April 11, 2021

MARKET COMMENTARY
Rays of Optimism Shine on Energy

Overall, it was a good first quarter, sparked by the roll-out of vaccines to quell the COVID-19 virus — while it is too early to declare victory, the outlook for economic growth has improved dramatically. Economists are revising upward their forecasts for global GDP growth and accommodative monetary and fiscal policies continue to be the norm for the foreseeable future. The Energy sector may be characterized as the comeback kid and was the best performing S&P 500 sector posting a 31% total return. It was aided by the 21% gain in crude oil as the WTI price at the end of the quarter stood at $59.16 per barrel. Interest rates also rose with the 10-Year Treasury ending the quarter at 1.74%, a 52-week high and nearly double the 0.92% yield at the start of the year.

Given this backdrop, our Infrastructure Income Portfolio generated a 12.8% total return for the quarter driven by the 18.9% return of our midstream holdings and modest returns from our utilities and renewables holdings, which were up 5.5% and 2.3%, respectively. This compares with total returns of 6.2% for the S&P 500, 20.9% for the Alerian Midstream Energy Index (AMNAX), 2.5% for the PHLX Utilities Index (XUTY) and -14.1% for the S&P Global Clean Energy Index (SPGTCLTR).

Key Takeaways from this Quarter:

1) Value investing significantly outperformed Growth by its largest quarterly margin in 20 years. According to S&P, Value factor investing generated a 10.8% return compared to just 2.1% for Growth.

2) In our view, it's the *velocity of the rise in interest rates* that matter more than the absolute level of interest rates. Markets can adjust more easily to a gradual rise in interest rates. The sharp increase during the quarter caused a dip in highly valued growth stocks; e.g., those with high price-to-earnings ratios such as clean energy and technology. Intuitively this makes sense because the present value of a stock is its future earnings discounted to the present. The higher the discount rate (interest rate), the lower the stock price.

3) Utilities and renewables performed poorly in February due primarily to the rapid rise in interest rates. The former historically have performed poorly in a rising interest rate environment and the latter was impacted by the rotation from high growth into value. Our renewables exposure generated a positive return due to our investment in YieldCos and our avoidance of clean energy stocks with lofty valuations.

4) The Texas Power Crisis highlights the need for a balanced approach in the transition to a decarbonized future. Wind and solar power are vital to meeting our climate goals but because these sources of energy are intermittent, backup sources, such as natural gas and nuclear are required. Please see our essay, "The Texas Power Crisis: Don't Blame Renewables, Don't Blame Natural Gas – We Need Both."

5) Growth capital expenditures in the energy sector are unlikely to meaningfully increase unless oil prices sustainably rise above $70 per barrel based on company rhetoric. The exception is among privately owned exploration and production (E&P) companies that account for approximately 25–30% of U.S. oil production and don't have to answer to public shareholders. Ostensibly,

