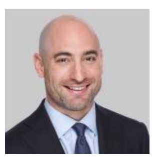
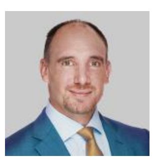
Global Infrastructure Income Strategy

Daniel Chu, CFA
Director, Portfolio Manager

Charles Hamieh
Managing Director, Portfolio Manager



Shane Hurst
Managing Director, Portfolio Manager



Nick Langley
Managing Director, Portfolio Manager

Key Takeaways

- Vaccine announcements raised hopes for higher economic growth as well as a return for travel and leisure, lifting cyclical areas of the market and economically sensitive user pays infrastructure assets.
- Stimulus remained front and center in the EU and U.S., with the EU also agreeing to more aggressive cuts in greenhouse gas emissions as it aims to be the first climate-neutral continent.
- We are constructive on utilities for 2021 and see opportunities in the transport space, while in many regions 2021 will see major steps forward in the rollout of 5G communications infrastructure.

Market Overview and Outlook: Markets Reflect Global Policy Push for Renewables

The ClearBridge Global Infrastructure Income Strategy performed strongly in the fourth quarter, modestly trailing infrastructure and global equity indexes, which rose handily as two effective vaccines for COVID-19 and their subsequent approval for use in many countries clarified a rough timeline for recovery in 2021.

The vaccine announcements raised hopes for higher economic growth as well as a return for travel and leisure, lifting cyclical areas of the market and economically sensitive user pays infrastructure assets. Renewables continued their strong performance, while energy rebounded. At the same time, vaccine rollouts began more slowly than hoped and infections continued to spike, resulting in a retrenchment of mobility restrictions in many areas.

The quarter saw a gradual reduction in political uncertainty as Joe Biden won the race for U.S. president and should govern with a small majority in Congress. The lack of an overwhelming Democratic mandate could remove the near-term risk of structurally higher taxes and more stringent regulation.

Stimulus remained front and center: the EU approved a €1.8 trillion stimulus plan and agreed to more aggressive cuts in greenhouse gas emissions over the next decade as it aims to be the first climate-neutral continent. The U.S. also passed another stimulus package, focused on delivering USD$900 billion in support with a focus on consumers, small businesses and vaccine distribution.

Hard economic data showed signs of slowing as unemployment levels remained elevated, albeit softened by support from government stimulus and job support programs, as well as accommodative monetary conditions.

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

Brookfield Renewable (BEPC) is a pure play renewables operator and developer headquartered in Canada, focused on international hydro, solar, wind and storage technology. Brookfield announced accretive acquisitions during the quarter that were well-received by the market.

Clearway Energy primarily owns and operates contracted renewable generation assets in the U.S. It also owns and operates conventional generation and thermal infrastructure assets. Shares were higher as the company announced additional growth opportunities (~2200 MWs) along with positive datapoints on its near-term contract expiry of California gas assets, in particular the sale of similar assets by AES at high multiples.

Turning to Western Europe, Portuguese renewables utility Energias de Portugal and U.K. electric utility SSE also performed well.

Energias de Portugal (EDP) is an integrated utility based in Iberia, operating electricity distribution, generation and energy supply businesses. It has a growing exposure to global renewables through its 83%-owned subsidiary EDPR (mostly onshore wind farms) and operates electricity distribution and generation businesses in Brazil through its 50%-owned EDP Brasil. Gains were mainly driven by the company's nine-month results beating expectations and its raising full-year guidance. In addition, strengthened commitment by the European Commission to reduce carbon emissions as well as positive federal policies under the newly elected U.S. President Biden also boosted sentiment for the renewables sector.

SSE is a diversified energy utility headquartered in Scotland. It is vertically integrated, operating over the entire supply chain in the U.K., with generation (including hydro, wind, gas turbine and coal-fired), electricity and gas networks, and retail businesses. It is the U.K.'s largest renewable energy generator. The company raised its fiscal year EPS guidance on the back of its Dogger Bank wind project farm-down. The farm-down or build-sell-operate model for renewable utilities assets involves selling equity stakes to other institutions or companies, typically pre-construction, to free up capital. During the quarter SSE agreed to sell a 10% interest to Italian oil and gas company Eni. Its announced upstream gas asset disposal also marked further progress in its asset recycling program. Furthermore, the U.K.'s regulatory reset in December, coupled with its energy white paper and Green Industrial Revolution Plan, provided a supportive backdrop for SSE's core network and renewables businesses.

