Reaves Asset Management

Review and Outlook

Third Quarter 2016

OVERVIEW

During the third quarter, investors generally rotated out of electric, gas and water utilities. As a result, the ERISA Composite's[1] total return net of fees was fractionally negative and trailed the performance of the S&P 500 Index[2] by 417 basis points. Year-to-date, the Composite outperformed the index by about 10 percentage points, net of fees. The average quarterly price for WTI[3] and Brent[4] crude held steady in the $45 to $46 per barrel range. Investors bought into exploration companies leveraged to the price of oil and sold the integrated energy companies. The 10-year U.S. Treasury[5] yield rose from 1.5% to 1.6% during the quarter after trading briefly above 1.7% in advance of the Federal Reserve's September meeting, which left interest rates unchanged.

ENERGY

In the third quarter the Composite's energy sector generated an internal rate of return (IRR)[6] that outperformed the 2.3% return for the S&P 500 Energy Sector Index[7]. The sector's better performing contributors tended to be exploration and production companies able to benefit from cost reduction and strong well results.

Despite the flattish commodity environment, domestic producers tended to perform very well. In part, this was due to improving well performance, particularly in parts of the Permian Basin and in the northern Oklahoma STACK[8] play. As technology improved, operators continued to drive down costs and increase per-well recovery such that the per-barrel costs to find and develop new oil reserves in select plays are falling below $10 per barrel, making them economic even in today's low-price environment. This renewed profitability sparked active mergers and acquisitions (M&A) in the quarter, in some cases with prices per acre at levels above the 2014 cyclical peak.

Production declines in the U.S. and in countries experiencing political strife, especially Nigeria and Venezuela, were largely offset by increases from Russia and partial recovery by OPEC producer Libya. Late in the quarter key OPEC members announced that they had come to an agreement that would effectively freeze output at current levels. While no details will be disclosed until the Group's official meeting in November, the deal raised confidence that further supply-driven downside was off the table. Meanwhile, domestic inventories stopped rising in August and have generally fallen versus prior year averages since that time, evidence that supply is better balanced with current demand, at least in the U.S. On the demand front, domestic usage continued to show healthy gains as consumers drove more miles and purchased larger vehicles.

COMMUNICATIONS

The Composite's communications investments generated an IRR of just under 3%. The results materially outperformed those of relevant benchmarks, as a rally in cable stocks offset price weakness in the high-yielding integrated telcos. The interest-rate sensitive integrated telecom stocks gave up some of their year-to-date gains.

The cable sector generated positive rates of return for the fourth consecutive quarter, driven primarily by strength in shares of Charter Communications (CHTR), which benefitted, in part from its inclusion into S&P 500 Index in September.

Traditional telecom investments generated mixed results, as strength at selected wireless carriers and specialty fiber companies was offset by weakness in the integrated telecoms and global enterprise-centric broadband companies. Wireless carriers, able to differentiate themselves with improved networks and innovative marketing campaigns, continued to gain market share. We expect that carriers with opportunities to participate in future wireless consolidation, anticipated by many in the market, will continue to attract investor interest.

Lastly, our investments in Real Estate Investment Trusts (REITs) that serve the communications industry – representing some of the larger-capitalization securities in the newly defined Real Estate Sector – provided mixed results. Notably, shares of selected tower companies were flat or weak during the quarter as unfavorable interest rate trends were exacerbated by subdued carrier capital spending resulting from objections to leasing costs and a lull in new spectrum coming to the market. We expect a looming reversal of the latter to stimulate activity that mitigates the impact of the former. Offsetting weak tower performance was strength in our investment in a largely wireline REIT with an attractive dividend yield and improving underlying tenant credit-quality. It is well positioned to benefit from anticipated consolidation of communications infrastructure assets.

UTILITIES

The negative return of the Composite's utilities in the third quarter was generally in line with the -5.9% return for the S&P 500 Utilities Index[9]. Investors entered the fourth quarter with renewed expectations that the Federal Reserve would announce a 25 basis point rate increase prior to year-end. The price change for the Composite's utilities holdings ranged from -3.5% to -11.4%. Nevertheless the Composite's year-to-date utility returns continued to better the S&P 500 Utilities Index by more than 250 bps and the S&P 500 Index by more than 11 percentage points. In short the selling was due to a broad-based change in investor sentiment without a deterioration in the fundamental outlook for earnings and dividends of the Composite's utility holdings.

