ClearBridge
A Franklin Templeton Company

Energy MLP Strategy

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Key Takeaways

- Energy MLP stocks significantly outperformed broad equities in the first quarter as post-election animal spirits faded amid escalating tariffs and skepticism over AI buildouts.
- Colder weather and hints of supply constraints amid geopolitical tensions kept energy prices elevated, while hopes of greater oil and gas production and exports also lifted midstream shares.
- We continue to emphasize balance sheet strength, asset footprint diversity and quality and carefully assess our holdings with an eye toward managing successfully through the short-term disruption and thriving in the long term.

Market Overview

Despite a fast start to the year — a broad-based rally propelled the S&P 500 Index +2.8% in January — the equity market struggled for traction in the first quarter of 2025. Post-election animal spirits faded in February and March as investors grappled with on again/off again tariff announcements and consternation over the AI outlook. By the end of the quarter, the S&P declined -4.3%, breaking the index's streak of five consecutive quarterly advances.

Energy (+10.2%) was the top-performing sector in the S&P 500 as oil price stability provided air cover for stocks to recover from the deeply oversold levels at which many shares entered the year. The first part of the quarter also saw energy gain from higher expectations of greater oil and gas production (which would raise volumes for pipelines) given the policy indications by the incoming U.S. administration, while possible sanctions on Russia and Iran production drove oil price strength and energy outperformance in March. The Alerian MLP Index gained +12.6%, benefiting from these trends as well as colder weather in January and February and continued power demand from AI-related data centers, which were supportive of natural gas.

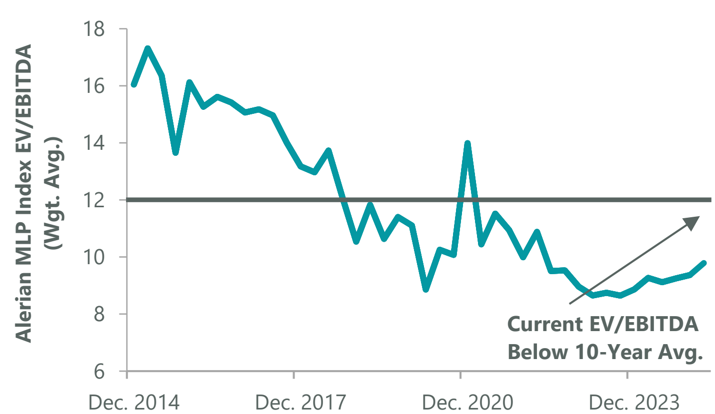
Demand for U.S. oil and gas is increasing amid concerns about geopolitical risks in the Middle East and Europe; the U.S. has surpassed Russia and Saudi Arabia in production of crude oil, and it is seeing substantial growth in liquified natural gas exports as it asserts its growing presence as an energy superpower. In addition, we expect the new administration to be less onerous in its regulatory framework, with less stringent controls on exports as well as pipeline permitting, all of which give us a fair degree of confidence in the future of U.S. oil and gas production growth and the placement of midstream to capture value.

Such hydrocarbon production growth is positive for midstream energy, which is well-positioned to benefit from growing volumes while maintaining limited commodity price exposure. This growth, combined with capital discipline on the part of midstream companies, makes us constructive on free cash flow, revenue, distribution and EBITDA growth in the sector as a whole, which has moved from being free cash flow negative to free cash flow positive and balance sheet leverage (debt/EBITDA) has decreased significantly, strengthening capital profiles. With little to no need for midstream companies to access capital markets for the foreseeable future, we expect excess cash flow (above and beyond capital spending and dividends/distributions) to be used for incremental share buybacks and further raising dividends/distributions.

Meanwhile, midstream energy valuations remain attractive, in our view. For example, using EV/EBITDA as one valuation metric, the Alerian MLP Index is still trading at modest multiples, especially compared to its long-term history (Exhibit 1). In addition, based on current distribution yields, the Alerian MLP Index not only screens attractive on a relative and absolute basis compared to yields in other equity asset classes, but also against high-quality fixed income securities (Exhibit 2).

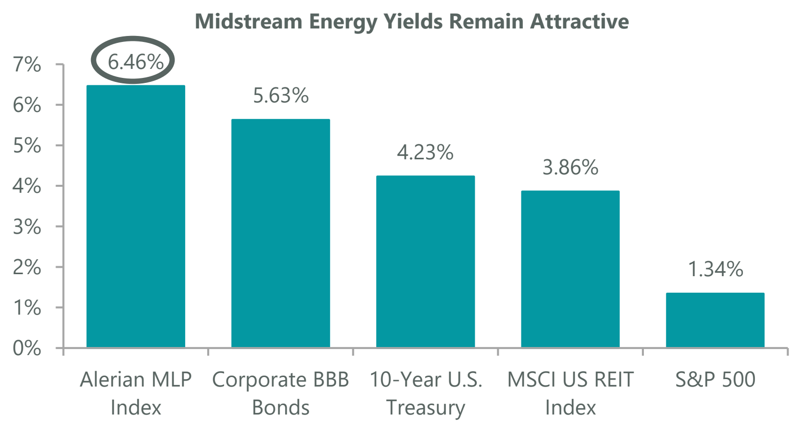
The sector would also stand to benefit from deregulation, an environment of greater M&A and capital markets activity broadly, which we expect to inflect higher under the Trump administration, adding catalysts to the stocks. M&A activity could provide an incentive for investors to embrace the new midstream energy business model, while any move toward less stringent permitting for pipelines would also be a positive.

