Reaves Asset Management

Review and Outlook

Second Quarter 2014

OVERVIEW

Each of the Reaves ERISA Composite's[1] core sectors – utilities, energy and telecommunications – contributed positively to the composite's total return. Oil and gas and energy equipment services contributed over half of the total return. Oil prices remained firm with the Brent and West Texas Intermediate (WTI) benchmark crudes closing the quarter well above $100.00. Henry Hub pricing for natural gas declined modestly to $4.41 per mcf.

In line with market expectations, the Federal Reserve continued the tapering of its monthly bond purchases, and the yield on the 10-year U.S. Treasury remained range bound between 2.82% and 2.44%.

Geopolitical events in the Middle East and the Ukraine were taken in stride by the markets as volatility, measured by the VIX[2], declined during the quarter from 13.88 to 11.57. In the U.S. inflation remains subdued, the economy is growing at a sub-3 percent rate and there is some improvement in the employment data.

ENERGY

For the second consecutive quarter the composite's energy holdings outperformed broader energy indices such as the S&P 500 Energy Index[3] on the strong performance of investments in oil service and energy infrastructure companies.

Differentials between the price of crude oil at Cushing Oklahoma (WTI) and U.S. Gulf Coast markets declined due to the ongoing effect of the startup of the southern portion of the Keystone XL pipeline and the prospective start of the Seaway line which will come into service late in the third quarter. These, as well as much improved takeaway capacity from the Permian and Bakken production basins, both because of increased pipeline and rail capacity, are alleviating some transportation bottlenecks. Crude oil imports fell to a multi-decade low as refiners were able to source domestic light and Canadian heavy crude oil feedstock at advantaged prices. Global prices remained relatively stable despite ongoing Libya production shut-ins, concern about ongoing military tension on the borders of Ukraine and the Islamic militant takeover of parts of northwestern Iraq. These issues are far from resolved; any one of them could be a cause for higher volatility and oil prices in the second half.

U.S. natural gas prices fell from high winter levels as seasonal demand weakened, but remained about 15% above second quarter 2013. As we mentioned last quarter, the winter of 2013/14 was so severe that it fundamentally altered the outlook for natural gas prices. The gas storage deficit will most likely take several months to alleviate fully at current production rates, although overall U.S. production keeps rising. This change has been good for our investments in gas infrastructure companies, particularly those developing pipelines and processing facilities around the growing Marcellus and Utica shale.

As we mentioned in our previous commentary, it was not until late 2013 that the oil service and equipment market showed signs of price stability after nearly two years of over building in anticipation of shale-related development. Since then upstream operators have been surprisingly quick to get back to drilling, despite weather-induced downtime in early 2014. The rise in drilling activity further reduced excess capacity, supporting service pricing. One of the industry leaders outlined a robust growth outlook through 2017 as production companies adopt key technologies to improve shale oil and gas recovery.

UTILITIES

In June the Federal Energy Regulatory Commission (FERC) issued an order in connection with a complaint led by the Massachusetts Attorney General. The complaint alleged that the 11.14% return allowed to the New England Electric Transmission Owners was unjust and unreasonable in today's low interest rate environment. In their final order, the FERC adjusted the allowed return down to 10.57%, which was largely in line with investor expectations. They also modified the existing methodology for calculating allowed rates of return. We view the outcome as moderately constructive and believe that it is supportive enough to help move investor attention beyond this controversy.

On June 23rd Wisconsin Energy announced that it had reached an agreement to purchase Integrys Energy for cash and stock representing a 17% premium to the prior day's closing price. Both utilities have adjoining operations in Wisconsin, while Integrys also owns gas utility operations in Chicago. The merger is a good fit geographically, culturally and financially as Wisconsin's excess cash flow can help fund Integrys' capital expenditure requirements over the next few years. Two additional potential transactions emerged toward the end of the quarter. CLECO (a Louisiana utility) announced that it had received several bids for its company and had hired financial advisors to review their alternatives. At the same time, several parties filed petitions in U. S. Bankruptcy Court designed to take control of Oncor (a Dallas utility) out of the bankruptcy trust of Energy Futures Holdings.

Investor enthusiasm for Yieldcos – electric generating companies with contracted assets focused on maximizing shareholder distributions – continued during the quarter. Following the success that NRG Energy experienced with its offering of NRG Yield Inc., Nextera Energy, on June 27th, floated a new subsidiary, Nextera Energy Partners, LP, with an initial public offering. It was well-received, with the final pricing coming in at a 25% premium to early expectations. The units ended the quarter, trading 35% above the offering price. We believe that this type of financing vehicle will offer power project developers an advantaged cost of capital and expect others may bring similar offerings to market.

TELECOMMUNICATIONS

Competitive intensity in U.S. wireless continued to increase, as evidenced by AT&T's updated guidance. The company pre-announced fairly solid subscriber metrics, but financials seemed to confirm that AT&T has moved aggressively to lower prices for new and existing customers in response to T-Mobile's successful marketing efforts based on discounted pricing. To date, Verizon has managed to stay somewhat above the fray on pricing, though subscriber gains have proven more challenging.

The Supreme Court ruled that start-up service Aereo's technology violated copyright law. The ruling was a clear positive for broadcasters (including Comcast-owned NBC Universal), but a bit more mixed for cable distributors. On the one hand, Aereo offered a service that could encourage some consumers to cancel video (though not broadband) subscriptions with cable operators. On the other, some cable and satellite operators had expressed interest in Aereo as a partial solution to increasing costs charged by broadcasters. In all, we view the ruling as somewhat neutral for cable.

From a regulatory perspective, the Federal Communications Commission began to explore new potential methods for enforcing Open Internet rules (commonly referred to as "net neutrality"). Among its considerations is the reclassification of broadband as a Title II service, which could ultimately subject it to price regulation. This would strike a large blow to cable distributors. We do not think the political appetite for this reclassification currently exists, but we will be monitoring lawmakers closely.

OUTLOOK

It appears that the Federal Reserve will end asset purchases in October based upon the minutes of its June meeting. Given moderate economic growth, excess capacity in the economy, gradual improvement in unemployment and lack of any wage increase pressure interest rates should remain below historical norms. It is by no means certain that an increase in interest rates would be negative for equities if policy is tightened because the economy is improving.

The current lack of revenue growth is a concern for equity investors. The prospect of moderate earnings growth and increasing dividends from selected portfolio companies remains attractive.

Mergers and acquisitions activity is likely to continue in the utilities sector. Telcos are likely to remain the highest yielding sector of the portfolio given the challenging competitive environment.

Demand for oil services and restructuring activity by selected energy companies should continue to deliver good returns. Changes in the global oil supply and demand balance and the effect on prices deserve constant attention. The potential return of some supply from the Middle East looks to be immaterial at this time.

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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 12/31/13 through 06/30/14.*

[2] *The CBOE Volatility Index (VIX) is a key measure of market expectations of near-term volatility conveyed by* S&P 500 *stock index option prices. Since its introduction in 1993, VIX has been considered by many to be the world's premier barometer of investor sentiment and market volatility.*

[3] *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.*