Reaves Asset Management

Review and Outlook

Third Quarter 2012

OVERVIEW

The two decisions announced by the Federal Reserve in September to launch a new round of asset purchases at $40 billion per month for an unlimited period and to keep short-term rates near 0% through the middle of 2015 should continue to be supportive of the broad equities markets and of our investments in utilities, telecom and energy in particular.

The energy sector was largely responsible for the solid performance of our portfolios during the quarter; however, domestic telcos and utilities also performed well.

Utilities

Recovery of the forward price curve of natural gas and the conspicuous underperformance of the forward electric power price curve were the critical commodity events for electric utilities. Natural gas prices improved due to a decline in the North American rig count, as producers continued to adjust to an oversupply of natural gas. Weather played a role as an abnormally hot July, followed by a relatively normal August, helped burn off excess supply. Coal-to-gas switching in electric generation also remains an important theme; capacity utilization for natural gas-fired generators continues to remain very high relative to past history even in the face of the higher short-term natural gas prices.

In contrast, power prices materially lagged the price increase of natural gas. Indeed, they actually fell dramatically in August and early September, and then recovered in the last week of the quarter. While the price of power often lags swings in the underlying fuels, we believe that the market may be reacting to anemic levels of weather-normalized demand for electricity, particularly among residential and small commercial users. For example, we think that even though new peak demand records were set in July, they were lower than generally expected. In late September the PJM power pool (the largest in the country, stretching from the Midwest to the Mid-Atlantic) published the results for an obscure auction for 2014/2015 electric capacity. This particular incremental auction revealed a 2% reduction to PJM's forecasted reserve requirement. We view this result as another sign of weak demand.

Our forecast for a weakening in usage trends has been an important part of our electricity market outlook for some time. Overall, we see electric demand growing at a rate of GDP less 3% – or actually declining in today's slow growth economy – driven by increased efficiency and conservation. Conversely many industry participants continue to forecast consumption growth. For example, PJM Interconnect is planning for 1.4% load growth. The expectation of weak demand and low electricity prices caused us to avoid companies with unregulated generation. We believe that select regulated utilities will, over time, actually benefit from a low level of demand allowing them to invest resources in badly needed infrastructure replacement and modernization. Investment of this nature has the potential to improve reliability and quality of service with potentially less impact on customers' monthly bills.

Telecommunications/Cable

Telecom performance was positive in the quarter with strong results from U.S. and Canadian integrated companies and the cable industry. The approval of Comcast's spectrum sale to Verizon Wireless and its cross selling arrangement with Verizon (discussed below) clarifies its intention to refrain from direct capital investment in the wireless industry and to focus on its core competency in video and broadband.

The Department of Justice and the Federal Communications Commission approved, with some limited conditions, the acquisition of spectrum by Verizon Wireless from a consortium of cable companies (Comcast, Time Warner Cable and Bright House Networks) as well as commercial selling arrangements among the companies that allow for joint product development and cross selling of cable and wireless services. Prior to the federal approval, Verizon Wireless announced a spectrum swap with T-Mobile.

Speculation about wireless industry consolidation intensified in the quarter as investors mulled over potential combinations of Sprint, T-Mobile USA, Metro PCS, Leap Wireless, ClearWire and DISH Network. After the quarter ended, two big acquisitions were announced. Deutsche Telekom announced a reverse merger of its T-Mobile USA unit into Metro PCS and Softbank, the number two wireless carrier in Japan, announced a 70% investment in Sprint.

Energy

Oil and natural gas prices increased in the quarter. West Texas intermediate rose almost 9% from $84.96 to $92.50 and Brent crude rose 16% from $97.55 to $113.30. Not surprisingly energy equities generally performed well. North American natural gas prices recovered as power generation demand grew while gas production stagnated. The gas-directed rig count reached lows not seen since 2002. Historically over 40% of domestic power generation was sourced from coal and 25% from gas. By the summer that relationship had reversed.

Investments in North American energy infrastructure continued to prosper as demand for new pipelines to gather and transport and then to process and refine oil and gas remained strong. This has been particularly true for companies with infrastructure exposure to shale development particularly in the Marcellus, Utica and Bakken.

OUTLOOK

In our opinion, the earnings growth expectation for the S&P 500[1] in 2013 is subject to meaningful downward revision. Given that constituents of the S&P 500 have significant international revenues, they are exposed to global macro-economic risks, including foreign exchange risk. We believe that the relatively predictable earnings and dividend growth characteristics of companies in these sectors should continue to produce competitive, risk-adjusted total returns. Currently, the S&P Utilities[2] 24-month rolling average of standard deviation is about half of that of the S&P 500: 9.1% vs. 18.8%.

Finally, U.S. economic growth remains low, sub 3%, and the Federal Reserve has indicated interest rates will remain low into 2015, contributing to a favorable investment climate for our portfolios.

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[1]*The S&P 500 Index is a capitalization-weighted, composite index of 500 stocks designed to measure performance of the broad domestic (broad market) 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.*

[2]*The S&P Utilities Index is a capitalization-weighted index containing 33 Electric and Gas Utility stocks (including multi-utilities and independent power producers). Prior to July 1996, this index included telecommunications equities.*

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