Reaves Asset Management

Review and Outlook

Third Quarter 2015

OVERVIEW

The ERISA Composite[1] outperformed the S&P 500 Index[2] in the third quarter on the strength of a rebound in utilities holdings. Investor fears of an interest-rate increase abated and utilities posted good returns as investors rotated back into the sector. The oil price and energy investments were the focus of investor fears in the third quarter. West Texas Intermediate[3] spent three days below $40.00 in mid-August and ended the quarter at $45.09, down 24.2% quarter on quarter. The aggressive selling of energy related stocks on fears of longer-term global oversupply, which had begun in the second quarter, continued, producing negative double-digit internal rates of return for both the S&P 500 Energy Index[4] and portfolio energy investments.

ENERGY

Our twelve to eighteen-month outlook on the sector is for general improvement in the energy markets on increased global demand, albeit at a more modest pace than assumed earlier in the year, and lowered supply as capital reductions begin to take their toll on production. Assuming no extra supply from Iran, global oil markets should be relatively balanced by mid-2016. By 2017, again without the impact of Iran, we expect the 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 by 2016, setting the stage for recovery in oil-sensitive shares. If Iran is able to produce at the aggressive levels it claims and absent any Saudi accommodation (factors impossible to predict), then our outlook for recovery is likely to be pushed out by about a year.

We expect that the oil price recovery will be tempered relative to previous cycles and that growth will be slower for all but a few very low-cost producers. As such, industry activity will likely plateau at relatively lower levels than in past recoveries. This environment will most likely lead to further industry consolidation as companies seek to gain scale and reduce costs. We are already seeing this particularly in the oil services sector where the top three players are all involved in mergers. Merger activity is also evident in the energy infrastructure space, especially among companies operating in Appalachia, where infrastructure development needs remain acute. For the industry, consolidation results in lower cost and higher operating margins. We have tried to position our portfolio to benefit from the trend by focusing on well-financed companies with strong balance sheets, low-cost producers, and companies with superior geologic assets.

COMMUNICATIONS

In the communications sector our investment in tower companies outperformed the broad market. However, those with significant foreign investments were hurt by the strong U.S. dollar. Tower fundamentals, in our view, remain strong as carriers build out spectrum in both domestic and foreign markets to respond to continued growth in wireless broadband demand. As we enter 2016 we expect U.S. comparables to improve. While several investments in specialty broadband companies underperformed the broad market on weaker than expected earnings growth, longer term, we expect these companies to continue to take market share from the integrated telcos resulting in strong revenue growth and improving free cash flow. Selected cable investments suffered temporarily on renewed investor concerns about the impact of cord cutting, sparked when Disney reduced its ESPN growth projections. We think cable companies will generally be able to defend video market share, with considerable growth opportunities in consumer and video broadband.

UTILITIES

M&A activity in the quarter was unusually high suggesting that utility managements see value at current price levels. On August 24th, Southern Company announced that it had reached agreement to buy Atlanta-based AGL Resources. Then, on September 4th, TECO Energy announced that it had agreed to be purchased by Emera, a Canadian utility. Both transactions were all cash and came at a meaningful premium to the companies' prior share price. In contrast, on August 25th, the Washington, D.C. Public Service Commission denied Exelon Corp.'s application to acquire PEPCO Holdings. The Commission's key complaint: that Exelon's ownership of generation potentially unwound the city's effort to keep its utility strictly in the business of distributing electricity and independent from the competitive generation market. Since then, the company has entered settlement discussions with the city and reached an agreement with the mayor's office.

OUTLOOK

For utilities, the regulatory environment is generally supportive. In August, the Environmental Protection Agency issued the final rule in its Clean Power Plan initiative to lower carbon emissions from electricity generating stations. The final rule made a number of positive adjustments from the original draft rule, most notably, moderating the slope of emissions reductions to full compliance. We continue to believe that the rule will benefit selected utilities in states with favorable return on equity regimes. It will create a significant investment opportunity over the coming ten years as utilities move toward compliance.

In energy we expect the pricing environment to improve over the next twelve to eighteen months. We also expect costs to come down as a result of technology investment and industry consolidation. Both of these trends should lead to increased earnings and cash flow. In the interim, exceptional dividend yields from selected energy companies are, in our opinion, sustainable and provide a return while waiting for a price recovery.

In telecom we think that demand for broadband (wireline and wireless) will continue to grow creating share-growth opportunities for cable companies and specialty broadband companies like Level 3. Tower companies are also positioned to benefit from demands for increased bandwidth capacity from wireless carriers.

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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 06/30/15 through 09/30/15*

[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] *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.*

[4] *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.*
