Reaves Asset Management

Review and Outlook

Third Quarter 2013

OVERVIEW

Performance was positive across each of the predominant sectors of the ERISA Composite:[1] energy, utilities, and telecommunications, with energy providing the strongest performance. Our focus on infrastructure development within domestic shale basins, electric transmission and Canadian telecommunications contributed to the positive results.

ENERGY

In the third quarter, our energy holdings outperformed broader energy indices like the Energy Select Sector SPDR (XLE)[2]. During the period, global oil price benchmarks like West Texas Intermediate and U.K. Brent rose largely in response to supply disruptions. Libyan production fell from a second quarter average of 1.4 million barrels per day to just 0.3 million barrels per day in September. Despite a change in government and subsequent internal power struggles, the country had been able to keep oil production at over 1.0 million barrels per day for most of 2012 and 2013. This changed in the quarter as a group in control of much of the western export capacity conducted general labor strikes. Global prices were also positively impacted by improvement in the Chinese economic outlook and stabilizing U.S. interest rates, driving money flow back into inflation hedges like commodities.

The best performers in the quarter tended to be domestic oil producers, particularly those with large acreage holdings in key domestic shale basins. Producers with exposure to the Permian Basin were notable outperformers as test well productivity improved, particularly for the Wolfcamp Shale. Many now believe that this formation will prove as productive as the Eagle Ford in West Texas and Bakken in North Dakota. The demand for infrastructure and services in this area is likely to continue to grow, improving the business outlook for oil service and equipment companies. Certain oil industry services companies also benefitted from an improving deep water and international oil industry spending outlook. This improvement was especially evident in the U.S. Gulf of Mexico, where the rig count surpassed pre-Macondo levels for the first time. The basin has proved fertile for exploration success. Also, as operators drill in deeper water depths the revenue opportunity per rig for oil service companies increases markedly.

ELECTRIC AND GAS UTILITIES

ERISA Composite utilities meaningfully out-performed the S&P Utilities'[3] return of 0.1%. Stock selection remained essential to investment performance. Electricity prices (notably in the PJM interconnect) continued a listless decline. However, a recent Public Utility Commission of Texas decision was a fundamental acknowledgement by the regulator that Texas could face a resource adequacy issue in the absence of new construction as its power market is the only market of size that is demonstrating meaningful load growth.

Corporate restructuring dominated the headlines among utilities during the quarter. On July 17th NRG Energy launched a highly successful initial public offering of a 25% interest in its subsidiary NRG Yield. The company will own a collection of NRG's electric generating assets whose output is committed under long-term contracts. Additionally, on July 25th, Oneok announced its intention to separate its gas distribution business into a standalone, publicly-traded company. The move will enable a recapitalization that will accelerate dividend growth.

On September 11th, Dominion Resources announced that it had received authorization from the Department of Energy to export liquefied natural gas (LNG) to non-free trade countries from a project to be developed at its Cove Point LNG facility, ending the most politically charged portion of the approval process. While the company still needs to secure approvals from the Federal Energy Regulatory Commission, the project should proceed quickly to construction next year, with ultimate commercial operations in 2017. Shortly after the receipt of the approval, Dominion announced the formation of Dominion Gas Holdings and its intention to create a master limited partnership (MLP) to help finance its gas midstream operations. The shutdown of the federal government notwithstanding, we think that the Department of Energy will continue to approve LNG export facilities and expect at least two more approvals this year, including Sempra, a composite holding. Sempra has also spoken about creating an MLP to finance the construction of its LNG project.

TELECOMMUNICATIONS

In addition to voice and broadband, we broadly define the sector to include towers, cable and communications technology. Comcast, Telus, and Vodafone were the top three performers, partially offset by negative returns from Verizon and AT&T. Verizon's acquisition of Vodafone's 45% stake in Verizon Wireless, for a total consideration of $130 billion in cash and stock, was the major sector event. Although the deal was a little pricier and a little more tilted toward stock than we would have liked, generally we consider it a positive development for both companies. For Verizon it means complete ownership of what we consider the most valuable wireless franchise in the U.S., with much clearer visibility to cash flow and dividend growth. While wireless competition is intensifying in the U.S., we view Verizon as best positioned among its peers to respond to the changing competitive dynamics (for this reason we reduced our exposure to AT&T). Verizon has significant growth opportunities from greater use of mobile data services. Some of the pressure on Verizon's share price likely resulted from short hedging initiated by Vodafone holders prohibited from owning Verizon.

Vodafone will return a meaningful portion of cash and Verizon stock directly to its shareholders when the transaction closes, most likely in the first quarter of 2014. The balance of the proceeds are to be dedicated to debt reduction and increased capital investment to offer differentiated communications services in Europe and emerging markets where Vodafone provides service. Both companies punctuated the announcement with a dividend increase.

The Canadian telecoms rallied during the third quarter when Verizon confirmed it will not enter the Canadian market. Additionally, no foreign telecoms declared an intention to participate in the forthcoming 700MHz spectrum auction when the deadline for formal commitments came due. Together, these two developments reassured investors that the relatively small and geographically dispersed Canadian market makes a rather un-compelling investment case for any potential new entrant into the three-player national market. Given its greater exposure to wireless, Telus outperformed BCE on the news. We are encouraged by these competitive developments, and continue to find Canadian telecoms' wireless growth, improving wireline fundamentals and shareholder-friendly capital policies to be attractive.

OUTLOOK

The domestic and global economies remain unstable. The dysfunction in Washington creates additional uncertainty and unknown market risks. The 125 basis point increase in 30-year mortgage rates slowed housing starts and refinancing. Given the continued economic weakness, we do not expect another material increase in interest rates. In this environment the stable demand for utilities and telecom services provides companies with relatively predictable revenues and income growth. Selected utilities have the ability to invest and grow their earnings and dividends in spite of the sluggish economy. Current dividend yields remain at least 100 bps higher than the yield of the 10-year U.S. Treasury.

We hold the consensus view that investment in energy infrastructure is a multi-year capital investment for certain utilities. With respect to oil prices, the accepted view appears to be that there is not much room for upside from current levels. What causes us concern is some data that shows oil stocks have been drawn down unseasonably since April. At the same time world oil supply has achieved new all-time highs in the past several months. At current oil prices the earnings outlook for a number of oil producers and oil service providers remains attractive.

The financial strength and liquidity of our composite holdings should permit us to exploit potential dislocations in the markets. Our outlook for earnings and dividend growth remains unchanged.

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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 06/30/13 through 09/30/13.

[2]The Energy Select Sector SPDR (XLE) is an exchange-traded fund (ETF) whose objective is to provide investment results that correspond to the performance of the Energy Select Sector Index. The index includes companies that develop and produce crude oil and gas, provide drilling and other energy related services.

[3]The S&P Utilities Index is a capitalization-weighted index containing 31 electric and gas utility stocks (including multi-utilities and independent power producers). Prior to July 1996, this index included telecommunications equities. This equity index does not currently have telecommunications or energy equities that are contained in the Reaves ERISA Composite.