Reaves Asset Management

Review and Outlook

Second Quarter 2015

OVERVIEW

The utilities holdings of the ERISA Composite[1] came under significant pressure as investors mounted a seemingly full-scale rotation out of the sector, more than offsetting positive returns from the energy and telecom sectors. It appears that the sale of utilities was motivated by an approximately 40 basis-point increase in the yield on the ten-year U.S. Treasury and an expectation that the Federal Reserve would likely increase the Fed Funds rate before year end. However, it has been our experience that such declines in response to interest rate fears are generally short-lived and history shows that the correlation between interest rates and the longer-term return from utilities is statistically low. Our outlook for earnings and dividend growth from composite utilities holdings is unchanged. The sharp contraction in the price/earnings multiples of utilities has improved their value relative to the S&P 500 Index[2] and the ten-year U.S. Treasury[3].

TELECOMMUNICATIONS

Our second quarter investments in telecom, defined to include the cable and tower industries, outperformed the broader market, driven by strength in the cable and legacy telecom segments. This strength was partially offset by towers, which were flat to slightly down during the quarter, due to concerns over interest rates and more difficult year-over-year comparisons. Given the considerable spectrum investment of carriers, we expect expenditures on the buildout of that spectrum to accelerate into the second half of 2015, with towers well-positioned to benefit.

Telecom experienced an active quarter on the merger and acquisition front. Regulatory momentum at both the Department of Justice and the Federal Communications Commission shifted somewhat swiftly against Comcast's proposed deal to acquire Time Warner Cable, prompting Comcast to walk away from the transaction. Ultimately, regulators were concerned that Comcast's unique breadth of assets and distribution scale would create too great an incentive – and too much ability – to impact the burgeoning online video market. For its part, Comcast reminded investors that Time Warner Cable was always a "nice to have" asset, more so than it was a "need to have", and therefore a break-up fee was not a condition of the proposed transaction. We tend to agree, given the favorable fundamental growth characteristics and economics of broadband and business services in particular.

When the deal engine stalled out at Comcast, Charter Communications reacted within weeks by announcing plans to acquire both Time Warner Cable and Bright House Networks. Collectively, "New Charter" should prove better-positioned to realize scale-based content rights and procurement benefits (albeit that it will still be smaller than standalone Comcast). Given the lack of media assets, and the lesser scale, we think Charter faces better odds of approval than did Comcast.

The Department of Justice has concluded that the acquisition of DTV by AT&T does not present anti-trust issues and the Federal Communications Commission approved the transaction on July 24, 2015. The combined entity would become the leading provider of pay-tv services in the U.S. and should benefit from significant economies of scale.

UTILITIES

The 5.8% decline in the S&P 500 Utilities Index[4] during the second quarter resulted in a year-to-date sector decline of 10.7%. Selling of utility stocks was, in our opinion, a response to the increase in long-term interest rates, which rose to 2.35% from 1.94%, as measured by the 10-year U. S. Treasury. In part, the rise in yields was driven by investor expectations that the Federal Reserve would increase its target for the Fed Funds rate later in the year.

On June 9th, the Federal Energy Regulatory Commission approved PJM's[5] new Capacity Performance product. Under the proposal, generators receiving a capacity payment in the auction will have to meet higher reliability standards or face large penalties. We believe that an expected increase in risk premium should drive auction prices higher than otherwise expected based upon supply/demand forecasts. As a consequence, the coming auction results should be favorable for select generators.

There was a flurry of utility-related news flow late in the quarter. WEC Energy Group completed its acquisition of Integrys. SCANA settled its outstanding petition at the South Carolina Public Service Commission to the schedule for the completion of new nuclear units at its VC Summer generating station. Finally, the Supreme Court of the United States remanded the Mercury and Air Toxics Standard (MATS) back to the Environmental Protection Agency (EPA). The Court concluded that the EPA needed to develop an up-front cost analysis. Although the Court's decision adds a degree of uncertainty to the process, we expect that the EPA will modify the rule accordingly and that there will be little impact to the standard.

