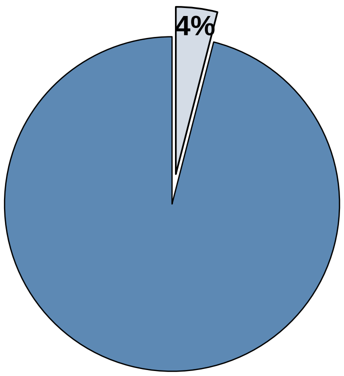
Investing in the Utilities Sector

UTILITIES SECTOR REPORT

Recommended Equity Weight for Utilities: 4%



Companies Mentioned in this Report:

Buy-rated

- **Alliant Energy** - (LNT - $59.98)
- **Ameren** - (AEE - $85.61)
- **American Electric Power** - (AEP - $89.09)
- **Atmos Energy** - (ATO - $99.68)
- **Duke Energy** - (DUK - $106.61)
- **Fortis** - (FTS - $45.35)
- **MDU Resources** - (MDU - $32.45)
- **NextEra Energy** - (NEE - $79.42)
- **Southwest Gas** - (SWX - $72.92)
- **Spire Inc** - (SR - $73.15)

Source: FactSet. Prices and opinion ratings are as of market close on 8/3/21 and are subject to change.

For more information:

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Despite being among the smallest industries in the stock market, we believe utilities can be an important holding in investors' portfolios. Utilities tend to pay a relatively high percentage of their earnings to shareholders in the form of dividends. In many cases, utility dividends grow slowly over time. This growing stream of income can help investors reduce the impact of inflation. Additionally, utilities display defensive characteristics since most customers view their services as essential. For that reason, we believe that traditional regulated utilities are among the companies least affected by changes in the health of the economy. This typically leads to more stable earnings in periods of economic downturns relative to many other industries. In the coronavirus-related market downturn in early 2020, the utilities sector did not act as defensively as we have seen in previous market downturns. Additionally, as may be expected, utility industry investment returns have lagged over the past year as the stock market has recovered and investors have shown a preference for more economically sensitive industries. We believe this has presented clients an opportunity to buy quality utility companies at reasonable prices.

In this report, we will discuss recent developments in the utility industry and summarize our current view on utility fundamentals, as well as discuss how valuation has changed over the past several years:

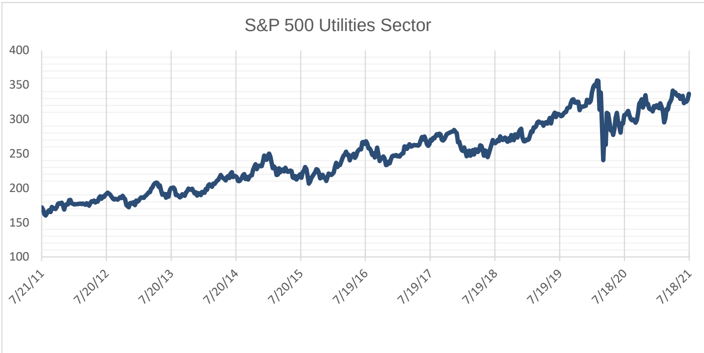
- We believe utility industry fundamentals will remain healthy and supportive of reasonable earnings and dividend growth.
- With utility stocks lagging the returns of the broader market over the past year and interest rates near their historic lows, we believe this has presented an opportunity to buy quality utility companies at reasonable prices.
- In the most recent downturn, utilities stocks traded down with interest rates. That is the opposite of what we have seen historically.

Why have utility stocks done well over the long term?

Utility investors have generally enjoyed good performance over the past decade as well as consistent dividend growth from many utility companies (see **Figure 1** on the next page). We believe a combination of utility-related factors, as well as macroeconomic issues, have created and sustained this positive environment. Within the utility sector, companies increased their emphasis on infrastructure and environmental investments, which has led to improved earnings growth (as utilities are allowed by regulators to earn a specified return on approved investments). This, combined with many utilities' management teams refocusing on core regulated businesses, has been attractive to investors.

