

ClearBridge

Investments

Global Infrastructure Income Strategy



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Key Takeaways

- We have seen past periods of bond yield rises that were mostly due to rises in real yields on strong growth expectations, which saw utilities and infrastructure sell off versus equities.
- We believe this is short-term market sentiment and historically we have seen global infrastructure indexes outperform global equities over the subsequent two years.
- We think utilities valuations, like infrastructure broadly, are attractive now, and, versus the more optimistic consensus narrative, our contrarian view is that the risks of a deeper recession remain considerable.

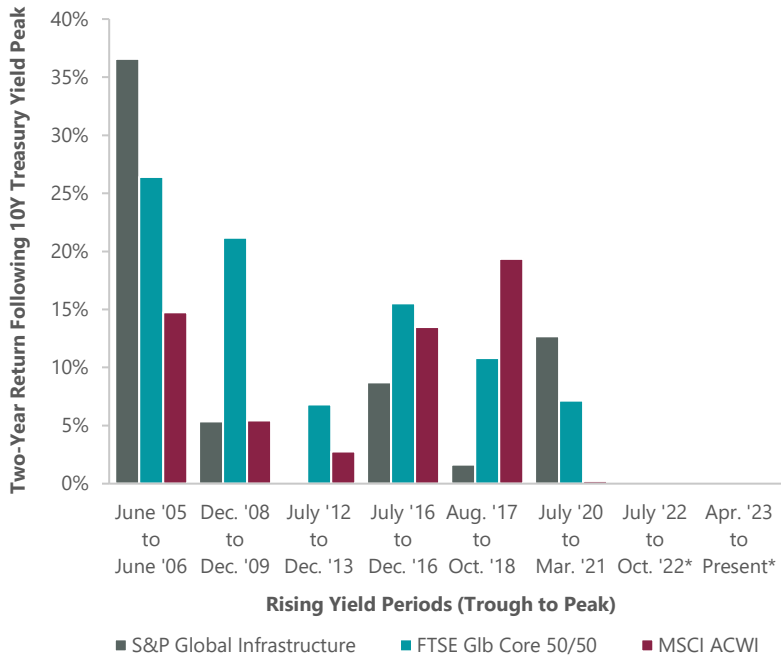
Market Overview

General equities as well as infrastructure retreated in the third quarter of 2023 as inflation, while it has fallen, is still above central banks' targets, and recent rises in energy prices make it difficult for central banks to loosen monetary policy. Central banks have therefore adopted a higher-for-longer narrative for policy rates, triggering a sharp rise in government bond yields, with the U.S. 10-year real bond yield reaching the highest level since late 2009.

Accordingly, rate-sensitive utilities led the S&P 500 Index down and were the main absolute detractors in the Strategy as renewable utilities in particular sold off. Infrastructure indexes underperformed global equities for the quarter. While we take a benchmark-unaware approach to managing the Strategy, the portfolio's defensive tilt vis-à-vis the S&P Global Infrastructure Index remained a relative headwind as market consensus continues to overlook utilities' ability to pass through higher interest rates and remains too rosy in its outlook, in our view. As higher rates begin to weaken corporate earnings, however, we believe our defensive tilt will be rewarded.

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Exhibit 1: Infrastructure Versus Equities Following Selloffs Driven by Bond-Yield Rises



*Two-year return not yet available. Source: ClearBridge Investments, FactSet.

Portfolio Performance

The rail sector was the sole positive contributor, led by Japanese rail operator West Japan Railway (JR West), one of Japan’s largest passenger railway operators. JR West operates the Shinkansen high-speed rail lines near Kansar, as well as commuter trains within the Osaka metropolitan network. Shares rose with the continued recovery of domestic traffic.

U.S. electric utility Constellation Energy was the top individual contributor. Constellation is primarily a nuclear generation company and is the largest producer of carbon-free electricity in the U.S., serving states including New York, Illinois, Maryland, Pennsylvania and New Jersey. The company’s combined generation capacity is more than 32 GW and 90% of annual output is carbon free. Shares rose as the market began to appreciate the potentially higher long-term margins the company can earn from providing baseload clean energy, which is being bid up at a premium by large customers such as Microsoft. Summer volatility in energy prices in Texas also bodes well for the baseload generation capabilities of Constellation’s nuclear assets.

Topping detractors were U.S. electric utility NextEra Energy (NEE) and U.S. renewables utility NextEra Energy Partners (NEP). NEE is an integrated utility business with a regulated utility operating in Florida and the largest wind business in the U.S. NEE’s regulated business includes Florida Power & Light, which serves nine million people in the State of Florida. NEP is a growth-oriented

contracted renewables company formed by its sponsor and general partner NEE to own, operate and acquire contracted renewable energy generation assets located in North America.

During the quarter, NEP decreased its growth guidance from 12%–15% per year to 5%–8% through to 2026 and announced a reduction to its 2023 cash flow expectations. In turn, this impacted NEE's share price as the reduction is a function of long-term interest rates, which investors now fear may be a problem for U.S. utilities more broadly. Canadian renewables operator Brookfield Renewable and renewables-focused European integrated utility Energias de Portugal (EDP) traded down in sympathy.

NEP's announcement came as a big surprise to investors and caused investor fear of further cash flow issues at the company. While we believe current capital markets make it difficult for the partnership to grow at historical levels, we see the new dividend guidance as achievable (with milestones such as the sale of pipeline STX), with upside if it is able to reinstate the asset dropdown program. In the meantime, growth will come through its wind repowering investments, which allow it to replace existing wind assets with larger, more efficient equipment. This enables NEP to not only achieve a higher energy output, but also reset the duration of tax credits it receives from the government. These high-IRR projects with more limited capital needs allow it to meet the new growth targets without access to equity markets.

