ClearBridge Investments

Global Infrastructure Value Strategy

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Key Takeaways

- 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.
- Renewables continued their strong performance, with the strategy benefiting from strong contributions from Western Europe and North America.
- 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: Emissions Question Shapes Policy, Infrastructure Returns

The ClearBridge Global Infrastructure Value Strategy performed strongly in the fourth quarter, in line with 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, Western Europe was the top contributor to quarterly performance, where Danish renewables utility Orsted and French rail operator Getlink performed well.

Orsted is the global industry leader in the offshore wind industry, with about 30% market share. Over the past few years, Orsted has gradually exited its fossil fuel activities and more recently its energy distribution and retail business, transforming itself into a green solutions provider. It is a pure play in renewables with over 90% of its earnings from regulated and contracted activities in 2019–25. A green recovery in the EU with a hydrogen strategy to combat climate change should be long-term drivers for Orsted. Shares performed well, mainly driven by strengthened commitments to reduce carbon emission by the European Commission, the U.K. raising its national offshore wind target and newly elected U.S. president Biden's pro-renewables position. The U.S. Congress also passed a stimulus package in December that included tax credits for renewables projects.

Getlink owns the concession over the Channel Tunnel rail link between the U.K. and France. The latest COVID-19 vaccine developments improve the prospects for the gradual reopening of economies and travel. Getlink should see gradual traffic recovery as the vaccine gets rolled out.

Turning to North America, Canadian renewables utility Brookfield Renewable, U.S. energy infrastructure company Cheniere and U.S. electric utility Edison International were the lead performers.

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

Cheniere Energy is an energy infrastructure company that owns and operates U.S. liquefied natural gas (LNG) export facilities. The vaccine announcements have helped improve the outlook for a recovery from COVID-19, which in turn improved the outlook for LNG. Cheniere is seeing continued strong demand in exports to emerging markets.

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. Shares were up on little incremental news.

U.S. communications company American Tower was the largest detractor from quarterly performance.

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. During the quarter, the company underperformed as concerns arose around the amount of churn resulting from the merger of T-Mobile with Sprint. The towers sector also underperformed as vaccine potential caused investors to switch into growth opportunities rather than continuing to hold the relative stability and safety of the tower business.

A green recovery in the EU involves a hydrogen strategy to combat climate change.

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 (53%) and consisted of exposure to regulated and contracted utilities (39%) and economically sensitive user pays infrastructure (14%), on average.

For the ClearBridge Global Infrastructure Value Strategy, the primary quantitative tool in portfolio construction is excess return, on which our stock-ranking system is based. As such, driven by valuation, we initiated positions in U.S. rail operator CSX, Spanish electric utility Iberdrola, U.S. electric utility Southern Company, Canadian energy infrastructure company Enbridge and Spanish communications company Cellnex.

We also used the opportunity to crystallize some gains by exiting U.S. water utility Essential Utilities, Spanish electric utility Red Electrica, U.S. electric utility American Electric Power and Canadian electric utility Emera.

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

On a relative basis, measured against the S&P Global Infrastructure Index, the ClearBridge Global Infrastructure Value Strategy underperformed the benchmark during the fourth quarter. Overall sector allocation detracted from performance and was partially offset by stock selection. In particular, an underweight to the airports sector and an overweight to the communications sector detracted. Stock selection in the rail sector was also detrimental. Conversely, overweights to the renewables and rail sectors, an underweight to the gas sector and stock selection in the electric, toll roads, energy infrastructure and renewables sectors proved beneficial.

On a regional basis, stock selection in the U.S. & Canada and an overweight to Western Europe were positive while stock selection in Western Europe, an overweight to the U.S. & Canada and an underweight to Latin America weighed on relative results.

On an individual stock basis, the largest contributors to absolute returns in the quarter included Orsted, Brookfield Renewable, Cheniere Energy, Getlink and Edison International. The primary detractors from absolute returns were positions in American Tower, Crown Castle, Cellnex, Enbridge and Southern Company.