Reaves Asset Management

Review and Outlook

Second Quarter 2012

OVERVIEW

What a difference a quarter makes! The bullish sentiment, so evident in the first quarter, gave way to a much more defensive stance in the second, with the broad market, as measured by the S&P 500[1], giving up some of the gains achieved prior to March 31. The S&P 500 produced a loss of 2.81%, following its stellar performance in the first quarter. The broad market took on a much more defensive tone in the second quarter on concerns about the European financial crisis, a hard landing in China and a slowing in the U.S. economy. Against this economic backdrop two of our sectors, utilities and telecom, including cable and tower companies, did well compared to the broad market, while the third, energy, lagged, as the price of a barrel of crude oil (West Texas Intermediate) tumbled from $103.27 to $84.77 or -18%. The oil price decline, brought on by fears of a global economic slow-down at a time of rising production in North America, drove broad-based selling of energy equities in spite of sound fundamentals.

SECTOR REVIEW

Energy

Despite the recent precipitous decline, the price of West Texas Intermediate (WTI) remains relatively high, above $80 per barrel. We believe that oil supply and demand are finely balanced with little spare production capacity. Given the uncertainty of Iran's response to the embargo on oil exports, effective July 1, and the rising tension in Egypt with the election of Muslim Brotherhood candidate, Mohammed Morsi, as President, we think upside pressure on the oil price is more likely than downside.

Natural gas is a story "with legs". The best energy performers in the portfolio were companies that are levered to recovery in North American natural gas fundamentals. The North American gas-directed rig count declined to levels not seen since 2000, at a time when fuel switching for electric power generation away from coal rose 20% year-on-year. Demand should continue to grow as natural gas takes market share from coal for power generation, and from gasoline as a transport fuel for short-haul bus and light-truck fleet transportation.

Telecommunications

U.S.-based integrated telecoms performed very well during the quarter as evidence of a more rational wireless pricing regime mounted. Subsidies to manufacturers are coming under tighter control and newly announced wireless broadband pricing plans are more sensitive to usage than the plans they are replacing. Increased smartphone penetration typically results in increased usage and migration to higher-price plans, which drives growth in average revenue per user (ARPU). Additionally, wireless tower companies, which are levered to increasing usage and network upgrades, continued their strong performance in June on news of acquisition activity. The wireline business continues to face headwinds, with legacy voice revenue declining, small business revenue under pressure from cable competitors, and the enterprise sector still mired by sluggish economic activity. Fiber-based consumer data and video services are a bright spot and a growth driver for the integrated telcos. More generally, the cable companies continue to take share in the battle over broadband.

Electric, Gas and Water Utilities

Utility earnings reported in the month of April were generally lower than a year ago as a consequence of one of the warmest winters in recorded history. Despite the weak start, nearly every company has been able to maintain its original earnings guidance for the year, a testament to the low volatility of the industry's earnings stream.

On June 25th, the a California Public Utilities Commission (CPUC) Administrative Law Judge issued a proposed Decision in the cost of capital case of the four water utilities regulated by the state of California. The decision reflects a settlement that was reached by all interested parties earlier this year. We believe that acceptance of the settlement allowing a 9.99% return on equity establishes a floor for the Cost of Capital Proceeding for the electric and gas utilities that will follow later this year. In today's low interest-rate environment, the sustainability of allowed returns is a significant issue generally, but is in sharpest focus in California, the state with the highest allowed returns. We believe that ultimately the need for continued investment (not to mention rate stability) will discourage regulators from lowering allowed returns drastically. So far, the track record has been solid, with many commissions authorizing equity returns in the 10.0-10.5% range, which would be roughly 50 to 75 basis points lower than a typical result five years ago when ten-year treasury rates were 300 basis points higher. We expect that the CPUC will lower authorized returns, but do so in a manner that is constructive and will enable the valuation discount of the California utilities to narrow.

On May 3rd, the Federal Energy Regulatory Commission (FERC) ordered hearings about a complaint filed by a group led by the Massachusetts Attorney General regarding allowed returns for owners of electric transmission. Given past practices, the market had seen a dismissal by the FERC as the most likely outcome and viewed the order negatively. The decision was not unanimous and we would include Commissioner Moeller's dissent as part of a larger body of evidence that the Commission remains supportive of its own policy of encouraging transmission investment. We believe that the FERC acted to make a modest public gesture to those who filed the complaint and it has created a situation in which all parties have the opportunity to settle their differences for their own benefit outside of a formal proceeding before the Commission itself.

On April 10th, Northeast Utilities (NU) completed its acquisition of NSTAR (NST), owner of gas and electric utilities in the Boston metropolitan area. The Duke Energy/Progress Energy merger closed July 2nd creating a company with $48 billion market capitalization. In total, three major utility mergers have closed in 2012. Looking ahead, we continue to see opportunity for industry consolidation.

OUTLOOK

U.S. economic growth remains low and the Federal Reserve has indicated interest rates will remain low well into 2014, creating a favorable investment climate for utilities and telecoms.

We have not altered our view that merchant electric power prices will remain soft; a situation we think favors regulated utilities and owners of transmission. Over the longer term, oil production growth out of the U.S. and Canada should pressure domestic prices relative to global benchmarks. While this will be a headwind for exploration and production companies, we think that opportunities will emerge in the pipeline, processing and refining sectors as domestic gas and oil usage increases and leads to infrastructure and downstream opportunities. Lower energy prices should also help the North American economic recovery.

Within telecommunications, we expect FCC approval by year end of Verizon Wireless' acquisition of spectrum from a consortium of cable companies and expansion of joint marketing efforts between Verizon Wireless and the cable companies. These developments, coupled with a stable-to-improving pricing environment should favor integrated operators in the cable and telecom space.

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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.*