Reaves Asset Management

Review and Outlook

Fourth Quarter 2013

OVERVIEW

Several developments in the quarter ended December 31, 2013 suggest continued growth opportunities in energy and utilities. In a press release dated December 18th, the Federal Reserve (the Fed) stated:

"In light of the cumulative progress toward maximum employment and the improvement in the outlook for labor market conditions, the Committee decided to modestly reduce the pace of its asset purchases".

For the fourth quarter, the month of December and the week subsequent to the Fed's statement each sector of Reaves' ERISA Composite[1] had a positive total return, confirming our expectation that the impact of implementing the taper was largely discounted by the market in the spring of 2013.

Secondly, we believe that the energy revolution in North America is firmly underway and probably accelerating. In October, based on U.S. government data, U.S. crude oil output exceeded imports for the first time in 18 years. In December, Mexico passed a constitutional amendment breaking the decades-old monopoly enjoyed by Mexico's national oil company, Petroleos Mexicanos (Pemex). It is particularly significant that the constitutional amendment ***allows companies the option to share in the actual oil production, or to contract independently of Pemex.*** Legislation to implement the constitutional amendments will be drafted during 2014.

Mexico now has the potential to experience the energy renaissance taking place in the United States and modernize its economy on the back of energy reform, while providing growth opportunities for domestic and foreign energy companies.

Similar to the third quarter, the ERISA Composite posted two months of positive returns and one month of modest negative returns resulting in a solid positive return for the quarter of 4.70%. Volatility, as measured by the VIX[2], peaked at 20.34 on October 8th, declined nearly 300 bps on December 18th, the day of the Fed's taper statement, and continued to decline closing out the year at 13.72.

ELECTRIC AND GAS UTILITIES

Portfolio utilities' performance was helped by the positive returns of selected regulated utilities, particularly those with exposure to transmission and renewables. The relative composite return benefitted from the weak performance of the highly underweighted merchant generators. The gas subsector produced the best returns. ONEOK's margins benefitted from recovering natural gas liquids (NGLs) pricing. Notably, ethane prices rose 9% for the quarter and propane rose 18%. The rise in propane continued a major price recovery in 2013 (over 40%), driven by the development and commercial operation of new export capacity. OneGas, ONEOK's gas utility, will be spun off to shareholders in the first week of February.

Controversy over allowed returns for electric transmission persists. On November 12th, a group of large industrial and commercial electricity consumers filed a complaint with the Federal Energy Regulatory Commission (FERC) alleging that owners of electric transmission were allowed rates of return that were unjust and unreasonable in today's low interest-rate environment. This so-called Section 206 complaint was the first of its kind in the MISO (Midcontinent Independent System Operator, Inc.) region. There are 13 cases at the FERC regarding reviews of transmission ROEs. The New England complaint is the only one that the FERC has agreed to consider. We expect the FERC to issue a constructive final order in 2014. The current base rate ROE of 11.1% may be subject to a small reduction. Our expectation is based on the belief that the FERC wants to maintain attractive incentives for transmission investment. Resolution of the uncertainty surrounding the allowed ROE for transmission investment should improve investor sentiment toward transmission investment.

During the quarter, the dialogue around the implications of increased deployment of distributed (or roof-top) solar generation gained increased notoriety. At issue: homes with installed solar capacity have a lower demand for energy from the grid, but the same demand for capacity (standby power). Since power bills are generally a function of volumetric consumption of energy, a subsidy can begin to emerge. This situation is most acute in places with high deployment such as Arizona as well as California, where the situation is exacerbated by a highly-tiered rate structure. We note that a number of states are starting to make modest adjustments, such as implementation of fixed charges, to address the problem constructively.

ENERGY

During the period, U.S. oil price benchmarks e.g., West Texas Intermediate, declined while global benchmarks e.g., UK Brent, remained stable. Increased production from Texas and North Dakota, accompanied by increased pipeline and rail availability, pressured domestic prices. Crude oil imports fell to a multi-decade low as refiners were able to source crude oil feedstock from local sources at advantaged prices. Global prices remained relatively stable because of ongoing Libyan production shut-ins and relatively strong emerging market and BRIC demand. U.S. natural gas prices rose due to extreme cold weather in much of the U.S. The relatively lower oil price in the U.S. favored super majors with large downstream and chemical operations. Our investments in takeaway infrastructure continued to generate strong positive returns.

Prospectively, our energy investments remain concentrated in subsectors we believe will benefit from investment required to develop new shale resources. While we do not see material upside for U.S. crude oil or natural gas prices, we do believe that companies with the ability to grow volumes and those investing in volume related infrastructure will do well. The Department of Energy's Energy Information Agency reported that domestic oil production reached 7.75 million barrels per day in October, an increase of over 800,000 barrels per day, or just under 12%, versus October of 2012, and the most the country has produced since the mid-1980s. This increase has material, positive implications for energy investment and for domestic, energy consuming industries.

TELECOMMUNICATIONS

Telecom, including cable and tower company holdings, outperformed the overall portfolio on superior results from investments in the cable and tower industries, both of which we include in our definition of the sector. Subsequent to quarter end, we trimmed our position in U.S. telecom holdings. We are becoming increasingly concerned about the competitive intensity in the U.S. wireless market that could result in lower margins for all the players.

OUTLOOK

A principal concern of investors is and has been Federal Reserve interest-rate policy. The Fed committed to implement the taper in January, and our clients' portfolios have not been adversely affected. Given the continued economic weakness, and the high level of unemployment, we do not foresee another material interest-rate increase. Market factors indicate that with a 1.5% inflation rate it is reasonable for the ten-year U.S. Treasury to trade in a narrow range around a 3.5% mid-point. Currently the ERISA Composite yields about 2.8%, and we look for 3.0% to 4.0% dividend growth together with mid-to-high single-digit earnings growth.

Some investors' conclusion that rising interest rates will permanently impair our clients' portfolio's performance is based on a backward look into the '70s, '80s and '90s when high and possibly rising inflation was a concern. An analysis of the current low growth, low inflation environment in a world where supply is plentiful and demand insufficient suggests a compelling case for our income-oriented investment approach. Our portfolios provide a competitive level of current income which is rising and tax advantaged. The income component dampens portfolio volatility. The income and dividend-paying ability of the portfolio companies is derived largely from non-discretionary revenues generated from ownership and operation of real assets.

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
rwilhelm@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 09/30/13 through 12/31/13.*

[2] *The Chicago Board of Options Exchange Volatility Index (VIX) represents one measure of the market's expectation of stock market volatility over the next 30-day period.*