Utilities & Telecoms: A Place to "Stay Rich"?

An interview with Ronald Sorenson, CEO of W.H. Reaves & Co.

W.H. Reaves manages portfolios that emphasize growing dividend income streams in the telecom, energy and utilities sectors. They identify companies that are profitable, have good balance sheets, and have a strong track record of paying – and raising – dividends. Connex sat down with Ron Sorenson, the company's CEO and Chief Investment Officer, to discuss the prospects for these sectors, during which he emphasized the continuing importance of technological advancement and regulatory change.

Ron, thanks for joining us. To start off – please tell us a little about W. H. Reaves.

BILL REAVES FOUNDED the firm in 1961, shortly after leaving Kidder Peabody where he was head of research and investment banking for utilities. The focus was on investing in utilities and at that time it was primarily electricity and gas. The next major phase came in 1983 when the justice department ordered that AT&T be broken up and turned into a number of regional telephone companies. Bill Reaves correctly foresaw that the breaking up of the AT&T monopoly would unleash a wave of innovation and competition in the industry, and consequently began following the telecommunications sector too. In 1990 we also began following water utility companies. That's a combined investment universe – in the US and Canada alone – of some $2.2 trillion.

I've been with the firm since 1990 and from my point of view the outlook is as good as it has ever been for these sectors.

You've spoken about utilities and telecommunication equities in the context of inflation hedging and income generation. To focus on the telecommunications piece to begin with – what are the major variables that investors need to be aware of when allocating to this sector?

THE SECTOR IS dominated by two companies: AT&T and Verizon. A portion of their business is the traditional fixed line business, which is declining, but the future lies with the wireless and broadband services that they offer. The companies have great financial strength, they pay very good dividends, and they have a long history of periodically raising their dividends.

Regulation is important: it has a big impact on the sector and it isn't always beneficial. For example, the 1996 Telecommunications Act was not helpful with respect to the ability of telephone companies to earn an adequate return

Ronald Sorenson

Vice Chairman, Chief Executive Officer, Chief Investment Officer and Portfolio Manager

Ronald J. Sorenson joined W. H. Reaves & Co. in 1991.

Mr. Sorenson was elected Vice Chairman and Chief Executive Officer in September, 2005 after previously holding the position of Chief Investment Officer. He is also responsible for portfolio management and development of private client accounts.

Before joining W. H. Reaves, Mr. Sorenson was a co-owner and Portfolio Manager of an investment advisory firm, PVF Inc. He was also Director of the BMC Fund Inc., a closely held mutual fund. He has more than 24 years experience in the investment industry and has served as Chairman of the Board for American Life Insurance Company of New York.

For nine years Mr. Sorenson lived in London, England where he was engaged, on behalf of private investors, in managing investments in the United States in both listed securities and private equity. Before moving to London, Mr. Sorenson practiced public accounting with Arthur Young & Co. where he gained experience with companies in a variety of industries, including energy and technology.

Mr. Sorenson received an undergraduate degree from Stanford University and an MBA degree from Columbia University, where he concentrated in Accounting and Finance. He is a Certified Public Accountant.

on capital investments – the result of that was that the major telephone companies dramatically cut back on their capital investment in broadband services, wireless, etc. The technology sector was deprived of revenues and unfortunately – while we developed the internet in the United States – we rank about 15th in the world when it comes to broadband penetration.

So my advice to investors is to keep an eye on the legislative and regulatory environment, and be aware of the new technology that will continue to drive innovation – and lead to new revenue generating activities – in the telecommunications space.

Now to turn to the utilities sector. Seems like there are a lot of forces pulling in different directions … weak electricity demand, regulatory change, continuing government spending on water infrastructure, for example. How do you see these forces playing out in the mid- to long-term?

BY WAY OF PREAMBLE, you need to understand that we have 50 states with multiple utilities in each state, and within each state there is a distinct regulatory environment. The economic outlook also varies significantly state-by-state.

With that background, you have to do a lot of research and be very discriminating. You are correct with respect to demand for electricity: the economic slowdown has destroyed a certain amount of industrial demand for electric power and it's questionable to what extent it will ever come back. Historically we've had modest growth each year in electricity consumption, but the trend is reversing now … consumers are moving to more energy-efficient appliances and conservation efforts are proving successful. At the same time, however, there are certain technological advances that are enabling the utility companies to reduce their operating costs. One is automated meter reading: in the past you had to have someone go into a home to read a meter, but now in some cases you can read meters directly over the internet, or they can drive by and read the meters. There's another important development with respect to energy conservation – we've all begun to recognize the importance of reducing carbon emissions, but if you have an electric utility industry and the only way you can grow your earnings is by continuously stimulating demand for electric power, obviously you're releasing ever more carbon. But there is a movement afoot in some states to allow energy companies to invest in energy conservation and earn on those investments in reducing consumption. These companies are being correctly incented to reduce carbon emissions.

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What makes these sectors good inflation hedges – and how do they compare with other popular inflation hedges like real assets, TIPS, and precious metals?

THE FIRST THING I'd point out is that companies in these sectors are continuously expanding their earnings. The electric utilities have grown their earnings over the past 5 years; the S&P 500 has not. So you have the underlying companies growing, and they're reinvesting in their businesses, they're investing in hard assets, and the book value is continuously growing for these companies. At the same time, since they're increasing their earnings they can increase their dividends, so the investor can gain access to a rising income stream, and that works to counteract the headwind of inflation. That's also true of gas utilities companies, which are taking advantage of the growing recognition that natural gas is an ecological alternative to oil and coal. Fortunately, technological advances in natural gas exploration activities have dramatically increased natural gas supplies.

Your investment strategy places a great deal of emphasis on identifying companies with a strong track record of paying dividends, yet you don't pursue the highest dividend yield. Talk to us in a bit more depth about the selection process at W. H. Reaves and what characteristics you look for in prospective investments.

RS: Bill Reaves understood how important it was to do your own research – if you use other people's research there's a strong chance someone else will already have exploited the opportunity when you hear about it.

At W. H. Reaves we look for companies that are profitable, we look at companies that are able to grow their earnings, we look at companies that have a commitment to and history of raising dividends, and we also look for companies that are operating in a state which has a supportive regulatory environment.

If you're rigorous in your selection process, it pays off. For example, during the very difficult economic period we've just emerged from, we did not experience a single dividend cut from any of the utilities in our portfolio.

Finally Ron – what are you most concerned about regarding the direction of the US economy? And what gives you most cause for optimism?

THE UNCERTAINTY WITH respect to tax policy is of concern to the utilities sector. Tim Geithner said recently that dividends won't be taxed at more than 20%, whereas they're currently taxed at 15%. Another source of uncertainty is carbon legislation – we haven't really dealt with that issue yet, and it's not clear whether unreasonable demands will be placed on utilities companies. At the same time, however, there's a great deal of cause to be optimistic about the prospects for a new wave of nuclear power plants. Aside from the ecological benefits of nuclear power, you need to bear in mind that these plants cost billions of dollars, they employ thousands of people for a long time, and once they're in operation they pay local property taxes and provide the cheapest power.

To conclude, I'd argue that the real beauty of a utility stock is that – in contrast to bonds – it has a rising income stream, your underlying asset value is growing, liquidity is superior, and the allowed return on equity can be positively (rather than negatively) impacted by rising interest rates when regulators set rates taking into account such increases.

I asked Warren Buffet a couple of years ago why he was investing in utilities and he said: "it's a great place to stay rich."