Energy Infrastructure: we examine a sector whose returns suffered due to aggressive growth and M&A, culminating in a period of 200% underperformance vs. the S&P 500. This unexciting "old economy" sector saw valuations stagnate for years, forcing companies to abandon growth ambitions and focus on capital efficiency. (Hint: we're not talking about midstream). After ~5 years of belt tightening, railroads recaptured investors' attention, and today, after ~20 years of massive outperformance vs. the S&P, railroads are (rightly) celebrated: limited competition, exposure to long-term GDP growth, low capex and massive recurring FCF. Midstream today resembles the early innings of the 2000s railroad recovery: declining competition, low capex, high FCF, with valuations that have been anchored to the negative experiences of the recent past.
Click here for our new midstream white paper, which explores midstream's excess (and growing) yield vs. fixed income

Natural Resources: "Why do inflation hedgers keep reaching for gold?" was the title of our January 2023 monthly investment letter. In that commentary, linked here, we noted that many investors cite a 1970s era positive correlation between gold and inflation. Since the early 1980s, the gold-inflation correlation has fallen notably. In 2023, we found that real yields appeared to offer considerably more explanatory power for gold prices than inflation. However, in the ~2 years since our last gold commentary, we have seen real yields rise markedly (suggesting a negative environment for gold), yet gold prices have risen and gold mining stocks have fallen. Gold has long been an inconsistent inflation hedge, but the idiosyncratic performance of the last 2 years suggests that gold's value as a hedge against low real yields may be diminished as well.
Click here for our 2022 white paper on Shale's increased strategic importance in a time of ESG

October 2024 Performance Summary and Market Commentaries

Please find below performance and commentary for our strategies – MLP & Infrastructure and Natural Resources. See performance tables at the bottom of the commentary. For additional information, please contact us at (832) 241-6400 or info@recurrentadvisors.com.

