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U ACCESS (IRL) ELECTRON GLOBAL UTILITY FUND

Quarterly Comment | Q4 2018

For Qualified Investors in Switzerland or Professional Investors or Eligible Counterparties as defined by the relevant laws.

Markets

- Global equity markets were down -13.42% during the fourth quarter, bringing the YTD performance to -8.71%, as measured by the MSCI Daily TR Net World Index. The final quarter of 2018 was not good for equity markets. Investors had to contend with rising US central bank interest rates, a sharp slowdown in Eurozone business confidence, weaker Chinese growth and rising geopolitical concerns (including Brexit, Italian politics and the ongoing trade conflict between the US and China). This all proved an indigestible cocktail for investors. The biggest challenge for markets is that global growth is slowing at the same time as the Central Banks are winding down quantitative easing.
- In contrast to the first three quarters of 2018, Developed Markets underperformed global markets in Q4. In the US, markets were dominated by fears of further rate hikes and that the US is late in its economic cycle, driving the S&P 500 down by -13.97%. The MSCI Europe declined by -11.32% over the quarter, with all underlying country indices being down meaningfully. The Nikkei 225 also saw a strong decline (-17.02%).
- Emerging Market (EM) equities also declined meaningfully in Q4 but did relatively better than Developed Markets, the MSCI EM being down -7.47% in Q4. The prospects of a Chinese stimulus and a slower pace of interest rates hikes in the US, as well as lower equity valuation were supportive factors. On a YTD basis, Emerging Markets still underperformed Developed markets, on aggregate, with the MSCI Emerging Markets being down -14.58% in 2018.
- In light of market sell-off, volatility increased sharply during this fourth quarter, closing the year much higher than in 2017. The regime change that we started to witness in February continues to be valid, as markets seem more focused on fears like slower growth, trade tensions or higher interest rates. The VIX closed Q4 at around 25, versus close to 12 at the end of Q3.
- After rising during most of 2018, US and European bond yields decreased in Q4. After initially moving higher in the first part of the quarter, yields sharply reversed from mid-November, as increased geopolitical tensions and question marks about the strength of the global economy drove equities lower, with investors selling equities and buying treasuries, in a classic risk-off trade. Monetary policy continues to tighten, although the Fed has lately been more dovish than during most of the year.
- In light of policy shifts progressing in the major economies, the increased volatility within all markets including equities is inducing allocators to look for alternatives or complements to their long-only equity allocation. We strongly believe that one efficient way to improve the risk-return profile of a traditional long-only equity portfolio is to favour Long/Short sector specialists like U Access (IRL) Electron Global Utility Fund. Indeed, this strategy is today characterised by tremendous structural changes, which should provide many long and short investment opportunities across the Infrastructure, Utilities and Alternative Energy fields.

Performance Review

- U Access (IRL) Electron Global Utility Fund generated a negative performance of -4.98% in Q4 (Class F USD, net of fees). This brought its net performance for the year to -2.79%. The portfolio ran an average 45% net long exposure over the quarter, which remained above historical average.
- Over Q4, U Access (IRL) Electron Global Utility Fund outperformed world equities on an absolute basis and on a beta adjusted basis. It slightly underperformed world utilities both on an absolute and a beta-adjusted basis. The portfolio's long book generated a negative contribution of -840bps, while the short book had a positive contribution of +290bps (all expressed in gross terms).
- In terms of subsectors, the positive contributor during the quarter was Water Utilities (+20bps). The largest detractor to performance was Electric Utilities (-370bps), followed by Infrastructure (-120bps) and Gas Utilities (-70bps). Despite its negative contribution in Q4, Electric Utilities remained the largest positive contributor YTD.
- Looking at regions, the US book detracted -90bps over the quarter. A long position in PG&E Corp (PCG) produced the region's largest loss. The worst wildfires in the history of California drove a more than 50% decline in the company's shares in November and December. The team exited the position by mid-November, avoiding further losses. In this region and in Q4, the negative performance of the long book was partially offset by the good performance of the short book.
- Europe also had a negative contribution in Q4 (-390bps). The largest detractor from performance was a short position in Spanish integrated utility Endesa (ELE SM), which rose after the surprise change of government. The new team's policies allowed the company to improve profitability in the short term, but it still faces significant challenges. On the long side, UK integrated utility Centrica (CNA LN) disappointed in Q4, as its margin contracted more than anticipated. Despite a challenging quarter, Europe was the largest positive contributor YTD.
- Elsewhere, Asia posted a loss during the quarter. Markets fell strongly in Q4, with the exception of India, and while utilities were not immune, they fell less because of their lower-beta nature. Beijing Enterprises Water (371 HK) was one of the detractors. The portfolio was positioned relatively defensively to the region, with longs concentrated in companies with greater earnings certainty.
- On the Infrastructure & Alternative Energy side, Infrastructure was a detractor over the quarter while Alternative Energy had a small gain. Avangrid (AGR), rebounded following a tough Q3 when it was hit by storm restauration costs and a transmission outage. One of the highest-conviction themes is the continued build out of natural gas infrastructure in China, as the country transitions from dirtier forms of energy such as coal-fired power generation. This theme has been expressed in several ways, including via the Chinese companies mentioned above as well as long positions in liquefied natural gas (LNG) project developers such as Tellurian and Pieridae Energy.

