncorrelated, alternative sources of yield that keep up with inflation. High Income Pass-Through Securities (HIPS), securities that must pay out at least 90% of their earnings to investors, may present such an opportunity. Offering high levels of income that keep pace with inflation, HIPS are not highly correlated with bonds or stocks, offering investors the opportunity for income, along with the benefits of diversification and risk reduction.

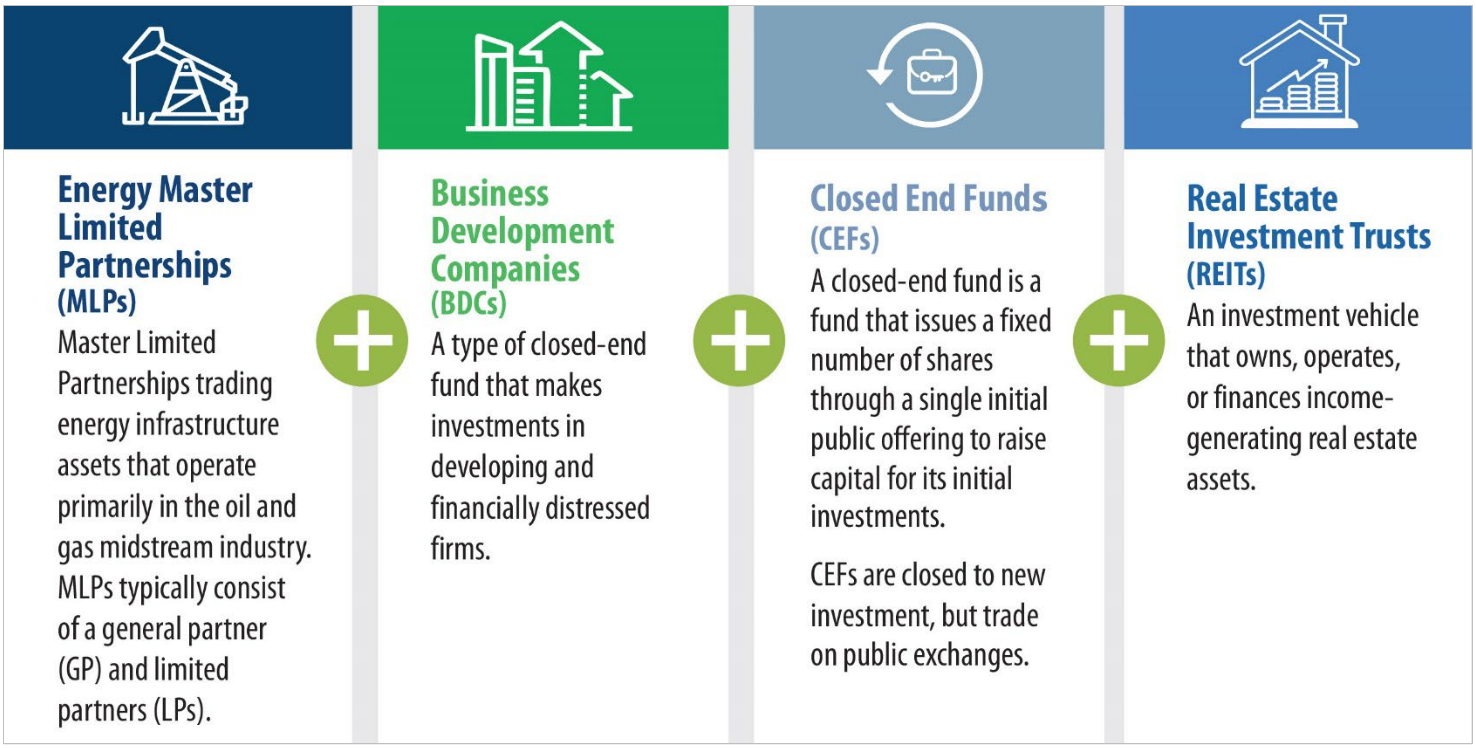
In this paper, we aim to discuss:

- The investment case for using alternative income using High Income Pass-Through Securities (HIPS) in a portfolio.
- How these securities are expected to perform in different economic scenarios.
- How we structured the HIPS Total Return Index (HIPSTR) to provide a diversified source of high-yielding, alternative income for investors.

What are HIPS?

The acronym "HIPS" stands for High Income Pass-Through Securities. These are securities that must "pass-through" at least 90% of their earnings to investors. As a result of the earnings pass-through, these entities are not subject to corporate taxation.

Examples of pass-through instruments and their definitions are explained below:



Source: EQM Indexes, Investopedia

Energy Master Limited Partnerships (MLPs)[1]

Master Limited Partnerships (MLPs) are structured as a hybrid legal entity that combines the elements of two business structures: a partnership and a corporation. Technically the structure is just a legal entity with no employees. General partners hold a stake in a venture with an option to increase their ownership.

1 Manning, Liz. Master Limited Partnership (MLP), Investopedia, May 23, 2022, https://www.investopedia.com/terms/m/mlp.asp

The MLP issues units instead of shares, but they are still listed on a national exchange, providing liquidity. Owners of MLPs are unitholders instead of shareholders, and those who buy into an MLP are designated as limited partners. MLPs have two classes of partners:

1. **Limited partners** are investors who purchase shares in the MLP and provide the capital for the entity's operations. They receive periodic distributions from the MLP, typically every quarter. Limited partners are also known as silent or passive partners.

