Reaves Asset Management

Review and Outlook

Third Quarter 2014

OVERVIEW

With few exceptions, nearly every stock in the ERISA Composite[1] sold off in the quarter. By sector, energy equipment and services, and oil and gas contributed most to the decline. They were followed by the utilities sector. The decline in energy equities generally reflected the fall in the West Texas Intermediate oil price from approximately $105.34 to $91.16, accompanied by U.S. dollar strength. The price of oil has decreased steadily, and is on track to reach a four-year low, driven by fears of a global economic slowdown accompanied by a steady increase in supply, primarily from the U.S. Investors and traders sold energy-related equities along with oil futures contracts.

Utilities were for sale at the start of the quarter, in our opinion, largely due to traders' expectation of rising interest rates. They recovered somewhat when the 10-year U.S. Treasury rate declined as low as 2.34% and then sold off again in September, as rates spiked, before closing about where they started the quarter. In summary, interest rate volatility drove utility stock price volatility.

The bright spots for the quarter were cable, railroads and tower holdings. With respect to sector weightings, there were no material (greater than 2%) changes in sector weightings. Among the top-15 holdings, only one utility investment was exchanged for another.

ENERGY

In contrast to the first half of the year, composite energy holdings posted a negative total return for the quarter. Political instability in key producing regions of the Middle East over the past twelve months increased and remains a factor supporting the price of oil that we do not see changing in the near term. However, the prospect of a steadily increasing supply of U.S. crude undermining global prices gave rise to the fear that OPEC, primarily Saudi Arabia, would take action to preserve their market share. In our view, selected North American companies with dominant positions in the lowest cost shale basins can continue to prosper in a relatively low oil-price environment. Such an environment should continue to be positive for infrastructure companies, whose revenues and profits are more a function of oil and gas volumes rather than prices. Energy company selection is focused primarily on integrated majors with opportunities to unlock value by restructuring operations or rationalizing assets as well as on the infrastructure and service providers. Generally, we continue to avoid commodity-sensitive exploration and production companies.

UTILITIES

Throughout most of the country, July proved to be unusually cool. The mild weather softened markets for electricity not only in the current period, but in forward markets as well. We see little opportunity for a dramatic improvement in electric power prices beyond a cold winter even given the anticipated coal-generation retirements in 2015. Exelon's decision to develop two highly efficient combined-cycle natural-gas plants at existing sites in Texas suggests that the marginal cost of new generation may often be less than the market expects.

At the direction of the President, the Environmental Protection Agency (EPA) has drafted proposed rules for regulation of carbon pollution by electric generating units and is currently accepting stakeholder comments. Under the current schedule, the EPA will release a final rule by June of next year, mandating states to adopt their

own State Implementation Plans by 2017, for initial industry compliance by 2020 with a final reduction in 2030. While each state will have its own requirements, the rule is currently designed to lower emissions by 30% off of 2005 levels.

While the rule will be subjected to various legal challenges, our current view is that it will be implemented in some form that may require even higher outlays of investment than was required for compliance with the Mercury and Air Toxics Standards (MATS) rule which will go into effect in mid-2015. Compliance with MATS led to tens of billions of dollars of investment and the retirement of over 45,000 MWs of coal generation. Owing to the political acceptance of environmental spending, much of the investment for MATS was recovered through clauses and riders specifically designed to adjust rates outside of the litigated rate case cycle. The regulation is expected to increase the use of natural gas as a source fuel for electric generation, providing incremental stimulus to the development of gas infrastructure in the U.S.

TELECOMMUNICATIONS

Competitive activity among U.S. wireless service providers intensified in the quarter as Sprint announced price cuts after ending negotiations to acquire T-Mobile USA. In July a U.S. wireline carrier announced it had received IRS approval to contribute part of its wireline assets into a tax-advantaged Real Estate Investment Trust subsequently to be spun off to shareholders. In response, investors bid up the price of several telecoms, including CenturyLink and Frontier Communications, they felt might be capable of implementing the same strategy. Subsequent to quarter end, Fitch reported that U.S. telecom and cable dividend payments rose 14% from one year ago.

Integrated Canadian carriers, like their American counterparts, are achieving revenue growth driven by increasing demand for video and data. While regulatory efforts at promoting a nationwide fourth wireless carrier persist, we think the near-term threat to incumbents is limited. As a result, wireless competitive dynamics in Canada appear relatively favorable and dividend yields are high.

OUTLOOK

The foreseeable capital investments available to portfolio utilities provide multi-year opportunities for stable earnings and dividend growth. Stock-price volatility due to investor concerns surrounding interest-rate expectations, GDP growth and commodity prices should persist. Periods of volatility can prove to be beneficial for portfolio returns over time.

Energy will continue to be an important source of investment returns. However, the unpredictability of oil and natural gas prices which are subject to geopolitical and domestic political risk as well as normal business risks insures that energy will be the most volatile sector of the portfolio.

While we are concerned about the potential for margin pressure in U.S. wireless, we note that the four major carriers are not only competing on marketing prowess, but also on network quality. Capital expenditures associated with the latter stand to benefit cellular tower owners.

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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 06/30/14 through 09/30/14.*

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