Important Information about Master Limited Partnerships (MLPs)

Baird has prepared this document to help you understand the characteristics and risks associated with an investment in securities of a master limited partnership ("MLP"), so that you can make an informed decision when buying or selling these securities. MLPs are income-generating investments that may offer attractive yields and distribution growth rates, but they are complex investments that have unique tax characteristics and significant risks. As a result, MLPs may not be suitable for all clients. Your Baird Financial Advisor can further explain the features, characteristics and risks of any particular security under consideration for your account. You should consult with a tax advisor before investing in MLPs.

Characteristics of MLPs

An MLP is a form of publicly traded partnership and taxed as a partnership. An MLP is generally structured as a limited partnership or limited liability company and managed and operated by a general partner or manager. Shareholders of an MLP are called "limited partners" or "unit holders." Unit holders own interests or units in the MLP ("units") that are traded on a stock exchange. MLPs make distributions to unit holders of their available cash flows. The general partner generally holds a minority stake in the MLP (often 2%), makes management decisions and receives incentive distribution rights based on the MLP's payouts (entitling the general partner to a higher proportion of distributions as certain target distribution levels are reached). The general partner or its affiliates may also own units as well as subordinated units in the MLP. Sometimes, the general partner's own securities are exchange-traded as well. Unit holders often do not have voting rights and are not entitled to elect a board of directors. MLPs typically establish a minimum quarterly distribution amount that they seek to pay, with the goal of increasing the distributions over time because of the general partner's incentive distribution rights.

As a partnership, an MLP does not pay entity-level income tax, therefore enabling it to distribute more cash flow to the unit holders. However, in order to avoid entity-level income tax, an MLP must earn at least 90% of its income from certain qualifying sources, which includes income and gains from certain activities involving natural resources such as oil, natural gas, natural gas liquids, refined petroleum products, coal , carbon dioxide and biofuels. Such activities include exploration, development and production; mining, gathering, pipelines and processing; refining; compression; transportation; and storage, marketing and distribution (but not retail sales). Qualifying sources may also include interest, dividends, real estate rents, income from the sale of real property, gain on the sale of assets, and income and gains from commodities or commodity futures. Most MLPs are involved in the energy markets, which

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is the focus of this document, although there are some MLPs with operations in the real estate and investment/financial sectors.

MLPs typically distribute all of their available cash flows, although the general partner has considerable flexibility in determining an MLP's available cash flows, which may vary based on the amounts retained for maintenance, operating and growth expenditures. An MLP's income, gains and losses pass through to the unit holders, who receive a Schedule K-1 each year. MLPs can pass through their deductible depreciation or depletion expenses, allowing them to distribute a tax-advantaged return of capital to investors that defers taxation until the units are sold. Distributions do not correspond to the amount of an MLP's net income. At times, distributions to investors may be less than the amount of an MLP's net income, although generally they significantly exceed the amount of the MLP's net income, which results in a portion of such distributions being regarded as a return of capital rather than as a taxable dividend. Thus, a high percentage of an MLP's distributions may be regarded as a return of capital, with the balance representing taxable income. The amount of a distribution characterized as a return of capital lowers an investor's cost basis in the units, which will lead to a larger gain or lower loss upon sale. Some of the tax upon an investor's sale of units may be taxed at a capital gains rate. The amount of the downward adjustment to an investor's cost basis resulting from the investor's allocation of depreciation and depletion expenses is recaptured and taxed as ordinary income. An investment in an MLP may not be advisable in an IRA or other tax-exempt or tax-deferred account because the tax benefits are better utilized in a taxable account and the IRA or other tax-exempt or tax-deferred account may be subject to "unrelated business income tax" on its proportionate share of the MLP's income. Alternatives to MLPs, such as closed-end or exchange-traded funds, may be a better solution for such accounts.

An MLP can be formed in several ways. An existing non-traded partnership may decide to go public, or several non-traded partnerships may "roll-up" into a single MLP. A corporation may spin off a group of its assets or part of its business to an MLP in which the corporation retains an ownership interest.

The term "MLP" also is commonly used when describing corporations, closed-end, exchange-traded and open-end funds that invest in MLPs, exchange-traded notes that track various MLP-related indices and other MLP look-alike structures that operate in the energy and natural resources sector. Royalty trusts are also a common structure for upstream energy companies. See "Alternatives to MLPs" below.

Baird's Equity Research department maintains research coverage on numerous MLPs. Please consult with your Baird Financial Advisor on whether Baird provides research reports on the MLPs in which you propose to invest and obtain copies of such reports. Baird's Investment Banking department may also serve as underwriter on public offerings of MLP securities. Your Baird Financial Advisor will receive a selling concession on the sale to you of MLP securities that Baird underwrites and thus have an incentive to offer them to you.

