Reaves Asset Management

Review and Outlook

Third Quarter 2011

OVERVIEW

Macroeconomic issues dominated investor concerns in the third quarter. Indecision on the part of EU leaders regarding how to best deal with a possible Greek sovereign debt default had a cascading negative effect on bond markets in other weak EU nations and called into question the long-term viability of the Euro currency. The failure of U.S. policy makers to reach agreement on the U.S. deficit problem added concerns that the whole developed world was devoid of competent leadership. At the same time the impact of first-half rate hikes by the Chinese government to cool an overheated property market began to be felt in declining demand for commodities. The VIX index, a standard measure of market volatility, began the quarter at 16.52, peaked at 48.0 on August 8th, and closed the quarter at an elevated level of 42.96.

Within this turbulent environment, electric and water utilities exhibited great defense, holding their value and generating cash from dividends, while commodity sensitive energy sectors were subject to indiscriminate selling.

SECTOR REVIEW

Energy

The price of West Texas Intermediate (WTI) declined 15.9% in the quarter, while global prices as represented by Brent were considerably stronger, declining only 4.3%. Energy equities, as exemplified by the XLE (Energy Select Sector SPDR), fell a much more severe 22.4%, leading the decline in global markets. This is somewhat surprising since the group's underperformance relative to broader markets had started in February and presumably had already discounted slower global growth. By the end of the quarter, many equities in the group appeared to be pricing a 2008-style decline in commodity prices.

Meanwhile, North American shale continued to generate headlines. Several operators disclosed impressive initial results of an oily play targeting the Utica shale in eastern Ohio. While it is still early days, the Utica shale can add to an already impressive opportunity set for Appalachian producers targeting the Marcellus shale, and for infrastructure developers helping get that production to markets. While these opportunities will have to overcome environmental opposition, particularly against the practice of hydraulic fracturing, which, in our opinion, remains largely misunderstood by the general public, the region should see continued growth.

Our long-term thesis that energy demand will grow faster than supply and thus underpin commodity prices remains unchanged. Near-term macro concerns provide us an opportunity to add to our favorite companies. We remain focused on companies that have advantaged businesses and can grow and prosper throughout the cycle, even in times of lower commodity prices.

Gas Utilities
Our gas utility investments benefited from strong growth trends in processing natural gas liquids (NGLs) like ethane and propane, and from rising demand, particularly for export and for the chemical sector. Shale-driven increases in U.S. ethane production have been largely absorbed by increased exports due to relative price attractiveness of U.S. NGLs. Domestic demand has also grown due to chemical companies and refiners substituting NGLs for naphtha, again, due to relative price attractiveness. These trends are likely to be more than temporary. Large scale investments are being made to increase export capacity in the Gulf Coast. And large chemical companies have announced plans for new facilities located near shale production regions predicated on the availability of ethane as both a fuel and a component in the manufacture of plastics.

Electric Utilities
Electric utilities contributed positively to investment performance during the quarter. In periods of economic upheaval, utilities tend to outperform. A dearth of adequate yield in the fixed income markets has added to demand for utilities and helps explain the positive absolute performance of the group in an otherwise down broader market. As such, utilities with large, stable, regulated asset bases tend to be the best performers, followed by companies that offer investors above-peer yield.

Fundamentally, utilities with large exposure to merchant generation (unregulated generation) were helped by two regulatory actions during the quarter. The U.S. Environmental Protection Agency released the final version of the Cross State Air Pollution Rule and a proposed Hazardous Air Pollutants rule. These rules, scheduled go into effect 2015, should meaningfully restrict emissions from coal-fired generation, which should result in the closure of older coal-fired plants. This reduction in generation supply should support power prices and be a positive for development of new natural gas and nuclear powered plants. With political fallout from the Fukushima disaster subsided, the Nuclear Regulatory Commission (NRC) appears poised to approve construction and operating licenses (COLs) for two new plants by early next year.

Telecom
While there were significant numbers of negative headlines, some of our telecom investments held up relatively well versus the boarder market. As with the utility sector, large integrated telecoms tend to outperform in down markets due to their high cash yields and the non-discretionary nature of their businesses.

Nonetheless, there were disappointments. The Department of Justice's (DOJ) decision to block the proposed acquisition of T-Mobile USA by AT&T, was somewhat surprising and a net negative for the sector. Consolidation within the wireless sector would lead to better capital efficiency and pricing, which would in turn encourage additional capital investment in mobile broadband. Without consolidation the environment could become more competitive due to weak undisciplined players, which may limit capital investment. A challenge to the DOJ decision is scheduled in U.S. District Court in 2012.

Additionally, our investments in rural telecom came under extreme pressure during the quarter. This was partly due to widening credit spreads which created significant head winds for this high-yielding sector. However, underlying fundamentals deteriorated as well, especially for some specific investments we had hoped would benefit from cost cutting post recent M&A.

OUTLOOK
As we look out over the next several quarters, we see little reason to expect substantive change in the interest rate or macroeconomic backdrop. Markets are likely to remain choppy.

As such, we continue to invest in large, stable, often regulated, generators of excess cash that pay dividends or repurchase shares and supply non-discretionary products.

Additionally, there are many favorable fundamental trends that should help us continue to generate value for investors. In the utility sector we see opportunities as environmental legislation opens the path for new investment in efficiency and new generation, all of which must be accompanied by investment in the generating grid. In addition we see opportunities for international investments. The same can be said for our telecom investments, where technological change can create new demand for the carrier services. In energy, our investments should continue to benefit from the shale revolution and expect to see even more opportunities for capital deployment in associated infrastructure as these trends go global.

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