Analyst: Mike Doyle, CFA

Figure 1



Source: FactSet, 7/21/21. S&P 500 Index is based on the average performance of around 500 widely held common stocks. S&P 500 Utility Index consists of 28 utility companies within the S&P 500 Index. These are unmanaged indexes and cannot be invested in directly. Past performance is no guarantee of future results.

On a separate plane, macroeconomic factors, such as the ongoing historically low-interest-rate environment and a corresponding lack of options available to investors to generate current income, have helped boost utilities in most years since the financial crisis. Many investors have used utilities and other defensive sectors as substitutes for bonds, as equity dividend yields often exceed bond yields for the same company. This philosophy has worked well in an ascending market for utility stocks, as some investors have been happy to realize significant capital appreciation in addition to healthy and often rising dividend payments. Over time, utility stocks have often reacted to increases and decreases in interest rates. Utility stocks typically have seemed to perform well when interest rates fall (or there is an indication that they will not rise further) and fall when rates rise. That relationship has been less consistent recently.

Utility company fundamentals remain solid

In our view, utility industry fundamentals remain healthy and supportive of reasonable earnings and dividend growth for the next several years. Regulated utilities hold virtual monopolies in their service territories, and they earn an allowed return on approved investments, of which there are hundreds of billions of dollars' worth needed in the U.S., according to independent sources. The national average for allowed returns for both electric and gas utilities remains at just under 10%, a level that we believe will enable utilities to sustain profit growth.

Additionally, many utility companies have realized that infrastructure spending to update, maintain, repair and expand power lines, pipes and power plants is a lower-risk way to grow earnings than diversifying into nonutility businesses. Companies have identified approved projects that they are able to finance and that can potentially lead to higher earnings. We have seen companies focusing on such investments and divesting ancillary, nonutility businesses, leading to more stable, reliable earnings. We believe well-managed utilities can increase earnings at 5% to 6% annually on average for the foreseeable future, with corresponding dividend growth.

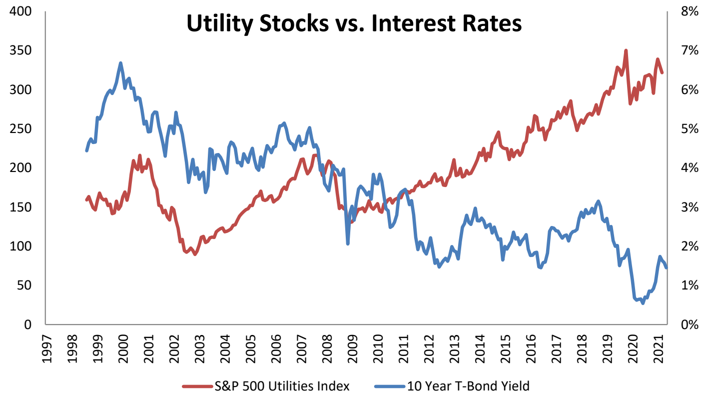
Absolute valuations closer to historical average

Utility valuations have become more attractive as shares have fallen from highs set early in 2020. On a price-to-earnings basis, shares are now trading closer to their historical averages, after trading near all-time highs. Until early 2020 when utilities traded down with interest rates, we generally have seen utility valuations moving in the opposite direction of interest rate movements, although there have been exceptions to this. More recently, utility stocks have seemingly been less influenced by the direction of interest rates. Over time, we believe the low-interest-rate environment has been an important factor in pushing utility stocks higher, since many investors buy them for their dividend yield. However, over the past year utilities have lagged the broader market despite interest rates trading near historic lows. With utility stocks lagging the returns of the broader market over the past year and interest rates near their historic lows, we believe this has presented an opportunity to buy quality utility companies at reasonable prices.

What about interest rates?

Let us look closer at the relationship between utility stocks and interest rates (the 10-year Treasury yield). We believe that investors should be aware that, historically, utility stock prices and the 10-year Treasury yield have tended to have an inverse relationship. This means that when interest rates rise, utility stock prices tend to move down, and vice versa. We have seen a weakening of this relationship since early 2020 (see **Figure 2**), but we believe this has largely been due to unusual circumstances as the coronavirus pandemic unfolded and as the economy recovered from this shock. We do believe that this relationship generally still holds.

