Reaves Asset Management

Review and Outlook

First Quarter 2014

OVERVIEW

Investors returned to utilities in the first quarter–all the commentary and analysis about when exactly the Federal Reserve would begin to raise interest rates notwithstanding. While concerns about rising rates may result in increased volatility around utility valuations in the short term, we think the longer-term fundamentals remain quite bullish. In late January, Moody's upgraded most investor-owned utilities from A3 to A2. The Moody's report, dated February 3rd, highlights almost universally improved regulation across the country. Most companies now have pre-approved mechanisms that allow immediate cost and investment recovery which eliminates regulatory lag and improves financial security. These mechanisms are an implicit recognition by the federal and state regulators that infrastructure requirements remain quite substantial, and that utilities need to be financially healthy in order to finance investments. The ConEd natural gas-line explosion in New York City on March 12th reinforces the need for replacement of aging infrastructure. For utilities that have the rate mechanisms for timely investment recovery and strive to operate their systems safely, infrastructure replacement will continue to be a material driver of earnings growth over the next few years. Few other sectors have the potential investment opportunities and surety of returns that utilities provide.

During the quarter, Reaves' ERISA Composite[1] had a positive overall return driven by the performance of the utilities holdings.

ELECTRIC AND GAS UTILITIES

Natural gas and power price spikes in January and February, particularly in the Northeast United States, illustrated the need for new electric transmission and gas pipelines. During the extreme cold weather, there wasn't sufficient pipeline capacity to bring enough natural gas to the Northeast for power-generation needs. The price of natural gas in New England soared to over $90 per mmcf on the coldest days, resulting in power costs of over $1,000 per megawatt hour and forcing electric generators to use coal and oil to make up shortfalls. During the same period, the price of natural gas was between $5 and $6 per mmcf in the rest of the country during the same period, highlighting how gas-constrained the region is. The situation could be even worse next year when Entergy shuts down its 1900 megawatt Vermont Yankee nuclear plant. In response, New England regulators are encouraging infrastructure investment in electric transmission and firm-capacity gas pipelines. The newly created New England States Committee on Electricity submitted a formal request to ISO-New England for assistance with transmission planning. It is in the process of building a large new electric transmission line to bring Quebec hydro power into the region. Support from the states along the right-of-way should help that project come into service more quickly.

We have been researching alternative energy companies. Improvements in energy recovery could make solar power competitive with natural gas-fired electric generation by 2018.

ENERGY

Portfolio energy holdings outperformed broader energy indices such as the S&P 500 Energy Index[2] on the strong performance of investments in oil service. During the period, U.S. oil price benchmarks like West Texas Intermediate rose slightly in price while global benchmarks like UK Brent fell slightly. Differentials between the price of crude oil at Cushing Oklahoma and U.S. Gulf coast markets declined as the southern portion of TransCanada's Keystone XL pipeline came into service alleviating transportation bottlenecks. Crude oil imports fell to a multi-decade low as refiners were able to source domestic and Canadian crude oil feedstock locally at advantaged prices. Global prices remained relatively stable largely because of ongoing Libya production shut-ins and concern about Russian military activity in Crimea and on the borders of Ukraine.

U.S. natural gas prices rose on increased consumption as a result of very cold winter temperatures which reduced storage inventories to multi-year lows. This year's winter was so severe that it has fundamentally altered the outlook for natural gas prices. The gas storage deficit will most likely take several years to alleviate fully at current production rates. This change has been good for our investments in gas infrastructure companies, particularly those developing pipelines and processing facilities around the growing Marcellus and Utica shales. The preponderance of gains in the quarter came from investments in integrated oil service companies. In 2011 and 2012 the industry overbuilt capacity in key services and equipment in anticipation of greater shale-driven demand than actually materialized. It wasn't until late in 2013 that the market showed signs of pricing stability and full absorption of this capacity. Additionally, upstream operators were surprisingly quick to get back to drilling, despite weather induced downtime. The rise in drilling activity further reduced excess capacity, supporting service pricing.

TELECOMMUNICATIONS

The return from telecom sector holdings, broadly defined to include cable and tower companies, was flat for the quarter. Cable company shares came under pressure as investors digested the pros and cons of Comcast's proposed acquisition of Time Warner Cable in an all-stock transaction. We expect that the deal will be approved because the two companies do not directly compete with each other. However, we anticipate a thorough review process with opposition mounted by consumer groups and media companies. To ease the way to acceptance, Comcast indicated its intention to abide by the net neutrality concessions agreed to as part of its NBC Universal acquisition and to divest up to three million subscribers.

Promotional activity in U.S. wireless accelerated, led by T-Mobile's successful marketing efforts. T-Mobile's continued market share gains forced AT&T to cut prices and Verizon to adjust some of its data plans. We have been closely tracking competition in U.S. wireless since recapitalizations of Sprint and T-Mobile were announced in late 2012 and we continue to be concerned about the escalating competitive environment.

T-Mobile's strong subscriber growth helped dampen expectations of a successful acquisition by Sprint in the near term even as Softbank

CEO, Masayoshi Son, came to Washington to drum up support for such an acquisition. Softbank, the number two wireless carrier in Japan owns 70% of Sprint.

OUTLOOK

As we look out over the next several quarters, we think the interest rate environment will remain relatively benign in the U.S. given the continued sluggishness in economic growth and the measured pace of Fed tapering. The expected total return from relatively higher-yielding utilities with growing earnings and dividends remains, in our view, attractive and competitive when the 10-year U.S. Treasury yield is range-bound between 2.5% and 3.0%. The severe winter weather, particularly in the Northeast, highlighted the weaknesses in the existing energy infrastructure. We expect to see increased policy and regulatory support for needed utility company investment in new infrastructure as well as upgrades of aging plant and equipment.

The ERISA Composite's energy investments remain concentrated in subsectors we believe will benefit from investment required to develop new shale resources. While we do not see likely to remain high for some time in the face of supply concerns. We do think that companies with the ability to grow volumes and those investing in volume-related infrastructure will do well. Mexico's constitutional and policy reforms in 2013 accompanied by legislation in 2014 are expected to provide multi-year earnings and investment opportunities for selected U.S. energy companies for shale resource and offshore oil exploitation, alternative energy and provision of energy infrastructure.

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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 12/31/13 through 03/31/14.*

[2] *The S&P 500 Energy Index comprises those companies included in the S&P 500 that are classified as members of the GICS energy sector. This equity index does not have telecommunications equities that are contained in the Reaves ERISA Composite.*