Reaves Asset Management

Review and Outlook

First Quarter 2012

OVERVIEW

Nothing has been fixed: sovereign default risk persists, Greece will likely default again and European banks have taken on even more sovereign debt. However, in the short term, the easing of the European financial crisis and signs of improving economic growth in the U.S. encouraged investors to take risk. For the next several quarters we expect interest rates to remain very low. Given economic uncertainty in Europe and the Middle East, we expect continued oil price volatility, biased toward the upside. For the first quarter 2012, the S&P 500[1] produced a double-digit return of 12.6%. Since 1978 there have been only 15 out of 137 quarters wherein the S&P 500 Index return exceeded 12%. Our portfolios failed to keep up, as is typical when investor sentiment is extremely bullish.

SECTOR REVIEW

Electric, Gas and Water Utilities

The price of natural gas declined due to unseasonably warm weather, and production growth from shale overwhelmed demand. At quarter end the spot price of natural gas at Henry Hub was $1.98 per million BTUs, a 33% decline from December 31, 2011. Utilities with significant regulated generation and transmission assets benefit from the low natural gas price. Lower gas prices benefit consumers and reduce the need for rate increases to pay for environmental compliance investments.

Cheaper natural gas-fired electric generation is often not as strategically located near major load centers as is coal-fired generation. The end result is growing demand for transmission projects designed both to improve access to newer gas-fired electric generation as well as to improve the reliability of the electric grid. We expect these investments to be smaller, cheaper and of shorter duration than large-scale transmission backbone projects. Compared to larger projects, these investments present less regulatory and operating risks to utilities and improve the visibility of earnings growth.

The regulatory backdrop in most state jurisdictions remains supportive and rate making was generally favorable during the quarter, despite a weak economy and low interest rate environment. During the quarter, state commissions authorized rate increases of over $1 billion. Of the 18 rate cases with a published allowed return on equity (ROE) decided during the quarter, the average allowed ROE was 10.5%, with only 4 decisions below 10%. This outcome supports the view that utility investment continues to be an important economic development objective for much of the country with regulators (aided by the tailwind of falling gas and electric prices) supporting rate stability over minimizing nominal rates in the short term.

Telecommunications

Our telecom holdings are broadly defined to include cable and tower companies as well as fixed-line and wireless telephone companies. Improving fundamentals and cash flow in the cable industry as well as data-centric wireless broadband growth in telecom are expected to continue to drive earnings growth. Spectrum availability is key to continued mobile broadband growth. In both the U.S. and Canada the federal communications regulators are planning auctions of spectrum, with the Canadian auction expected in 2013. The regulatory commissions in both countries are keenly aware of the need to free up additional spectrum to meet the growing demand for wireless broadband services. This is generally positive for the wireless industry and suggests continued growth for tower companies. In the rural telecom sector, where we are invested primarily for yield, we remain focused on those companies best able to shift their revenue mix from legacy voice to growth opportunities in broadband, video, and cloud services, while maintaining their cash flow and dividend payments.

Energy

The West Texas Intermediate (WTI) spot oil price at Cushing traded between $96 and $109 during the quarter. Growing demand and the high oil price present opportunities for the oil service industry. Increased drilling in the Gulf of Mexico and new oil and gas discoveries, particularly off the coast of East Africa and Brazil require material, multi-year capital investment. U.S. and Canadian exploration and production from shale oil and gas and Canadian tar sands development are fueling increased demand for takeaway infrastructure – gathering systems, natural gas processing and treatment facilities, and long-haul transportation. Railroads have benefited from hauling sand and pipe to shale drilling locations and taking away liquids. Finally, given expected volatility in oil prices our focus is on investment in large oil service and integrated oil companies whose strong balance sheets, substantial cash flow and dividend policies allow them to look beyond short-term fluctuations in oil prices.

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. Interest rates could rise a bit near term given recent domestic economic strength, but we don't see that as long lived given the size of potential tax increases in 2013 as Bush-era cuts expire. Markets are likely to remain choppy. As such, we continue to invest in large, stable, often regulated, generators of excess cash that pay dividends and/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 we expect to see even more opportunities for capital deployment in associated infrastructure as these trends go global.

For further information contact:
Rowland O. Wilhelm, Jr.
Vice President, Director of Sales & Marketing
Reaves Asset Management
10 Exchange Place, Jersey City, New Jersey 07302
Telephone 201.793.2383
Fax 201.332.8593
rwilhelm@whreaves.com
www.reavesassetmanagement.com

[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.*