Reaves Asset Management

Review and Outlook

Fourth Quarter 2012

OVERVIEW

During the 2012 fourth quarter, both the utilities and telecom sectors experienced some profit taking and stock prices of companies in both industries declined from the highs reached in mid-summer. As of December 31st, the Utilities Select Sector SPDR Fund (XLU)[1] was down about 8.9% from its 7/30/12 high of $38.23. In part, we think the decline was due to market concerns about a substantial rise in U.S. taxation rates on dividend income. We now know that U.S. rates on dividend income will move from 15% to 23.8% – a more benign outcome than many were expecting. Importantly, dividends and long-term capital gains will continue to be treated equally, alleviating concerns that favorable tax treatment for capital gains would distort dividend payout policies at U.S. companies.

Utilities

Although the utilities sector's returns in our portfolios were negative, they outperformed the S&P 500 Utilities Index[2] in the fourth quarter. An important contribution to benchmark outperformance was the underweighting of electric utilities whose primary business is merchant generation.

During the quarter, it became more evident to investors that the Federal Energy Regulatory Commission (FERC) would continue to support transmission investment.

In 2012, 33 electric and gas utilities raised their dividends. The average increase was 4.1%, excluding the four utilities that raised their dividend over 10%. Twelve companies raised their dividend by 7% or more. The outlook for dividend increases in 2013 remains positive and we expect an experience similar to 2012.

Fear of material decreases in allowed returns on equity (ROEs) for regulated utilities has been a concern of investors throughout this multi-year period of low interest rates. 2012 was generally a constructive year in terms of rate activity. State commissions issued 108 final rate orders, with an average increase of $30 million (vs. $60 million requested – in keeping with the typical relationship between companies' requests and the final order). We would highlight, that despite a fall in 10-year U.S. Treasury interest rates of over 33% (from a 2011 average of 2.77% to a 2012 average of 1.79%), the average allowed ROE only fell from 10.2% to 10.1%. We believe that state commissions remain committed to keeping their utilities financially healthy, with stable rates and, with respect to job creation, providing incentives to attract investment into their states. In addition, utilities are often among the largest property tax payers within their service territory.

Telecommunications

Telecom, the highest yielding sector of the composite, delivered a negative total return. Undoubtedly there was some profit taking in the fourth quarter as a result of uncertainty about future taxation of both dividends and capital gains.

Two important announcements occurred regarding mergers in the wireless space. Deutsche Telekom announced that its T-Mobile USA unit would merge with Metro-PCS. Two weeks later, Softbank, the number two wireless carrier in Japan, announced it was taking a 70% majority stake in Sprint for $20 billion. Both transactions require approval from the Federal Communications Commission, the Department of Justice and various state public utility commissions.

The two proposed transactions raise the possibility of intensifying wireless competition that could eventually pressure industry margins. The heightened probability of a more competitive environment increases the attractiveness of the tower companies and providers of communications infrastructure. While these companies are not classified as telecoms, they provide infrastructure critical to the wireless service providers.

The wireline industry continues to derive growth from providing video, broadband and ancillary services. Selected cable companies are well positioned to provide these services in the consumer and small/medium business segments because of their past investment in high-speed broadband assets. In the evolving “rural telecom” sector, we think the ability to offer high-speed broadband and video services will continue to be a differentiator among competitors.

Energy

Energy equities, sensitive to macroeconomic conditions, generally performed poorly in the quarter, despite relatively firm commodity prices. Global oil prices declined slightly in response to fears that failure to reach a “grand bargain” on U.S. fiscal spending and taxes would tip the U.S. economy and possibly the global economy back into a recession.

Companies, including railroads, which provide the gathering, processing, and transmission facilities necessary to develop shale-based oil and natural gas resources are a particular focal point of our investment interest. One particular catalyst that we are looking for in early 2013 is U.S. approval of the Keystone pipeline. This is a long-delayed pipeline which would provide crude oil transport from Canada to the U.S. Gulf Coast.

Domestic oil is experiencing a production renaissance from shale, albeit not quite to the extent of U.S. natural gas. We believe that U.S. and global crude oil price benchmarks will continue to diverge, with U.S. benchmarks lagging global ones. Relatively less expensive U.S. oil and natural gas can provide a long-term energy cost advantage for domestic consumers of both oil and natural gas. As such, we expect to see increased investment in key consuming industries like petrochemicals, refining, and manufacturing which, in turn, will spur new demand for pipelines and processing infrastructure. Gas utilities should experience volume growth.

OUTLOOK

A 10-year U.S. Treasury yield over 3% and rising short term rates? GDP growth over 3%? Rising inflation? Not likely in 2013. A new high in U.S. oil and natural gas prices over $5.00 per mcf? Growth in electricity consumption and electricity prices? Not in likely 2013.

Stock market volatility may well accompany what promises to be a passionate and protracted debate in Washington D.C. over the debt ceiling and a host of fiscal-policy matters. The multi-year downward trend in inflation and Treasury bond yields will likely persist until excessive debt issues are resolved.

A portfolio comprised of companies providing essential products and services, which are growing their earnings and dividends and are well financed, has the potential to consistently compound value and deliver good returns to investors. The downside support from highly predictable revenues and earnings, superior dividend yields and a record of relatively lower market volatility should serve investors well.

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[1] *The Utilities Select Sector SPDR Fund (XLU) invests primarily in companies that produce, generate, transmit or distribute electricity or natural gas. As of 12/31/12, there are 33 companies in the Utilities Select Sector SPDR.*

[2] *The S&P Utilities Index is a capitalization-weighted index containing 31 electric and gas utility stocks (including multi-utilities and independent power producers). Prior to July 1996, this index included telecommunications equities. This equity index does not currently have telecommunications or energy equities that are contained in the Reaves ERISA Composite.*