
Reaves Asset Management

Review and Outlook

First Quarter 2016

OVERVIEW

The ERISA Composite¹ significantly outperformed the broad market measured by the S&P 500 Index² on strong positive contributions from utilities and communications holdings. Although negative for the quarter, returns for the energy sector turned positive in March following declines in January and February.

With the Federal Reserve's December 17th interest rate increase completed and the probability of four additional Fed increases in 2016 greatly diminished, the utilities sector experienced significant money inflows throughout the quarter. In early March, the Fed softened its December view, suggesting it might only raise rates two times this year and implicitly acknowledging that U.S. monetary policy is partly influenced by global economic factors.

UTILITIES

Large money flows entered the sector anticipating a more dovish stance at the Federal Reserve and a decline in the 10-year U.S. Treasury yield from 2.3% on December 31, 2015 to 1.8% on the last day of the quarter. Mergers and acquisitions (M&A) speculation bolstered investor sentiment. ITC Holdings Corp. agreed to be purchased by Fortis Inc., a Canadian utility; Dominion reached an agreement to acquire Questar Corp. in an all cash transaction; and Westar Energy announced it was undergoing a strategic review. The acquisition of Cleco Corp. by Macquarie and other private buyers, initially rejected by at the Louisiana commission, was subsequently authorized on re-hearing. Exelon's acquisition of Pepco Holdings was approved in Washington, D.C. – after two previous rejections.

In what we consider a marginal negative to the utilities industry, the Supreme Court issued a stay on the Clean Power Plan (CPP), pending the resolution of legal challenges currently before the D.C. Circuit of the U.S. Court of Appeals. The plan would be generally good for most utilities as it calls for large investment in renewable and gas-fired generation.

While the CPP is significant to the long-term growth trajectory of the industry, its impact on the near and medium-term earnings outlook is decidedly less so. If implemented, we expect that the CPP will be a major driver of earnings growth in the next decade. The new Supreme Court justice is likely to be the swing vote when the case, as most observers expect, is finally decided on its merits by the Supreme Court.

Independent of the Supreme Court's decision, Oregon recently enacted legislation that calls for a 50% renewable energy mandate by 2040. This will require Portland General to make several billion dollars of investment, leading to outsized rate-base and earnings growth. Utilities rarely have the ability to plan more than a few years ahead because state energy policy often changes with elections. Utilities with visible, long-term rate-base growth, like Atmos Energy's long backlog of pipeline replacement projects, are often rewarded with premium valuations.

American Water Works was added to the S&P 500 during the first quarter. The stock has been a top performer while also being among the least volatile. The business model is simple – replace old pipe with new and purchase municipal systems that require significant investment for safety reasons. Much of the water infrastructure in the United States is in disrepair, e.g. Flint, Michigan, with significant amount of pipe that needs to be replaced. American Water Works should be able to grow its asset base by close to 10% per year for a long time.

COMMUNICATIONS

Cable investments contributed positively to portfolio results during the quarter. In particular, shares of Charter Communications and Time Warner Cable – proposed merger partners – rallied as investors grew more optimistic about regulatory approval prospects with several state approvals and the perception, from ex parte filings at the Federal Communications Commission, that Federal regulators had begun to negotiate conditions to the deal's approval. Our view

is that the combined company has the potential to grow materially its cash flow for years to come. We remain constructive on the cable sector overall, as market share gains in high-margin consumer and broadband services persist and show signs of acceleration. What's more, Charter and Time Warner Cable collectively added video subscribers in 2015 for the first time in a decade, while Comcast barely missed turning positive. Cable's operating performance suggests that investor alarm about cord cutting may be overdone. For now the video distribution business is alive and well.

Investors' search for safety and income benefited telecom stocks in general and Verizon, a composite holding, in particular. Additionally, shares of long downtrodden Frontier Communications provided an outsized positive return. Demand for yield, and anticipation of the closing of the company's accretive purchase of certain Verizon properties, motivated investment into the stock.

