
Reaves Asset Management

Review and Outlook

Second Quarter 2018

The ERISA Composite¹ returned 6.67%, net of fees, during the second quarter, outperforming both Reaves' custom equal-weighted benchmark² and the S&P 500 Index³ returns of 5.38% and 3.43%, respectively.

Our positive performance occurred despite a rise in interest rates. The yield on the U.S. 10-Year Treasury note⁴ increased from 2.74% at the end of the first quarter to as high as 3.13% before finishing at 2.86%. One of the biggest misperceptions about Reaves' investment strategy is that the portfolio cannot perform well when interest rates rise because of our large utility allocation. In fact, interest rates are just one of many factors that affect our performance and over time, the impact has been almost nonexistent. The annualized returns of the portfolios in the ERISA Composite have been almost the same during periods of rising and falling interest rates.

U.S. 10-Year Treasury Yield ⁵	Rising (297 Months)	Falling (189 Months)
ERISA Composite, net of fees+	12.89%	12.86%

Note – Since the inception of the ERISA Composite, 01/01/1978, interest rates, as measured by the yield of the U.S. 10-Year Treasury note, have trended lower during 297 months and trended higher during 189 months.

Source: Federal Reserve +Annualized

We have been able to achieve this performance because our portfolios have intentional checks and balances that offset some of the portfolios' interest rate risk. Most importantly our investment in energy companies has historically performed well in periods of rising rates. When inflation helps fuel rising rates, we can expect commodity prices and consequently energy equities to perform well. Indeed, the biggest costs our utility companies face are procuring electricity and natural gas

for home heating. Our exploration and production and pipeline holdings benefit from rising prices and help to offset the risk that utilities can face asking regulators to pass on higher costs.

A significant percentage of the composite is also invested in communications infrastructure companies. We focus on companies that can generate growing amounts of free cash flow, much of which can be used for increasing dividends and share buybacks. Many of these companies can raise prices and have long-term contracts with revenue that increases yearly by a few percent so the inflation impact is lessened for these companies.

Within utilities, we focus on companies that can grow at above average rates. Investors come to the sector for yield so short-term changes in interest rates are always going to influence stock prices. However, in their rush to capture yield, investors often ignore growth potential. Herein lies our opportunity to deliver value. The sector is the one area in the market where investors often overpay for yield and underpay for growth. Many times, we find utilities that can grow at above average rates but trade at average to below average valuations. Finding higher growth at reasonable valuations has been one of the keys of our investment performance historically. This approach, while not eliminating the impact of interest rate increases, can certainly dampen its effect.

Our goal is not to hedge all interest rate risk. Our first priority is to build a portfolio of investments with the best growth opportunities adjusted for risk. Choosing from these three sectors allows us to have a thoughtful balance of macro risks.

SECTOR REVIEW AND OUTLOOK

UTILITIES

Reaves' ERISA Composite's utility investments returned 6.02%*, in the second quarter, outperforming the 3.74% return of the S&P 500 Utilities Index⁶.

The strongest segment was the gas distribution utilities. These are smaller companies that, in recent years, have been acquisition targets because of their strong-growth outlook. The companies have been beneficiaries of regulators creating automatic recovery programs to encourage pipeline replacement. After a few high-profile distribution pipeline explosions in California and New York, the programs were created to help utilities with the costly process of replacing decades-old pipelines that could pose public safety hazards. The benefits of the programs are threefold. First, and most obvious, the safety of the gas distribution network improves. Second, the automatic recovery part helps immensely with credit quality. Credit ratings agencies have upgraded many utilities in recent years because of such programs. Recovery has typically been part of a drawn out, fully-litigated process with uncertain outcomes but these programs have increased certainty and consequently credit quality. Third, from the investor point of view, anything that increases certainty can lead to higher valuations. The pipeline replacement programs are typically multi-year deals that allow significant capital expenditure. As long as companies can finance the spending, the long-term outlook is excellent.

Utility financing concerns dominated the headlines in the first part of the year. Near-term lower cash flow from tax reform meant many companies had to issue equity to make up the gap. Investors focused on the immediate problem--this funding gap. We chose to take the longer-term view and are betting that these companies will be able to grow at above average rates for many years. We selectively increased our positions during the downturn in the first quarter and were rewarded soon thereafter.

ENERGY

The ERISA Composite's energy investments returned 15.67%* in the second quarter, outperforming the 13.48% return for the S&P 500 Energy Index⁷. Conditions for energy producers improved for the fourth

quarter in a row and equity prices finally started to reflect the better fundamentals. Concerns about rapid supply growth in the U.S. have abated due to pipeline constraints in the Permian Basin which, we believe, show that domestic production growth has probably peaked in the near term.

