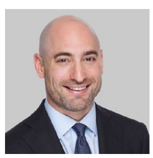
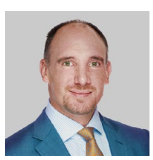
Global Infrastructure Income Strategy

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

- The Strategy outperformed the S&P Global Infrastructure Index as well as global equities for the quarter.
- Several indicative takeover offers in Australia helped the Asia Pacific region, which was the top contributor to quarterly performance.
- The continuing recovery, helped by increased vaccinations globally, is supportive of user-pays infrastructure, although we expect relatively smaller pricing dislocations between regions and sectors and are focusing more on individual mispricings.

Market Overview

The Strategy outperformed the S&P Global Infrastructure Index as well as global equities for the quarter. Economic activity continued to rebound amid strong consensus expectations for corporate earnings and economic growth forecasts. Meanwhile, COVID-19 vaccine rollouts gained pace in many regions, helping ease mobility restrictions despite the new Delta variant causing an increase in confirmed cases.

Government policy remained supportive, with previously announced stimulus continuing to be implemented. Bond rates remained range bound during the quarter; the Fed continues with the view that the recent inflation spike is largely transitory, with upside risk addressable through possible tapering later in the year. Strong labor and wage data, combined with large increases in commodity prices, highlight the risk of inflation to the upside in the near term. However, slack in the labor markets compared to pre-pandemic levels is expected to contain inflation risk over the longer term. Markets remained flat despite strong economic data due to potential fears that supply chain bottlenecks and larger than expected commodity price increases would be headwinds to the recovery.

Portfolio Performance

On a regional basis, Asia Pacific was the top contributor to quarterly performance, of which Australian airport operator Sydney Airport and Australian electric utilities AusNet Services and Spark Infrastructure were the lead performers. All benefited from takeover bids during the quarter that highlighted the scarcity value of these assets and the potential for further M&A activity.

Sydney Airport manages Australia's largest airport at a strategic and operational level under a 99-year lease. Sydney Airport's share price increased during the quarter as a result of an indicative takeover offer by a group of infrastructure investors that was revised several times to $8.75/share and resulted in the granting of due diligence by the board.

AusNet Services owns and operates energy infrastructure in Australia, including the electricity transmission network in Victoria, an electricity distribution network that delivers electricity to over 720,000 consumer connection points in eastern Victoria and a gas distribution network that delivers natural gas to about 700,000 consumer connection points in central and western Victoria. AusNet's share price rallied during the quarter on the back of competing indicative takeover offers at $2.50/share from Canada's Brookfield and $2.60/share from newly added portfolio holding APA Group, with exclusive due diligence having been granted prior to the higher bid being announced to the market.

Spark Infrastructure is an Australian company that invests in regulated energy networks. It owns electric distribution networks in South Australia, central Melbourne and western Victoria. It also has a 15% stake in TransGrid (NSW electricity transmission) as part of a consortium. Spark Infrastructure's share price increased during the quarter as a result of an indicative takeover offer by a group of private equity investors that was revised several times to $2.95/share and Spark entering into a Scheme Implementation Deed with the acquirers.

U.S. communications company Crown Castle was the largest detractor from quarterly performance.

Crown Castle is the leading independent owner and operator of wireless communications infrastructure in the U.S. with a portfolio of approximately 40,000 towers. Shares underperformed after Crown Castle announced that growth in its small cells business had slowed due to delays in the permitting process and carriers focusing network buildout on macro tower sites. This was further compounded as investors moved away from defensive securities as bond yields rose.

Positioning and Outlook

On a regional level, the Strategy's largest exposure is in the U.S. & Canada (42%) and consists of exposure to regulated and contracted utilities (29%) and economically sensitive user-pays infrastructure (12%).

The Fit for 55 package in the EU, COP26, and the Biden infrastructure bill are potential renewables sector catalysts.

During the quarter we initiated positions in U.S. energy infrastructure company Williams Companies, Australian gas utility APA Group and U.S. electric utility Entergy. We exited U.K. water company Pennon, U.S. electric utility Pinnacle West, Brazilian electric utility Taesa and Australian electric utility Spark Infrastructure.

Looking ahead, the continuing recovery, helped by increased vaccinations globally, is supportive of user-pays infrastructure, although we expect relatively smaller pricing dislocations between regions and sectors, as many sectors have recovered well post the selloff last year; going forward, the focus will be more on individual mispricings. As rising inflation gains traction, North American pipeline companies provide energy exposure and tend to do well in inflationary environments. Renewables are seeing key input costs like solar panels, aluminum and copper on the rise; however, the Fit for 55 package in the EU, COP26, and the Biden infrastructure bill are potential sector catalysts, as the latter is for U.S. utilities, even while utilities may see some pressure from higher bond yields.

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 six of the nine sectors in which it was invested (out of 11 total) in the third quarter, with the airports and electric sectors the leading contributors and the communications and toll roads sectors the main detractors.

On a relative basis, measured against the S&P Global Infrastructure Index, the ClearBridge Global Infrastructure Income Strategy outperformed during the third quarter. Overall stock selection contributed to relative results but was partially offset by sector allocation. Stock selection in the electric, airports and renewables sectors aided the most. Meanwhile, stock selection in the energy infrastructure sector, underweights to the airports and ports sectors and an overweight to the communications sector detracted.

On an individual stock basis, the largest contributors to absolute returns in the quarter were Sydney Airport, AusNet Services, Clearway Energy, Exelon and Spark Infrastructure. The largest detractors were Crown Castle, Iberdrola, National Grid, CCR and Entergy.