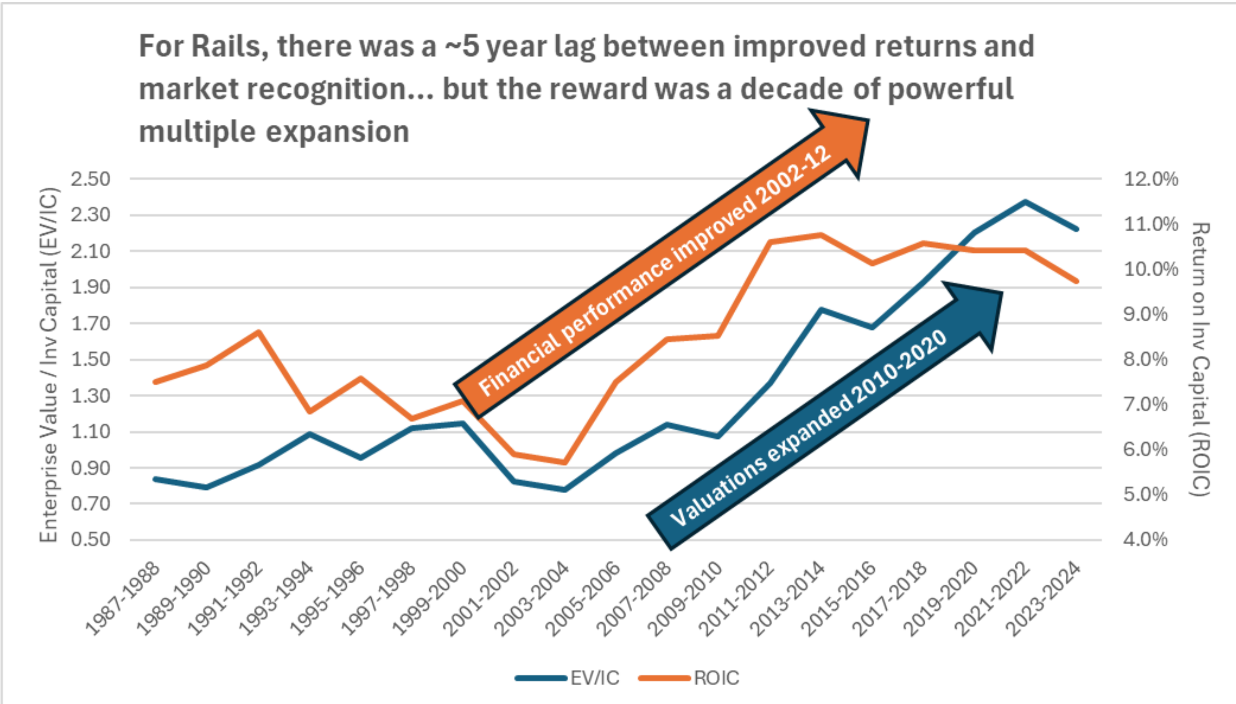
MLP & Infrastructure

Performance review

During the month of October 2024, the Recurrent MLP & Infrastructure Strategy generated net returns of +1.81%, outpacing the Alerian MLP Index's (AMZ) -1.34% return by +3.15%. Since the strategy's July 2017 inception, Recurrent's MLP & Infrastructure Strategy has outperformed the AMZ by +43.46% (+3.40% annualized), net of fees. On a gross basis, the Strategy has outperformed by +64.76% and +4.85% respectively. See performance section at bottom for more detail, plus performance detail on the Recurrent Energy Infrastructure Strategy, which seeks to track the MLP & Infrastructure Strategy while excluding MLPs.

Today, Railroads are considered rock-solid assets, with limited competition and strong FCF – but it was not always this way

Railroads have become "consensus longs" for many asset managers over the last 20 years, as a strong fundamental story and consistent outperformance vs. the S&P 500 tends to do. But many of the attributes cited today – "wide moats," "capital discipline," "highly free cash flow generative" – reflect the improved financial performance that railroads demonstrated during the 2000s and since. For much of the 1980s and 1990s, railroads were poorly run, chasing M&A, expanding outside of their railroad monopolies, and operating with low margins.



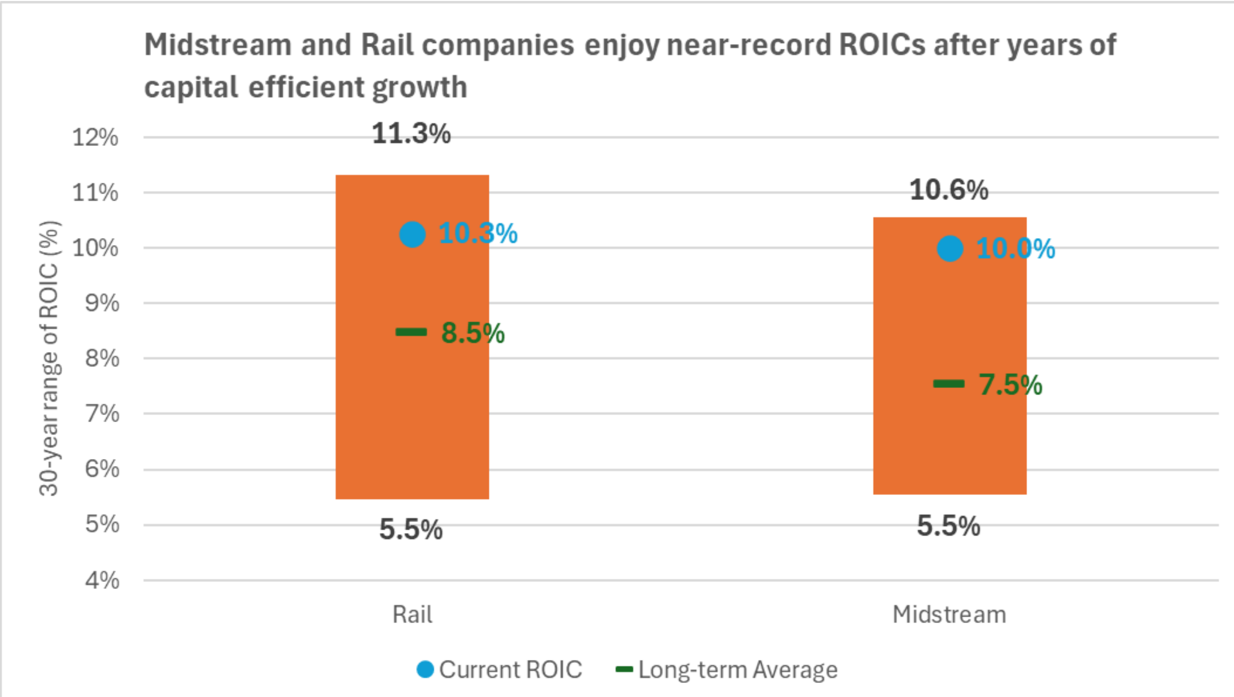
Note: includes large-cap North American railroads (UNP, CP, CNI, KSU, CSX, NSC)
Source: Recurrent research, Bloomberg, public filings