Permian takeaway constraints reached crisis levels in the quarter. The discounts producers were willing to take to get their production to market were as wide as they have ever been. We believe that this pressure is unlikely to change until new pipe capacity comes online in late 2019. This, however, is a net positive for our portfolio. Our investments in Permian infrastructure should continue to do well and experience an improved runway for growth projects. Meanwhile, we have been careful to avoid producers in the basin lacking firm transport capacity or an active hedging program.

The change in the historical direction of the flow of oil is another increasingly important feature of the energy landscape. The U.S. is importing less and exporting more. This has changed the infrastructure needs along the Gulf Coast and how refiners and petrochemical companies operate. Export infrastructure and pipeline capacity needs to expand in the Gulf and petrochemical facilities must adjust to the lighter oil being produced in the Permian Basin.

At its June meeting, OPEC (Organization of Petroleum Exporting Countries) committed to adding more barrels to the market. This should relieve some of the near-term constraint. However, given global capacity tightness, we believe it is unlikely that prices decline much from current levels unless there is a recession.

COMMUNICATIONS

Our ERISA Composite's communications investments⁸ returned -0.13%* during the second quarter, outperforming the -0.94% return of the S&P 500 Telecommunications Services Index.⁹

Our largest investments within the sector are in cable companies which performed poorly to date this year. However, we continue to think the group is attractively positioned from a competitive perspective. Over the last five to ten years, cable has been very effective at

growing its broadband business because in most of the country cable operators are able to offer faster speeds than telecom rivals. As cable has capitalized on this competitive advantage, investors have cheered the swapping of low-margin video dollars for high-margin broadband revenue. They have also reaped the benefits of share repurchases and growing dividends. Lately the Federal Communications Commission has reduced regulatory oversight of the industry. Cable also benefitted disproportionately from reductions to the federal tax rate. Coming into 2018, this combination of a technology advantage, light regulation, and falling tax rates made us optimistic that strong shareholder returns will persist. The market has nonetheless tested our resolve.

In our opinion, cable weakness in 2018 has been the result of increased concern about broadband growth. Many investors believe that the market is slowing down due to high product penetration. The bearish thesis continues to be that the sector's outsized market share gains are also at risk due to competition from new technologies. Comcast Corporation's bid to acquire media companies Sky Inc. and Twenty-First Century Fox Inc. added fuel to the fire, as bearish investors saw this as Comcast's response to competitive threats by diversifying into a less attractive business.

As long-term investors, we remain comparatively sanguine. We acknowledge that broadband penetration is slowing, but note that this was a given. After all, household broadband penetration has moved north of 80%. The concern about competition is more complex. Wireless companies have been trumpeting efforts to launch 5G, a theoretically competitive technology to cable broadband. The technology is as-yet unproven outside of lab environments and appears limited in scope even in the medium term. The timing of Comcast's pursuit of media acquisitions disappointed investors, but we believe it is unrelated to broadband growth. Comcast has sought vertical integration for decades. A prime set of assets came for sale coincident with an entirely distinct concern about broadband growth. We think cable stocks have been broadly punished by misinterpretation of an idiosyncratic strategy. The market dislocation has thus made cable look more attractively-priced, in our view.

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¹ The Reaves ERISA Composite reflects the dollar-weighted return of all corporate ERISA pension accounts with assets of at least \$1,000,000 under management. All references to performance and holdings reflect the Reaves ERISA Composite. This quarterly commentary covers the period 03/31/18 through 06/30/18.

² Reaves' custom equal-weighted benchmark is comprised of three industry sectors that are most closely aligned to the sectors employed in the ERISA Composite: 1/3 S&P 500 Utilities Index, 1/3 S&P 500 Energy Index and 1/3 S&P 500 Telecommunications Services Index.

³ *The S&P 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic 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.*

⁴ *The 10-year U.S. Treasury note is a debt obligation issued by the United States government that matures in 10 years. A 10-year Treasury note pays interest at a fixed rate once every six months and pays the face value to the holder at maturity.*

⁵ *Treasury yield curve rates are comprised of real market yields that are calculated from composites of secondary market quotations obtained by the Federal Reserve Bank of New York. These rates are commonly referred to as "Real Constant Maturity Treasury" rates or R-CMTs.*

⁶ *The S&P 500 Utilities Index is a capitalization-weighted index containing 29 electric and gas utility stocks (including multi-utilities and independent power producers). Prior to July 1996, this index included telecommunications equities.*

⁷ *The S&P 500 Energy Index comprises those companies included in the S&P 500 Index that are classified as members of the energy sector.*

⁸ *The communications sector includes securities from the telecommunications, consumer discretionary and equity real estate investment trusts (REITs) sectors.*

⁹ *The S&P 500 Telecommunications Services Index comprises those companies included in the S&P 500 index that are classified as members of the telecommunication services sector.*

**Reaves sector performance is calculated gross of fees.*

An investor cannot invest directly in an index. Past performance is no guarantee of future results. All investments involve risk and loss of principal.