ClearBridge Investments

Global Infrastructure Value Strategy

Richard Elmslie
Managing Director, Portfolio Manager

Charles Hamieh
Managing Director, Portfolio Manager

Shane Hurst
Managing Director, Portfolio Manager

Nick Langley
Managing Director, Portfolio Manager

Key Takeaways

- General equities rebounded strongly during the quarter, supported by policy stimulus and the easing of mobility restrictions, with infrastructure making robust but less significant gains.
- Utilities' earnings have not been impacted and they still offer significant predictability of returns and strong dividends growing well above inflation.
- We remain defensively positioned with the majority of the portfolio in high-quality globally diversified utilities, while selectively increasing our exposure to user-pays assets, which should resume offering stable cash flows with a modicum of elasticity throughout the economic cycle.

Market Overview and Outlook

General equities rebounded strongly during the quarter, supported by policy stimulus and the easing of mobility restrictions. Global infrastructure underperformed general equities during this exceptionally strong rebound. The benchmark S&P Global Infrastructure Index rose 13.87%, while the MSCI World Index advanced 19.36%.

During the quarter governments unveiled unprecedented fiscal stimulus aimed to support economies during the coronavirus pandemic. Lockdowns gradually eased during the quarter, although in key geographies such as the U.S., risks of a second wave are increasing, and lockdown measures are beginning to be re-introduced in some regions. The significant fiscal stimulus provided substantial support to equity markets.

Hard data showed meaningful improvements from the rapidly induced coronavirus lows at the start of the quarter. Purchasing manager indexes, retail activity, employment numbers and economic growth showed signs of recovery, although all remained well below pre-COVID-19 levels, keeping economies under stress and raising the risk of insolvencies as stimulus is dialed back. Political risk remains elevated as governments attempt to manage the impact of such large synchronous health and economic events.

Within the infrastructure benchmark, sectors comprising GDP-sensitive user-pays assets such as toll roads (+26.83%), airports (+21.11%) and rail (+19.59%) led the way as economic activity picked up from a general worldwide standstill, while more defensive utilities such as electric (+5.84%) and water (+7.82%) trailed.

On a regional basis, being the first region to shut down and begin to reopen, Asia Pacific Developed outperformed (+31.81%). For most of the quarter not yet feeling the effects of COVID-19-induced shutdowns, Latin America also performed well (+30.32%). Between the two regions in terms of virus exposure and facing shutdowns for most of the second quarter, the U.S. & Canada lagged (+7.82%).

On a regional basis, the U.S. & Canada was the top contributor to quarterly performance, led by U.S. gas utility Cheniere and U.S. communications companies Crown Castle International and American Tower.

Cheniere Energy is an energy infrastructure company that owns and operates U.S. liquefied natural gas (LNG) export facilities. The share price of Cheniere rallied during the quarter as confidence in the stability of the business increased following a constructive first-quarter earnings call that also allayed fears over the safety of Cheniere contracts.

Crown Castle is the leading independent owner and operator of wireless communications infrastructure in the U.S., where it has a portfolio of approximately 40,000 towers. Crown Castle shares performed strongly, as it rallied with general equities and was further bolstered by low bond yields and investors' confidence in the resilience of the business model during the pandemic.

American Tower owns, operates and develops wireless communication towers, leasing tower space to wireless phone operators. It owns around 52,000 towers, of which 22,000 are located in the U.S. American Tower, like Crown Castle, outperformed as investors preferred the tower sector due to its relative insulation from the economy and the decline in bond yields. Share performance was also boosted by the rally in general equities.

Elsewhere in the region, U.S. rail operator Union Pacific also contributed to quarterly performance. Union Pacific is the largest listed railroad company in North America. Union Pacific's share price rallied during the quarter due to quarterly results released in April showing exceptionally good operating ratio improvement. Furthermore, volumes, while lower year over year, are starting to look slightly better than expected.

