Reaves Asset Management

Review and Outlook

Fourth Quarter 2016

OVERVIEW

Strong performance in energy and cable holdings enabled our ERISA Composite[1] to generate a positive return in the fourth quarter despite significant price pressure on our communications REIT (real estate investment trust) holdings and an overall flat return from utilities. That flat return is all the more remarkable given the mounting investor concern over interest rates following the presidential election and a 25 basis-point increase in the federal funds rate announced in December. We are pleased to report, that for calendar 2016, the ERISA Composite returned 19.9% net of fees, 7.9 percentage points better than the S&P 500 Index[2].

The two significant events for our stocks in the quarter were the unexpected election of Donald J. Trump as president of the United States and the decision by OPEC to limit oil production. The conventional wisdom was that a Trump victory would trigger a broad and sustained sell-off of U.S. equities. The conventional wisdom was right for about three hours in the overnight market. As investors awoke to the new political reality in the U.S. on November 9th, they determined that the potential benefits of anticipated Trump administration policies on regulatory and tax reform and fiscal stimulus more than offset concerns about global trade and budget deficits. With expectations for stronger growth, investors quickly discounted higher interest rates and sent the 10-year U.S. Treasury note[3] to a yield of 2.45%. As expected, the market simultaneously sold off interest-rate sensitive equities, including utilities and communication infrastructure companies organized as REITS. By the end of the quarter, the utilities sector, as measured by the S&P 500 Utilities Index[4], had recouped nearly all of the post-election loss.

COMMUNICATIONS

Communications investments returned 3.1% in the quarter, underperforming the S&P 500 Telecom Services Index,[5] as strong results in our traditional telecom (+13.6%) and cable (+5.6%) holdings were offset by weakness in communications REITs (-8.4%). The sector performed especially well following the election given the prospects for a lessening of regulatory oversight, greater probability of mergers and acquisitions (M&A) activity, and a reduction in corporate tax rates which will be most beneficial to the large incumbent operators.

The expected Federal Communications Commission (FCC) transition from outgoing FCC Chairman Wheeler to an as-yet unnamed President-elect Trump appointee was greeted warmly by investors. Chairman Wheeler led an activist, pro-consumer Commission across a range of issues, including the re-classification of broadband as Title II communications services and efforts to promote competition in the set-top box and business data services markets, among others. In contrast, the telecom transition advisors struck a decidedly pro-industry tone signaling clear benefits to cable and telco internet service providers. The risk of onerous rate regulation or unbundling requirements associated with Title II should be greatly reduced as the FCC is likely to lose its strict oversight of broadband. Potential new revenue streams such as paid prioritization or interconnection fees can be reimagined by investors. Cable, the dominant provider of wireline broadband, is a principal beneficiary of this outcome.

Likewise, anticipation for relaxed M&A oversight at both the FCC and the Department of Justice was well received. Several large deals – AT&T's attempted acquisition of T-Mobile and Comcast's ill-fated takeover of Time Warner Cable among them – were rejected by the Obama administration, and likely would have faced better odds with a traditional pro-industry regulator. We think the prospects for the announced deals involving AT&T, Time Warner, CenturyLink and Level 3 have all improved since the election as has the likelihood of an acquisition of T-Mobile. Were T-Mobile to be acquired by Sprint, the outcome would be unequivocally negative for the tower companies. This partly explains tower weakness in the quarter relative to other REITs. While it is difficult to quantify precisely wireless consolidation risk to towers, backing out interest rate and foreign exchange sensitivity suggests to us that the initial sell-off was overdone.

Lastly, the prospect of corporate tax reform strongly benefits larger capitalization stocks in the communications space in particular. Notably, AT&T, Comcast, and Verizon are all investment grade-rated, with largely domestic revenue streams, and are material cash tax payers. For AT&T and Verizon, in particular, the potential for a better regulatory environment and lower taxes have outweighed the run-up in interest rates that would have otherwise punished these large dividend-payers. Communications REITs were not immune to the negative impact from rising interest rates and, while they should not be hurt by corporate tax reform, neither are they positioned to benefit from it vis-à-vis the broader market.

ENERGY

Energy investments in the fourth quarter generated an internal rate of return (IRR) of 2.4%, underperforming the 7.3% return for the S&P 500 Energy Index[6]. The underperformance was primarily due to a deliberate lack of exposure to companies with poorer balance sheets, particularly oil service and drilling companies, which tended to outperform as commodity prices rose.

During the period, the average price of West Texas Intermediate (WTI)[7] grade oil rose to $49.27. Brent[8] averaged over $50.00 for the first time since mid-2015. In a significant announcement in mid-November, OPEC members said that they that would reduce production by 1.5 million barrels per day in a bid to balance markets by mid-2017. Much of the burden of production cuts falls on Saudi Arabia as other key members such as Iran and Iraq are already producing well below historical quota levels. The Saudis are especially keen to see higher prices given the planned partial sale and listing of state oil company Saudi Aramco in global markets. The initial public offering of less than 5% of Aramco, which potentially values the company at $2 trillion, is expected to be the largest in history and will provide considerable banking revenue.

