Reaves Asset Management

Review and Outlook

Fourth Quarter 2011

OVERVIEW

Market volatility for the year reached its peak in the middle of the third quarter. As a result, portfolios began the fourth quarter positioned with above normal cash weightings and utilities the highest weighted sector. Despite the market volatility each of our major sectors (utilities, energy and telecom) generated positive returns. Additionally, our portfolios posted a strong performance as compared to the S&P 500 Index[1].

SECTOR REVIEW

Gas Utilities

In the quarter we saw a significant drop in the price of natural gas as a result of unseasonably warm weather, weak industrial demand, and increased production from shale plays. In the gas sector investment remains focused on transport and processing rather than production. The portfolio benefitted from exposure to producers of natural gas liquids, particularly as demand for ethane as a chemical feedstock increased.

Electric Utilities

Sustainability of allowed returns in a low interest rate environment was a concern for utility investors in the fourth quarter and throughout the year. In the regulated space, where much of our electric investment is concentrated, allowed return on equity (ROE) seems to be trending downward to the 10% level. Given the very low level of real interest rates this is not an unexpected development. States where we have seen this trend include Michigan, Nevada, and Wisconsin. In a similar development impacting electric transmission, a coalition of stakeholders filed a complaint in late September with FERC asking for lower allowed returns to owners of electric transmission. Share prices of selected companies providing transmission was impacted. We believe rate decision-making at FERC will continue to be driven by the goal of stimulating investment in electricity transmission infrastructure.

Another major concern of utility investors has been the potential earnings impact of new environmental regulations. The material decline in natural gas prices has made the pending Environmental Protection Agency (EPA) rule for Cross State Air Pollution (CSPR) and the new hazardous air pollutants rule, officially known as the Maximum Achievable Control Technology (MACT) rule, much less onerous. Reduced fuel costs due to a declining or low-priced natural gas market partially mitigate the cost of incremental spending to implement the new EPA rules. In response to legal challenges, the United States Court of Appeals for the D.C. Circuit issued, on December 30, 2011, its ruling to stay CSAPR pending judicial review in 2012.

Electricity prices, which are generally well correlated to the price of natural gas, fell dramatically during the quarter. For example, the 2013 calendar strip price for peak power in the PJM market (the largest market in the U. S., stretching from Chicago to New Jersey) fell 15%. Our view is that the market has not fully discounted the impact that a sustained low natural gas price will have on unit revenue and dispatched volumes of solid fuel (i.e., coal and nuclear) generators.

Energy

Energy sector performance rebounded in the quarter, mostly reflecting the rise in crude oil prices from $79.20 per barrel on September 30th to $98.83 on December 30th (West Texas Intermediate Cushing spot prices). The quarter was noteworthy for the favorable but extreme volatility of energy shares, some of which traded up to peak prices exceeding 35% appreciation for the quarter. While the year-end WTI closing price of $99.11 was equivalent to the July peak, energy stocks did not recover all of the losses from the third quarter. To avoid some of the volatility of crude oil prices, energy investment has been focused on integrated majors and selected oil service companies.

Telecom
The fourth quarter was generally positive for telecoms. Late in the quarter AT&T decided to end its attempt to acquire T-Mobile USA, bowing to strong opposition from the U.S. Department of Justice (DOJ) and the Federal Communications Commission (FCC). The decision means that AT&T must look elsewhere for spectrum to satisfy its medium-term requirements. Otherwise, the quarter was generally quiet in the telecom space as several of the major rural players turned their attention to integrating recent acquisitions.

OUTLOOK

Sovereign debt risks and financial market risks remain high. Economic growth is likely to remain below normal, and Europe could slip into recession as a result of its continued pursuit of austerity. Volatility in equities and commodity markets is expected to persist throughout 2012.

We expect interest rates to remain low, sustaining a generally supportive environment for utilities and telecoms. Within the electric utilities space, we will continue to favor regulated transmission and distribution over merchant generators until we detect pressure driving power prices higher.

In the natural gas sector, our investment will remain focused on gathering, processing, and transmission infrastructure. Demand for such infrastructure is growing as production companies seek to develop shale plays across the U.S. Given the widening gap between natural gas and oil prices (relatively low gas price and high oil price), we will especially look for opportunities associated with "wet" natural gas formations, driven by growing demand for natural gas liquids, especially ethane.

In the telecom space we expect to see increased operating synergies and enhanced revenue opportunities from the recent round of consolidation in the wireline sector. Given the rapid growth of wireless data and the demand for spectrum, we expect some merger and acquisition activity in the wireless space in the coming year. However, with the DOJ and the FCC taking fairly hardline stands on mega mergers, we expect to see smaller deals, characterized by joint ventures, and special arrangements to use spectrum more efficiently as the preferred M&A path.

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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.*