

Pros & Cons of Owning Utilities

Debating the outlook for utilities

Brenda Bloch-Young, September 2, 2020

OLLI Investment Forum

Utilities have underperformed since February

Underperformed the S&P by 21% after 2 years of growth

- This sector tends to underperform coming out of a recession.
- The sector is unlikely to participate in the expected acceleration of earnings growth in the coming months.
- This sector is negatively correlated to interest rates and inflation (both expected to rise.)
- When compared to other sectors, little or no appreciation is expected.
- Many utilities may have been overvalued in this low interest rate environment.

What could make utilities work now?

Stability in earnings through the pandemic?

- An environment of low interest rates for longer than expected and little or no inflation.
- Valuations screen attractive versus bonds (higher yield now than BBB bonds.)
- Electricity demand
- ESG strategies deploying capital to decarbonize is an attractive theme for many investors.
- Democratic sweep in November would boost moves toward clean energy that many utilities are pursuing and include favorable tax incentives.

Morningstar Dividend Investor

September issue leads with 3 pages on utilities

- Dividend Select Portfolio has a 6.2% position in this sector
- Dividend Deferred Portfolio has a 14.2% (difference is MLPs)
- With low yields in bonds over the last several years, investors have used utilities for income. In February, the median price/ fair value was 1.24. That dipped to .76 after the March virus correction. Now, the median is trading at approximately fair value.
- Travis Miller likes EIX, AES, DUK, SO, and NEE
- On August 27th, George Metrou increased the position in FE and reduced the position of D

Morgan Stanley's view

Correlation to financials...?

- Note that utility dividend yields are now above BBB bond yields - a dynamic not seen since 1985.
- Recent underperformance relative to other defensive sectors could make this sector a more appealing defensive play going forward.
- Interest rates and inflation moving higher sooner than most investors expect.

Utilities and Banks foretelling a different outcome. Which one is Right? Utilities underperformance suggest rates are moving much higher while banks underperformance say the opposite. We believe this sets up a very good risk reward trade to own banks/financials either outright or with Utilities as a long on the other side.

XLU

Top 10 holdings, yield 3.29%

• NextEra Energy, Inc.	16.72%
Dominion Energy Inc	8.00%
Duke Energy Corporation	7.16%
Southern Company	6.76%
American Electric Power Company, Inc.	4.74%
Exelon Corporation	4.41%
Xcel Energy Inc.	4.40%
Sempra Energy	4.37%
WEC Energy Group Inc	3.61%
Eversource Energy	3.48%

Maybe utilities do belong in your portfolio now.....?