Domestic inventories stopped rising in August and have generally fallen versus prior year averages since that time, evidence that supply is better balanced with current demand, at least in the U.S. On the demand front, domestic usage continued to show healthy gains, despite evident weakness in manufacturing-related demand, as consumers drove more and purchased larger vehicles. Our outlook was for a balanced market by mid-late 2017 before the OPEC cuts, so if the cartel is truly able to deliver on less global production, prices should average significantly higher in 2017 than 2016.

Despite the better commodity-price environment, domestic producers did not perform particularly well in the quarter. Instead of the sector being the beneficiary of increased general money flow from bonds into equities, as was the case with much of the market after the election, performance appears to have been driven more by shorts covering negative bets on weaker companies.

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, 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, generally favoring producers versus service and equipment suppliers. Such an environment will most likely lead to further consolidation as companies seek to gain scale and reduce costs.

UTILITIES

The Composite's utility investments generated a positive 36 basis-point IRR in the quarter, better than the 14 basis-point return on the S&P 500 Utilities Index. The positive return came in the face of a 50% increase in the yield of the 10-year U.S. Treasury to 2.45%. This suggests that the market is discounting a positive benefit from anticipated infrastructure investment that offsets the headwind of higher interest rates.

The stock price of selected companies with generation exposure rose meaningfully even though the price of power in PJM[*] remained at extremely depressed levels, with 2018 power rising only 2.1% in the face of a 7% increase in the price of natural gas. In the generation market, the quarter's most significant news was the passage of legislation to subsidize two nuclear plants in Illinois, following the New York legislation passed in the summer, to preserve the operation of two other nuclear plants. Though both of these laws will undergo numerous court challenges, we expect them to prevail. We also believe that one to three additional states may pursue a similar course. Nonetheless, while we recognize the potential positive impact on some industry players whose shares benefitted during the quarter, we believe that the risk/reward in owning solid fuel generation remains unattractive.

For utilities, we expect the impact of the election to be mixed and, while positive overall, could be less positive than for other market segments. Sorting out the puts and takes is complicated. Because utilities recover income taxes through retail rates, there is no clear benefit to shareholders from promised lower corporate taxes. At the same time utilities should not see a direct cost from the possible ending of the interest expense deduction. These changes will have a varying impact on individual utilities companies, dependent upon the utility's status as a cash taxpayer, its regulatory jurisdiction and the amount of debt it carries apart from the regulated utility subsidiary. We believe that customer rates will only fall very modestly as a consequence of the proposed tax law changes that we have seen thus far and that capital recycling at the companies will increase. Put another way: the earnings growth difference between those who have a large backlog of capital spending opportunities and those who do not should increase.

On the environmental front, we do not see meaningful changes happening at the state level and believe that selected states will continue to pursue the same environmental goals that existed before the election. Although Trump promised to save the coal industry during the campaign, we would observe that its death happened not at the Environmental Protection Agency, but in the energy

[*] PJM is a Regional Transmission Organization that manages the electric transmission grid from the Mid-Atlantic to the Midwest. It represents the largest market for power in the United States.

market itself at the hand of cheap natural gas and weak international markets over which the President has no control. Should some of the major federal initiatives be rolled back, we do not see a meaningful change in coal's fortunes at this point.

We are excited about the opportunity for an improvement in federal regulation under the new Administration and Congress. The prior regime was unable to fill two vacancies (of five seats) at the Federal Energy Regulatory Commission (FERC) and, with the term of a particularly divisive Democrat ending, we should exit 2017 with a much more constructive FERC.

OUTLOOK

With the new Administration now in place, prudence demands a cautionary stance given the uncertainty about the timing and the details of expected changes in fiscal policy and an overhaul of the Federal tax code. Generally, we expect the new policies to have a beneficial impact on energy and communications holdings as investment in the national infrastructure is encouraged and the regulatory burden on energy and communications companies is reduced. The expected policy changes also portend a rise in long-term interest rates, which always represents a challenge to the short-term investment performance of utility stocks. Prior to the election utility stock prices weakened, declined sharply for five days post the election, and then began a recovery as discussed above. It is noteworthy that the anticipated rise in interest rates comes at a time of great strength for the utility business model and a supportive regulatory backdrop. We remain convinced that, with their outlook for stable and predictable earnings growth, selected utilities remain very well positioned to overcome the impact of moderate and measured interest rate increases and reward their shareholders with rising dividend income and capital appreciation.

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 09/30/16 through 12/31/16.*

[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] *The 10-year U.S. Treasury note is a debt obligation issued by the United States government that matures in 10 years. A 10-year Treasury note pays interest at a fixed rate once every six months and pays the face value to the holder at maturity.*

[4] *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). 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.*

[5] *The S&P 500 Telecommunications Services Index comprises those companies included in the S&P 500 that are classified as members of the telecommunication services sector.*

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

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

[8] *Brent Crude is a major trading classification of sweet light crude oil that serves as a major benchmark price for purchases of oil worldwide. This grade is described as light because of its relatively low density, and sweet because of its low sulfur content.*