2. **General partners** are the owners who are responsible for managing the day-to-day operations of the MLP. They receive compensation periodically based on the partnership's business performance.

To maintain its pass-through status, at least 90% of the MLP's income must be qualifying income. Qualifying income includes income realized from the exploration, production, or transportation of natural resources or real estate.

The majority of the distribution amounts made by MLPs generally qualifies as return of capital (ROC) as opposed to dividend income. Unitholders do not pay income tax on ROC distributions. However, ROC distributions reduce the cost basis of the holding.

Advantages of MLPs

1. **High Income** – Most MLP cash flows can generate significant yield.

2. **Keeps Up with Inflation** – Given that MLPs are tied to natural resources, their income distributions keep up with inflation. And because 80-90% of the distributions are often tax-deferred, MLPs offer substantially higher yields than equities. Also, given their pass-through entity status and the avoidance of double taxation, more capital is available for projects, giving the structure a competitive advantage.

3. **Tax Advantages** – Historically, most distributions qualify as return of capital, which is non-taxable. Such distributions reduce the cost basis and potentially attract higher capital gains, although some structures, such as exchange traded funds, can sometime reduce this impact, hence making the investment highly tax efficient.

Disadvantages of MLPs

1. **Complicated Tax Treatment** – Investing directly in MLPs can be complex. It requires filing K-1 forms in each state in which an MLP operates. Tracking the tax basis also requires administrative work. K-1 forms may not be available before tax filing deadlines, requiring investors to file estimated tax returns that will need to be amended when K-1 forms are received.

2. **Exposure to Energy** – MLPs mostly operate in the energy industry in areas such as pipeline transportation, refinery services, and oil service supply and logistics. MLPs tend to be positively correlated with the energy sector. This sector generally provides good protection against inflation but can also be volatile.

Business Development Companies (BDCs)[2]

Business Development Companies (BDCs) are a special type of investment that combines the attributes of publicly traded companies and closed-end investment vehicles, allowing investors to gain exposure to private-equity or venture-capital type investments.

BDCs are specialty finance companies that make investments in the debt and/or equity of small to mid-size companies. BDCs are taxed as Regulated Investment Companies (RICs), providing they distribute 90% of their income to investors, thus allowing the corporate entity to be federally tax exempt.

Advantages of BDCs

1. **Liquid Alternative Exposure to Private Companies** – BDCs are listed on national exchanges and provide access to private instruments not typically accessible to retail investors. BDCs allow retail investors to get exposure to private equity-like investments without lockups, accreditation requirements, or minimum investments.

2. **Attractive Yields** – BDCs offer high dividend yields due to their favorable tax structure.

3. **Professional Management** – BDCs may be internally or externally managed with the majority of newly formed BDCs being externally managed. Most BDC managers will offer significant managerial assistance to the companies held in the portfolio.

[2] Schwab, *Business Development Companies (BDCs),* https://www.schwab.com/stocks/understand-stocks/bdcs

Disadvantages of BDCs

1. **Higher Risk Profile/Diversification Risk** – BDCs are generally specialized in one sector of activity. Investing in a single BDC can carry a high level of risk.

2. **Management Team Risk** – Most internally managed BDCs operate with a small team of managers.

3. **Credit and Interest Rate Risk** – BDCs generally borrow money in order to lend to companies at higher rates. They accomplish this by using a variety of fixed-rate and floating-rate loans. Changes in interest rate policy can dramatically affect the margin between borrowing and lending costs and the amount the BDC is able to distribute.

4. **Operating Expenses** – BDCs are more akin to a traditional operating company than a fund. It has its own employees, management, and offices, and the resulting operating costs might appear higher to some investors than the management fees charged by traditional funds. Also due to SEC regulations, a mutual fund investing in a BDC must disclose BDC operating expenses as part of the fund total expense ratio.

Closed-End Funds (CEFs)[3]

Closed-end funds are investment vehicles specifically designed to provide income. A closed-end fund raises capital by issuing a fixed number of shares, which can only be redeemed under specific conditions, and then invests the proceeds in financial assets. Unlike open-end funds, new shares are not issued based on investor demand. Instead, shares are purchased and sold on the secondary market.

The price at which the shares of a CEF trades is determined by the market and is usually different from its net asset value (NAV). The price is said to be at a discount or premium to NAV when it is trading below or above the NAV.

Advantages of CEFs[4]

1. **Predictable Income** – CEFs are specifically designed with a goal of translating their total returns into consistent, predictable—and often, tax-advantaged—income over time.

2. **Professionally managed** – A team of professionals actively manages all aspects of the fund—including its holdings, leverage, and distributions—seeking to produce regular monthly or quarterly distributions. CEFs often employ leverage to enhance income.

[3] Wikipedia, *Closed-end Fund*, January 24, 2023, https://en.wikipedia.org/wiki/Closed-end_fund
[4] Guo, Joanne, *What is a Closed-End Fund?*, Seeking Alpha, May 5, 2022, https://seekingalpha.com/article/4490940-closed-end-fund

3. **Access a Broader Investment Universe** – CEFs offer exposure to a wide array of income-producing assets, including those that are difficult to access in other investment vehicles, such as less-liquid securities, alternatives, and micro caps.