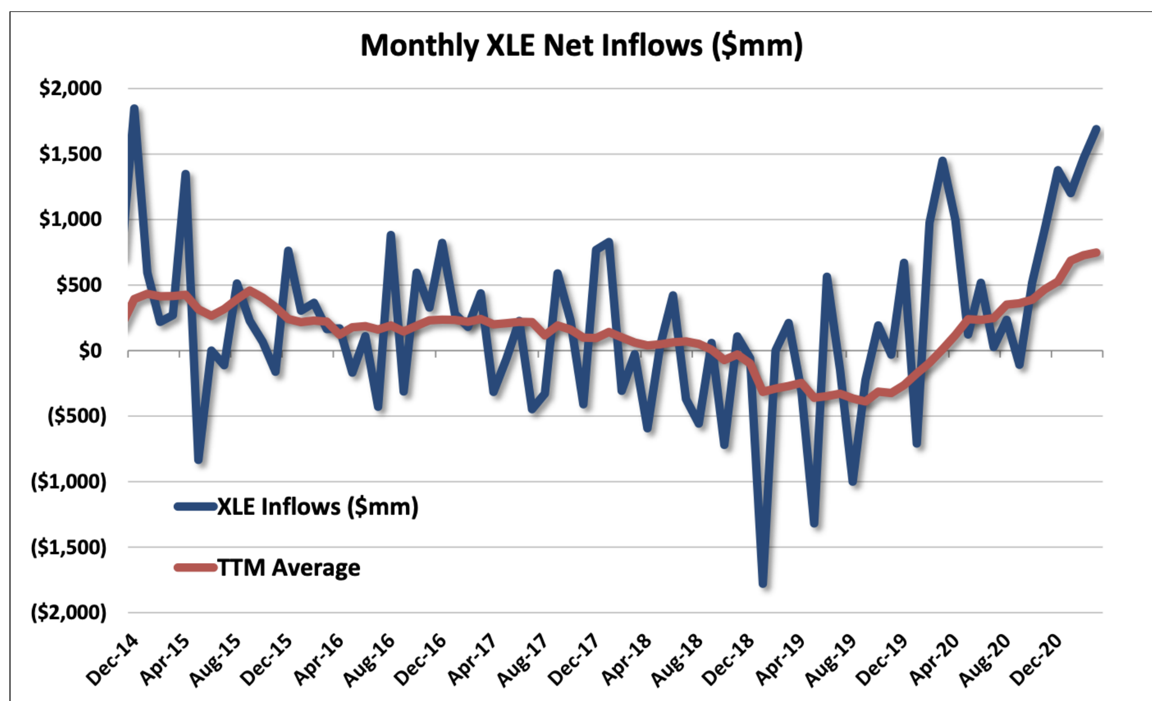
private companies want to develop reserves and grow production to a critical level that makes them attractive for sale to a public company. The bottom line is that U.S. oil and gas production is poised for only modest increases over the next couple of years. The Energy Information Administration (EIA) doesn't project a return to 2019 production levels until 2023.

Rays of Optimism Shine on Energy — Here is Why:

Energy companies have gotten the message.
The narrative among companies is consistent. They have embraced financial discipline and ESG (environmental, social and governance). Companies will be rewarded for generating free cash flow, returning cash to shareholders via dividends and share buybacks, and scoring well on ESG factors such as emissions, transparency in reporting and management compensation.

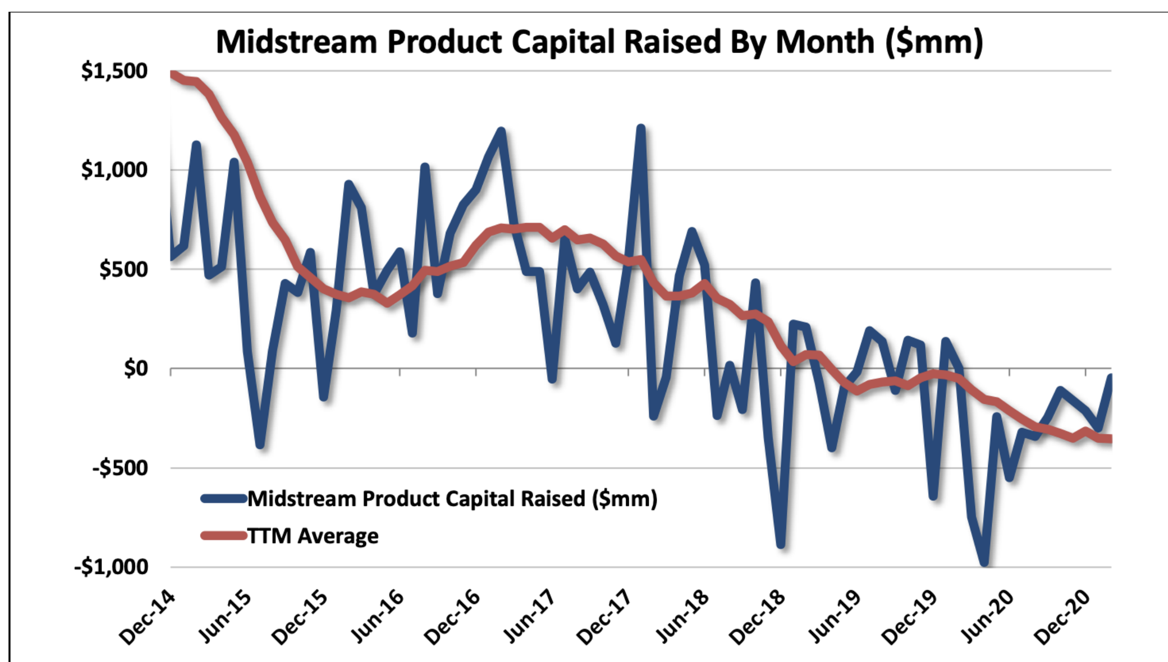
***Fund flows are improving*.**
The midstream energy sector has rebounded nicely relative to the broader market but has underperformed the commodity sensitive energy sectors such E&P and oilfield services. According to U.S. Capital, the cumulative six-month inflow of funds into energy set a new record at $7.2 billion. We attribute the appreciation in the price of midstream stocks to the exhaustion of selling pressure. Indeed, March was the first month since February of 2020 that did not see outflows from midstream products. Please see Exhibits 1 and 2 for details.