Exhibit 1: Midstream Energy Trades at Modest Multiples



As of March 31, 2025. Source: ClearBridge Investments, FactSet.

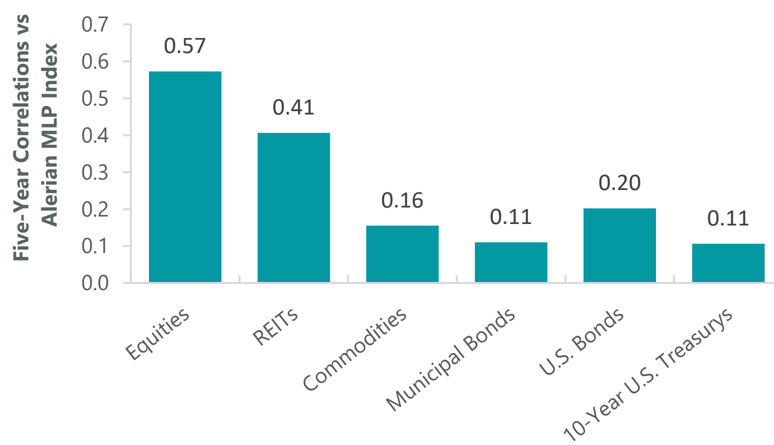
Exhibit 2: Midstream Energy Dividend Yield Vs. Other Securities



As of March 31, 2025. Source: ClearBridge Investments, FactSet.

One potentially overlooked benefit of midstream energy is its low correlation to other asset classes, including to bonds and interest rates, and its powerful role as a portfolio diversifier (Exhibit 3).

Exhibit 3: Midstream Offers Low Correlation to Other Asset Classes



Source: FactSet, as of March 31, 2025. Five-year correlation of Alerian MLP Index (midstream), S&P 500 Index (equities), S&P GSCI Energy Index (commodities), Bloomberg U.S. Municipal Bond Index (municipal bonds), Bloomberg Capital U.S. Aggregate Bond Index (U.S. bonds), Bloomberg Capital U.S. Treasury 7-10 Year Note (10-year U.S. Treasurys), FTSE NAREIT All Equity REITs (REITs).

Portfolio Positioning

We view the best way to take advantage of this opportunity is with an active diversified portfolio emphasizing balance sheet strength, asset footprint diversity and quality, and we have positioned the Strategy to capitalize on the opportunity while using only prudent leverage. On a sector basis, our largest exposure is to diversified energy infrastructure, where our largest holdings are Targa Resources, which is focused on natural gas and natural gas liquids, ONEOK, likewise focused on natural gas, and Energy Transfer LP, which owns and operates natural gas transportation pipelines and storage facilities. These are the largest positions in the portfolio and reflect our conviction that these companies are well-positioned to not only maintain distributions but exhibit growth over time.

Outlook

With high relative yields, expected growth in income, limited interest rate risk and limited commodity exposure, energy infrastructure stocks remain well positioned. The transformed midstream business model, including emphasis on free cash flow after dividends/distributions, balance sheet delevering, share buybacks and dividend/distribution increases, is still in the early innings of being recognized by investors. This, coupled with high current yields, could allow for the midstream sector to experience cash flow multiple expansion (relative to today's undemanding multiples).

We remain opportunistic and tactical in managing through the high level of volatility in the energy market. Oil supply remains adequate for the time being and the risk of escalation of the war in the Middle East involving oil-related infrastructure such as those in Iran appears diminished. We carefully assess our holdings with an eye toward managing successfully through the short-term disruption and thriving in the long term. We continue to believe midstream companies and MLPs represent an attractive secular investment opportunity as the U.S. cements its status as an energy superpower. Such an environment should exhibit sustained hydrocarbon production increases, which can bode well for high-quality energy MLPs as volumes to be processed are poised to increase over time.

Portfolio Highlights

The ClearBridge Energy MLP Strategy underperformed its Alerian MLP ETF benchmark during the first quarter. In terms of absolute performance, all four primary subsectors in which the Strategy is invested made positive contributions, with the diversified energy infrastructure subsector the main contributor.

On a relative basis, the Strategy underperformed due mainly to sector allocation effects. In particular, overweights to diversified energy infrastructure and gathering/processing subsectors and underweights to liquids transportation & storage and natural gas transportation & storage subsectors detracted. Stock selection in liquids transportation & storage and a cash position also weighed on relative results. Stock selection in gathering/processing proved beneficial, by contrast.

In terms of individual holdings, Targa Resources, Genesis Energy LP, MPLX LP, Antero Midstream and Plains All American Pipeline LP were the main contributors. The sole individual detractors were Energy Transfer LP and DT Midstream, while ONEOK, Delek Logistics Partners LP and South Bow were the least positive contributors.

During the quarter we exited South Bow, which had been inherited following its spinoff from TC Energy, Suburban Propane Partners LP, Aris Water Solutions and Brookfield Infrastructure Partners LP.

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