Reaves Asset Management

Review and Outlook

Second Quarter 2016

OVERVIEW

The second quarter, capped by the June 23rd vote by the United Kingdom to leave the European Union was, in our view, characterized by investors' search for safety and yield. The 10-year U.S. Treasury[1] continued its price appreciation resulting in the yield declining to 1.49% at June 30th, a decline from 2.27% on December 31, 2015 and 1.78% on March 31, 2016. The U.S. dollar appreciated against the British Pound and the Euro. The average price of West Texas Intermediate Crude (WTI)[2] increased from $33.68 in first quarter to $45.53 for the second quarter.

The ERISA Composite[3], for the second consecutive quarter, significantly outperformed the broad market measured by the S&P 500 Index[4] on strong positive contributions from utilities and energy holdings. These two sectors comprised approximately two thirds of the composite at June 30. Utilities offered investors yield and safety with dividend yields averaging about 3% during the quarter, on largely U.S.-based earnings and an absence of foreign-exchange risk. In energy, the major integrated oil companies offered relatively high dividend yields. The increase in the average price of WTI motivated investor buying, resulting in stock price appreciation.

UTILITIES

The composite's utilities performed well in the second quarter, bettering the 2.5% return for the S&P 500 Index and the 6.8% return for the S&P 500 Utilities Index[5]. American Water Works (AWK) was added to the S&P 500 in March 2016; inclusion in the S&P 500 is typically a boon for a stock as index-tracking funds buy shares.

Despite the outperformance, we think there is still value in utility stocks. Over the last five years, the yield on the S&P 500 Utilities Index has ranged between 90 and 260 basis points above the 10-year U.S. Treasury. As of this writing, the index yield of about 3.2% is at the high end of the historical range (172 basis points) suggesting demand for utility shares can continue for some time.

We believe our utility investments are relatively well-positioned against a rise in the Fed Funds rate, particularly if the rise is in 25 basis point or less increments over an extended period of time. The composite is comprised of utilities that we believe can grow earnings and dividends faster than the index average. As of June 30th, these investments yielded 2.8%, nearly 30 basis points below the index average. In our view, relatively higher-yielding utilities stocks with lower earnings growth rates are likely to be the most negatively impacted by rising interest rates because their lower earnings growth rate diminishes their ability to raise the dividend over time. Short-term price declines by our utilities holdings in response to a gradual back up in interest rates can, in our view, be overcome by their above-average earnings and dividend growth.

ENERGY

In the second quarter the composite's energy investments generated an internal rate of return (IRR) of 13.5%, well above the 11.6% return of the S&P 500 Energy Index[6]. Approximately half the sector's performance contribution for the quarter was generated by large integrated oil companies with dividend yields ranging between 3.0% and 5.8%.

The average price of WTI-grade oil rose quite sharply in response to production outages in Nigeria resulting from political upheaval and declines in both Venezuelan and U.S. shale production. Domestic inventories stopped rising in April and have generally fallen versus prior year averages since that time; evidence that supply is better balanced with current demand. On the demand front, domestic usage continued to show healthy gains as consumers drove more and purchased larger vehicles. The commodity rally coincided with credit spreads contracting and healthier capital market conditions which allowed companies with poor balance sheets, but better quality resource bases, to recapitalize and allowed higher quality companies to make bolt-on acquisitions.

Our 12-18 month outlook remains generally sanguine and is the same as we conveyed in our last quarterly commentary. We continue to believe that global oil markets should be relatively balanced by late 2016 as worldwide production declines start to reduce global inventories while central bank efforts to generate inflation and economic growth may improve demand. By mid-2017, we expect the oil market to be undersupplied, justifying higher prices and setting the stage for a broad recovery in oil-sensitive shares.

While we see industry recovery, our best guess is that it will be tempered relative to previous cycles and that production 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. Nevertheless, in Appalachia infrastructure development needs remain acute.

COMMUNICATIONS

Communications investments, including traditional telecoms, towers, and cable companies contributed positively to the second quarter results, with an internal rate of return of 7.4%, slightly ahead of the 7.1% return of the S&P 500 Telecommunications Services Index[7]. Wireless towers investments generated material outperformance that was somewhat offset by more modest, but positive, returns from cable and traditional telecom companies. Indeed, we believe the outsized positive contribution from REIT-classified towers during the quarter, while supported by defensible business characteristics, was buoyed by persistently low rates. More fundamentally, the re-rating in tower multiples follows early 2016 concerns that current industry growth rates were indicative of an unfavorable long-term trend. We believe investors have begun to reject these fears, and that the health of the tower business model endures. More specifically, expectations for increasing wireless carrier demand from newly-auctioned spectrum bands, as well as from developing 5G technologies, should drive improving growth trends in the coming years.

More broadly speaking, cable stocks were fairly resilient in the face of a regulatory onslaught during the quarter. That is, cable held on nicely as the U.S. Court of Appeals upheld Title II, and the FCC moved forward with efforts to increase oversight of the set-top box and business data services businesses. What's more, Hulu (majority owned by Disney and Fox, with Comcast as a passive investor) announced plans to create an online video bundle in early 2017 that would compete with traditional content distributors. While details are scarce, this represents the first major effort by media companies to disrupt the traditional pay TV ecosystem – thus, it is perhaps the most genuine threat to cable video profits to date. Nonetheless, we continue to view cable stocks as secularly undervalued, as consumer and business demand for broadband – non-discretionary as it is – continues to accelerate.

OUTLOOK

Macro risks abound. The amount of global negative-yielding sovereign debt outstanding set another new high as of June 24th, reaching $11.7 trillion, up from $10.4 trillion at the end of May. (*Fitch Ratings Press Release*, 06/29/*16*). Subsequent to the quarter end, the 10-year U.S. Treasury yield had been driven below 1.4% by investors pursuing income and safety. As of this writing it is at 1.6%. Deflationary trends are prevalent. Euro Stoxx Banks[8] stock prices have experienced material declines, and there is concern the Italian banking system requires a bail out. There is a fear that the European Union may disintegrate.

In our view, Federal Reserve rate increases will be pushed out into the future once again and an ultra-low interest rate environment will persist for some time to come. In such an environment, the relatively high price-earnings ratios of utilities and telecom companies appear justified. Based upon the companies' dividend yields relative to the 10-year U.S. Treasury yield their valuation has improved since the beginning of the year. We have tried to position the composite to provide high quality, predictable current income which can increase over time. Visible earnings growth and an absence of foreign exchange risk contribute to the preservation of capital.

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[1] *The 10-year U.S. Treasury note is a debt obligation issued by the United States government that matures in 10 years. A 10-year Treasury note pays interest at a fixed rate once every six months and pays the face value to the holder at maturity.*

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

[3] *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 03/31/16 through 06/30/16.*

[4] *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.*

[5] *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.*

[6] *The S&P 500 Energy 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 equities that are contained in the Reaves ERISA Composite.*

[7] *S&P 500 Telecommunications Services Index is a capitalization-weighted index containing the five S&P 500 Index telecommunications services sector companies. This equity index does not currently have utilities or energy equities that are contained in the Reaves ERISA Composite.*

[8] *Euro Stoxx is a series of market indices that are representative of the European and global markets.*