As seen in the graph above, for much of the 1985-2005 period, railroads were valued at or below 1x enterprise value vs. invested capital (EV/IC). A sub-1x valuation reflected the fact that the market expected semi-monopolistic railroads, titans of the American economy, to actually earn less than their cost of capital over time! As it turns out, these concerns were not unfounded: railroad returns on invested capital (ROIC) had been falling for much of this timeframe as a result of poor margins and aggressive asset growth.

In the early 2000s, management teams focused on less asset growth, and greater capital efficiency, pushing returns from 5% to nearly 11% in less than a decade, well above the cost of capital for well-capitalized rails. Given the turbulence of the Great Financial Crisis (GFC) in 2008-2009, railroads initially received little recognition for their efforts, and remained in the 1.0-1.1x EV/IC range for close to 5 years after demonstrating clear improvement. By 2015, ROIC improvements proved durable, and were driving unprecedented FCF. Rail valuations had reached an unprecedented 1.70x by 2013-15, and even as ROICs plateaued over the last decade, multiples continued to expand to the current level of 2.2-2.3x EV/IC.

Today, Midstream is not given anything like the respect (or valuation) of the Rails – are they really comparable?

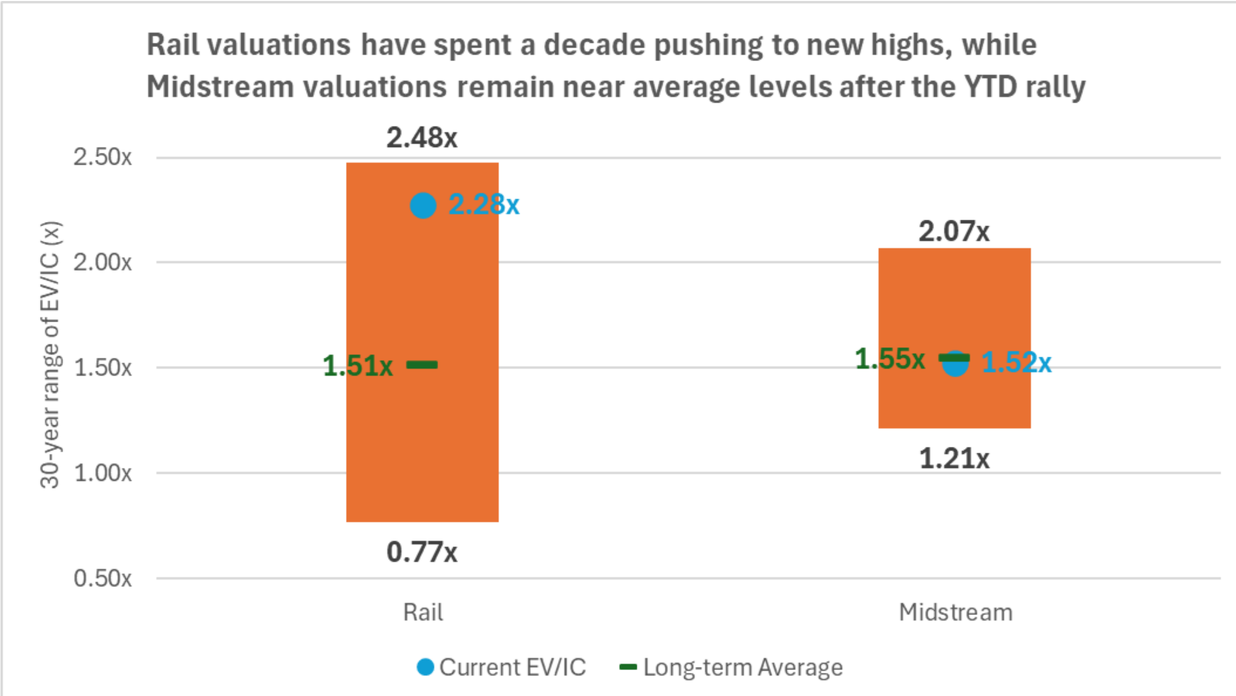
Are railroads really a comparable industry to the pipeline industry? Let's examine the long-term returns on capital shown below:



