Reaves Asset Management

Review and Outlook

Second Quarter 2013

OVERVIEW

As a result of a strong April employment report on May 3rd, coupled with a broader discussion about the eventual tapering of monthly quantitative easing, interest rates moved dramatically higher in the quarter; specifically 86 basis points from the 1.63% low on the ten-year U.S. Treasury to 2.49%. The rate rise unsettled the equity markets, particularly income-oriented equities. Utilities and telecommunications stocks were sold aggressively. The Utilities Select Sector SPDR (XLU)[1], with a market capitalization of $5.5 billion, traded 2.6 times normal volume over two multi-day periods in May and June as interest rates spiked. As a consequence, our ERISA Composite[2] underperformed the broad market. The decline in utility and telecom prices may have been an overreaction. During June's last four trading days electrics and telecoms rebounded, achieving the best performance for the week among the ten sectors of the Dow Jones Industrial Average[3]. Managing portfolios with a concentration in high-yielding telephone and utility common stocks through several full market cycles has given us experience in periods of both rising and falling interest rates. Uncertainty over the future direction of interest rates will continue to be a source of volatility for equities in general.

Electric and Gas Utilities

Power prices remain weak, evidenced by the results of the annual PJM Interconnection[4] auction for electric capacity. For most of the power pool, capacity prices for the planning year 2016/2017 fell by over 50%. The auction attracted offers of a record amount of new imports from the Midwest. The ongoing increases in energy efficiency coupled with weak demand contributed to power price weakness. We believe the auction result is another data point suggesting that power markets have limited opportunity for better prices in the foreseeable future. We do see opportunity in the auction results for selected companies to provide electric transmission. Much of the newly-bid import capacity does not have firm electric transmission rights to PJM. Closer to the delivery period there should be additional demand for transmission projects.

We would also note that during the quarter the price difference (also known as basis) between TETCO M3 (an important pricing point for natural gas generators in PJM) and the nationally recognized Henry Hub price swung by over 25 cents from a modest premium to a discount. This outcome is in keeping with our expectation that strong production growth in the Marcellus shale will create a regional surplus of natural gas priced at a sustainable discount to national prices. The pricing disparity gives added financial incentive for infrastructure developers to invest in pipeline takeaway capacity from the region. Cheap gas will continue to impair the profitability of the region's solid fuel generators by enabling low priced electric-power generation.

Energy

During the quarter, U.S. oil price benchmarks like West Texas Intermediate (WTI) were largely stable, and UK Brent, a global crude benchmark, declined to $102.16 from a peak of $111.08. Increased pipeline capacity from the WTI delivery hub of Cushing, OK supported prices versus coastal grades and imports. China's disappointing economic performance and higher interest rates in the U.S. weakened commodity prices, driving money flow out of inflation hedges like oil. The Henry Hub U.S. natural gas price of $3.56 per mcf at quarter end was the low for the quarter but was materially higher than the $1.84 per mcf low reached in 2012. U.S. natural gas prices were generally weak in the quarter as supply growth remained surprisingly high despite reduced gas-directed drilling activity.

Our energy investments remain concentrated in sub-sectors expected to benefit from investment required to develop new shale and deep water resources. Although we do not see material upside for energy commodity prices, especially in the U.S., we do believe that companies will do well if they have the ability to grow volumes, provide essential equipment and services or invest in related infrastructure. The Energy Information Agency reported that domestic oil production reached 7.3 million barrels per day in April, an increase of over 1.0 million barrels per day versus April of 2012, and the most the country has produced since the mid-1980's. This increase has profound positive ramifications for energy investment and for domestic energy-consuming industries.

Telecommunications

The landscape within the domestic wireless sector became clearer during the quarter as two rejuvenated players emerged. The merger between T-Mobile USA and Metro PCS closed in May and just after the quarter ended Softbank acquired Sprint, which had acquired 100% of Clearwire. Most recently, AT&T announced it was acquiring LEAP Wireless. Industry consolidation raises the possibility of intensifying wireless competition that could eventually pressure industry margins. The increased capital spending announced by each of the major wireless players is indeed a harbinger of a more competitive dynamic within the industry. Within the wireless marketplace, tower companies remain attractive as mobile data demand and network upgrades drive growth opportunities.

Investor sentiment toward Canadian telecom turned decidedly negative at the very end of the quarter after Verizon announced it was exploring opportunities to launch wireless services in Canada. If Verizon decided to enter the Canadian market, the margins of the Canadian incumbents would come under increasing pressure.

The cable industry was also a focus of investor interest in the quarter with growing speculation that Charter Communications would attempt to acquire the much larger Time Warner Cable in an attempt to consolidate the industry. Cable tends to benefit from the demand for higher speeds and throughputs, particularly in markets where the local telco has only copper assets. Cable revenue growth, in our view, will be driven by additional share gains from telecommunications companies in the consumer broadband and small and medium business markets.

OUTLOOK

We believe that equity and bond market volatility, cheap natural gas prices, growing natural gas supply, increasing electricity efficiency and low electric power prices are here to stay. Composite investments are selected to benefit from these trends.

As for interest rates, the Federal Reserve has said it intends to keep short-term rates, which it not the market controls, low until the unemployment rate declines to 6.5%. Additionally, there is no inflation and the economy is operating well below output capacity. Given high unemployment, labor has no leverage to extract higher wages.

Allowed returns for utilities remain largely unchanged in the current low interest-rate climate. Investors often overlook the fact that the utility companies are allowed to recover interest expense in rates. Selected composite companies will grow their earnings through increased infrastructure investment which is not necessarily dependent on GDP growth. Lastly, the liquidity of portfolio holdings makes it possible to benefit from price dislocation due to market volatility. Our outlook for earnings and dividend growth remains unchanged.

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[1] *The Utilities Select Sector SPDR (XLU) is an exchange-traded fund (ETF) whose objective is to provide investment results that correspond to the performance of the Utilities Select Sector Index. The Index includes services, electrical power providers and natural gas distributors.*

[2] *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 03/31/13 through 06/30/13.*

[3] *The Dow Jones Industrial Average is a price-weighted average of 30 actively traded stocks. It is used as an indicator of the overall condition of the stock market.*

[4] *PJM Interconnection (PJM) is a Regional Transmission Organization (RTO) that coordinates the movement of wholesale electricity in all or parts of 13 states and the District of Columbia, an area that includes more than 60 million people. PJM is headquartered in Valley Forge, PA and is currently the world's largest competitive wholesale electricity market.*