4. **Fully Invested** – CEFs do not have to manage inflows and outflows and can remain fully invested.

Disadvantages of CEFs

1. **Liquidity** – Some CEFs offer limited liquidity. It is important for investors to assess their possibility of exiting the position without depressing the price level.

2. **Price Volatility** – CEFs are subject to additional price volatility as their trading prices can differ from their net asset values.

3. **Leverage** – While the use of leverage can enhance returns, it can also amplify losses.

Real Estate Investment Trusts (REITs)[5]

REITs, or real estate investment trusts, are companies that own or finance income-producing real estate across a range of different property sectors. Most REITs trade on a public stock exchange, although there are many private REITs.

REITs invest in most real estate property types, including offices, apartment buildings, warehouses, retail centers, medical facilities, data centers, cell towers, infrastructure, and hotels. Most REITs focus on a particular property type, but some hold multiple types of properties in their portfolios.

REITs are another type of pass-through securities. They do not pay corporate income tax, among other things, and they distribute at least 90% of their earnings. Distributions can be taxed as income, capital gain or return of capital.

Advantages of REITs[6]

1. **Competitive Long-Term Performance** – REITs have provided long-term total returns to equities.

2. **Substantial, Stable Dividend Yields** – REIT dividend yields historically have produced a steady stream of income through a variety of market conditions and can keep up with inflation.

[5] Nariet, *What is a REIT?,* https://www.reit.com/what-reit
[6] Sampa, K. *REIT: 13 Advantages and Disadvantages for Investors*, June 15, 2022, https://smart-cre.com/reit-13-advantages-and-disadvantages-for-investors/

3. **Liquidity** – Shares of publicly listed REITs trade on the major stock exchanges.

4. **Portfolio Diversification** – REITs offer access to the real estate market and typically have a low correlation with other stocks and bonds.

Disadvantages of REITs

1. **Interest Rate Sensitivity** – REITs can be volatile due to changes in interest rates and trends in the real estate market.

2. **Specific Exposure to the Real Estate Market** – Most REITs operate in one specific sector of the real estate market and/or a specific region. This can lead to a high concentration of risks when bought individually.

Diversified Sources of Alternative Income

Although each category of pass-through securities has its own advantages, there are significant benefits in putting them together, because their returns have historically been uncorrelated. A basket of pass-through securities can help provide a diversified source of alternative income while increasing the predictability of this income and reducing the overall risk.

Daily Return Correlation Matrix: March 15, 2021 – March 15, 2023 [7]

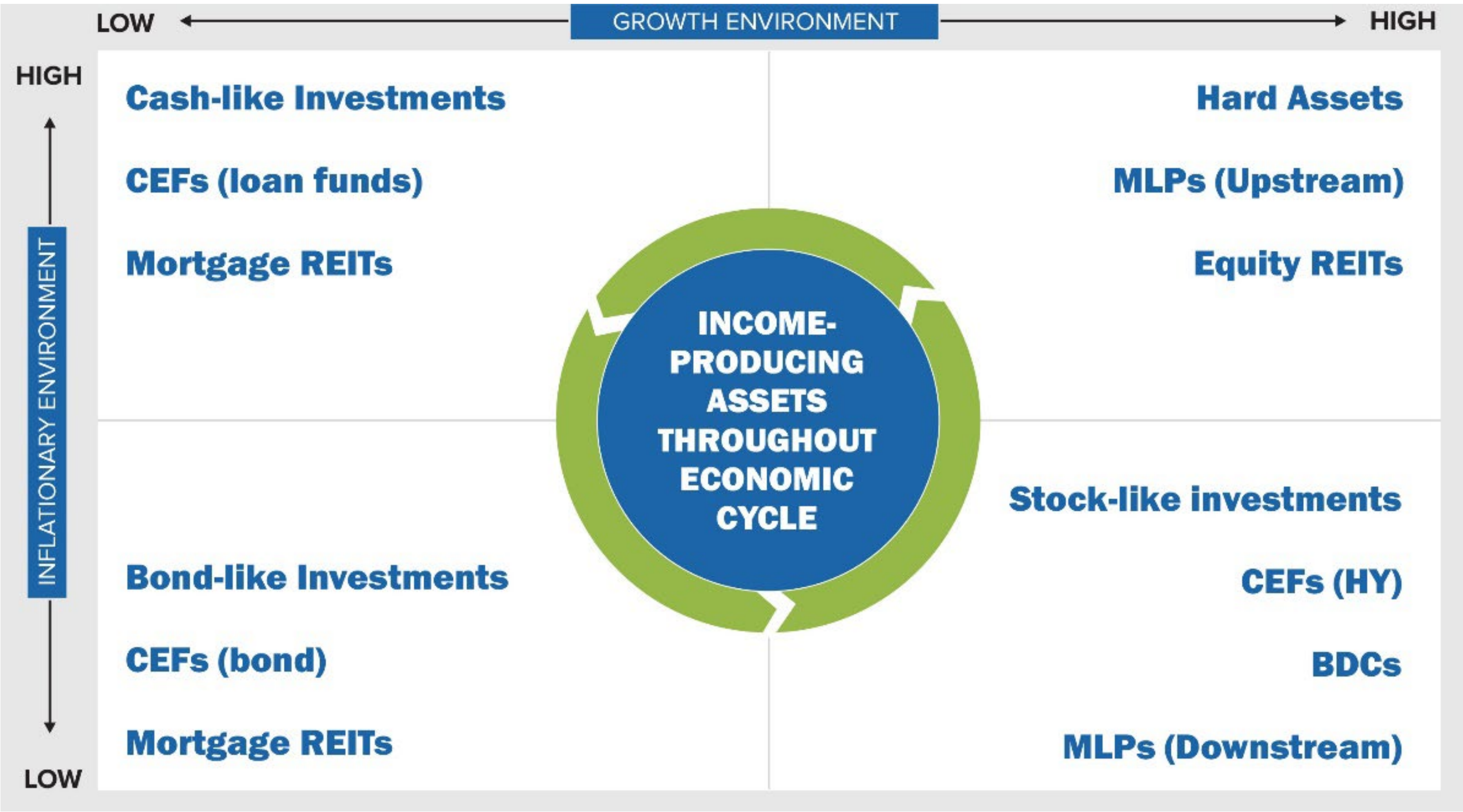
	MLPs	BDCs	CEFs	REITs
MLPs	1.000	0.592	0.572	0.447
BDCs	0.592	1.000	0.746	0.629
CEFs	0.572	0.746	1.000	0.702
REITs	0.447	0.629	0.702	1.000