Note: includes large-cap North American railroads (UNP, CP, CNI, KSU, CSX, NSC) and large-cap North American pipeline companies (KMI, WMB, OKE, TRP, ENB, LNG, MMP, EPD, TRGP, ET, PBA, KEY).
Source: Recurrent research, Bloomberg, public filings

Clearly, the return profiles - both the range of ROICs as well as the potential for high-growth to put very stable assets at financial risk – reflect some obvious similarities, and reflect increased capital discipline in both industries (well-established discipline for rails, more recent discipline for midstream).

Do both industries deserve the same valuation? Interestingly, midstream and railroad valuations have historically averaged approximately 1.5x EV/IC. Today, rails sit near the peak 2.5x EV/IC valuation, while midstream sits near average valuations despite generating near-peak ROICs. Clearly there is a disconnect between midstream returns and current valuations, which sit nearly 40% cheaper than railroads while offering comparable returns.



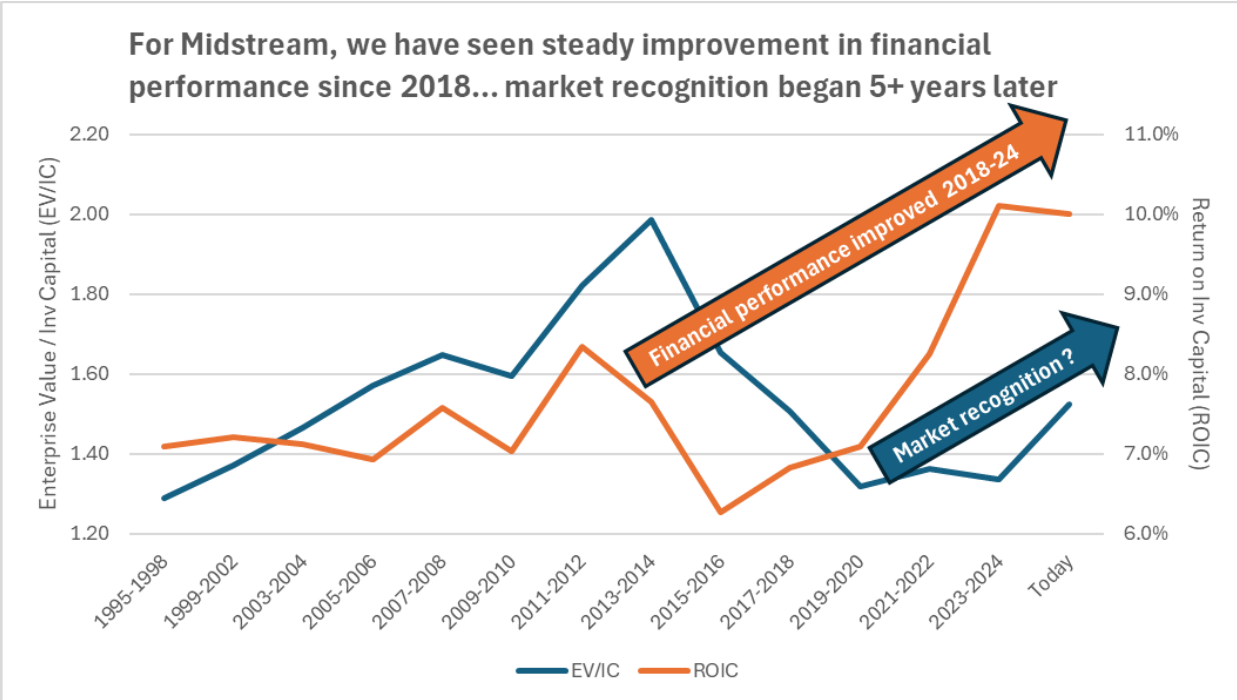
Note: includes large-cap North American railroads (UNP, CP, CNI, KSU, CSX, NSC) and large-cap North American pipeline companies (KMI, WMB, OKE, TRP, ENB, LNG, MMP, EPD, TRGP, ET, PBA, KEY).
Source: Recurrent research, Bloomberg, public filings

