Reaves Asset Management

Review and Outlook

First Quarter 2017

OVERVIEW

Strong positive performance in communications and utilities more than offset negative returns from energy, allowing the ERISA Composite[1] to return 2.54%, net of fees, in the first quarter. The communications sector benefitted from better than the broad market performance (as measured by the S&P 500 Index[2]) from cable and tower companies, somewhat offset by lagging performance from integrated telecoms. The utilities portfolio returned slightly better than broad market results as sentiment improved and investors concluded that the Federal Reserve would be measured in raising rates in 2017. Energy results were largely negative as West Texas Intermediate (WTI)[3] crude oil prices turned lower in early March before recovering to $50.60 at quarter end, reflecting investor concerns about rising U.S. production and the likelihood of continued OPEC reductions. We hold to the view that global oil markets will be roughly in balance by mid-2017.

UTILITIES

Utilities generally turned in a strong performance in the first quarter. The S&P 500 Utilities Index[4] returned 6.4%, slightly better than the broad market. Several factors drove the returns. While changes in sentiment are difficult to measure, we think sentiment improved dramatically. Interest rates also helped as long-dated treasury yields fell modestly, reflecting a view that the Federal Reserve would be measured in raising rates over the course of 2017.

Renewable generation, an industry where we continue to see good value among select participants, received favorable attention early in the quarter when Treasury Secretary Steve Mnuchin expressed support for the existing structure of renewable generation tax credits during his confirmation hearing. The broad market had taken an overly cautious view on the prospects for further renewable resource development under the Trump administration. Mnuchin's comments seemed to calm investor fears.

California's three largest investor-owned utilities contributed to the positive news flow. On February 7th, they announced an agreement with major intervenors to extend the existing structure used to calculate allowed returns for two years. In exchange for a modest decrease in return, the utilities removed much of the uncertainty around future rates and alleviated one of the major investor concerns regarding the California companies.

There were positive developments at the Federal Energy Regulatory Commission (FERC). On January 26th, Norman Bay announced his resignation as Chairman and Commissioner. Bay articulated a populist point of view which resulted in a difficult approval process and contributed to considerable investor uncertainty about allowed returns. Currently, there are only two sitting FERC commissioners (of five seats) and, as a result, FERC is denied a quorum. We expect Administration appointment and Senate confirmation of a new FERC commissioner over the next two months. With the recent resignation of Bay and this summer's departure of Constance Honorable, another populist advocate, we should have a much more constructive FERC by the end of the year.

The outlook for merchant generation deteriorated again in the first quarter, offsetting the group's outperformance at the end of last year. The price of forward natural gas and power fell during the quarter and the outlook for electric capacity continued to worsen. On February 8th, ISO-New England (the regional electric transmission authority) released the results of the auction for electric capacity for the planning year ended in May 2021. The price of $5.30 per kW/month was meaningfully lower than last year's auction price of $7.03 and investor consensus of approximately $6.50. The result continues to point to oversupply of generation (even in the face of major plant retirements) and the market's expectation of new electric and gas transmission capacity to bring in supply from neighboring regions.

COMMUNICATIONS

Our communications investments outperformed the S&P 500 Telecommunications Services Index[5] and the S&P 500 in the first quarter by 1,251bps[6] and 247bps, respectively. Strength was relatively broad-based, with solid returns in cable (+11.0% in the quarter) and communications-focused REITs (+10.1%) outpacing our returns in traditional telecom investments (+3.2%). We continue to be materially underweight large capitalization U.S. telecoms, helping to explain a significant amount of the outperformance versus the benchmark during the quarter. In a continuation of trend following the surprise results of the U.S. Presidential election in November, several of our investments benefitted from a more favorable regulatory backdrop – both real and perceived – during the first quarter. Notably, the appointment of former FCC commissioner Ajit Pai to the Chairman's position was clearly supportive for internet service providers, as Pai wasted no time in beginning the process of rolling back or scrapping much of his predecessors' agenda. We note that Pai has been a vocal critic of overreach by telecom regulators throughout his career.

Our cable investments performed well during the quarter. Charter benefited from share repurchases pacing ahead of expectations, but the outperformance was bolstered by market chatter that Verizon was discussing a deal to acquire Charter. We believe that the industrial logic for such a combination would be extremely compelling. However, the financing and regulatory hurdles – even with a more permissive DOJ and FCC – make such a deal quite complicated. More fundamentally, we continue to view favorably the durable free cash flow growth generated by U.S. cable, and now view the regulatory environment to be more permissive.