Types of Energy MLPs

Energy MLPs are commonly divided into three types: upstream, midstream and downstream. These types follow the flow or commercial movement of oil, natural gas, natural gas liquids, refined petroleum, coal and other energy-related natural resources from producing wells (upstream) through storage and transportation (midstream) to end-users (downstream). Upstream companies operate at or near the oil and gas wellheads and focus on exploration, drilling and production activities. Midstream companies engage in gathering, processing, compression, transportation and storage activities, moving the product from upstream locations. Downstream companies are involved in refining, marketing and distribution activities. Some energy MLPs provide energy-shipping and marine transport services or offshore drilling services, as well as companies engaged in energy-related activities involving other natural resources or materials such as coal, propane, liquefied natural gas, high purity sand used in the fractionation process, and other minerals. There are various sub-sectors in the upstream, midstream and downstream sectors in which MLPs operate. The performance, results and risks of MLPs within each sector and sub-sector can vary dramatically, and will differ by the commodity or natural resource type, cash flow stability and other factors.

Alternatives to MLPs

Persons seeking exposure to MLPs may instead buy shares in funds that in turn invest in MLPs. These typically include closed-end funds, but can also include open-end funds (i.e., mutual funds) and exchange-traded funds ("MLP funds"). Closed-end and exchange-traded funds offer shares that are traded on an exchange. Their shares may trade at a discount or premium from their net asset value. Mutual funds do not trade on an exchange but their shares are redeemable on a daily basis at net asset value. Funds that are regarded as regulated investment companies (such as mutual funds) for tax purposes may only invest up to 25% of their assets in MLPs, thus not maximizing the tax benefits of MLP ownership. Closed-end and exchange-traded funds can elected to be treated as a corporation for tax purposes or may create subsidiary corporations to invest in MLPs in order to avoid such limitations. As taxable corporations, these funds will pay corporate level taxes on their net income, which reduces the amount of distributions they can pay to shareholders, but the shareholders will only be subject to potential income tax liability to the extent the funds pay distributions. In contrast, a regulated investment company is not subject to entity-level tax so long as it pays out nearly all of its net income and capital gains each year and meets other conditions.

As is the case with distributions made by an MLP, a high percentage of the distributions made by an MLP fund is tax deferred and recaptured when the investment is sold, but with an MLP fund the investors will pay tax at the capital gain rate when they sell their investment rather than at ordinary income rates paid to recapture depreciation in a direct MLP investment. MLP funds avoid the tax and administrative burdens of direct MLP ownership. Investors in MLP funds will not receive complicated Schedules K-1; instead, they receive a Form 1099. In addition, IRAs and other tax-exempt or tax-deferred accounts do not recognize unrelated business income tax on their investments in MLP funds. MLP funds are managed by professional investment advisers registered with the SEC.

MLP funds impose annual management and operating fees and expenses that do not apply with a direct MLP investment. An investment in a MLP fund may offer greater diversification through ownership of units of multiple MLPs than a direct MLP investment, although MLP funds may be regarded as "non-diversified" under the Investment Company Act and are concentrated by sector or industry. MLP funds may also engage in leverage, which would add to the leverage embedded in the MLPs themselves, as well as hedging techniques such as options, futures, swaps and other derivatives transactions.

Energy companies may also be structured as corporations and issue shares of common stock that are publicly traded. A corporation is subject to corporate-level tax, so a portion of its potential distributable cash flow is taxed before distributions are made to shareholders. In addition, distributions are subject to an additional income tax at the shareholder level. A corporation may also pay out a smaller portion of its cash flow to shareholders than an MLP and instead reinvest it in the business or finance an expansion project. Shareholders of an energy company taxed as a corporation will receive a Form 1099 each year showing their income from distributions rather than a more complicated Schedule K-1 which unit holders receive for an investment in an MLP.

U.S. royalty trusts are a type of structure in which a cash flow stream from a designated set of assets (such as oil and gas reserves) is paid to shareholders in the form of cash dividends. They can set up as partnerships or grantor trusts. Royalty trusts are not actively managed entities. Their assets are operated by a separate entity, which is often the sponsor (or creator) of the trust. They do not make acquisitions or increase their asset base. Royalty trusts typically have no debt. Royalty trusts are not MLPs. Unit holders are typically taxed on their pro rata share of the royalty trust's income and gains attributable to the assets of the trust and will be entitled to their pro rata share of the deductions and expenses attributable to the assets of the trust (subject to certain limitations). However, term interests or production payments in a royalty trust may be treated as debt for tax purposes and not entitled to depletion deductions. With a royalty trust, a sponsor contributes to the trust one or more types of interests in proved undeveloped reserves (PUDs) and/or proved developed reserves (PDPs). The types of interests include production payments, pure or overriding royalty interests and net profits interests. A production payment is a term-limited right to a specific share of the production; pure royalty interests are interests in a percentage of the gross revenues from the production; and net profits interests are interests in a percentage of the net profits of the production after deducting production costs. A royalty trust may terminate on a specified date or continue until the trust assets are exhausted. A perpetual royalty trust usually contains a royalty interest and/or a net profits interest and not a production payment. A term royalty trust usually contains a production payment. Common royalty trusts are drilling trusts (treated as partnerships) to which most of the assets contributed are interests in PUDs owning royalty interests, and PDP trusts (treated as grantor trusts) owning net profits interests.