Qualitatively, we would argue that both industries possess leverage to long-term US GDP growth, both industries enjoy wide moats created by the difficulties of building new assets, and as non-consumer-facing businesses, both railroads and midstream are relatively lightly regulated with the ability to grow revenues above inflation over time.

One potential argument in favor of a “midstream discount” is ESG, or “terminal value” risk associated with fossil fuels. While this argument was in vogue over the past several years, today the realities of continued energy demand growth since COVID, as well as the potential for future fossil fuel demand growth from datacenters and AI, meaningfully undermines the case for a “terminal value discount”. We believe the reason for Midstream’s cheaper valuation is much more straightforward: multiple expansion requires time and consistent execution. Investors need to be shown.

We believe the persistent “Midstream discount” has a simple explanation: valuations can take years to reflect improved returns

Railroad investors - after nearly 20 years of weak ROICs, thin margins, and empire-building - took 5+ years to recognize the obvious progress made by the railroads in the early 2000s. The GFC compounded this issue as investors were preoccupied by macro risks. Similarly, midstream investors have been slow to capitalize the progress made by midstream companies in increased ROICs over the last several years, with the COVID pandemic playing a similar confounding role as the GFC did for the railroads. As we examine the chart below, the valuation improvements seen in 2024 have been noteworthy, but have still meaningfully lagged ROIC improvements (ROICs are 70% above historical lows, while EV/IC valuations are 25% higher than lows).



Note: includes large-cap North American railroads (UNP, CP, CNI, KSU, CSX, NSC) and large-cap North American pipeline companies (KMI, WMB, OKE, TRP, ENB, LNG, MMP, EPD, TRGP, ET, PBA, KEY).
Source: Recurrent research, Bloomberg, public filings

Natural Resources

Performance Review

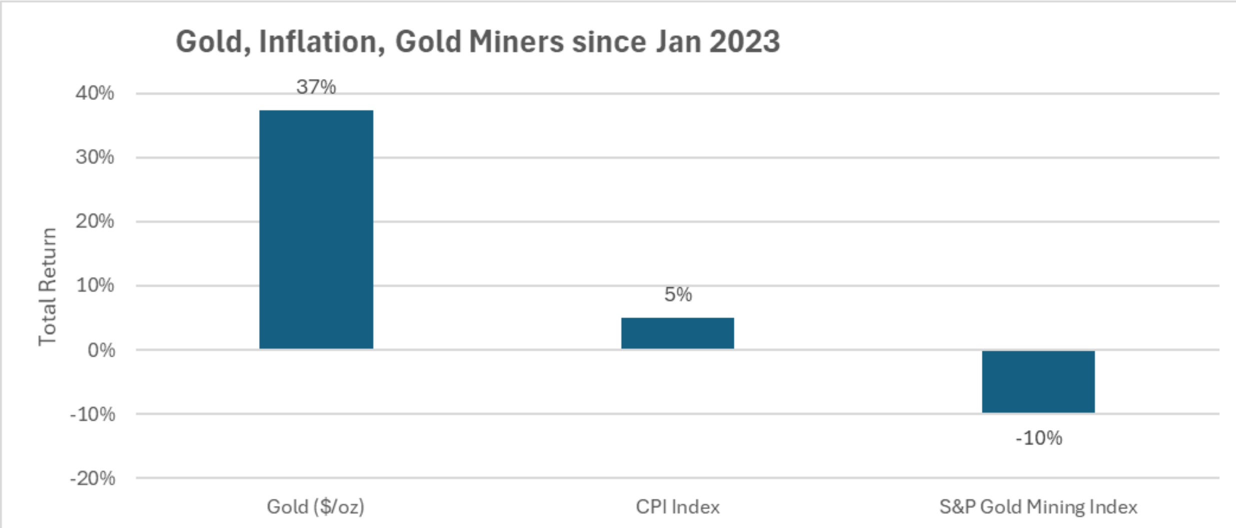
In the month of October, the Recurrent Global Natural Resources Strategy fell -4.72% net of fees, slightly more than the S&P Global Natural Resources Index's -4.48% fall. During the month, the portfolio's chemicals and refining holdings fell nearly 11% and 9% respectively, detracting from relative performance. Portfolio holding Alcoa Corporation increased 4% during the month, adding to relative portfolio performance.