Communications-focused REITs, and towers in particular, also benefitted from an improved fundamental outlook. The level of certainty around new spectrum build improved as AT&T was awarded the FirstNet contract (a network for First Responders conceived in the wake of communications failures during emergencies such as 9/11 and Hurricane Katrina). The Broadcast Incentive Auction (originally introduced with the 2010 National Broadband Plan) finally wrapped up. The total carrier expenditure on spectrum was lower than expected, leaving carriers potentially more capital to spend on network build outs. The multi-year supply of new spectrum that needs to be built should lead to accelerated growth at towers. A negative note: the end of the auction also means that carriers are free to pursue merger talks at a time when the regulatory environment toward consolidation is the most benign it has been in nearly eight years. However, historically cheap valuations entering the year and the somewhat unmatched durability of the tower business model leaves us relatively sanguine.

Lastly, competition in U.S. wireless remains fierce, and it intensified during the quarter as all four major carriers moved to offer unlimited data plans. For Verizon in particular, this came after years of questioning the economics of such a pricing scheme. We expect this competitive intensity to persist, and choose to stay underweight large-cap telecom accordingly. We note, however, that there are a number of potential positive catalysts for AT&T and Verizon. Namely, we think the ubiquitous rumor of a Sprint-T-Mobile merger would – all else being equal – be constructive for competitors. However, while we take no view on these rumors, anti-trust hurdles are significant. Additionally, as large, domestic, investment-grade cash tax-payers, both AT&T and Verizon could be positioned to benefit disproportionately in the event of any progress of corporate tax reform. That said, we prefer to rely on easier-to-analyze metrics, and thus remain mostly on the sidelines.

ENERGY

In the first quarter the composite's energy portfolio generated an IRR of -4.71%, outperforming the -6.68% return for the S&P 500 Energy Index[7]. Returns were generally negative across the portfolio, with some positive performance from pipelines and exploration and production companies.

During the period, the average price of WTI grade oil rose from the fourth quarter of 2016. However, it peaked early and spent much of the quarter in decline, ultimately closing just above $50 per barrel. Despite OPEC's November 2016 pledge to curtail production by 1.5 million barrels per day (b/d) inventories mostly rose in the quarter. This indicates that not enough supply had been taken off the market. The reduction was partly offset by increases in supply from Libya, which added about 500k b/d, and by reduced winter-heating demand, a result of milder weather. In the last quarter of 2016 many investors had aggressively purchased energy shares on the expectation that commodity prices would rise throughout 2017. As those expectations moderated, short-term traders divested in favor of other sectors.

Adding to the concern about the long-term potential for higher prices was the rapid rise in the North American rig count. The rig count changed direction from contraction to expansion in mid-2016 as domestic oil prices rose above $48.00/bl. More importantly, the new rigs are far more capable than those of even three years ago. Each rig can drill bigger wells faster than those of previous generations and is, therefore, much more productive. The rising rig count sparked fears that U.S. production would grow at an accelerating rate in 2017 after declining for much of 2016. This growth could conceivably offset OPEC rebalancing effort. Regardless, it furthers our conviction to focus on the lowest cost producers with the greatest financial flexibility. To the extent that prices remain lower for longer, these companies can still grow and prosper.

That said, our 12-18 month outlook remains generally sanguine. We continue to believe that global oil markets should be relatively balanced by mid-2017 as production outside the U.S. starts to decline as a result of lack of industry investment. However, this outlook could conceivably be pushed back if OPEC decides not to renew production cuts and returns to a policy of letting the market ration supply. Thus, while we see recovery, our best guess is that it will be tempered relative to previous cycles and that growth will be slower for all but very low-cost producers. As such, industry activity will likely plateau at what before might have been considered "mid-cycle" levels. This means there is likely to be less need for oil services, tools, rigs and incremental associated pipeline and processing infrastructure than in previous upcycles, generally favoring producers versus service and equipment suppliers. Such an environment will most likely lead to further consolidation as companies seek to gain scale and reduce costs.

OUTLOOK

We have positioned the portfolio to take advantage of opportunities we see in each of our sectors. Within utilities we expect continued support, in select states, for renewables investment and multi-year investment in generation and transmission infrastructure. We anticipate a more accommodative FERC that will adopt a smoother approval process while providing investors with greater transparency around allowed rates of return. While we expect short-term interest rates to rise, we think the Fed will take a gradualist approach. We anticipate a less-accommodating Fed policy will reflect an improving U.S. economy.

Within communications we expect continued growth at the cable and tower companies, driven by increasing demand for streamed video accessible from wired and mobile devices, and accelerating digitization of myriad processes and services all of which drive broadband demand.

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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 12/31/16 through 03/31/17.*

[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. All references to the broad market refer to the S&P 500 Index.*

[3] *West Texas Intermediate (WTI), also known as Texas light sweet, is a grade of crude oil used as a benchmark in oil pricing.*

[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). 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.*

[5] *The S&P 500 Telecommunications Services Index comprises those companies included in the S&P 500 that are classified as members of the telecommunication services sector.*

[6] *Basis point (bps) refers to a common unit of measure for interest rates and other percentages in finance. One basis point is equal to 1/100th of 1%, or 0.01% (0.0001) and is used to denote the percentage change in a financial instrument.*

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