Reaves Asset Management

Review and Outlook

Fourth Quarter 2017

OVERVIEW

The ERISA Composite[1] returned 4.5%, net of fees, in the fourth quarter, underperforming the 6.6% return of the S&P 500 Index[2]. For the year the ERISA Composite rose 9.4%, net of fees, versus the S&P 500's return of 21.8%. Despite the underperformance versus the S&P 500 we are pleased with our results for the year as the ERISA Composite outperformed, by nearly 600 basis points, an internal equal-weighted benchmark comprised of the utility, energy, and telecom services sectors[3].

Generally, we expect this kind of performance in bull markets. The value we have provided historically has come from protecting against the downside in bad markets, but downside protection comes at a cost of underperforming in strong markets. We aim to capture 70% of the upside and miss 50% of the downside based upon our belief and experience that this outcome produces competitive total returns over a full market cycle.

COMMUNICATIONS

Composite communications investments[4] returned 3.3% during the fourth quarter; finishing the year up at 16.2% and outperforming the S&P Telecommunications Service Index[5] by 17.5%. Momentum in tower stocks actually accelerated in the fourth quarter driven by three bullish indicators. First, and perhaps more importantly, the oft-rumored merger of T-Mobile US with Sprint was scrapped, eliminating the threat of reduced competition and lower demand for tower space. Second, and coincident with the first benefit to towers, Sprint announced a material increase in its capital spending plans in 2018 and beyond. The company has underinvested in recent years as its cash flow position has been tenuous, and it actively sought accretive M&A[6]. Lastly, AT&T gained final approvals for its government-aided FirstNet network. Building out this network, AT&T is expected to simultaneously deploy multiple spectrum bands that now lay fallow, bolstering tower growth rates beginning in 2018.

Cable stocks were under continued pressure early in the fourth quarter before recovering a bit to close out the year. Investors remain concerned about the evolving competitive landscape with a new focus on AT&T's fiber plant extensions. Potential increased competition from fiber to cable broadband is threatening to profitability, but we believe the scope of AT&T's deployments will be limited as fiber investments are uneconomic in much of the country. Our view is that cable will maintain a superior technological platform in the vast majority of the country for years to come and, as such, our constructive view of U.S. cable stocks is unchanged.

ENERGY

Energy generated an IRR[7] of 10.2% in the fourth quarter, outperforming the 6.0 % return for the S&P 500 Energy Index[8]. The higher price of oil was the principal driver of stronger equity performance. Global demand for oil has been very strong, propelled by improving economic conditions. At the same time, global production growth has been minimal. U.S. growth has been lower than expected as operators are focusing on returns over growth while OPEC[9] cuts have been enough to materially reduce inventories, creating a balanced market and higher prices.

Surprisingly, prices of oil and gas equities mostly lagged the increase in the price of oil. The S&P 500 Energy Index was down about 1.0% in 2017 despite strength in the broad market and a 15% gain in the price of oil. This divergence was unrelenting through much of 2017 and was most likely due to investors discounting a future where electric propulsion displaces the internal combustion engine. The result has reduced access to capital and raised the cost of capital for producers. While this dynamic has been negative so far, we think it sets the stage for positive performance in 2018. The equity markets have forced producers to be more disciplined in finding growth which has reduced new potential supply. This is a fundamentally positive development which could lead to higher valuations. In the context of higher oil prices and better capital discipline, valuations appear much more attractive for the sector. While we believe that electrification poses risks over the very long term, the next couple of years could see a cyclical recovery in the oil and gas sector due to better fundamental health.

UTILITIES

Utilities suffered a disappointing end to the year. Our utility investments underperformed the S&P 500 Index by nearly 10%, from a high on 11/14/17 through the end of the year, as it became clear that tax reform would pass and the probability of four Fed funds rate increases in 2018 rose. Despite this disappointment, the utility portfolio still generated about an 18.0% return for the year. For the quarter, the performance of composite utilities rose almost 1.9%, outperforming the S&P 500 Utilities Index[10] return of 0.2%.

Changes in tax rates have no impact on a utility's net income as all taxes are fully passed through to customers. While the impact to the company is neutral, and positive to the customer, investors sold utilities to buy stocks in sectors where lower taxes are a very positive catalyst. The California wildfires also added to investor stress. Edison International and PG&E are both facing tens of billions of dollars in liability from forest fires in their respective service territories. PG&E's potential liability is so severe that its Board of Directors decided to suspend its dividend. California is the only state where utilities face strict liability regardless of fault, so the impact in our investing universe is limited to companies in this state. PG&E's dividend suspension gave investors another reason to sell and certainly added to the end-of-year underperformance.

OUTLOOK

Energy is well positioned to sustain its recent positive performance. We believe that fundamental tightness in the oil market could lead to higher prices and strong performance in the sector.

Tower stocks likewise have positive catalysts heading into the new year with Sprint and AT&T increasing network capex. Cable stock valuations are attractive and the companies will benefit from tax reform.

Utilities, on the other hand, entered 2018 under continued pressure. The S&P 500 Utilities Index has meaningfully underperformed the S&P 500 Index since the high on November 14th. While tax reform clearly benefits other sectors of the market much more, performance differences like this have tended to be buying opportunities in the past. As such, we are cautiously optimistic on the sector, especially since the fundamentals for utilities outside of California remain constructive.

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
reavesassetmanagement.com

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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 09/30/17 through 12/31/17.*

[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.*

[3] *The equal-weighted benchmark consists of: 33.3% S&P Telecommunications Services Index, 33.3% S&P Utilities Index and 33.3% S&P Energy Index.*

[4] *Securities in the communications sector include cable, telecom and telecom Real Estate Investment Trusts (REITS).*

[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] Accretive M&A (*Mergers and Acquisitions): An acquisition is accretive when the combined (pro forma) EPS is greater than the acquirer's standalone EPS.*

[7] *Internal Rate of Return is a method of evaluating an investment's growth. It is one of the two discounted cash flow (DCF) techniques (the other is net present value or NPV) used in comparative appraisal of investment proposals where the flow of income varies over time.*

[8] *The S&P 500 Energy Index comprises those companies included in the S&P 500 Index that are classified as members of the energy sector.*

[9] *The Organization of the Petroleum Exporting Countries is an intergovernmental organization of 14 nations, as of May 2017, with a major influence on global oil prices.*

[10] *The S&P 500 Utilities Index is a capitalization-weighted index containing 28 electric and gas utility stocks (including multi-utilities and independent power producers). Prior to July 1996, this index included telecommunications equities.*