Source: Bloomberg

[7] MLPs – Alerian MLP Index, BDCS, S&P BDC Index, CEFS, S-Network CEF Index, REITS, Dow Jones REIT Index.

The graphic below shows how different income classes are expected to perform in high and low **Growth Environments** and **Inflationary Environments**.

Aiming at Income Generation During Different Market Cycles



Source: Graniteshares

EQM INDEXES

The empirical evidence that these income classes perform differently through time and under different market conditions is highlighted in the quilt table below. It reinforces the advantage of combining these different asset categories together.

Income-Oriented Returns Evolve Over Time - The lack of any pattern in returns from one year to the next reinforces the importance of asset allocation diversity rather than trying to predict the next winning asset class.

2015 (%)	2016 (%)	2017 (%)	2018 (%)	2019 (%)	2020 (%)	2021 (%)	2022 (%)
2.82	24.18	14.78	-4.10	28.74	4.75	41.20	30.92
-1.05	18.31	8.69	-7.01	28.16	-4.79	40.17	-9.39
-3.68	14.81	0.64	-8.26	24.66	-8.85	37.42	-18.03
-32.59	8.88	-6.52	-12.42	6.56	-28.69	15.79	-25.01

Asset Class*
MLPs
BDCs
CEFs
REITs

** Annual returns are for the following total return indexes: MLPs = Alerian MLP Index, BDCs = S&P BDC Index, CEFs = S-Network Composite Closed End Fund Index, REITs = Dow Jones REIT Index.*
Past performance is not predictive of future returns. It is not possible to invest directly in an index.

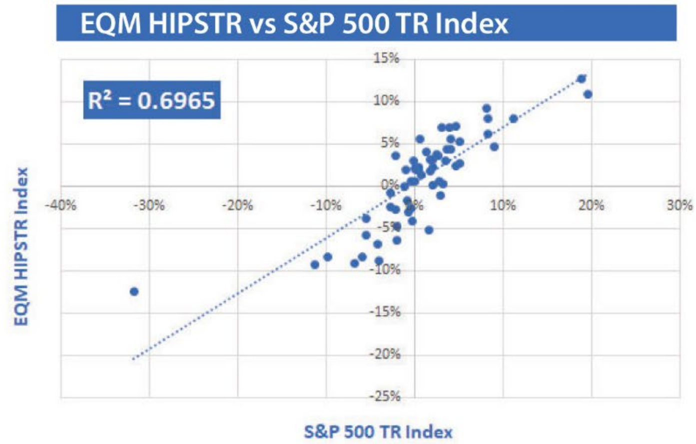
Bringing Diversification to Income Portfolios

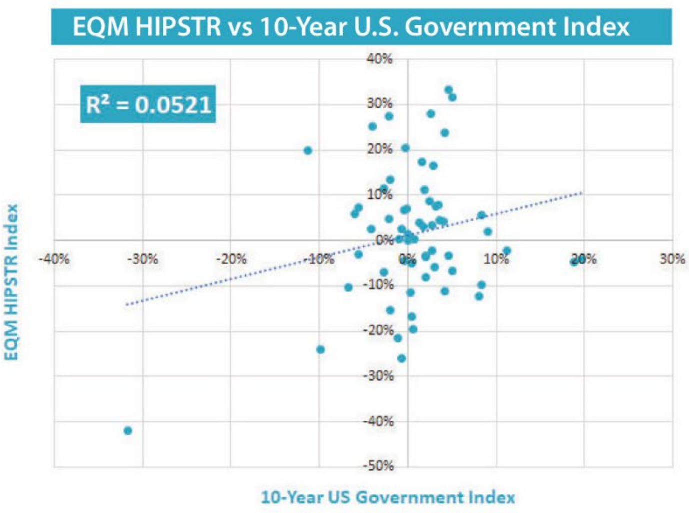
HIPSTR is an income index that is more correlated to equity indices than fixed income instruments[8]

