Reaves Asset Management

Review and Outlook

Fourth Quarter 2015

OVERVIEW

The basis of our long-term performance history, the ERISA Composite[1], posted a positive total return for the quarter but did not keep pace with the S&P 500 Index[2]. High-yielding utilities and telecom stocks not only absorbed the Federal Reserve's interest rate increase, they produced positive mid-single digit returns. The decline in crude oil prices, which began in June 2014 with Brent[3] crude oil trading at approximately $112 per barrel, continued unabated, closing at $36.61 on December 31st. Some energy holdings had positive returns for the quarter, but the market's broad-based liquidation of energy-related master limited partnerships (MLPs) hurt some of our holdings with stakes in MLPs. Overall, the result was a single-digit decline for the energy sector. The price of oil declined due to rising domestic inventories, falling commodity prices, fears of a global economic slow-down, particularly in China, and the agreement reached between the U.S., the European Union and Iran over Iran's nuclear program. The agreement, resulting in a lifting of sanctions, will allow Iran to start exporting oil again late in the second quarter 2016.

UTILITIES

The positive return from the composite's utility investments lagged the S&P 500 for the quarter as the broad market, based disproportionately on a few large-cap stocks, recovered from the China-induced lows of August. In contrast to utilities' positive return in December, the broad market declined subsequent to the Federal Reserve interest rate increase.

The nation experienced record-warm temperatures in the fourth quarter. December in the Northeast was among the warmest recorded, punctuated by a 72 degree high in Burlington, VT on Christmas Day. The warm weather's impact on natural gas demand drove the spot gas price below $1.80 and knocked the forward 2016[4] price down over 11%. Electricity fared better, but could not stave off the decline in unregulated, independent power producers. We expect regulated utility companies will report fourth quarter earnings well below those of the prior year. However, most investors will likely continue their traditional practice of focusing on the longer-term, weather-normalized earnings of electric and gas utilities.

Mergers and acquisitions activity experienced in the third quarter continued into the fourth. On October 26th, Duke Energy announced that it had reached an agreement to buy Piedmont Natural Gas for $60 per share in cash, a 40% premium to the prior day's closing price. While Duke was a natural buyer of Piedmont, we believe that the transaction portends continued industry consolidation. On November 30th, ITC Holdings announced that it had begun a strategic review to evaluate sale of the company following indications of interest from other companies. So far, the media has identified five possible suitors including three utilities and two private equity funds.

Federal policy support for continued investment in renewables came on December 18th when President Obama signed the 2015 Omnibus Spending Bill. The law extended bonus depreciation, the production tax credit for wind generation and the investment tax credit for solar. The bill also legalized the export of crude oil.

COMMUNICATIONS

The communications segment of the composite provided a solidly positive return. Tower stocks, in particular, rebounded from a soft third quarter that was characterized by a combination of rate hike fears, foreign exchange concerns, and a pause in carrier capital spending. Tower management teams reinforced this last concern during the fourth quarter with somewhat uninspiring outlooks for 2016. However, shares of American Tower and Crown Castle International recovered due largely to investor perception that management teams were being conservative. Perhaps investors have remained sanguine given that wireless carriers rarely pause capital projects for long, and industry bellwether AT&T – a historically lumpy spender – has been dormant and is now conceivably due to reaccelerate its network build. That said, we acknowledge that part of what makes the tower business model so robust is the combination of strong visibility into both near-term carrier spending and the long-term supply of new spectrum coming to market. As we begin 2016, these two dynamics appear juxtaposed as atypically opaque carrier budgets balance the demand creation from a couple of major spectrum auctions this spring. While near-term performance may prove to be a bit volatile – we will look for opportunities to trade around our bullish, long-term tower thesis.

Cable stocks performed well into the quarter, driven by continued solid financial results. Growth in high-margin broadband and business services revenues continue to enhance the free cash-flow profile of cable distributors, while the video business – often left for dead by the media and investors alike – continues to prove resilient. In fact, both Charter Communications and Time Warner Cable have guided to positive video subscriber additions in 2015 for the first time in roughly a decade, even as the overall industry subtly declines. Put differently, cable actually looks poised to take video market share for the first time since the introduction of satellite TV. From a regulatory perspective, we have been pleased with cable's resilience in 2015 – the industry bounced back nicely from both Comcast's abandoned pursuit of Time Warner Cable, and the reclassification of broadband as a Title II service. Looking forward, we continue to think that regulators appear less concerned about Charter's deal for Time Warner Cable than they were about the Comcast transaction. We also expect the impact of Title II to be fairly limited, due to a combination of forbearance on more onerous clauses, ongoing litigation, and election-season inertia.

ENERGY

We think that for the share prices of oil and oil service companies to recover, oil supply and demand must come into balance. At year end the dividend of the composites' energy holdings averaged over 4.0%. The ability to pay the dividend during this period of declining oil and natural gas prices is fundamental to the decision to continue holding the energy companies currently in the composite. Low prices are driving continued selling of energy companies while the companies massively reduce investment budgets and cut costs. At the same time low prices are stimulating demand, even for gasoline which has long been considered inelastic. The basis for investment in energy companies rests on the fact that, in the long term, current oil prices are not sustainable.

Balance sheet strength and cost cutting will enable the best companies to ride out low prices. As the balance sheets of potential asset sellers are likely to be increasingly stretched, mergers and acquisitions should begin to occur.

While we do not expect an immediate turnaround, our 12-18 month outlook is generally sanguine and it is likely that that a bottom for energy equities relative to the S&P 500 will be made in the next two quarters. Assuming Iran adds an additional 500 kbd[5] to global markets in the first half of 2016, global oil markets should be relatively balanced by late-2016 with worldwide production declines starting to reduce global inventories and demand up in response to lower prices. By 2017, we expect the market to be undersupplied, justifying higher prices. Futures prices tend to discount a forward outlook well in advance, so the impact of lower supply and higher demand should be seen in commodity strip prices by mid-2016 and should set the stage for recovery in oil sensitive shares.

OUTLOOK

Although total return for the composite was unsatisfactory, sector returns excluding energy were not. We expect composite energy companies to continue paying their dividends and to reduce both operating and capital expenditures until oil supply and demand come into balance. Equity share-price recovery is dependent upon a recovery in oil prices, although not necessarily to prices seen at the peak in 2014. In 2004 and 2008, the composite portfolio experienced $35-$40 per barrel oil. With respect to current energy prices, our view is that it is appropriate to focus on the high level of current income from composite energy holdings and the entire composite while awaiting a recovery in oil and natural gas prices.

The year's modest negative total return from utilities, due to a reduction in valuation from extended levels at the beginning of 2015 as well as investors' fears about the impact of rising interest rates, is not indicative of weaker industry fundamentals. We believe that selected utilities' earnings growth in 2016 should be comparable to the S&P 500, while their dividend yields are higher and will continue to grow. Foreign exchange risk is notably absent from their operations as it also is for cable and the large majority of telecom assets.

In communications, the composite remains focused on broadband demand as a major driver of growth. The acquisition of Time Warner Cable by Charter Communications is expected to close in the first quarter, removing a material uncertainty for Charter, a top-ten holding.

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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 09/30/15 through 12/31/15.*

[2] *The S&P 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic 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.*

[3] *Brent Crude is a major trading classification of sweet light crude oil that serves as a major benchmark price for purchases of oil worldwide.*

[4] *The forward 2016 price is the predetermined delivery price for an underlying commodity, i.e., natural gas.*

[5] *500,000 barrels of oil per day.*