

Review and Outlook

Second Quarter 2010

Due in part to the oil leak in the Gulf of Mexico, the second quarter was a difficult one for our portfolios. The share prices of nearly all of our energy companies declined irrespective of any direct involvement with the DeepWater Horizon disaster. However, even with the negative energy performance, our portfolios outperformed the S&P 500¹ during the quarter as the telecoms and utilities exhibited defensive characteristics.

We maintained our investments in oil services and several of the integrated majors, finding valuations and dividends at current levels attractive. Longer term, we have a bullish outlook on oil and oil service and increased production and consumption of natural gas.

The telephones in our portfolios produced a negative return overall in the quarter on continued access line erosion, lethargy in the global enterprise business, and wireless competition. Similar to utilities, the group did have yield support and substantially outperformed the broad market. Rural wireline consolidation continued in the quarter with the announcement of the acquisition of Qwest Communications by CenturyLink Inc., and the divestiture on July 1 of about 4.0 million access

lines by Verizon to Frontier Communications. In our view, consolidation is a positive for the industry. We think that the recent announcement of tiered wireless broadband pricing by AT&T is a very encouraging sign and may be the first step back to more rational pricing based on usage. We continue to think there will be growing demand for wireless broadband as carriers begin to implement 4G data services. A disciplined pricing structure that allows these providers to monetize increasing broadband traffic should benefit the major wireless providers.

Within the utilities sector, focus remains primarily on the regulated utilities in states with favorable regulatory regimes. Recovery of electric demand this year is expected to be modest. In our view, overall demand for electricity in the United States will remain weak as a result of the weak economic recovery and increasingly successful conservation efforts. Decoupling of electric utility revenues from sales has been adopted in some states and is under consideration in some others in an effort to reduce growth in electricity consumption.

The outlook for increased natural gas utilization remains favorable. Gas utilization in the US will grow because it is the cleanest of the fossil fuels and domestic supplies are ample.

An important political consideration is that natural gas can be a substitute for imported oil from the Middle East and elsewhere. Significant gas price increases are not expected because growing demand can be met by growing supply from various domestic sources, including shale. Companies in a position to profit from increased gas volumes are focused on gathering, processing, transport, and local distribution.

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 W. H. Reaves (“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.

The fundamental strengths of our portfolios remain:

- The current income stream is superior to the 10 year U.S. treasury at 3.0%
- Dividend increases support a rising income stream
- Fears of an economic slowdown contribute to stock price volatility, but the earnings power of portfolio investments is driven by the non-discretionary nature of the products and services provided
- Individual holdings are liquid and pricing is transparent
- Balance sheets are reasonably leveraged
- Dilutive equity offerings are not a risk
- Within the sectors there is broad diversification as to:
 - Business model
 - Regulatory oversight
 - Markets served

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