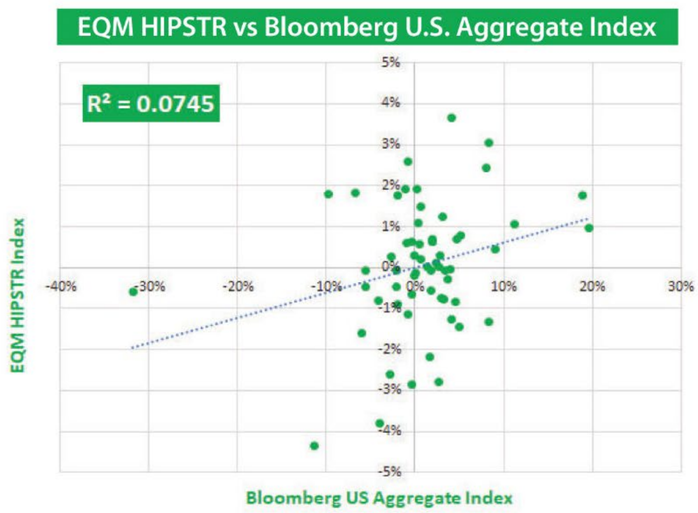
Adding HIPSTR to an income portfolio allows a better diversification of risk which is expected to translate in a more predictable income stream

HIPSTR Correlation Characteristics

- HIPSTR is an income play
- However, it behaves more like equity than fixed income
- HIPSTR offers a good risk diversification to traditional income portfolios





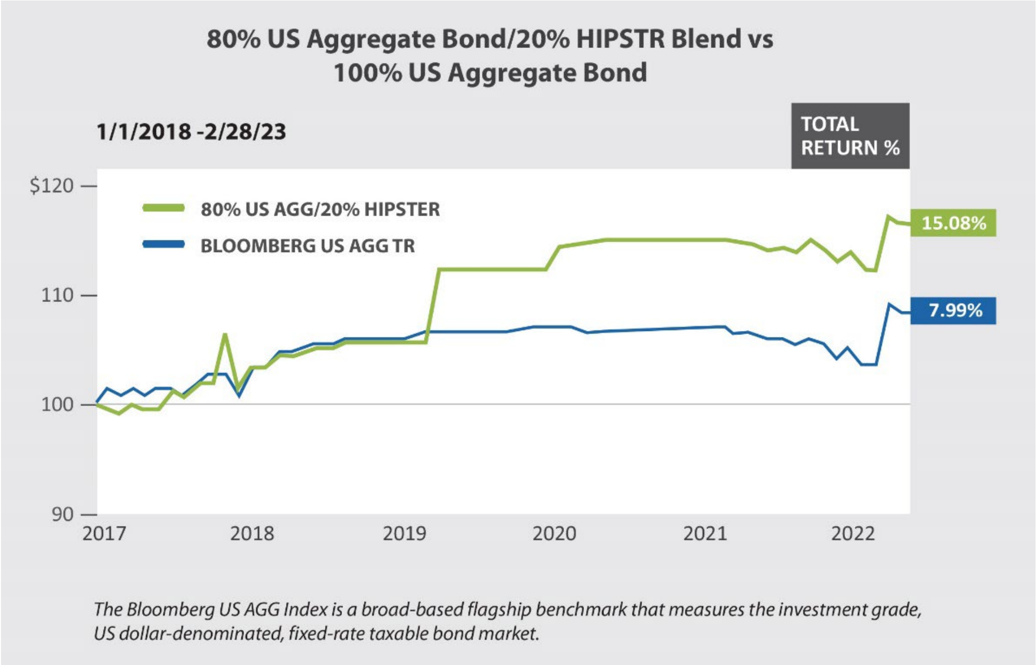


Source: Bloomberg data, U.S. Treasury yields 10 tenors. U.S. Treasury securities issued by the federal government are backed by the full faith and credit of the of the U.S. Government. They are however subject to inflation risk which is when Treasury yields may not keep up with inflation thereby reducing purchasing power. Past performance is not a guarantee of future returns. Short term performance may not be indicative of long-term results. Time period: February 2018 to February 2023. Based on monthly correlation data.

[8] Indexes used for the correlation analysis: HIPSTR Index, S&P 500 TR Index, U.S. Generic Govt 10 Year Index, and the Bloomberg U.S. Aggregate TR Unhedged Index.

