W.H. **Reaves** Asset Management

**Review and Outlook**

**Fourth Quarter 2010**

The positive equity market performance for the fourth quarter was underpinned by the Federal Reserve's commencement of quantitative easing (QE2) and the extension of the Bush tax cuts for two more years. Volatility, measured by the VIX Index, declined from 23.70 to 17.75, and at one time traded at 15.45, below its level before the Lehman bankruptcy. However, in contrast to the third quarter when the 10-year U.S. Treasury yield declined by 43 basis points to 2.53%, the interest rate on the 10-year U.S. Treasury rose 79 basis points to 3.31%. Despite the rise in interest rate our portfolios produced positive returns, slightly exceeding the S&P 500 Index.[1]

The returns for the quarter were driven by our Energy sector exposure, which accounted for about two thirds of the portfolios' returns. Investments in the Telecommunications and Utility sectors also produced positive absolute returns. Continued favorable tax treatment of qualified dividend income enhances the value of the relatively high dividend yields paid by utilities and telecommunication equities.

**Telecommunications**

Our investment in rural wireline carriers drove returns in the quarter. Market participants appear to be gaining comfort with the rural telecom sector's dividend sustainability and outlook. Industry consolidation has been a significant source of cash-flow growth for the rural companies in the portfolio. Frontier's acquisition of rural access lines from Verizon Communications should be accretive to cash flow and integration appears to be going well. The acquisition of Qwest Communications by CenturyLink is expected to close in the first half of 2011. We believe the expected synergies combined with Quest's tax-loss carryforwards should improve cash flows for the combined company over the next several years.

Late in the quarter the Federal Communications Commission (FCC) issued its net neutrality order. The order may be subject to lawsuits challenging the Commission's authority to regulate broadband. Due in part to the FCC's midsummer loss in a case against Comcast, Inc. over the issue, the order

[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.

was less onerous than early proposals calling for the re-regulation of broadband as a telephone service. We view the order as relatively benign for the broadband carriers. The order prohibits blocking of lawful internet content and unreasonable discrimination on wireline networks. Most important, it does allow for tiered pricing to end users, as well as "reasonable" network management practices. It excludes wireless broadband from the network management rules, and takes a measured approach toward the development of specialized services.

**Electric, Gas and Water Utilities**

Most of the electric utility investments were focused on companies with significant regulated operations. The portfolios have minimum exposure to companies with large unregulated generation fleets. The unregulated generation business remains challenged by low electricity prices which are in turn driven by the low price of natural gas, $4.30 per mm BTU's at year end. Conversely, performance of regulated utilities, operating in selected states with favorable regulatory regimes, remained robust.

In general, natural gas processors and transporters outperformed the market in the quarter on higher volumes and stronger margins. Continued development and investment in transportation and processing infrastructure to serve upstream oil and gas producers focused on increasingly ubiquitous shale plays has been a source of earnings growth. In addition, despite the absence of legislation, the retirement of old, small coal plants has accelerated. We do not expect these retirements to lead to increased demand for natural gas or natural gas infrastructure.

The portfolios have some investments in water utilities. Ongoing consolidation in the industry will likely contribute to earnings and dividend growth over the coming year.

**Energy**

Energy sector investment performance was primarily driven by a rise in the price of oil. The price of West Texas Intermediate (WTI) increased from $79.97 to $91.38 per barrel despite no evident shortage in inventories or productive capacity. Addition of liquidity to markets by the Federal Reserve's quantitative easing program, as well as rapid emerging market economic growth, sparked general commodity price increases from which oil benefitted.

While a significant performance contribution came from exploration and production companies, the fourth quarter also marked a shift in investor sentiment regarding the oil service subsector. Rapid development of North American shale plays, which are generally more service and equipment intensive, coupled with a shift in international oil company willingness to invest more aggressively resulted in one of the best quarters for the subsector since the 1990's. Lifting of the Gulf of Mexico drilling moratorium following the Deepwater Horizon disaster also helped.

## Outlook

The businesses we invest in are generally improving as economic conditions recover. Earnings are growing again, balance sheets are sound, growth opportunities continue to emerge and valuations are not stretched. Thus, we remain cautiously optimistic as we look out into 2011 and expect to continue our focus on differentiated investments that can outperform regardless of economic conditions.

While we expect a benign interest rate environment, if we are wrong we know that the improvement in the underlying earnings of our investments means these companies can and will increase their cash returns to shareholders, in contrast to bonds, by raising dividends or repurchasing shares.

In addition, we see ample growth opportunities for our investments. Some are helping rebuild the country's aging infrastructure. The regulatory backdrop continues to improve because of the recognition of this need on the part of politicians. Other investments are helping supply the energy needs of increasingly voracious emerging markets. These investments not only help insulate our portfolio against inflation but also generate substantial dividend income. Others still, are building the communications and information superhighways that the world needs to facilitate its growth.

In short, we don't know what 2011 will bring from a macroeconomic standpoint and expect the year will be full of surprises. We hope for the best, but these are uncertain times. What we do know is that we have built a portfolio of well-researched, high-quality companies in vital industries that have the ability thrive, grow, and continue to generate increased returns for our investors in good times and bad.



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