Understanding the risks

The risks associated with an investment in an MLP are important considerations in making a purchase decision. The risks for any particular MLP investment are generally contained in the prospectus and/or in the MLP's information filings (such as annual reports, quarterly reports and current reports that are filed with the Securities and

Exchange Commission), which are publicly available at www.sec.gov. Please read the information carefully and consult with your Baird Financial Advisor before investing in MLPs.

Common risks associated with an investment in an MLP include but are not limited to the following risks described below:

- Market risk. An investment in an MLP is subject to risk that the price will fluctuate based on market, sector, company-specific and other conditions, events or developments. At times, the market price of an MLP may be correlated with the equities markets, but at other times, it may not be so correlated.

- Commodity price risk. The value of an investment in an MLP and the amount of distributions it makes may depend on the prices of the underlying commodity, such as oil or natural gas. Many MLPs are sensitive to changes in the prevailing level of commodity prices.

- Macroeconomic risk. A general economic downturn may negatively impact energy demand, trigger a reduction in exploration and production activity and adversely affect an MLP. Macroeconomic factors may also cause a decline in the equities markets generally, including the prices of MLP units.

- Interest rate sensitivity risk. MLPs have shown sensitivity to interest rate movements. In an increasing interest rate environment, MLPs can experience upward pressure on their yields to stay competitive with other securities that are interest-rate sensitive. At times, the prices of MLPs have been correlated with the bond markets, as they can be viewed as yield-based investments.

- Liquidity risk. There can be no assurance that MLP units will have an established trading market, adequate trading volumes or sufficient liquidity. Units in MLPs are particularly attractive for retail investors and have not proven to attract significant institutional interest. The lack of institutional interest in MLPs may affect liquidity and price efficiency.

- MLP operating risk. The price of units in an MLP and the amount of cash flows it generates and distributes to unit holders are subject to various risks associated with the business and activities conducted by the MLP, which vary based on the MLP's applicable sector or sub-sector, including the following:

    - Changes in applicable commodity prices
    - A decline in the production or a decrease in the volume of oil, gas and other commodities
    - Reduced applicable oil and gas drilling activity
    - Natural decline in the production of wells and mines in the MLP's area of operation
    - Incorrect estimates of reserve quantities and anticipated revenues
    - Disruptions in the supply of and demand for oil, gas and other natural resources, which can be affected by various factors such as seasonality, weather conditions, catastrophes, environmental incidents and acts of terrorism

- Dependence of key suppliers, contract operators, lessors, lessees and customers, and the loss or unprofitability of important contracts
- Geographic concentration and dependence on particular fields, mines and reserves
- Competition, including the availability of alternative energy sources and changing technology
- Increased operating costs
- Labor shortages, equipment challenges and related difficulties
- Increased regulation and heightened regulatory enforcement, including potential environmental liability and climate change laws
- Dependence on the general partner and key personnel

Upstream, midstream and downstream energy MLPs have other risks that are particular to their sectors and sub-sectors. MLP funds have additional risks associated with their structures.

- Capital access risk. Because MLPs pay out most of their operating cash flows, they rely on capital markets for access to equity and debt financing in order to fund organic growth projects and acquisitions and make targeted distributions. If market conditions limit an MLP's access to capital markets, the MLP's distribution growth prospects could be at risk. MLPs may also face increased costs of capital, and at times may have significant interest costs and other debt burdens. Covenants and other restrictions imposed by an MLP's lenders may limit its growth.

- Growth risk. Because MLPs distribute most of their available cash flows and are under pressure to grow their distributions, they generally need to make acquisitions. Difficulties experienced by an MLP in obtaining acquisition financing may slow its growth. Additionally, an MLP may face challenges in making acquisitions on acceptable terms due to competition. Acquisitions and growth initiatives are also subject to construction, integration and implementation risks.

