Reaves Asset Management

Review and Outlook

Second Quarter 2011

OVERVIEW

Equity markets reacted to European sovereign debt worries, the supply chain impact of the earthquake/nuclear disaster in Japan and the anticipated end of the Federal Reserve's asset purchase program (QE2). Investors rotated into defensive investments which led to utilities outperforming the broad market. However, energy investments underperformed due to the prospect of slowing emerging market demand growth and rising Saudi production.

SECTOR REVIEW

Electric, Gas and Water Utilities

There were meaningful developments in the market for electric capacity during the quarter. In mid-May PJM (Pennsylvania, New Jersey, Maryland), the largest regional transmission organization (RTO) in the United States, conducted an auction for generating capacity for the market years 2014/2015. While capacity prices in the eastern portion of the RTO fell, prices in the rest of the RTO surged well above expectations. Uncertainty regarding power plants' ability to meet newly proposed EPA rules appears to have been the main price driver. The possibility exists that these rules will reduce enough capacity to improve the longer-term supply/demand balance in the region.

Domestic natural gas utilities/energy infrastructure companies appear to have ample development opportunities due to demand for pipeline and processing capability by oil and gas producers. Shale oil and gas development, particularly around the Bakken in North Dakota and Montana, has fundamentally altered demand for infrastructure and should ensure a positive future even with lower commodity prices. In addition, increased demand for natural gas liquids from the chemical sector has kept midstream and processing margins healthy. Our concern lies in valuations rather than fundamentals as the subsector is no longer as attractive as it was 18 months ago and so has less margin of safety.

Energy

Reduced expectations for oil consumption growth drove the decline in the energy sector. Weaker U.S. and Eurozone economic data, ongoing lack of housing sector growth and concern about inflation's impact on Chinese economic prospects reversed short-term upward price trends. In addition, Saudi Arabia promised unilaterally to hike oil production and the International Energy Agency (IEA), probably pressured by central bankers, coordinated a release of strategic reserves from US and European government stockpiles. As a result, the price of Brent oil declined 4.9% in the quarter, which had a cascading negative effect on the value of our oil-sensitive investments.

The size of opportunity around infrastructure development for Canada's oil sands was reinforced by our recent due diligence trip to the country. While the Canadian Association of Petroleum Producers (CAPP), an industry trade organization, estimates that Canadian production can grow from 3.2 million barrels per day (Mbd) now to 4.6 Mbd by 2020, individual company plans suggest this estimate is low. At least three different companies have plans to reach 1.0 Mbd by 2020**,** effectively doubling what they are each producing today. CAPP assumes that natural declines of older fields will offset a certain percentage of the growth. However, technological advances have revolutionized North American hydrocarbon production, improving the industry's ability to extract larger percentages of original oil in place at lower cost from mature fields. To put this into perspective, production in the U.S., the world's oldest basin, is actually growing for the first time since the mid 1980's.

Telecom

The wireless communications business remains the engine of growth, driven by adoption of mobile broadband delivered via increasingly sophisticated smartphones operating over advanced 3G and now 4G networks. Large telecom companies have successfully started to implement tiered pricing which will allow them to monetize volume growth in data usage.

Wireless remains a brutally competitive business; however, consolidation in the United States should ease some of the competitive intensity. Over the course of the quarter we believe investors became more confident in the probability of successful completion of AT&T's proposed acquisition of T-Mobile USA. We think the deal could represent a structurally positive change in the industry's ability to price its services more rationally. In Canada several new wireless competitors have entered the market in the past year as a result of federal government policy to foster competition. The new entrants are focused on the low end of the market with various prepaid plans. Despite the increased competition in Canada, BCE has been able to take wireless share by focusing on data services at the high end of the market. Focused cost management and prudent capital investment enable BCE to improve cash flow. As a result the company has been able to raise its dividend twice in the past year.

OUTLOOK

Utilities provide compelling relative yield in a world where the 10-year Treasury note yields only about 3.0%. Historically, regulated utilities have traded at a yield discount to Treasuries. Currently, they are at a premium, reflecting uncertainty about the macroeconomic outlook. The premium appears excessive given the fact that regulated utilities have long histories of dividend growth even during periods of economic duress as in 2008 and 2009. In our view, the rising dividend income stream from selected utilities provides a superior investment alternative to fixed income securities.

Industry consolidation among electric utilities is a key trend. We think that many midcap utilities will become part of larger organizations in the coming years. Three new deals have been announced in the last six months. Constellation Energy Group agreed to be purchased by Exelon Corporation; First Energy acquired its adjacent competitor, Allegheny Energy; and Duke Power agreed to acquire Progress Energy. Regulators have become more amenable to consolidation, accepting the view that efficiencies resulting from consolidation can help fund infrastructure development at lower net cost to consumers. While acquisition premiums have been modest so far, we think this trend will underpin valuation.

In energy, we continue to see long-term upside for two groups; those with the resources that are being revolutionized by technology, and those that provide the technology. With increasing frequency we learn of new oil and gas plays in shale and the Canadian tar sands opened by the industry, or of mature plays becoming more economic because extraction technology has improved. In our view, the holders of these resources should be able to grow their business even through periods of depressed oil or gas prices. By the same token, selected oil services firms that supply the technology have become a more strategically important piece of the energy value chain.

The high valuations accorded to companies that build and operate oil and gas infrastructure is a growing concern for us. Over the past 24 months, the sector has generated positive returns in such companies and in our view there continues to be long-term growth opportunities, particularly around Canada's oil sands and oily shale plays in the US like the Bakken or Eagle

Ford. However, many new funds focused on oil and gas Master Limited Partnership's and infrastructure have been formed in the past twelve months, bidding up prices of the equities, reducing yields and, more importantly, reducing the margin for error if expectations are not met. We continue to monitor valuations.

In telecom, explosive mobile data growth coupled with more rational pricing and industry consolidation present big telecom with its best opportunity in years to grow earnings meaningfully despite continued contraction in legacy wireline voice. Both Verizon and AT&T are racing to complete their 4G networks. We also see opportunity in the rural telecom sector. We think the shares of the major players are oversold on acute but temporary concerns about the future success of integration efforts. Rural telcos, because of their high dividend yields and relatively lower level of competition may be seen as a defensive haven during periods of heightened economic uncertainty.

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