

# Value Strategy

QUARTERLY COMMENTARY

| DECEMBER 2022



Our global listed infrastructure strategies underperformed infrastructure benchmarks and global equities for the quarter.

The outlook for interest rates and inflation continues to cause volatility in markets as investors digest expectations of a global slowdown in growth in conjunction with central bank tightening, with elevated volatility in the U.K. and Europe as a result of sustained high energy prices.

Inflation continues to sustain itself at a higher level for longer, making it difficult for central banks to refrain from loosening policy even as the economic outlook deteriorates. Although maintaining a tightening position is common across most economies, varying economic circumstances may lead monetary policies to diverge in the extent of tightening. As a recession continues to be part of consensus expectations, the duration and depth of the recession remains the largest risk to investors.

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## Portfolio Performance

On a regional basis, the U.S. and Canada was the top contributor to quarterly performance (+3.46%), of which U.S. electric utility PG&E Corporation (+0.74%) and U.S. water company American Water (+0.52%) were the lead performers.

PG&E Corporation (PG&E) is a regulated utility operating in central and northern California that serves 5.3 million electricity customers and 4.4 million gas customers in 47 of the state's 58 counties. PG&E outperformed following its inclusion in the S&P 500 Index and after the Fire Victim Trust sold some of its stake in the company, easing a market overhang. In addition, the company displayed evidence of their operational improvements, with no major fires seen so far this fire season.

American Water provides water and wastewater utility services to customers across several states within the U.S. Shares did well after American Water announced the acquisition of a municipal facility, providing additional opportunities for growth. Also, sentiment toward the company improved after a leading broker highlighted the more attractive valuation given relative performance to peers over the year.

Turning to Western Europe, U.K. water company Severn Trent (+0.51%) and Spanish electric utility Iberdrola (+0.42%) also performed well during the quarter.

Severn Trent is a regulated U.K. water utility that provides water and wastewater services to the Midlands and Wales, serving over 4.5 million households and businesses. In November, the market received the much-awaited confirmation signal of Severn Trent's weak first half earnings and FY23 earnings outlook; it welcomed its confident messages on its outcome delivery incentives. Ofwat's PR24 Final Methodology published in December also came in slightly better than the market expected. U.K. bond yields falling from October's peak also assisted performance.

Iberdrola is a multinational integrated electric utility company headquartered in Spain. Iberdrola is engaged in energy networks, renewables and wholesale and retail operations. The company has expanded internationally with operations in the U.K. (via Scottish Power), the U.S. (via Avangrid), Brazil (via Neoenergia) and Mexico. The market received its strategic plan update positively, as it emphasised protecting the balance sheet and increased investments in regulated networks. In addition, the appointment of a new CEO, separated from the chairman role, signified improvement in corporate governance.

U.S. energy infrastructure company Cheniere (-0.27%) was the largest detractor from quarterly performance. Cheniere Energy is an energy infrastructure company that owns and operates U.S. liquefied natural gas (LNG) export facilities along the U.S. Gulf Coast. Shares were down along with weakness in the energy sector driven by weaker commodity prices amid recession concerns and warmer weather in Europe.

All returns are in local currency.



## Positioning and Outlook

On a regional level, the strategy's largest exposure is in the U.S. and Canada (50%) and consists of exposure to regulated and contracted utilities (31%) and economically sensitive user-pays infrastructure (19%).

For the **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, the Investment Committee initiated positions in Canadian electric utility Hydro One, U.K. water company United Utilities, Brazilian electric utility Eletrobras and Canadian gas utility TC Energy.

The strategy also used the opportunity to crystallise some gains by exiting U.S. communications company Crown Castle, U.S. electric utility CenterPoint Energy, U.S. gas utility Sempra Energy and U.S. renewables utility Clearway Energy.

## Quarterly Stock Highlight

This quarter we review U.S. rail operator CSX.

CSX is one of the five leading North American rail companies, with over 21,000 miles of rail, covering 23 states and 40+ ports. CSX is engaged in the transportation of rail freight in the Southeast, East and Midwest via interchange with other rail carriers, to and from the rest of the U.S. and Canada.

CSX's freight transportation services are crucial to the functioning of the U.S. economy. CSX provides an efficient and unique service relative to other transport modes and has historically exhibited pricing power ahead of inflation (subject to light-hand economic regulation). Volumes are cyclical in the short-term, but captive shippers, price controls, margin improvement and strengthening return on invested capital (ROIC) mean that over the medium and long term, cash flows are more predictable and generally growing.

CSX operates the second-largest listed U.S.-centric railroad in terms of market cap operating in the East Coast.

Currently, CSX is the best-run railroad in the U.S. in terms of operating ratio, having been the first company to pioneer precision scheduled railroading (PSR) in the country. Under this system, CSX have been able to materially lower costs across their network, generating consistent EPS growth for their shareholders.

CSX was formerly managed by legendary railroader Hunter Harrison. However, after his unfortunate passing, Jim Foote has continued his legacy by seeking to drive further efficiency gains with ongoing improvement even into the latter years of their PSR rollout. Mr Foote announced his retirement in 2022 and Joseph Hinrichs (former Ford Motors executive) will assume the CEO role. With volumes steadily improving from the COVID-19 lows, a top-tier management team and a culture focused on driving further efficiencies in a volume growth environment, CSX remains well positioned to generate additional value for shareholders.

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