



## **Do Limited Partnerships Belong in the Wilshire 5000<sup>SM</sup>?**

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The goal of the Wilshire 5000 Total Market Index<sup>SM</sup> is to represent the neutral position of the U.S. equity investment opportunity set. Put another way, the combined holdings of all U.S. equity money managers should be reflected by the makeup of the Wilshire 5000. This passive index is designed to be the ideal tool and benchmark to evaluate U.S. equity money managers. This paper from Wilshire Index Research will explore if the inclusion of Master Limited Partnerships (MLPs) is consistent with this goal.

### **Background**

The initial definition of the Wilshire 5000 stated that all U.S. listed common stocks were to be included in the index. Common stocks were deemed the best way to ensure that the securities were equity investments, not equity proxies or equities from other markets such as ADRs. Though U.S. REITs were created by Congress in 1960, relatively few existed before the passage of the Tax Reform Act of 1986 permitted REITs to both own and manage their properties as vertically integrated companies and set the stage for a wave of equity REIT IPOs in the mid-1990s<sup>1</sup>. Previously listed real estate operating companies were changing their corporate structure to something other than common stocks. These investment trusts had equity exposures similar to their former operating company stock that was not represented elsewhere. This corporate equity structure differed from common stocks primarily because of incentives in the U.S. tax code which made them exempt from paying corporate trust taxes. In 1991, Wilshire evaluated the inclusion of these equity styled investment vehicles in the Wilshire 5000 and determined that they needed to be included. Extending the logic to limited partnerships, it was natural to enhance the composition of the Wilshire 5000 from all listed common stocks to all listed equity stocks. Accordingly, REITs and MLPs became part of the index effective December 31, 1992.

Unfortunately, REITs and MLPs are treated differently when it comes to taxes and associated paperwork. Congress recognized the effects of untaxed REIT earnings flowing to tax-exempt entities and adjusted the tax code such that entities do not risk their status. REIT income flows to the investor as ordinary income which is documented on a standard 1099 form available in November each year. MLP investors are considered owners of the partnership. MLP investors are sent their K-1 statements months later (February of each year), usually for a taxable amount that is different from the cash distributions. Worse than the paperwork issues, the U.S. Tax Code still treats cash distributions from MLPs as unrelated business taxable income (UBTI). These distributions are deemed unrelated to the activity of tax-exempt institutional investment funds such as pensions and endowments and thus may create an undesirable tax liability. Every few years, Congress considers amending the tax code to make up for this MLP oversight and to treat them similar to REITs, but bills designed to do this have consistently failed to make it out of committee. At this point in time, it is Wilshire Index Research's view that comparable tax relief for MLPs may never happen.

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<sup>1</sup> [www.reit.com](http://www.reit.com), June 16, 2009.

Though there are a number of ways for a tax-free entity to invest in MLPs without jeopardizing its status, most choose not to, deciding it is not worth the risk, or simply to avoid the administrative issues involved.

Moreover, some MLP prospectuses have language to discourage tax free investors from investing in them with phrases like, “‘Eligible Holder’ means a Person subject to United States federal income taxation”<sup>2</sup> and “the following are **not** considered Eligible Holders: Mutual Funds, REITs, and S corporations with ESOP shareholders.”<sup>3</sup>

### What are Money Managers Doing?

The December 31, 2008 holdings of all U.S. equity portfolios from the Wilshire Cooperative<sup>SM</sup> system were evaluated to measure the institutional investor’s use of MLPs. Of the 4,025 analyzed portfolios, fully 10 percent contained at least one MLP. (See Figure 1.) Of interest was that of the 432 MLP containing portfolios, 333 included only one MLP. Of those 333, 183 owned the single MLP, Lazard Ltd. If Lazard was not an MLP, then the percentage of institutional portfolios that contained at least one MLP would fall to 6.2 percent. A similar result is found when looking at the 2,409 institutional portfolios with under 100 U.S. equity investments.

**Figure 1: Institutional Portfolios that Contain MLPs  
December 31, 2008**

	Universe	Universe-LAZ*	Under 100 Stocks
<b>Total Portfolios</b>	4,025	4,025	2,409
<b>Portfolios w MLPs</b>	432	249	164
<b>Percentage</b>	10.7%	6.2%	6.8%

\*If Lazard Ltd were not an MLP

Figure 1 demonstrates that a small number of managers invest in MLPs for their institutional clients. Figure 2 shows that institutional managers invest in MLPs virtually 1/10<sup>th</sup> the amount as would be expected if MLPs were treated as part of the investable universe.

**Figure 2: MLP Coverage in Wilshire 5000 and Institutional Portfolios  
December 31, 2008**

	Count		Market Cap	
	W5000	Portfolios	W5000	Portfolios
<b>Percentage MLPs</b>	1.92%	0.18%	0.66%	0.07%

### Conclusion

The market as represented by 4,025 institutional accounts have voted with their investment feet by deciding that limited partnerships are not part of their opportunity set. Given that the tax treatment and the MLPs themselves discourage the average investor from investing in MLPs, Wilshire Index Research has concluded that Master Limited Partnerships should be excluded from the float of Wilshire 5000 Total Market Index.

<sup>2</sup> Semgroup Energy Partners, L.P., SEC Form S-1 Amendment No. 5, June 29, 2007.

<sup>3</sup> Boardwalk Pipeline Partners, LP, SEC Form S-1, September 20, 2006.

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