It seems clear from the scenarios we've been running that the long-term value of NEP will likely be lower than our previous forecast. However, with the stock now trading at around half the value of its base assets (and accounting for no growth), even if you assume interest rates stay higher for longer, our view is that there is a margin of safety and, believing the stock to be oversold, we have been buyers.

Fears related to NEP have caused its sponsor NEE to lose its premium valuation status; it is now trading in line with the U.S. regulated utility peer group. The decision to change NEP's guidance has raised questions on management's credibility. However, we believe NEE's balance sheet and earnings sustainability remain intact despite the current environment.

Longer term, we continue to be constructive on renewables growth. While the current interest rate environment has negatively impacted projects that are being executed under low interest rates, going forward we believe renewable projects are now taking a higher cost of capital environment into account with limited impact to demand for renewable energy. We still believe NEE will remain a market leader in renewables development and be able to execute projects at healthy rates of return, and we added to our position during the quarter.

Market consensus continues to overlook utilities' ability to pass through higher interest rates.

Utilities' Earnings Power Lags Rises in Bond Yield

Taking a step back, recent underperformance of regulated utilities and contracted renewables can be attributed to 1) the sharp rise in bond yields and the higher-for-longer rates narrative, which has reduced the appeal of utilities and their associated dividends; and 2) negative sentiment for the sector following NEP's announcement, in particular around how higher-for-longer yields may impact financing needs and ultimately earnings over the next few years.

As we have previously highlighted, regulated assets generally have their allowed returns (whether real or nominal) adjusted at each regulatory reset. This leads to some lag to changes in bond yields, but tends to have an immaterial impact on fundamental valuations in the medium to long term. U.S. utilities are currently trading at their largest P/E multiple discount (over the next two fiscal years) relative to the S&P 500 Index since the Global Financial Crisis recovery began in 2009. Our modelling shows an annual average excess return of over 9.5% across the sector (calculated as expected five-year internal rate of return minus required return), which we find attractive.

Our view is that the fundamentals for our U.S. utilities (and utilities in general) remain intact. We are taking a disciplined approach, however, given the surprise move by NEP, and are retesting our assumptions around the medium-term financing needs of our companies before we look to take fuller advantage of the volatility by purchasing high-quality utilities at a discount.

Communications Towers: Still a Strong Signal

Communications towers have also come under pressure in 2023, with our two holdings American Tower and Crown Castle among top detractors year to date. These companies generally have inflation pass-throughs built into their contracts but have less flexibility to pass through higher financing costs over the longer term.

Concerns a deteriorating economy might slow carrier investments in their networks and slow near-term growth has impacted sentiment. The sector was also impacted as the market shifted away from defensive sectors including communications towers with longer-term contracts and stable demand as general U.S. equities rebounded on the expectation of a soft landing. However, we believe the long-term growth in capex spend remains an attractive tailwind for U.S. communications towers as wireless carriers roll out 5G, and we are optimistic on the long-term value to come from the role of towers in 5G, as well as eventually 6G.

Outlook

Despite the volatility, we are maintaining our defensive positioning as we believe the impacts of tightened financial conditions will eventually affect the economy and ultimately corporate earnings (we are starting to see weakness in earnings from higher interest costs). The Fed and other central banks around the world have to maintain their hawkish position and have started to accept recessionary risks as increasingly likely but necessary to combat the stubbornly high inflation.

We maintain this defensive positioning despite the economy's robustness. There is a large debate on whether there will be a soft landing (no recession) versus a deeper recession. Monitoring the economic data will be key here, and the defensiveness of our portfolio positioning will depend on this. Although economic data and corporate earnings have been resilient, there is a clear dislocation between general market performance and what leading economic indicators are saying.

Our overarching view is that utilities can handle higher interest rates over the next couple of years. In a slowing growth environment, we believe their predictability of earnings makes utilities attractive compared to general equity sectors where earnings uncertainty results in less confidence among investors and higher volatility.

We think utilities valuations, like infrastructure broadly, are attractive now, and, versus the more optimistic consensus narrative, our contrarian view is that the risks of a deeper recession remain considerable. With the sector trading at attractive valuations, combined with idiosyncratic drivers such as a large project completion at Southern Company, wildfire recovery at Edison International and a reduction in regulatory risk at Entergy, we continue to look for opportunities to increase our weight in U.S. utilities.

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 seven of the eight sectors in which it was invested (out of 11 total) in the third quarter, with the rail sector the standout positive contributor. The electric, renewables and gas sectors were the main detractors.

On a relative basis, the ClearBridge Global Infrastructure Income Strategy underperformed the S&P Global Infrastructure Index

during the quarter. Overall stock selection and sector allocation detracted, with stock selection in the renewables, gas and energy infrastructure sectors, an underweight to the energy infrastructure sector and overweights to the renewables and communications sectors detracting the most. Conversely, stock selection in the electric, rail and toll roads sectors proved beneficial.

On an individual stock basis, the top contributors to absolute returns in the quarter were Constellation Energy, Williams Companies, West Japan Railway, Union Pacific and Severn Trent. The largest detractors were NextEra Energy Partners LP, NextEra Energy, Energias De Portugal (EDP), APA and Brookfield Renewable.

During the quarter we initiated a position in U.K. water company Severn Trent and closed a position in U.S. energy infrastructure company Williams Companies.

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