ClearBridge Investments

Global Infrastructure Income Strategy

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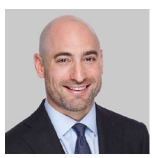

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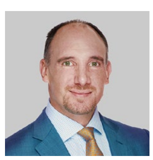

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Key Takeaways

- The Strategy led infrastructure as well as global equities in a quarter made volatile by ongoing COVID-19 disruption.
- Electric utilities in the U.S. and Europe drove outperformance, driven by a combination of value-creating asset sales, strong operating results and receding political risk.
- Going forward, in an uncertain macroeconomic environment, the certainty of future earnings and growth will be key: infrastructure and utilities significantly outperform other equities on this measure.

Market Overview

The ClearBridge Global Infrastructure Income Strategy outperformed the S&P Global Infrastructure Index during the fourth quarter as well as global equities as represented by the MSCI All Country World Index. Macroeconomic factors continued to be tied to the outlook for U.S. Federal Reserve policy given the current environment of higher inflation, with market expectations for a faster pace of interest rate hikes compared to previous months. The spread of the Omicron variant has started to impact mobility globally, although the severity of the new variant seems milder than previous strains. Markets have remained volatile in response. Ongoing COVID-19 disruption, supply chain issues and high inflation have the potential to delay the full economic recovery; however, markets are not expecting a recession in the near term.

Portfolio Performance

On a regional basis, the U.S. and Canada was the top contributor to quarterly performance, of which U.S. electric utility Exelon and U.S. renewables utility Clearway Energy were the lead performers.

Exelon is a U.S. energy provider with one of the cleanest and lowest-cost power generation fleets. Its utilities serve millions of electric and gas customers across Delaware, Illinois, Maryland, New Jersey, Pennsylvania and the District of Columbia. The share price of Exelon rose as the company received approvals for its anticipated spinoff, in addition to broader datapoints in support of nuclear power.

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Clearway Energy primarily owns and operates contracted renewable generation assets. It also owns and operates conventional generation and thermal infrastructure assets. Clearway Energy's share price continued to benefit from the completed sale of its thermal assets, which was above expectations, generating USD$1.3 billion in incremental proceeds. Additionally, there was optimism surrounding a stimulus bill pass-through which contains renewables subsidies.

Turning to Western Europe, U.K. electric utility National Grid and Spanish electric utility Iberdrola also performed well.

National Grid is one of the world's largest publicly owned utilities, focused on transmission and distribution activities in electricity and gas. National Grid performed strongly during the quarter as the business continued to de-risk following prior regulatory decisions and significant M&A. The company also benefited from falling real rates, a solid set of half-year results and strong Investor Day presentations.

Iberdrola is a multinational integrated electric utility company engaged in energy networks, renewables and wholesale and retail operations. The company has expanded internationally with operations in the U.K. (via Scottish Power), the U.S. (via Avangrid), Brazil (via Neoenergia) and Mexico. The share price rallied as political risks receded after the gas clawback measures proposed by the Spanish government in September were scaled back significantly.

Spanish airport operator AENA was the largest detractor from quarterly performance. AENA is the monopoly owner of the Spanish airport system, operating the 46 airports under a dual-till regulatory regime. AENA also manages London Luton Airport, with a 51% stake. AENA's share price fell following the emergence of the Omicron variant and the uncertain outlook for travel.

Positioning and Outlook

On a regional level, the Strategy's largest exposure is in the U.S. and Canada (44%), consisting of regulated and contracted utilities (31%) and economically sensitive user-pays infrastructure (13%).

During the quarter we initiated new positions in Mexican airport operator Grupo Aeroportuario del Sureste, U.K. water company United Utilities, Canadian infrastructure company Brookfield Infrastructure Corp. and U.S. electric utility FirstEnergy. We exited French toll road operator Eiffage, Australian airport operator Sydney Airport and Australian electric utility AusNet Services.

With supply chain issues, higher housing costs, higher commodity prices and producer price inflation remaining square in the sights for 2022, we think higher inflation is a risk for global markets. We expect growth to slow to trend or below by mid-2022 and U.S.

Treasury yields to rise, which will mean a continuation of negative real bond yields. Additional forecast volatility, and therefore market uncertainty, will arise as new COVID-19 variants appear and circulate. However, with high levels of vaccination across the developed world and less propensity for mobility restrictions and lockdowns, we expect the economic implications to be limited.

Real yields should remain negative and continue to support investment in infrastructure.

Rising bond yields are relatively more important for longer-duration assets. Within infrastructure, utilities tend to be shorter duration (as their assets are repriced by regulated returns at frequent regulatory resets, making them relatively less sensitive to movements in bond yields over the medium term), whereas toll road and concession assets without the ability to reprice their assets or returns tend to be longer duration and hence relatively more sensitive to changes in interest rates. We expect nominal bond yields to remain relatively low by historic standards for the long foreseeable future; this means real yields will remain negative and continue to support investment in infrastructure.

Should inflation persist as we believe it will, infrastructure portfolios will hinge mainly on what type of growth we see: amid lower growth, we would look to add utilities, with bond yields lower and utilities not sensitive to a downswing in GDP. If growth surprises to the upside, transport infrastructure, in particular toll roads, will look attractive as higher GDP would result in higher economic activity and higher throughput.

Going forward, in an uncertain macroeconomic environment, the certainty of future earnings and growth will be key: infrastructure and utilities significantly outperform other equities on this measure, with the impact of the pandemic and large trends such as decarbonization in the face of climate change either largely known or highly predictable.

In terms of valuations, over the last decade we have seen a steady decline in the cost of capital for utility and infrastructure companies, combined with an increase in forward earnings growth, particularly in the utility sector that is investing in its asset base to decarbonize economies and mitigate the effects of climate change. We believe the market has not taken into account the cheaper cost of capital and better growth profile for these sectors. Based on this disconnect, we believe there is room to run for infrastructure in 2022.

Portfolio Highlights

We believe an absolute return, inflation-linked benchmark is the most appropriate primary measure against which to evaluate the long-term performance of our infrastructure strategies. The approach ensures the focus of portfolio construction remains on delivering consistent absolute real returns over the long term.

On an absolute basis, the Strategy delivered gains across nine of the 10 sectors in which it was invested (out of 11 total) in the fourth quarter, with the electric, renewables and gas sectors the leading contributors and the energy infrastructure sector the sole detractor.

On a relative basis, measured against the S&P Global Infrastructure Index, the ClearBridge Global Infrastructure Income Strategy outperformed during the fourth quarter. Overall stock selection and sector allocation contributed to relative results. Stock selection in the gas, renewables, toll roads and airports sectors, an underweight to the airports sector and an overweight to the communications sector aided the most. Meanwhile, stock selection in the energy infrastructure sector detracted.

On an individual stock basis, the largest contributors to absolute returns in the quarter were Exelon, National Grid, Clearway Energy, Crown Castle and APA. The largest detractors were AENA, Pembina Pipeline, CFE Capital, Brookfield Renewable and Gibson Energy.