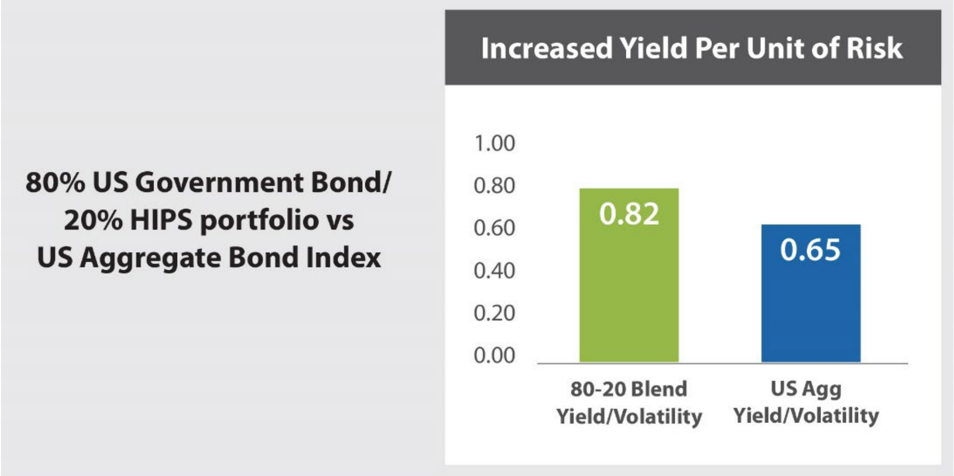
Integrating HIPS with Bond Portfolio

Our research indicates that allocating 80% to U.S Aggregate Bonds and 20% to HIPSTR generates superior total returns during the backtest period from 12/31/2017 and 2/28/2023, and also increased the yield per unit of risk (as measured by standard deviation). The 80/20 blended allocation generated a cumulative total return of 15.08% vs. 7.99% for U.S. Aggregate Bonds.



Source: Bloomberg/EQM as of 2/28/23, HIPSTR Index and Bloomberg US Aggregate Bond TR Index

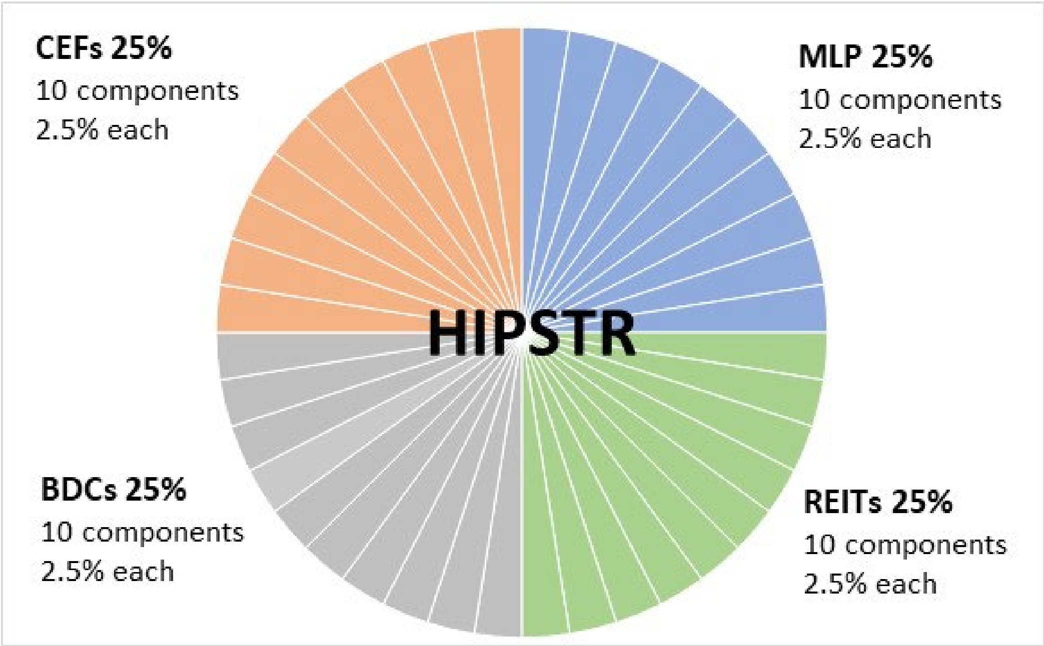
In addition, the blended 80-20 allocation generates a higher ratio of 0.82 yield per unit of risk versus 0.65 for a 100% US Aggregate Bond allocation, as measured by yield divided by standard deviation.



Source: Bloomberg/EQM as of 2/28/23

Our Index Approach

The EQM High Income Pass-Through Securities Index (HIPSTR) provides diversified exposure to high income pass-through securities. Each category is equally weighted at 25%, and each category has 10 components with the aim of providing a diversified and stable income stream.