Investment Discussion: Gold...proven to be an inflation hedge???

In our January 2023 monthly commentary, we looked at the commonly-held view that gold and inflation are positively correlated. From that genesis, investors understandably extend the view that inflation and gold mining stocks are positively correlated.

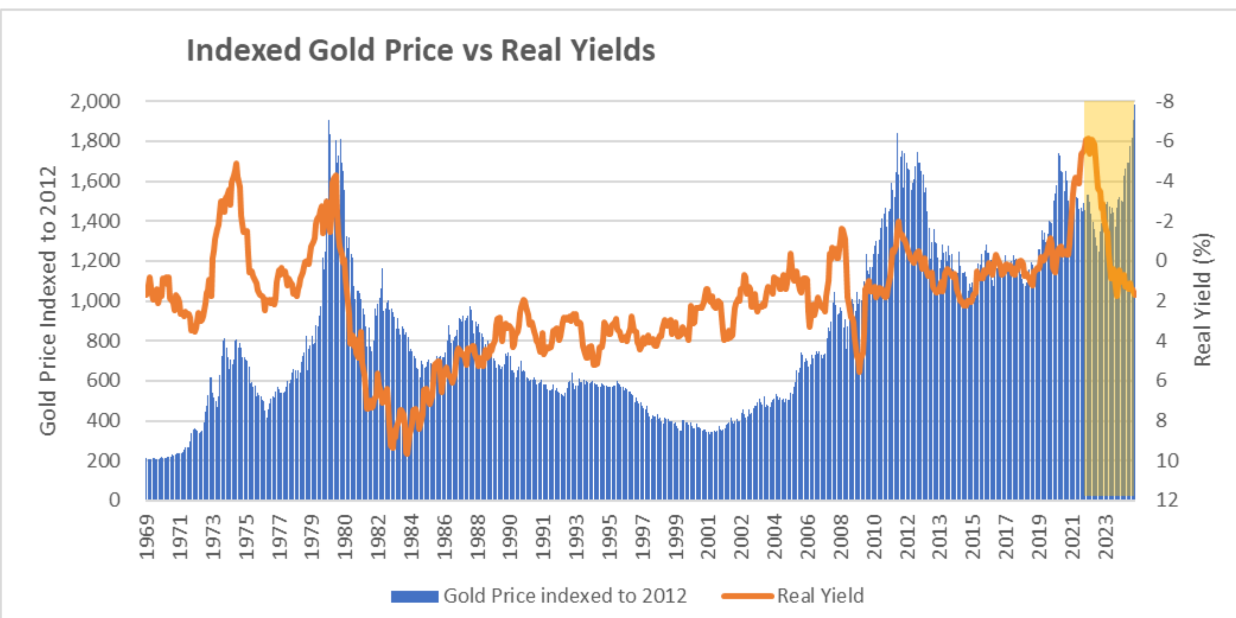
Perhaps the most notable finding from the January 2023 monthly commentary was that the correlations between inflation and gold have been weak since the early 1980s. During the inflationary period of the 1970s, the inflation-gold correlation was at its highest. However, since the early 1980s, correlations between inflation, gold and gold mining companies have fallen. While inflation has been a poor explanatory variable for gold performance since the 1970s, our historical study showed that real yields still offered significant explanatory power, with negative real yield environments often producing the best times to hold gold. Accordingly, the relationship between real yields, gold and gold mining stocks may instead be more relevant than correlations to inflation.

Since our January 2023 monthly commentary, our findings on inflation have been largely confirmed: the relationship between inflation, gold and gold mining stocks has further diverged. While the pace of CPI has fallen to 2.8% CAGR during the period, gold prices have increased 37%. Contrary to conventional belief, the global mining index has fallen 10%! While two years is a relatively short time period in which dislocations can certainly occur, this level of discrepancy is worth noting.