In Asia Pacific, Australian toll road operator Transurban also contributed to quarterly performance. Transurban 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. Additionally, it owns several toll roads in North America, predominantly in the area surrounding Washington, D.C. Transurban's share price performed strongly during the quarter as mobility restrictions eased, allowing traffic to return to Transurban's toll roads.

U.S. electric utility Edison International was the largest detractor from quarterly performance. Edison International is the parent company of Southern California Edison (SCE), one of the largest electric utilities in the U.S., and Edison Energy, a nonregulated energy services company. SCE serves more than 14 million people in California. The share price of Edison fell during the quarter as peer PG&E's post-bankruptcy equity raise was an overhang for Edison shares.

Portfolio Positioning

On a regional level, the Strategy's largest exposure is in the U.S. & Canada (49%) and consists of exposure to utilities (38%) and economically sensitive sectors (11%).

Going into this year, the Strategy was defensively positioned as a result of our view that we were approaching the end of a long economic cycle. As we move through the current COVID-19-related volatility we continue to remain defensively positioned, with the majority of the portfolio in high-quality globally diversified utilities, which offer a resilient, predictable return to investors. At the same time, we have been selectively increasing our exposure to user-pays assets.

Our view remains that the economic impact of COVID-19 will be quite significant. We envision a more gradual recovery than the market does, which looks to be pricing in a V-shaped economic recovery. Much of the soft data and mobility data, in some key states of the U.S. and in parts of Europe and Asia, has been positive, but we are looking for this to translate into sustainable real economic activity.

As real economic activity picks up, user-pays assets will resume their role of offering stable cash flows with a modicum of elasticity throughout the economic cycle. Utilities, meanwhile, have been as resilient as ever. Their earnings have had minimal impact and they still offer significant predictability of return and strong dividends growing well above inflation. Our view remains that infrastructure plays a unique role in a portfolio, offering predictability of cash flow, good diversification of returns and a healthy dividend growing at well above inflation.

To this end the last three months have been a small hiccup for the asset class. Our view remains that infrastructure plays a unique role in a portfolio, offering predictability of cash flow, good diversification of return and a healthy dividend growing at well above inflation.

We are looking for positive soft data to more fully translate into real economic activity.

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 the seven sectors in which it was invested (out of nine total), with the gas sector the leading contributor and the water sector the main laggard.

On a relative basis, measured against the S&P Global Infrastructure Index, the ClearBridge Global Infrastructure Value Strategy underperformed the benchmark during the second quarter. Overall stock selection and sector allocation detracted from performance, in particular stock selection in the toll roads and water sectors. An underweight to the airports sector and an overweight to the water sector were also detrimental. Conversely, stock selection in the gas sector, an overweight to the rail sector and an underweight to the electric sector proved beneficial. On a regional basis, stock selection in Western Europe and an underweight to Asia Pacific Developed weighed on relative results, while stock selection in and an underweight to the U.S. & Canada contributed positively.

On an individual stock basis, the largest contributors to absolute returns in the quarter included Cheniere Energy, Transurban, Union Pacific, Crown Castle and American Tower. The primary detractors from absolute returns were positions in Edison International, National Grid, Equatorial Energia, United Utilities and CMS Energy.

Our primary quantitative tool in portfolio construction is excess return, on which our stock ranking system is based. The Strategy also uses yield quality as a secondary measure. As such, driven by valuation, during the quarter we initiated positions in French rail operator Getlink, New Zealand airport operator Auckland Airport, Italian toll road operator Atlantia, and U.S. electric utilities CMS Energy and Edison International.

We also used the opportunity to crystalize some gains by exiting Brazilian electric utility Equatorial Energia, Canadian electric utility Hydro One, Mexican rail operator Grupo Mexico Transportes, U.K. gas utility National Grid, U.S. gas utility Williams Company, U.S. electric utility Dominion and Canadian gas utilities Enbridge and AltaGas.