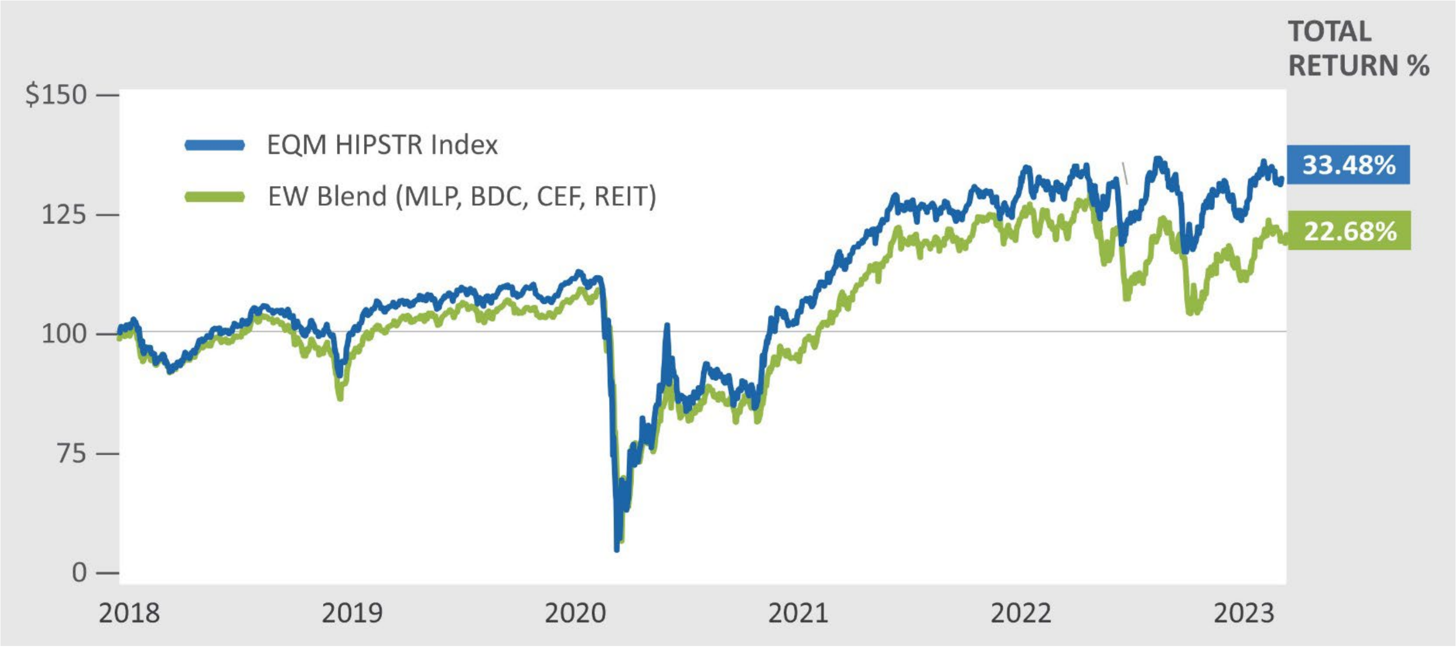


To maintain optimal diversification, the index is rebalanced quarterly back to an equal-weighted index of 40 high income pass-through securities. The index is reconstituted annually to select the securities with highest yield after being filtered by liquidity and volatility levels.

HIPS Index Backtested Performance

In performance backtesting, applying these universe constraints, the EQM High Income Pass-Through Securities Index (HIPSTR) beat an equally weighted blend of MLP, BDC, CEF, and REIT indexes.

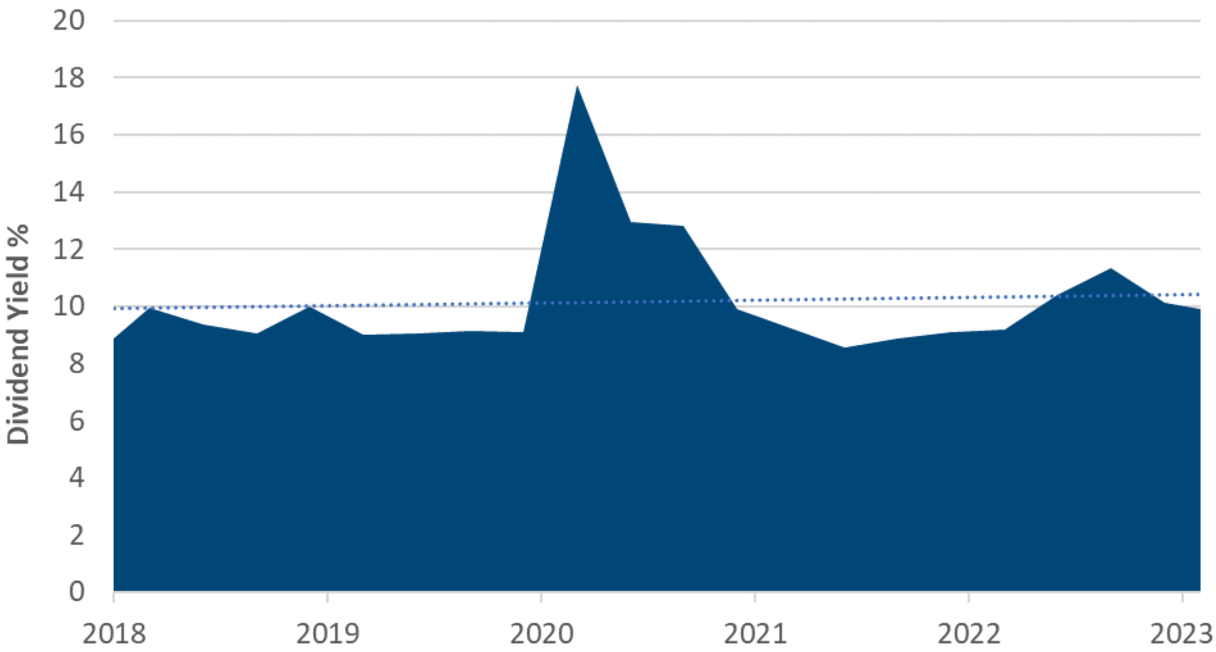
EQM High Income Pass-Through Securities Index
Simulated Performance History
1/1/2018 - 3/3/2023



Values between January 1, 2018 and March 3, 2023 have been calculated pursuant to a backtested methodology. Backtested performance is hypothetical and is provided only for informational purposes to indicate historical performance had the index been available over the relevant time period. It is not possible to invest directly in an index. The EW Blend is an equal weighted benchmark consisting of the following four indexes: Alerian MLP Total Return Index, S&P BDC TR Index, S-Network Composite Closed-End Fund Index, and the Dow Jones Equity REIT TR Index.
Source: EQM Indexes

As demonstrated in the chart below, the Index has also provided attractive yields during the backtest period, averaging around 10% over the last five years.