Portfolio Activity

- At the end of the quarter, U Access (IRL) Electron Global Utility Fund was running a 45% net long exposure and a 245% gross exposure, both of them standing above their respective historical medians. This confirms the overall positive sentiment of the manager regarding long and short investment opportunities in the sector.
- In terms of gross exposure, Electric Utilities and Infrastructure had the highest allocations, followed by Gas Utilities and Water Utilities. Looking at regions, the portfolio had a slightly higher net long exposure to North America at the end of Q4, compared to that of Q3. The investment team remains positive on Europe and Asia and holds net long exposures in these regions, but they are now similar to the net long exposure to North America.
- Among notable portfolio changes, the investment team made several adjustments since the prior quarter. As mentioned, the net exposure to North America slightly increased. In terms of major stock specific changes, the investment team decided to sell NextEra Energy (NEE), which had been one of the fund's strongest contributors, as its valuation became less attractive. Another change, as mentioned previously, was selling the position in PG&E Corp (PCG), following risks related to California wildfires.
- U Access (IRL) Electron Global Utility Fund was invested in 97 names at the end of December. The number of holdings in the portfolio increased slightly since the end of Q3. At the end of Q4, the top 10 holdings on the long side represented 68% of the portfolio and the top 10 shorts 48% of the portfolio.

Outlook & Positioning

- In terms of outlook and starting with the US, the valuation backdrop is mixed for utilities, with the group trading at a sizeable premium to the broad market on P/E but reasonably valued versus bonds. Fortunately, numerous relative value opportunities look very attractive within the sector, and the investment team intends to maintain focus on identifying interesting idiosyncratic opportunities and secular themes versus making a large sector call.
  - The trend of utility investors overly focusing on risks without recognising potentially transformative upside continues to provide good investment opportunities. For 2019, several de-risking and transformational stories appear compelling.
  - State policies and technological evolution continue to support clean energy. Renewables are the cheapest form of new generation in the United States, and the gap with conventional fossil generation only grew wider in 2018. Local policies are strengthening this trend, with many states accelerating policies designed to transition to zero emission generation.
  - Mid-cap utilities look expensive. As of year-end 2018, mid-cap utilities traded at a 15% valuation premium to large-cap utilities, close to a record high. The investment team is therefore entering 2019 with a long exposure concentrated mostly in larger-cap names and will monitor opportunities to potentially add more short exposure in the mid-cap space during the year.
- In Europe, the industry is on a good trend overall to grow earnings in the high single-digit range, thanks to the cost-cutting efforts of the last few years, continued capital investment, and risk optimisation. In addition, the team anticipates more M&A and corporate simplification to continue, creating more focused groups with greater scope for synergies and efficiencies. On the flip side, risks around elections and affordability are rising. Following last year's power price rise and more governmental focus on purchasing-power challenges in several countries in Europe, there is concern that the European elections in May and other general election cycles in specific countries will heighten intervention risk across public service industries.

- In Asia, renewables have reached a critical point. As happened in Europe over the past decade, renewable energy has relentlessly undermined the profitability of other generation sources. In the case of China, explosive growth in subsidised renewable capacity has worsened deficits, which in turn has forced the government to cut subsidies, and hence the return on renewable power. With renewables rapidly approaching power price parity with other generation sources, but with the subsidy deficit at an extremely high level, renewables are at a historical crossroad. The potential resolution of this situation (or lack thereof) creates multiple investment opportunities. Also, China gas demand is expected to continue to grow at double digits, despite the risk of weaker industrial activity as the economy slows. Overall, the team is turning more positive on Asian utilities, years of hostile regulatory environment is now well reflected in prices, and any marginal improvement could provide a strong boost to stock prices
- Political change brings a US infrastructure plan closer to reality. Investors have been disappointed by the lack of progress on a US infrastructure plan after a brief bout of euphoria following the 2016 presidential election, as the challenges involved in procuring funding and whether and how to involve private participants have stymied movement. With the Democrats recently taking control of the House, making it more difficult for the administration to enact legislation, an infrastructure bill now represents one of the few areas of bipartisan agreement where legislation could be enacted, and there is potential for the Congress to attempt to push a bill forward this year.