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Portfolio Strategy

ClearBridge Global Infrastructure Income Strategy Commentary Q2 2022

Jul. 15, 2022 10:08 AM ET | ANNSF, ANYYY, BEP... | 1 Like

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Summary

User-pays infrastructure and utilities continued to perform well amid a steep selloff for equities as their stable cash flows, growing dividends, essential service nature and ability to pass through inflation offered a safe haven in a volatile quarter.

Heightened expectations of a takeover offer for an Australian toll road operator helped the Asia Pacific region outperform, while defensive sectors globally saw some profit taking.

Tailwinds for infrastructure include transport benefiting from the recovery of mobility as we move into summer in the Northern Hemisphere and as COVID-19 becomes more endemic in most parts of the world, as well as investments in decarbonization and energy security.

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Infrastructure's Defensive Traits on Display

Market Overview

User-pays infrastructure and utilities continued to perform well amid a steep selloff for equities as their stable cash flows, growing dividends, essential service nature and ability to pass through inflation offered a safe haven in a volatile quarter.

Volatility came from many areas. While COVID-19 has become endemic around most of the world, its effects in China, which has maintained a zero-COVID policy and persisted in lockdowns, have hampered global growth. The Russian invasion of Ukraine continues to have an impact on commodity prices and supply, which, while felt more in Europe, also affect the rest of the world. Central banks globally are taking liquidity out of the markets by raising rates and tightening monetary policy in order to combat inflation, raising the risks of a policy mistake. With the hawkish turn for central banks, the probability of recessions globally has increased. This meant a tough quarter for markets with the MSCI AC World Index down substantially (15.66%). Through all of that volatility, the ClearBridge Global Infrastructure Income Strategy showed its defensive characteristics, outperforming the S&P Global Infrastructure Index (7.66%) as well as broader equity markets.

Portfolio Performance

On a regional basis, Asia Pacific was the top contributor to quarterly performance, where Australian toll road operator Atlas Arteria (OTCPK:MAQAF) led performance. Atlas Arteria's key assets are a 31% stake in the APRR, AREA and ADELAC concessions in France and 100% ownership of Dulles Greenway in the U.S. In addition, it owns the Warnow Tunnel in Germany. The French concessions represent ~75% of the company's value. Atlas Arteria performed strongly as a result of a large Australian pension fund (IFM) taking a 15% stake in the company at $8.10/share, with the expectation this would ultimately lead to a takeover offer.

Other sources of relative support from the region included Transurban (OTCPK:TRAUF), which owns a suite of intra-urban toll road assets that dominate the Australian toll road network in the three state capital cities on the eastern seaboard. The company saw easing concerns on bond rates and paid a slightly better than expected second-half dividend, a sign of ongoing traffic recovery given that Transurban distributes free cash flow. APA, Australia's largest gas pipeline operator, was also fairly resilient, offering some inflation protection and benefiting from a strong environment for gas.

Defensive sectors — electric, gas and water — saw some profit taking globally after a strong start to the year, with National Grid (NGG) and SSE (OTCPK:SSEZF) in the U.K. the main individual detractors. Energy infrastructure, mostly in Canada, performed poorly on profit taking, as the strong demand for commodities, which has been driven by structural underinvestment and supply disruptions related to the war in Ukraine and which led to exceptional performance in the first quarter, was overpowered by concerns of how a global recession would impact demand.

With growth stocks out of favor amid higher interest rates, contracted renewables also performed poorly, mostly in the U.S., with no change in theses or catalysts for these high-quality assets that will benefit from the huge investments they should receive as we move toward a net-zero world.

Outlook

We believe there will be a rough road ahead for equities, with risks stemming from recession fears, global political tensions, liquidity being removed from the system, high inflation and slowing growth. At the same time, infrastructure and utilities see a number of tailwinds and are at very attractive valuations, in our view.

Tailwinds include transport infrastructure benefiting from the recovery of mobility as we move into summer in the Northern Hemisphere and as COVID-19 becomes more endemic in most parts of the world. Decarbonization, a generational theme, can be accessed in a number of ways, whether through contracted renewables, global regulated utilities, or even through midstream pipelines that are beginning to facilitate an energy transition through hydrogen or carbon capture and storage. There are a number of ways we can access this very dominant theme within our portfolio.

Energy security remains an issue, especially in Europe, and we see that accelerating the move toward decarbonization and greater investment in energy infrastructure, again benefiting our pipelines and utilities. Utilities around the world continue to strategically implement changes to improve the consistency of their forward cash flows. We have seen this historically with U.S. companies like Exelon (EXC), but we continue to expect companies like Public Service Enterprise Group (PEG) and European utilities to simplify their businesses as well. Communication infrastructure also remains attractive with continued demand for data and strong tailwinds from 5G driving strong cash flows and demand.

There is no change in the listed and unlisted infrastructure dynamic: we see private infrastructure capital continuing to come to listed markets to find attractively priced assets for acquisition. Currently, with over $300 to $400 billion of dry powder, or capital waiting to be invested, unlisted players will benefit the companies in our listed infrastructure universe as these companies sell these assets, often non-core or minority interests, for well in excess of where they are currently trading. On average, we have seen these sales done at roughly a 30% premium to where they are currently trading or their implicit value within these companies.

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 saw negative contributions from all 10 sectors in which it was invested (out of 11 total) in the second quarter, with the electric, renewables, airports and gas sectors the leading detractors and the rail, communications, toll roads and water sectors the least negative.

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

On an individual stock basis, the largest contributors to absolute returns in the quarter were Atlas Arteria, Southern Company (SO), Constellation Energy (CEG) and Eutelsat Communications (OTCPK:EUTLF). The largest detractors were National Grid, SSE, Aena (OTCPK:ANNSF), Brookfield Renewable (BEP) and Public Service Enterprise Group.

During the quarter we initiated positions in Brazilian electric utility Engie Brasil (OTCPK:EGIEY), Italian gas utility Italgas (OTC:ITGGF) and U.S. electric utility OGE Energy (OGE), and we exited positions in U.S. electric utilities Southern Company and FirstEnergy (FE).

Original Post

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