EQM HIPSTR Index Dividend Yield History



Source: EQM/Bloomberg, as of 2/28/23

Key Takeaways

- The EQM High Income Pass-Through Securities Index (HIPS) Index provides exposure to a diversified blend of high income-producing securities.
- The Index has a low correlation with fixed income securities, improving portfolio risk-reward outcomes while delivering an attractive, inflation-resistant source of yield.
- HIPSTR has historically performed well under many different economic scenarios.
- While there are many other ETF Index products offering alternative income exposure, the HIPSTR Index's unique equal-weighted blend of MLPs, BDCs, CEFs, and REITs offers a consistent source of uncorrelated high income.

ABOUT US

EQM INDEXES LLC.

EQM Indexes LLC is a woman-owned firm dedicated to creating and supporting innovative indexes that track growth industries and emerging investment themes. Co-founded by Jane Edmondson, a former Institutional Portfolio Manager with more than 30 years in the investment industry, our index design expertise spans a wide range of asset classes and financial instruments.

We partner with issuers and work jointly with other index firms to provide benchmarks for Exchange Traded Products (ETPs) such as Exchange Traded Funds (ETFs), Exchange Traded Notes (ETNs), and other similar products. EQM Indexes LLC also assists firms on a fee basis to design and implement their index ideas.

EQM Indexes does not offer investment advice, nor offer the sale of securities.

IMPORTANT DISCLOSURES

EQM Indexes, LLC ("EQM Indexes") is a woman-owned firm dedicated to creating and supporting indexes that track growth industries and emerging investment themes. Co-founded by Jane Edmondson, a former Institutional Portfolio Manager with more than 30 years of investment industry experience, EQM Indexes' index designs spans a wide range of asset classes and financial instruments. EQM Indexes does not provide investment advice, nor offer the sale of securities, but does partner and receive compensation in connection with licensing its indices to third parties to serve as benchmarks for Exchange Traded Products ("ETPs") such as Exchange Traded Funds ("ETFs"), Exchange Traded Notes ("ETNs"), and other similar products. All information provided by EQM Indexes is impersonal and not tailored to the needs of any person, entity or group of persons.

The EQM High Income Pass-Through Securities Index ("HIPSTR" or the "Index") is an Index of EQM Indexes LLC and is calculated and published by BITA GmbH seeking to generate diversified, high income utilizing U.S. exchange-listed high income pass-through securities in the following alternative income asset categories which must return 90% of their taxable income to shareholders: Closed-End Funds (CEFs), Business Development Companies (BDCs), Real Estate Investment Trusts (REITs), and Energy Master Limited Partnerships (MLPs). The index is reconstituted annually and rebalanced quarterly back to an equal weighted index of 40 high income pass-through securities.

It is not possible to invest directly in an index. Exposure to an asset class represented by an index is available through investable instruments based on that index. EQM Indexes does not sponsor, endorse, sell, promote or manage any investment fund or other investment vehicle that is offered by third parties. and that seeks to provide an investment return based on the performance of any index. EQM Indexes makes no assurance that investment products based on the Index will accurately track index performance. or provide positive investment returns. EQM Indexes is not an investment advisor and makes no representation regarding the advisability of investing in any such investment fund or other investment vehicle. A decision to invest in any such investment fund or other investment vehicle should not be made in reliance on any of the statements set forth in this article. Prospective investors are advised to make an investment in any such fund or other vehicle only after carefully considering the risks associated with investing in such funds, as detailed in an offering memorandum or similar document that is prepared by or on behalf of the issuer of the investment fund or other vehicle Inclusion of a security within an index is not a recommendation by EQM Indexes to buy, sell, or hold such security, nor is it considered to be investment advice. EQM Indexes makes no express or implied warranties or representations with respect to the Index.

DEFINITIONS[9]

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Liquid Alternatives – an alternative investment, is a financial asset that does not fall into one of the conventional investment categories that trades on a public exchange. Conventional categories include stocks, bonds, and cash. Alternative investments can include private equity or venture capital, hedge funds, managed futures, art and antiques, commodities, and derivatives contracts. Real estate is also often classified as an alternative investment.

Yield – earnings generated and realized on an investment over a particular period of time. Yield is expressed as a percentage based on the invested amount, current market value, or face value of the security. Yield includes the interest earned or dividends received from holding a particular security.

Correlation – a statistic that measures the degree to which two securities move in relation to each other.

R-Squared (R^2) – a percentage between 0 and 100, with 100 signaling perfect correlation and zero no correlation at all. The figure does not indicate how well a particular group of securities is performing. It only measures how closely the returns align with those of the measured benchmark. It is also backwards-looking—it is not a predictor of future results.

9 Investopedia, Schwab, Wikipedia, Seeking Alpha, and Nareit.