- Distribution risk. Most MLPs establish minimum quarterly distribution amounts they intend to pay based on certain assumptions, and seek to grow those amounts. However, those assumptions may prove to be incorrect and are subject to significant risks and uncertainties. As a result, the actual amount of distributions made to unit holders may be less than the minimum quarterly distribution amounts. In addition, the amount of distributions that an MLP makes is based on its distributable cash flows, which will be affected by changes in the MLP's revenues, expenses, capital expenditures and reserves and by determinations made by the general partner. Thus, at times, distributions made by an MLP may be less than anticipated. An MLP may issue additional units or incur indebtedness in order raise capital to make distributions, which could decrease the amount of distributions it can make in the future. The general partner and/or its affiliates may own subordinated units, which receive distributions after the minimum distribution amounts plus arrearages are paid to the common unit holders. However, those subordinated units are convertible into common units upon achievement of certain dividend levels. The conversion of the subordinated units may adversely affect the amount of future distributions that are paid per common unit.

- Conflicts of interest risk. MLPs are controlled by their general partners. MLPs are not governed by a board of directors. Unit holders have limited voting rights and very little say in the management or operation of the MLP. Unit holders do not elect the general partner or its board of directors. It is very difficult for unit holders to remove or replace the general partner. Although the general partner has a duty to act in the best interests of the MLP, the general partner also has duties to its owners. As a result of these relationships, conflicts of interest may arise between the MLP and its unit holders on the one hand and the general partner and its owners on the other hand. The general partner may make decisions or take actions that may be detrimental to the MLP and its unit holders. For example, the general partner is entitled to make decisions that will affect the amount of distributions that the MLP makes to unit holders (such as acquisitions and growth initiatives or the issuance of additional units), which will impact whether the general partner will receive incentive distributions and the amount of those distributions. The general partner may have the right to reset or modify the minimum quarterly distribution amounts or cancel the MLP's distribution policy. The general partner may be able to transfer its incentive distribution rights, which may cause the general partner not to be as highly motivated to increase the amount of distributions the MLP makes. It is also possible that the general partner or its owners may engage in other businesses or take actions that compete against the MLP. An MLP's partnership agreement may contain provisions that restrict or eliminate certain duties of the general partner and limit the general partner's liability to the MLP. The general partner may have a limited call right to require the unit holders to sell their units at unattractive prices.

- Tax risk. MLPs are generally taxed as partnerships, meaning that their income, gains, losses and expenses are passed through to their unit holders who receive a Schedule K-1 each year While this structure provides potential tax benefits, it can also create burdensome tax reporting obligations to unit holders. Unit holders may be subject to state and local taxes (in addition to federal taxes) on the MLP's income allocable to them. It is possible that, at times, unit holders may recognize their share of the MLP's taxable income without receiving distributions equal to such share of income or sufficient to cover the taxes owed on such income. Many MLPs pay distributions in amounts that exceed their net income, often significantly so. As a result, a portion of distributions made to unit holders is classified as return of capital, not as an income distribution or return on capital. Such portion reduces the unit holder's tax basis in the units and results in a larger gain upon sale. A significant amount of the distributions may be subject to recapture and taxed as ordinary income upon sale of the MLP units. An investment in an MLP may not be ideally suited for an IRA or other tax-exempt or tax-deferred account because some of the income generated by the MLP, as well as the proceeds received upon the sale of the MLP, may be subject to unrelated business income tax (UBIT). This is a tax assessed on income from pass-through entities, such as MLPs, held in retirement and other tax-preferred accounts. The cost of filing the tax return for these accounts is also an expense assessed against the account. For more information on the taxation of MLP's, please see this FAQ. Investments in MLP funds also can have varying tax consequences. Moreover, the tax treatment of MLPs could be subject to potential legislative, judicial or administrative changes or differing interpretations. A change in an MLP's business or other actions taken or not taken by an MLP could cause the MLP to lose its status as a partnership for tax purposes, which may cause the MLP to pay federal income tax on its income at the corporate tax rate. If an MLP were classified as a corporation for tax purposes, the amount of cash available for distribution would be reduced and part or all of the distributions might be taxed as dividend income. Investors should consult with their tax advisors before investing in MLPs or MLP funds.

- Regulatory risk. The profitability of MLPs may be adversely affected by changes in the regulatory environment. The businesses, operations and assets of most MLPs are heavily regulated by federal and state governments. Increased regulation can dramatically increase an MLP's operating costs. Applicable environmental laws provide for civil penalties and regulatory remediation, thus adding to an MLP's potential exposure.

Before investing in MLPs, it is important to understand and discuss with your Baird Financial Advisor the structure and terms of the security and the potential risks. If buying such investments in an offering, you should obtain and read the prospectus. If buying in the secondary market, you should review the issuer's publicly available financial and other information (such as recent annual, quarterly and current reports). You can obtain these materials from your Baird Financial Advisor or on the SEC's EDGAR database at www.sec.gov. More information about MLPs can be obtained from the National Association of Publicly Traded Partnerships at its website, www.naptp.org.

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