Reaves Asset Management

Review and Outlook

First Quarter 2013

OVERVIEW

For the second year in a row, the S&P 500[1] produced a double-digit return for the quarter ended March 31st. However, this time our ERISA Composite[2] kept pace with the broad market represented by the S&P 500, largely due the double-digit returns of electric, gas and water utilities. The 13.0% total return of the S&P Utilities[3] was its best quarterly performance in nearly ten years. Part of this move was invariably catch-up, as investors chased a rising stock market, buying a sector with limited risk and meaningful underperformance in 2012. In addition, utilities and telecom continue to be among the highest yielding sectors of the equity markets. The investment into utilities was broad based – every stock in the S&P Utilities Index logged a positive return and the standard deviation among them was a modest 4.6%. As a result, the yield on the ERISA Composite declined from approximately 3.4% at the beginning of the quarter to 3.0% at the end.

Utilities

Most of the utility companies in our universe released their fourth-quarter and full-year results. Electric utilities generally exhibited good earnings growth for 2012 and delivered, on average, about a 4% earnings increase. Many fully regulated companies grew at a rate above that level, while those companies with significant merchant-power exposure held back the average.

While the flow of regulatory decisions slowed down materially from the prior quarter, there were several positive events worth highlighting. On January 17th, Virginia's Attorney General reached an agreement with Dominion Resources and American Electric Power that effectively ends their ongoing dispute regarding allowed returns. That agreement ultimately evolved into legislation modifying Virginia's 2007 re-regulation law. The legislation was passed by both houses of the state legislature and awaits the Governor's signature. We believe that each party gains something under the new law: the Attorney General is able to record a public victory while the utilities are able to lower materially their regulatory risks.

On January 18th, the trial staff of the Federal Energy Regulatory Commission (FERC) filed testimony to a complaint made by a group led by the Massachusetts Attorney General against the owners of electric transmission in New England, alleging that the FERC had allowed unjust and unreasonably high returns. While the staff recommendation for 9.66% return on equity is low, we believe the broad range of rates of return considered reasonable in the deliberations provides the commission the latitude to continue to allow double-digit returns; a result that would favor owners of transmission assets.

Allowed returns continue to be sticky in today's low-interest rate environment. In rate cases decided during the quarter, the average allowed return on equity (in those cases in which one was ordered) was 10.1%.

Electricity prices had a very solid quarter; with forward (2015) prices in the PJM Interconnect (the nation's largest) rising 6.7%, outpacing coal and natural gas meaningfully. After a weak 2012 price environment, we think that the market is primarily focused on anticipated plant retirements in 2015 as a consequence of environmental regulation. Nonetheless, electricity demand remains weak, driven by increasing amounts of conservation, increased renewables competition and the potential for development of incremental generating capacity. Further, we believe that there is some speculation on an improvement in the summer market. While we remain respectful of the market's view, we believe that the rise in electricity prices is somewhat overdone. Over the past 12 months the spot price of natural gas has increased from $2.12 to $4.02 but we remain wary of the generating stocks in the face of the continued low level of electricity prices.

While gas-utility dividend yields are generally below those of electric utilities, the gas companies benefited from the flow of funds seeking the relative safety of regulated utility earnings and above-market dividends.

Energy

Within the energy sector, the best performance came from refining, followed by exploration and production, particularly those producers levered to natural gas. The major integrated companies mostly underperformed smaller cap subsectors and the S&P 500, evidence that investors were adding risk exposure. Oil and gas infrastructure companies were slight laggards.

Several trends drove performance in the quarter. First, onshore North American oil production continued to increase rapidly, particularly in North Dakota and Texas. Unlike the case in the last two quarters of 2012, increased rail infrastructure allowed this growing supply to access more coastal refining markets. This proved beneficial to rail shippers, producers in the Bakken and Permian that had been penalized by large price discounts, and coastal refiners. It was somewhat negative for established pipeline companies that continue to have large expansion projects slowed by regulatory issues.

Second, shareholder activism demanding structural changes at several major energy companies has intensified as investors seek to unlock underlying asset values.

Third, cold winter weather and lack of production growth improved the near-term prospects for domestic natural-gas prices. This healthier environment proved beneficial to companies focused on low-cost basins like the Marcellus. While prices have recovered, they remain low enough to continue encouraging switching away from higher cost alternatives, and low enough to attract industrial activity. Thus, not only did upstream producers perform well, associated infrastructure and utility companies outperformed peers.

Looking forward, we believe that a balanced portfolio with representation across the value chain and in some energy consumers will provide good returns. We don't see much long-term upside for either oil or natural gas prices, but see significant opportunities for companies able to grow volumes profitably, those that ship and process energy, and consuming companies that can benefit from lower and more stable North American prices.

Telecommunications

With the notable exception of a domestic wireline carrier that rather unexpectedly announced a revised capital allocation strategy shifting cash returns from dividends to share repurchase, our telecom and cable holdings kept pace with the S&P 500. The integrated telecom carriers in U.S. and Canada remain a focal point of investor enthusiasm because they offer high-quality income at very attractive yields. Fixed and mobile broadband services, particularly video, continue to drive growth. However, the telecom landscape in the U.S. is expected to change with the anticipated emergence of better capitalized wireless competitors to challenge the two major incumbents. The competitive dynamics within the wireless industry may intensify and eventually pressure industry margins. A more competitive environment should create opportunities for tower companies driven by rising demand for mobile network capacity to support data and video services.

OUTLOOK

The continuing moderate pace of economic recovery in the U.S. has not changed our expectation of single-digit, reasonably predictable earnings growth for the ERISA Composite's utilities and telecom companies accompanied by above-average dividend yields and periodic dividend increases. The global economy is dominated by ongoing deleveraging in the private sector and financial institutions, which is deflationary. Generally commodity prices have been falling since early 2011. The attractiveness of regulated, dividend-paying utilities and telcos increases as concerns over deflation rather than inflation occupy both institutional and retail investors' minds.

For further information contact:
Rowland O. Wilhelm, Jr.
Vice President, Director of Sales and Marketing
Reaves Asset Management
10 Exchange Place, Jersey City, New Jersey 07302
Telephone 201.793.2383
Fax 201.332.8593
rwilhelm@whreaves.com
www.reavesassetmanagement.com

[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.

[2] 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.

[3] The S&P Utilities Index is a capitalization-weighted index containing 31 electric and gas utility stocks (including multi-utilities and independent power producers). Prior to July 1996, this index included telecommunications equities. This equity index does not currently have telecommunications or energy equities that are contained in the Reaves ERISA Composite.