Reaves Asset Management

Review and Outlook

Fourth Quarter 2018

At the beginning of 2018, investment strategists forecasted rising interest rates, strong economic growth and accelerating corporate earnings because of the federal tax cut. The conclusion was to sell utilities. The strategists got it mostly right for the first three quarters: the U.S. 10-year Treasury[1] rate rose to a high of 3.2%, GDP[2] growth accelerated to 3.4% (as of the end of the third quarter), S&P 500 Index[3] earnings rose 19% and utilities underperformed the market. In the fourth quarter, things changed. Investors started fearing a slowdown and the S&P 500 fell while utilities gained. Utilities ended the year with a positive return while nearly every other sector declined in value.

Trying to figure out what the macro economy is going to do, and then picking the right investment strategy to take advantage of that, is extremely hard. As we saw in 2018, even when the forecast is mostly right, things can change so quickly that there is no certainty that an investor will make money.

Instead of guessing about the macro environment and trying to pick which group will outperform, we build our portfolios from the bottom up with companies that can produce a growing stream of earnings, cash flows and dividends in any environment. These companies have a foundation in reality; producing earnings by delivering products that people use every day. The returns the portfolios generate in any given quarter are largely out of our control but, over time, we believe the market will reward this creation of value with higher stock prices. The portfolios may or may not outperform in any given year but we remain confident that they are invested in steadily growing companies which we believe will produce a competitive total return in the long run.

Energy and communications investments did not perform as well as utilities, and the portfolios' total returns for the year were negative. We apply the same fundamental standard to investments in energy and communications that we do to utilities and, for that reason, we remain confident in the long-term potential of the portfolios. Our investment strategy has been consistent since its inception in 1978 and has served investors well for over four decades.

Portfolio Review

The ERISA Composite[4] declined a disappointing 6.2% during 2018. Utilities were strong, particularly in the fourth quarter when the S&P 500 fell 13.5% but declines in our communications and energy investments offset the benefit from utilities.

	Annualized Returns as of 12/31/18	
	Reaves ERISA Composite (net of fees)	**S&P 500 Index**
Since Inception	12.45%	11.40%
Since 1/1/2000	7.42%	4.86%
Since 3/1/2009[5]	11.21%	15.69%

Source: eVestment and Reaves data.

Utilities

The portfolio's utility investments outperformed the S&P 500 Utilities Index[6] in 2018. Our approach is to find companies that can grow at above average rates while avoiding worsening regulatory situations; the complexity of the industry makes it particularly difficult. Each state regulates utilities differently, and one needs only to look at the California utility stocks to see how slight differences in regulation can lead to wildly disparate results. Wildfires, elections, nuclear construction problems and equity offerings led to an especially wide range of returns during the year.

Many investors are concerned about the group after it outperformed the S&P 500 by 20% in the fourth quarter. Just looking at short-term performance misses the story: on a yield basis, we think utilities look more attractive today than before the start of the fourth quarter. The U.S. 10-year Treasury fell from a high of 3.2% to 2.7%, during the quarter, making utilities' dividend yields relatively more attractive. On a fundamental basis, the volatility of the last month plus the wide range of returns over the past year, in our view, has revealed pockets of compelling value.

Communications

The investments in communications comfortably outperformed the S&P 500 Communications Services Index[6] during the year. Wireless towers and large-cap telecom were standout performers as investors turned defensive. Towers have extraordinarily high barriers to entry and significant ongoing demand from wireless carriers. Today, a particularly large swath of spectrum sits idle, waiting to be deployed on towers. These dynamics provide us with great comfort in our long-term tower investments despite the potential near-term headwinds from the Sprint and T-Mobile merger. The data center investments experienced some weakness. As real estate providers to the cloud, data centers are principal beneficiaries of the massive shift to outsourced IT services. However, during the fourth quarter investors grew concerned about the pace of spending by the large cloud service providers. We think the market reaction appears overdone. Cloud capacity did slow modestly but seems to be the result of accelerated building activity in the first half of 2018. Our expectation is that multi-year growth rates for data centers will continue to outpace those of other communications infrastructure providers.

The composite's cable investments outperformed the market in the fourth quarter but were still disappointing overall for the year. Cable's core product, broadband, is non-discretionary, has increasingly high utility and maintains a significant technology advantage over competitors in most of its markets. Near term, we think there is reason to believe that new competition for cable broadband is slowing, not growing. Thus, while tax loss selling hurt the sector at the end of the year, we think cable metrics and financials are supportive of more defensive investment behavior moving forward.

Energy

At the end of the third quarter, the composite's energy investments had been the best performing part of the portfolio. What followed was a disaster – the price of oil fell 38% and dragged the energy investments down greater than 20%. As best we can tell, the Kingdom of Saudi Arabia increased production in the third quarter in anticipation that U.S. sanctions on Iran would reduce that country's output. Instead, numerous waivers were granted for countries buying Iranian oil and production stayed high. North American production continued to grow at a rapid pace, inventories swelled, and the market quickly became oversupplied.

Going forward, the inventory imbalance will have to clear before things get better. OPEC[7] announced production cuts in the fourth quarter that came into effect in January and should provide some price support, assuming demand remains healthy. The Iranian sanction exemptions expire on March 1, 2019, and we believe they will not be renewed. These factors should help begin the rebalancing process in oil and provide sounder fundamental footing in the second and third quarters of 2019. In the meantime, valuations and dividend yield look attractive. During the 2014-2016 downcycle, many companies reduced debt and complexity while adopting policies prioritizing return of capital to shareholders over growth. The industry is now in a much better position to maintain and grow dividends.

Outlook

The outlook for long-term earnings, cash flow and dividend growth in our universe of investments is strong. Low-cost renewable energy replacing high-cost coal and nuclear power gives many utilities the room to grow earnings in the high single digit range without overburdening customers with rising bills. The increasing demand for data underlies our investments in broadband and towers, and the trend of businesses deciding to outsource IT services to the cloud is still in the early stages. Energy companies have done a good job of reducing debt and costs while prioritizing return of capital, setting them up to be less dependent on commodity prices in the future. In our opinion, focusing on companies like these with steady growth at reasonable valuations should lead to a good outcome.

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
reavesassetmanagement.com

---

[1] *The 10-year U.S. Treasury note is a debt obligation issued by the United States government with a maturity of 10 years upon initial issuance. 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. The U.S. government partially funds itself by issuing 10-year Treasury notes.*

[2] *Gross Domestic Product (GDP) growth rate measures how fast the economy is growing.*

[3] *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.*

[4] *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. Unless otherwise noted, this quarterly commentary covers the period 09/30/18 through 12/31/18. Concerning the table on page one, composite performance for the period 01/01/78 (inception) to 12/31/99 was 16.98% and the S&P 500 Index was at 17.37%.*

[5] *March 1, 2009 marked the beginning of the current bull market phase, a period of several months or years during which asset prices consistently rise. For purposes of this commentary, a bull market phase is considered to have ended when a bear market phase has begun.*

[6] *The S&P 500 Utilities Index is a capitalization-weighted index containing those electric and gas utility stocks (including multi-utilities and independent power producers) in the S&P 500 Index considered to be members of the utilities sector.*

[6] *S&P 500 Communications Services Index is a capitalization-weighted index containing those companies in the S&P 500 Index that are considered members of the communications services sector.*

[7] *OPEC (Organization of Petroleum-Exporting Countries) is an organization formed in 1961 to administer a common policy for the sale of petroleum.*