Utilities were hardly impacted by the pandemic in 2020 due to their essential service nature.

Canadian gas utility TC Energy was the largest detractor from quarterly performance.

TC Energy is a high-quality North American energy infrastructure company leveraged to the natural gas growth thematic. Joe Biden winning the U.S. presidential election increased risk to TC Energy's Keystone XL pipeline project, as Biden has previously warned that, if elected, he will cancel the presidential permit for the project.

Looking ahead, we see many infrastructure projects being accelerated as governments look for opportunities to support local economies. These will likely be skewed toward a diverse range of "local" projects, using local materials, aggregates, labor and contractors. We expect a number of these projects to be financed by the private sector and "paid for" by extending concession agreements. These are often neutral to near-term earnings but accretive to value and are often missed by the market.

In the U.S., Biden's election should further boost the focus on infrastructure spending, with projects related to renewable power generation and electric vehicles in the utilities sector likely to benefit.

We are constructive on utilities for 2021, as they were hardly impacted by the pandemic due to their essential service nature, supportive regulation, importance in leading the decarbonization of economies and their social importance as major employers. A variety of trends should accelerate asset growth and subsequent earnings, cash flow and dividend growth in the medium and longer term. These include higher renewable energy targets, gas to electricity switching (in residential as well as commercial), the build-out of electric vehicle charging infrastructure and the need to build grid resilience against increasingly destructive weather events related to climate change.

We also see opportunities in the transport space. Governments are seeking to use the "new normal" brought about by the pandemic to change consumer behavior when it comes to travel — Europe is incentivizing rail over air travel, promoting 2021 as "the year of rail" — to reduce transport sector emissions. Additionally, in both Europe and North America we expect policies to support the onshoring of supply chains.

Finally, in many regions 2021 will see major steps forward in the rollout of 5G communications infrastructure. This will enhance the medium- to long-term earnings growth of the wireless tower industry, which is well-represented in listed markets across the U.S., Europe, Asia and emerging markets.

Portfolio Positioning

On a regional level, the Strategy's largest exposure was in the U.S. & Canada (37%) and consisted of exposure to regulated and contracted utilities (32%) and economically sensitive user pays infrastructure (5%), on average.

For the ClearBridge Global Infrastructure Income Strategy, the 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, we initiated positions in Canadian gas utility TC Energy and U.S. electric utility Exelon Corporation.

We also used the opportunity to crystallize some gains by exiting U.S. electric utilities Dominion Energy and Duke Energy, U.K. water utility Severn Trent and Italian gas utility Italgas.

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 seven of the eight sectors in which it was invested (out of 11 total) in the fourth quarter, with the electric and renewables sectors the leading contributors and the communications sector the only detractor.

On a relative basis, measured against the S&P Global Infrastructure Index, the ClearBridge Global Infrastructure Income Strategy underperformed during the fourth quarter. Overall sector allocation detracted from performance, in particular a large underweight to the airports sector, while stock selection effects were positive. Overweights to the electric and communications sectors, an underweight to the rail sector and stock selection in the gas, energy infrastructure and renewables sectors dampened relative results. Conversely, stock selection in the electric sector and an overweight to the renewables sector were beneficial.

On a regional basis, stock selection in Western Europe, Latin America and Asia Pacific Developed detracted from relative returns, while stock selection in the U.S. & Canada, an overweight to Latin America and an underweight to the U.S. & Canada proved beneficial.

On an individual stock basis, the largest contributors to absolute returns in the quarter included Brookfield Renewable, Transmissora Alianca, EDP, SSE and Clearway Energy. The primary detractors from absolute returns were positions in TC Energy, Enagas, Crown Castle, Italgas and Gibson Energy.