ENERGY

The composite's energy investments had a positive return despite a -1.88% decline for the S&P 500 Energy Sector Index[6]. The outperformance was primarily due to strong performance from our investments in Williams Cos. which received a buyout bid from a competitor and Occidental Petroleum Corporation, which repurchased a significant portion of its public float with funds generated from asset sales late in 2014, as well as raising its cash dividend.

During the period, the average price of West Texas Intermediate (WTI)[7] grade oil rose from mid first-quarter lows. However, the price peaked in May, went sideways for a while and then declined at the end of the quarter as negotiations between the U.S. and Iran over Iran's nuclear program appeared to be gaining momentum. As of this writing a deal has been announced. Lifting sanctions would allow Iran to start exporting oil again, possibly adding as much a 500 kb/d[8] in the future to already well-supplied global markets.

Global demand appears to have been very strong in the first half of 2015. Energy equity prices remain volatile as global supplies remain elevated because of robust OPEC and U.S. production. U.S. production should start to decline by the end of 2015, if it is not already doing so. The pace of this decline remains an open question and will be a principal factor in defining what, if any, upside oil prices and energy equities have from here. The details of any deal the U.S. reaches with Iran over its nuclear program will also be an important factor.

Mergers and acquisitions (M&A) in the energy industry are one possible response to low oil prices. Firms are seeing fewer organic growth opportunities and looking for ways to gain scale and efficiency. This was the rationale for Energy Transfer's recent bid for Williams Cos., a top-ten holding. Williams has an enviable project backlog as a result of its infrastructure dominance in the Marcellus and Utica shale production areas and Energy Transfer sees less organic development opportunities in its areas of dominance around the midcontinent oil producing areas. We expect that M&A activity will heat up over the next year, especially among exploration and production companies, where scale and capital access will become more important for survival.

OUTLOOK

At some point, possibly in the next six months, the Federal Reserve will, in our view, raise interest rates at a modest pace. However, given the persistence of macro risks including tensions in the Middle East and Ukraine, slowing growth in China, weakness in commodity prices worldwide, and continued uncertainty about Greece, a global slowdown is certainly possible. In that event any decision to raise interest rates could remain on hold well into 2016. Fear of a rise in interest rates has motivated investors, incorrectly in our opinion, to sell utilities. In the short term this may appear to be a good decision. However, select utilities will have the ability to grow earnings and dividends as a result of various growth opportunities, including rate-base growth, increasing demand for transmission and strategic positions in renewable generation. In our view many of these companies will be able to increase dividends at a pace greater than anticipated interest rate increases in the coming years.

We believe merger and acquisition activity will persist in the cable industry and is likely to occur in the energy sector as well.

Stock price volatility will continue to be a factor given the uncertainty arising from divergent interest rate policies, uneven economic growth and weak oil and commodity prices. The relative certainty of earnings and current income from the composite investments are attractive characteristics in the current global climate.

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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 03/31/15 through 06/30/15.*

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 *The ten-year U.S. Treasury is debt owned by the U.S. government for a period of ten years. Each note has a stated interest rate which is paid semi-annually.*

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 PJM is the nation's largest regional transmission organization stretching from Illinois to New Jersey and Virginia.

6 *The S&P 500 Energy Index is a float-adjusted capitalization-weighted index comprised of 45 companies included in the S&P 500 that are classified as members of the energy sector as per the Global Industry Classification Standards (GICS). This equity index does not have telecommunications or utility equities that are contained in the Reaves ERISA Composite.*

7 *West Texas Intermediate (WTI) is a popular oil price benchmark. WTI is the underlying asset in New York Mercantile Exchange's oil futures contract. This type of oil has low sulfur content (sweet). The U.S. Department of Energy maintains historical data for this oil price.*

8 *500 kb/d is 500,000 barrels per day.*