Reaves Asset Management

## Review and Outlook

### First Quarter 2015

## OVERVIEW

The ERISA Composite[1] posted a negative total return for the quarter while the S&P 500[2] eked out a positive total return of just under 1.0%. Volatility, measured by the VIX[3], trended lower during the quarter while the 10-year Treasury yield rose above 2.2% mid quarter before closing at about 1.9% at the quarter's end. Oil and natural gas prices remained low and declined.

Returns for the portfolio's energy holdings were overwhelmingly negative with the exception of one exploration and production holding characterized by low-cost shale assets and a long-standing investment in a mid-stream services provider with a major presence in the Marcellus Shale region. While oil prices appeared to be stabilizing around $50 per barrel a great deal of uncertainty as to the level and direction of oil prices persists.

Portfolio utility investments outperformed the S&P Utilities'[4] -5.2% decline, but their return was still negative. Cable companies and a solar company, which was purchased in the first quarter of 2014, were the quarter's standout performers. Telecommunications were slightly positive with the help of meaningful dividend income.

## UTILITIES

In February, utilities had their worst month relative to the market in over a decade. Following their exceptional return in the fourth quarter of 2014, investors appeared to rotate out of utilities in response to the mid-quarter increase in interest rates. Given the persistent low level of long-term interest rates, investors are concerned that allowed returns on equity (ROE) for utilities may be challenged in the future. In particular, allowed returns for transmission investment remain under scrutiny by the Federal Energy Regulatory Commission. However, in our opinion, prospective revisions to allowed ROEs should retain sufficient incentive for companies to continue investing in new transmission. The need for material new transmission investment is recognized by regulators and legislators alike.

Weather this winter was colder, arrived later and stayed longer than normal in the Eastern Interconnect. Eastern generators handled the colder than normal weather better than they did last year, largely as a consequence of being better prepared following last year's volatility.

The shortage of both gas and electric infrastructure in New England is particularly costly in the winter months. We expect that new projects (both announced and unannounced) will ultimately fix the problem, but, in the meantime, the higher rates due to inadequate infrastructure will cost New England $4 billion annually versus $1 billion in 2013[5]. Anticipated cost savings should justify utility rate requests to support new investment.

## TELECOMMUNICATIONS

Despite the U.S. Federal Communication Commission's (FCC) decision to move forward with plans to re-classify broadband as a Title II service, cable was a solid contributor to performance during the quarter. While Title II is likely to be litigated for years, investors were relieved by the Commission's intention to forbear on price regulation and network unbundling. Equities engaged in merger and acquisition activity with transactions awaiting FCC approval were not adversely affected.

## ENERGY

It's all about the price of oil.

During the period, U.S. oil price benchmarks like West Texas Intermediate slid marginally from point to point, but bottomed in January, recovering somewhat by the quarter's end. Producers started to cut development budgets for the year, reducing the number of operated rigs and wells drilled. Capital spending on new production should be down by about 35% in 2015 vs 2014. This should result in a decline in the rate of U.S. production growth by midyear and, depending on how long producers choose to emphasize capital preservation over growth, could result in a production decline by early 2016. As supply trends reverse, we expect a moderate recovery in oil prices.

However, we do not expect this period of lower oil prices to end quickly. There is a chance that OPEC members will conduct an emergency meeting to reduce global supply at some point, but that is probably not likely in the very near term. In fact there is potential for even greater OPEC supply if bilateral talks between the U.S. and Iran result in lifting of sanctions. Also, it remains unclear how increased well productivity will factor into U.S. supply. As completion technology and understanding of basin geology has improved, per-well recoveries have increased. This means that new wells are more prolific than the old ones, so that reducing the number of wells drilled may not have the commensurate linear reduction in North American productive capacity. It also means that producers in key shale regions will be able to do more with less, furthering the cost advantage over marginal domestic and international producers. As such, our strategy remains to invest in companies we believe are low cost, have strong balance sheets and some structural advantage that will allow them to survive these hard times and prosper once conditions improve.

U.S. natural gas prices also fell in the quarter due in large part to excess domestic production. Better U.S. economic conditions and lower oil prices failed to provide sufficient support. Lower oil prices should help reduce supply as operators will be less inclined to drill mixed oil and gas wells based on the economics of the oil produced. However, our investments in gas infrastructure companies, particularly those developing pipelines and processing facilities around the growing Marcellus and Utica shales, recovered in value.

## OUTLOOK

There has been no reduction in geo-political risks and, in our opinion, they will persist. We believe oil and gas prices may remain low for some time to come. Global demand remains weak and the European Central bank is engaged in quantitative easing to ward off deflation. The U.S. dollar continues to strengthen as the U.S. economy grows, and interest-rate policy diverges from the Eurozone.

If the new neutral real rate of interest is much lower now, and in the future, than what it was from Volcker 1979 to Bernanke 2009[6], portfolio utility and telecom investments with above average and regularly increasing dividends and little or no foreign exchange risk provide competitive, risk adjusted returns. Appalachia remains in need of large scale infrastructure development to process and transport low cost gas being produced there - a theme we think will drive growth for many years. Abundant and cheap natural gas provides the basis for a liquefied natural gas export industry.

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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 12/31/14 through 03/31/15.*

[2] *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.*

[3] *VIX is the ticker symbol for the Chicago Board Options Exchange (CBOE) Volatility Index, which shows the market's expectation of 30-day volatility. It is constructed using the implied volatilities of a wide range of S&P 500 index options. This volatility is meant to be forward looking and is calculated from both calls and puts. The VIX is a widely used measure of market.*

[4] *The S&P 500 Utilities Index is a capitalization-weighted index containing 30 electric and gas utility stocks (including multi-utilities and independent power producers). This equity index does not have telecommunications or energy equities that are contained in the Reaves ERISA Composite.*

[5] *Annual data is from ISO New England's press releases dated February 28, 2014 and February 27, 2015, respectively. ISO New England is the independent, not-for-profit corporation responsible for the reliable operation of New England's electric power generation.*

[6] *Paul Volker and Ben Bernanke were both elected Chairmen of the U.S. Federal Reserve (head of the central banking system of the United States). Volker served from 1979-1987 and Bernanke served from 2006-2014. The official title is Chair of the Board of Governors of the Federal Reserve System of the United States. The position is currently held by Janet Yellen.*