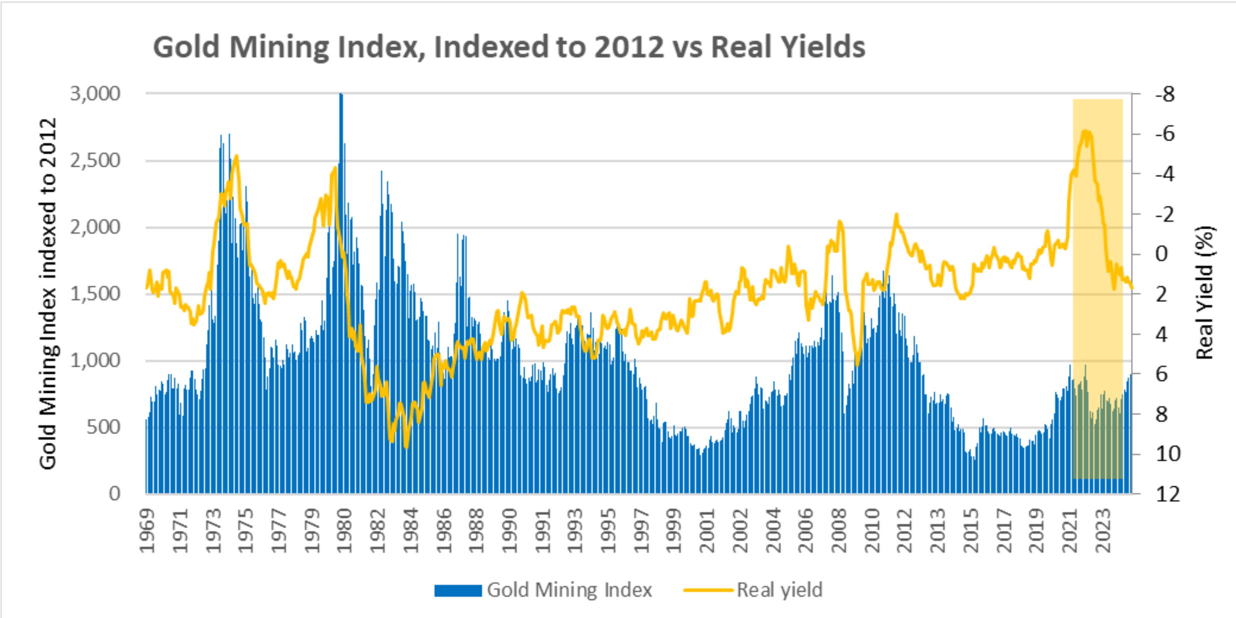
Source: Bloomberg, Recurrent research

Instead of inflation, our January 2023 analysis showed that real yields could prove to be a more valuable indicator to predict gold prices. However, in the last two years the relationship between gold prices and real yields have moved contrary to longstanding historical relationships. Both real yields and gold prices have increased, in contrast to commonly held views. This unexpected divergence can be seen in the highlighted portion of the graph below.



Source: Bloomberg, BGMI, Recurrent research

More interestingly, gold mining stocks continue to move independently from expected relationships with gold prices and inflation. During recent conversations, investors and prospects regularly raise the topic of gold and gold mining stocks. While investors remain convinced of the relationship between gold mining stocks and inflation, the data does not corroborate that perspective, as seen below. Gold mining stocks have not only massively underperformed the commodity, but have remained almost entirely uncorrelated to inflation data (as well as gold commodity prices).



Source: Bloomberg, BGMI, Recurrent research

As we noted in our January 2023 monthly commentary, the 1970s was the peak for gold as an inflation-hedge asset. While our analysis has long shown that many areas of the global economy and markets rhyme with the 1970s, data surrounding gold and gold mining companies has not exhibited similar tendencies in recent years. In fact, the dissimilarities potentially point to idiosyncratic elements of the 1970s gold market (i.e. the political decision to move off the gold standard), which may better offer explanatory power to gold and gold mining stock returns of the 1970s period.

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