Tower stocks shook off an inauspicious start to the year to provide a positive contribution by the end of the quarter. An early January news report that Sprint was considering a radical rebuild of its wireless network led previously sanguine tower investors to shed holdings. A recovery in the sector took place coincident with commentary discrediting the report on the earnings calls of tower companies, wireless competitors, and even Sprint itself. More broadly, while some wireless carriers have slowed the pace of investment in their networks a bit, we continue to be rather positive on the tower business. We are encouraged by the constant need for investment in the ultra-competitive U.S. wireless segment, the expectation for churn levels – above normal due to recent M&A – to return to normal, and the significant amount of wireless spectrum coming to market in the coming years.

ENERGY

During the period, the average price of West Texas Intermediate (WTI)³ grade oil continued to decline from the fourth quarter, but ended the first quarter well above the January low of \$26.68/bbl⁴. Despite rising domestic inventories and disappointing global demand, markets recovered, settling in the high \$30s. This was in response to further economic stimulus from central banks in China and Europe, as well as a swing to a more dovish rate policy from the U.S. Federal Reserve. Companies with poor balance sheets and lower-quality resource bases greatly outperformed their healthier peers.

While we do not expect an immediate oil price turnaround, our 12-18 month outlook remains generally sanguine. We continue to believe that global oil markets should be relatively balanced by late 2016 as worldwide production declines begin to reduce global inventories while demand continues to grow. By mid-2017, the oil market may well be undersupplied, justifying higher prices. Futures prices tend to discount a forward outlook well in advance, so the impact of lower supply and higher demand should be seen in commodity strip prices by mid-to-late 2016 and should set the stage for a broader and healthier recovery in oil sensitive shares, underpinned by real buying, as opposed to the panic-driven short-covering of the first quarter.

While we see recovery, our best guess is that it will be tempered relative to previous cycles and that growth will be slower for all but very low-cost producers. As such, we think industry activity will likely plateau at what before might have been considered “mid-cycle” levels. This means there is likely to be less need for oil services, tools, rigs and incremental associated pipeline and processing infrastructure than in previous upcycles. Such an environment will most likely lead to further consolidation as companies seek to gain scale and reduce costs. In the oil services sector the top three companies are currently involved in deals. This phenomenon is also evident in the energy infrastructure space, especially among companies operating in Appalachia, where infrastructure development needs remain acute. For example, Columbia Pipeline Group agreed to be acquired for cash by TransCanada Inc. during the quarter. We expect ongoing consolidation, especially among upstream producers as banks complete their resource base reviews and access to credit becomes less available.

OUTLOOK

The returns for the quarter were achieved with much less volatility than that of the S&P 500. The earnings outlook and dividend growth expectations for composite investments are unchanged. The continued strength of the U.S. dollar erodes corporate earnings. Negative interest rates and continued quantitative easing with little or no inflation stimulated are indications of ongoing economic weakness outside the U.S. The majority of composite holdings are not subject to macro-economic risks external to the U.S. It is reasonable to expect interest rate increases in the future; however, the earnings and dividend growth of composite investments are sufficient, in our opinion, to more than offset the headwind of gradually rising interest rates.

For further information contact:
Rowland O. Wilhelm, Jr.
Vice President, Director of Sales and Marketing
Reaves Asset Management
10 Exchange Place, Jersey City, New Jersey 07302
Telephone 201.793.2383
Fax 201.332.8593
rwillhelm@whreaves.com
www.reavesassetmanagement.com

¹ *The Reaves ERISA Composite reflects the dollar-weighted return of all corporate ERISA pension accounts with assets of at least \$1,000,000 under management. All references to performance and holdings reflect the Reaves ERISA Composite. This quarterly commentary covers the period 12/31/15 through 03/31/16*

² *The S&P 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. The typical Reaves portfolio includes a significant percentage of assets that are also found in the S&P 500. However, Reaves' portfolios are far less diversified, resulting in higher sector concentrations than found in the broad-based S&P 500 Index.*

³ *West Texas Intermediate (WTI), also known as Texas light sweet, is a grade of crude oil used as a benchmark in oil pricing.*

⁴ *\$26.68 per barrel of oil*

This commentary has been prepared solely for informational purposes and is not to be construed as providing investment services. Opinions and estimates are as of a certain date and subject to change without notice. Past performance does not guarantee to future results. Any investments may not be suitable for everyone. An investor should consider investment objectives, risks, charges and expenses carefully before investing.