Figure 2



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Moves up in rates have often spurred declines in utility stocks, while retreats in interest rates have driven utilities higher. We believe that making interest rate predictions and trying to time entry and exit points for stocks based on interest rate predictions is a risky endeavor. Nevertheless, we caution investors that we believe a significant rise (or indications of a significant future rise) in interest rates could have a negative effect on utility stocks.

Should I adjust my portfolio as interest rates move?

We think it is appropriate to periodically review portfolios and rebalance sector weightings. Certain life events or macroeconomic changes can demand timely examination of portfolios. We are aware that many investors have a weighting in excess of 4% in utilities, and we understand that there may be individual reasons why this is appropriate. Importantly, we recommend investing based on principles and not trying to move in and out of stocks based on predictions, whether for the economy, the stock market as a whole, or interest rates in particular. We believe in diversification and quality and advocate owning a portfolio of dividend-paying stocks for the long run, through the ups and downs of the interest-rate cycle.

Coming out of the recession in 2009, many economists thought interest rates would increase, but they have yet to move significantly higher, relative to historical levels. The main point to remember is that even professionals find it very difficult to predict the direction and magnitude of interest rate changes, so we would not recommend making major changes to portfolios based on predictions. We continue to believe utility stocks have some attractive characteristics, and we believe they should be part of a diversified portfolio, regardless of short-term movements in interest rates.

While utilities offer a number of positives for investors, we note the risk of having too heavy a weighting in any one sector. For those investors whose utility holdings are significantly higher than our 4% recommendation, we suggest looking to the Edward Jones Equity Income Buy List for ideas in other sectors. The Equity Income Buy List consists of a mix of dividend-paying stocks from different sectors recommended by the Edward Jones Securities Research Department. The list is designed to provide an above-average dividend yield and the potential for rising income.

Factors in evaluating utility companies

We look at many factors when developing ratings for our utility coverage. Important factors include the degree of exposure to nonutility businesses, regulatory treatment, and growth potential. We generally prefer companies that derive a very high percentage of their earnings from regulated utility businesses (rather than the nonutility businesses some companies in the industry are involved in). **Duke Energy (DUK)** has divested the vast majority of its nonutility businesses over the course of many years and now earns nearly all of its income from its regulated utilities. We also look for companies that operate under supportive regulatory treatment. **Alliant Energy (LNT)** is an example of a company that operates under very supportive regulation in its service territories in both Iowa and Wisconsin. Finally, we analyze potential for growth at utilities with a preference for those that we believe have significant investment opportunities that can lead to faster growth. **NextEra Energy (NEE)** operates a Florida utility with opportunities to invest not only in new customer connections as Florida's population grows, but also in the hardening of its utility infrastructure to combat hurricanes and other storms that occur in the state. Additionally, NextEra develops renewable power projects (primarily wind and solar power) for other utilities.

Risks besides valuation

Despite their regulated nature, utility stocks carry various risks that investors should consider. Risks to the relative performance of utility stocks would include better-than-expected or faster overall economic growth, evolving or new legislation concerning environmental guidelines and/or renewable power sources, and rising long-term interest rates. Utility-specific risks would include the potential for declining allowed returns, rate-case fatigue as companies repeatedly seek reimbursement of capital spending, fluctuations in commodity prices, and managing regulatory relationships.

Valuation

Methods used to evaluate the attractiveness of utility stocks include traditional measurements such as price-to-earnings (P/E), price-to-book value (P/B), and P/E relative to the summation of our earnings growth outlook and the dividend yield (PEGY), both on an absolute basis and relative to competitors.

Risks common to all utilities include

- Rising long-term interest rates can negatively impact the share price as alternative investments become more attractive.
- Adverse regulatory or legal decisions, as well as significant changes in commodity prices such as for electricity and natural gas, can negatively impact earnings, cash flow and the share price.
- A weak economy can reduce demand and thus negatively impact earnings, cash flow and the share price.

Please see the individual research reports for additional information, including disclosures, analyst certifications, valuation and risks specific to each company.

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I certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers; and no part of my compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in the research report.
Mike Doyle, CFA

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