Reaves Asset Management

Review and Outlook

Fourth Quarter 2014

OVERVIEW

The ERISA Composite[1] posted a positive total return for the quarter; however, volatility returned with a vengeance. On a positive note, utilities, cable and tower companies, telecoms and railroads all delivered positive total returns. Declines in oil, gas and oil-service holdings offset much (roughly 80%) of the positive return from the balance of the portfolio. While it is of little consolation that no one anticipated the steep decline in the price of Brent and West Texas Intermediate crude oil, perhaps the biggest surprise was Saudi Arabia's decision to maintain its output and let market forces set the price of oil. We expect the decline in oil prices will result in reduced capital expenditures by oil-producing companies, leading to reduced revenues and earnings for oil-service companies. Finally, the strength of the U.S. dollar dampens the global demand for oil.

UTILITIES

The S&P 500 Utilities Index[2] delivered a 13.19% return in the quarter. The period was characterized by a climate of slowing global growth, falling interest rates, a flattening yield curve, declining oil and natural gas prices, and a strengthening U.S. dollar. It appears the prospect of global deflation as a major economic trend stimulated investor interest in the relative stability of utility earnings and dividends. Increased merger and acquisition activity raised additional investor interest. An investor group led by Macquarie Infrastructure and British Columbia Investment Management announced the acquisition of Cleco Corporation, a Louisiana utility and Nextera Energy agreed to acquire Hawaiian Electric Industries.

Two developments during the quarter helped boost the stock performance of utilities with solid-fuel generation. Overall, the outlook for increased power prices has not improved but the price of power, relative to gas, has. The forward price of natural gas (as measured by the 2016 calendar strip) fell 25% during the quarter, partly as a consequence of a generally weak energy commodity environment, no doubt influenced by a forecast of warmer than normal weather. Conversely, the forward price of power for 2016 at PJM (the regional transmission organization responsible for electric markets stretching from Chicago to the Mid-Atlantic region) fell only about 7%. This reflects, in part, the market premium assigned to the forward price of power in anticipation of a number of coal-fired plant retirements expected this year as the industry works to comply with the EPA's Mercury and Air Toxic Standards (MATS) rules. Additionally, proposed changes to PJM's capacity market to enhance reliability during periods of peak power demand suggest greater revenue opportunities for generators. The proposals include the creation of a new Capacity Performance product, which will give generators with a reliable on-site fuel supply (e.g., coal, nuclear or fuel oil) the opportunity to sell a premium-priced product.

ENERGY

Prior to the fourth-quarter decline in oil prices, we maintained the view that there was little prospect of higher prices. The energy portfolio was positioned to minimize commodity risk and benefit from owning companies with growing earnings from investment in essential infrastructure or providing a broad range of services. Alas, the approximately 50% decline in crude oil prices and 40% decline in natural gas prices was accompanied by indiscriminate selling throughout the energy sector.

Composite energy holdings underperformed broader energy benchmarks such as the S&P 500 Energy Index[3]. This was surprising given what we believed to be a defensive positioning in the sector. There was little evidence of any company-specific fundamental factors driving pricing. As such, our discussion of the quarter will focus on the macro underpinnings.

While economic conditions remain relatively healthy in North America, in Europe deflation fears have increased and the euro has weakened. Given that global commodities, in particular oil, are priced in U.S. dollars, a strong dollar is generally negative for demand. While global demand was "flattish", supply continued to rise. Libyan production, about 200,000 barrels per day (b/d) in the second quarter, was as high as 800,000 b/d in the fourth quarter (although it has subsequently fallen below 200,000 b/d because of renewed fighting). U.S. production also continued to grow rapidly, adding about 1.3 million b/d of capacity over the past 12 months.

The Kingdom of Saudi Arabia's stated objective of maintaining market share effectively started a global price war. While the kingdom's unit production costs are low, we believe that when social costs are factored in and based on the kingdom's 2015 budget, a price of $100+ per barrel is required to balance the budget. The 2015 revenue budget implies the kingdom expects to receive a price of approximately $65 per barrel. The kingdom has accumulated monetary reserves estimated at $750 billion. Therefore, the Saudi's can weather a prolonged period of weak crude oil prices. It is likely to take some time for the market to find the equilibrium price for oil.

We expect that a period of lower oil prices will force activity curtailment, especially in North American shale, where costs are higher. This should be partially offset by improving technology and efficiency, but not fully, so that by the end of 2015 we anticipate that U.S. production will, at a minimum, stop growing and possibly even start declining. This should improve the price outlook for global oil, particularly for forward years, providing relief to the lower cost domestic producers where we tend to concentrate our investments.