Exhibit 1. Monthly XLE Net Inflows



Source: U.S. Capital Advisors, LLC

Exhibit 2. Midstream Product Capital Raised By Month



Source: U.S. Capital Advisors, LLC

Back to the future – stocks perform well after secondary offerings.
The market easily absorbed three secondary transactions, albeit small ($125 to $175 million) in March. These included Western Midstream Partners, LP (NYSC:WES), Hess Midstream LP (NYSC:HESM), and Crestwood Equity Partners LP (NYSC:CEQP). Subsequent to the transactions, all three stocks traded higher. The selling shareholders were private equity firms that held their positions for lengthy periods and Occidental Petroleum Corporation (NYSC:OXY) that was required to get its WES holdings below 50% for deconsolidation reporting purposes.

OPEC plus is being supportive of oil prices.
At its latest meeting on April 1, OPEC plus approved the gradual rise in production under the mechanism agreed upon at its December 2020 meeting. They will continue to hold monthly meetings as “the volatility (*in oil prices*) observed in recent weeks warrants a cautious and vigilant approach in monitoring market developments.” There is a tug of war between an improving demand outlook owing to vaccine inoculations and fiscal and monetary stimulus on one end and a resurgence of COVID-19 in Europe and India. The next OPEC plus meeting is scheduled for April 28th.

The Assessment:
More Stimulus, More Inflation – Good. Higher Taxes – Bad.

It's too early to assess the impact of Biden’s $2 trillion dollar plus Infrastructure plan. Initially, the market has responded positively, focusing on the potential for jobs growth and boost to the economy. To date, the potential negative economic impact of higher corporate taxes (28% vs. 21% currently) and the likelihood of higher interest rates down the road have been mostly ignored. Regardless, inflation is likely to move higher, which we believe is a plus for midstream companies as the replacement value of their assets should be worth more. MLPs should perform better relative to c-corps as a consequence of potentially higher corporate taxes. Finally, clean energy will likely do well given more government subsidies. *To be continued…*

Our Stance:
We're Still Bullish.

In our view, the narrative is improving. Energy companies are not only taking steps to reduce carbon emissions such as using renewable energy to electrify their operations where it makes economic sense. Additionally, they are becoming more vocal and demonstrative of their commitment to ESG and financial discipline. Free cash flow that can be used to return cash to shareholders is the byproduct of financial discipline. The word is getting out that the transition to clean energy requires renewables such as solar and wind *and* fossil fuels. Fossil fuels are vital to human welfare and when combined with the rapid adoption of clean energy can significantly reduce carbon emissions.

SAM Partners' Infrastructure Income Strategy seeks to provide *sustainable* income and growth with capital preservation. This is accomplished by investing in a concentrated portfolio of high-quality midstream energy companies, utilities and renewable energy companies. In a world starved for yield, we believe these stocks offer a compelling value proposition. Our Infrastructure Income Strategy offers investors a current yield of 5.7% (as of 3/31/21) and growth potential of 3 to 4%. The midstream portion of the portfolio has a *sustainable* yield of ~7% while utilities and renewables provide yields of 3% and 4%, respectively.

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