While today's low interest-rate environment pressures allowed rates of return on equity for all utilities, our view is that Federal Energy Regulatory Commission (FERC)-regulated electric transmission returns are particularly vulnerable to downward adjustment because of the FERC's specific calculation methodology. On September 30th, the FERC released a final order in a complaint filed against transmission owners in the MISO (Midcontinent Independent System Operator) region. The long-awaited decision largely mirrored the previously released decision from the FERC-appointed Administrative Law Judge and orders owners to lower rates to reflect a reduction in the authorized return on equity to 10.3% from 12.4%. There are two subsequent MISO complaints and two against New England companies that we expect will be ruled upon by the Commission over the next 18 months. More importantly, though, we believe that the current FERC will continue to be receptive to similar complaints in the future.

M&A activity continued in the quarter. Southern Company agreed to purchase a joint-venture interest in Kinder Morgan's Southern Natural Pipeline. The transaction allows financially-extended Kinder another opportunity to reduce leverage. The transaction should accelerate the growth of the pipeline, benefitting both partners. On July 29th, Nextera Energy announced a plan to acquire Oncor Electric Delivery (the Dallas, TX electric transmission utility) for $18.4 billion dollars. The deal still needs approval from the Texas Public Utility Commission and a bankruptcy judge.

New York State approved its Clean Energy Standard in August which will ultimately require 50% of its consumption of electricity to be sourced from renewable sources by 2030. New York's effort represents a continued pattern of states attempting to jump start the development of new sources of renewable and non-carbon emitting generation. We see the trend as being generally positive for utilities. As part of the plan, New York has also agreed to subsidize its upstate nuclear plants, whose size and age make them uneconomic in the current market climate. Following the announcement, Exelon Corp. announced that it had reached an agreement to buy the Fitzpatrick plant (located near Oswego, NY) from Entergy. Unlike other attempts to subsidize generation, we believe that this initiative should survive scrutiny by the Federal Energy Regulatory Commission. It is, however, being challenged in state court.

OUTLOOK

It is our view 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 improve demand. By mid-2017, we expect the oil market to be undersupplied, justifying higher prices. Futures prices tend to discount a forward outlook well in advance, so the impact of lower supply and higher demand should be seen in commodity strip prices prior to the close of 2016 setting the stage for a broader and healthier recovery in oil sensitive shares.

Despite periodic investor rotation out of utilities in response to expectations of an interest rate increase, utility earnings and dividend growth should be sufficient to overcome small, 25 bps, interest rate increases over an extended period. The standard utility dividend yield has an R-squared[10] of just over 0.8 to the yield on the 10-year U.S. Treasury demonstrating that utility valuations are primarily driven by interest rates. Utility yields are well above the 10-year U.S. Treasury and should remain so in a climate of persistently low inflation and economic growth.

With respect to selected communications companies we acknowledge that U.S. cable stocks face new hurdles in the form of rising regulatory scrutiny and, in some cases, new competition. Nonetheless, we are unchanged in our expectation for robust cash flow generation from cable, driven by additional share gains in core markets, and enhanced by opportunities to develop nascent enterprise and wireless services.

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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 06/30/16 through 09/30/16.*

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

[4] *Brent Crude is a major trading classification of sweet light crude oil that serves as a major benchmark price for purchases of oil worldwide. This grade is described as light because of its relatively low density, and sweet because of its low sulfur content.*

[5] *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.*

[6] *Internal Rate of Return (IRR) is a measure for calculating and evaluating an investment's performance.*

[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.

[8] The STACK refers to shale oil and gas deposits in primarily two Oklahoma counties, Canadian and Kingfisher. The acronym stands for Sooner Trend Anadarko Canadian Kingfisher.

[9] 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.

[10] *In statistics, the coefficient of determination, denoted R2 or r2 and pronounced "R squared", is a number that indicates the proportion of the variance in the dependent variable that is predictable from the independent variable.*

This commentary has been prepared solely for informational purposes and is not to be construed as providing investment services. Opinions and estimates are as of a certain date and subject to change without notice. Past performance does not guarantee to future results. Any investments may not be suitable for everyone. An investor should consider investment objectives, risks, charges and expenses carefully before investing.