U.S. natural gas prices also fell in the quarter due to warmer than normal winter weather which reduced seasonal heating demand. Lower oil prices should help reduce gas supply as operators will be less inclined to drill mixed oil and gas wells based on the economics of the oil produced. However, there are several reasons that could cause, probably over a multi-year period, spot prices to rise. Increasingly, utilities are switching to natural gas from coal, and industrial demand is growing. Also, the U.S. is developing an export market for gas.

TELECOMMUNICATIONS

There was no pause in U.S. wireless price competition during the fourth quarter. For evidence, witness Sprint's new TV advertising campaign starring former AT&T and Verizon customers provided with chainsaws (among other tools) to cut their bills in half by switching to the smaller carrier. We don't anticipate improved wireless pricing in the near term, and have continued to pare back our exposure accordingly. Reductions in U.S. wireless holdings funded investments in tower operator Crown Castle (CCI) and broadband infrastructure provider Cogent. The former fits neatly with our thesis that increasing competition for wireless network supremacy will disproportionately benefit tower operators. While CCI lacks the growth profile of its larger peer AMT, CCI's more robust dividend policy, coupled with the attractive contract price escalators of the tower industry, provide solid total return potential and downside protection in volatile markets. As for Cogent, we think it's a fairly unique investment – an underleveraged, fast-growing, infrastructure-provider with limited capital-investment needs. We believe the company has built an enduring cost advantage that should help support a policy of returning cash to shareholders, while limiting the impact of potential customer defection in response to evolving content delivery methods.

U.S. cable stocks had an eventful quarter, highlighted by President Obama's public statement in support of reclassifying broadband as a Title II telephone service under the Communications Act of 1934, while, importantly, forbearing on price regulation. Investors initially recoiled at the mention of Title II, a fairly heavy-handed, if legally rigid, set of regulations.

However, concerns were largely mitigated when Comcast CEO Brian Roberts emphasized days later that the Time Warner Cable deal was "full steam ahead," indicating a level of comfort with the proposal. Shares of all three parties to the deal, Comcast, Time Warner Cable, and Charter, rallied as a result. For our part, discussions with company management teams, as well as with industry and regulatory experts, continue to reinforce our confidence that the value-creating deals are likely to close, with a palatable regulatory construct.

OUTLOOK

Geopolitical risks are abundant. The collapse in oil prices and sanctions against Russia may cause serious pain there with potentially negative repercussions for the European Union, not the least of which would be deflation which the European Central Bank is now actively combatting with its newly announced quantitative easing (QE) program.

In any event, we expect greater volatility in markets. Markets will likely gap up and down as there are fewer liquidity providers because balance sheets on the sell side, most notably the big banks, are substantially lower due to regulatory pressures.

Investors' multi-year expectations for higher interest rates and inflation were wrong. Declining interest rates and inflation in the Eurozone raise fears of deflation. In the U.S. the consensus opinion is that the Federal Reserve will begin raising interest rates in the latter part of 2015. Based on market history there is a fear that price-earnings ratios (P/E) must decline in response until the Fed is done raising rates.

Given the Composite's characteristic of moderate earnings growth, dividend yields above the S&P 500 Index[4] and the 10-year U.S. Treasury, coupled with annual dividend growth, any decline in P/E ratios in response to modest quarter-point Fed increases should be temporary. Foreign exchange risk is minimal given that the loci of company revenues and markets are predominantly in the U.S.

As we look out over the next several years, we expect the oil price to stabilize and move higher, although we doubt it will return to the $100 level. We also expect the Federal Reserve to initiate a series of modest interest rate increases in the latter part of 2015. If events unfold according to these expectations, we are prepared to shift some of our utilities investment to energy to take advantage of new opportunities in the oil patch and avoid the expected temporary downdraft in utilities prices as the Fed begins to tighten.

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[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 09/30/14 through 12/31/14.

[2]The S&P 500 Energy Index comprises those companies included in the S&P 500 that are classified as members of the GICS energy sector. This equity index does not have telecommunications equities that are contained in the Reaves ERISA Composite.

[3]The S&P 500 Utilities Index is a capitalization-weighted index containing 30 electric and gas utility stocks (including multi-utilities and independent power producers). This equity index does not have telecommunications or energy equities that are contained in the Reaves ERISA Composite.

[4]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.

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.