WH Reaves Asset Management

Review and Outlook

First Quarter 2011

The first quarter of 2011 was remarkable. The 5.92% return of the S&P 500 was the best first quarter since 1998 and the quarter's rally was the seventh in the last eight quarters. In spite of civil war in Libya, popular uprisings in Egypt, Tunisia, Bahrain and Yemen, ongoing concerns over European sovereign debt, and the earthquake/nuclear disaster in Japan, the VIX index ended the quarter where it began at 17.7. Between March 11th and the 16th the VIX spiked up to 29.4 and promptly receded to pre-tsunami levels. $15.8 billion flowed into U.S. stock ETFs, a 34% decline from the last quarter of 2010 while only $250 million flowed into foreign focused ETFs – a 98% drop from the fourth quarter 2010. The market's resilience in the face of adversity lends support to the argument that "there's a tremendous amount of protection in prices".

ENERGY

The first quarter was very strong for energy equities. Performance was driven in particular by investments in integrated oil companies and companies with exposure to shale gas which benefitted from rising global oil prices and a renewed investor focus on the natural gas sector. In addition, Japan's Fukushima nuclear disaster triggered active financial-sector demand for oil and gas securities and raised fears that nuclear power, especially in Europe, could become politically toxic.

During the period, the price of West Texas Intermediate (WTI) grade oil rose 16.8% from $91.38 per barrel (bbl) to $106.72 per bbl. The price of Brent crude increased more than 23% from $93.49 to $115.16 per bbl, driven by acceleration in global demand versus the fourth quarter of 2010 and fear of supply curtailments out of the Middle East. In particular, civil war in Libya has reduced global supply by about 1.0 million barrels per day (global supply was about 87 million barrels per day in 2010).

Some of the factors that made the first quarter so profitable appear temporary. Libyan production will be replaced by other OPEC members in the near term. On the nuclear front, we believe cooler heads will prevail. We would expect that after a period of review and perhaps some design modifications, implementation of long-term plans for nuclear power plant construction will resume. Growth of emerging market hydro carbon demand growth has not changed and will continue supporting oil, coal, LNG and fuel oil commodity prices. Given the rapid increase in price in a short time, we do not expect a repeat performance in subsequent quarters.

Specific investments continue to present opportunities. We see additional upside in oil service and equipment companies. Global spending on oil development is entering a multi-year up-cycle. In addition, new technology enables additional recovery from some old oil fields onshore in the United States.

UTILITIES

The announcement of less stringent than feared EPA rules for coal plant emissions recovery also helped stocks towards the end of the quarter. Power prices are still a headwind for many companies, but we continue to find good opportunities in selected regulated utilities. We remain underweight in the merchant generators.

The nuclear accident in Japan had only a slight negative impact on the share price of utilities having some nuclear exposure; utilities with substantial nuclear investments experienced sharp price declines. Initial indications are that regulators are unlikely to overreact to the disaster and punish the U.S. nuclear industry. The NRC issued a license extension for a Vermont-based nuclear plant at the very end of the quarter; a positive development. The approval of the Vermont legislature is the final step required for the license extension. Japan's nuclear disaster will have an impact on the nuclear power industry.

We expect that the approval process for COL's (construction and operating licenses) for new nuclear units has been pushed back at least a year, but we continue to believe that the principal barrier to new construction is economic, not regulatory. As a precaution we did reduce the portfolio's nuclear exposure in anticipation of continuing headline risk as the nation assesses the role of nuclear energy.

Demand for the midstream services of gas utilities continues to be strong. Despite new gas fired generation, gas consumption has stayed flat for the last 10 years. The need for midstream investment has grown dramatically due to new production from U.S. on shore shale formations with a high concentration of liquids. Also the technology of midstream processing for natural gas is getting more complex, creating a barrier to entry into the market. The March 31st Henry Hub price for natural gas of $4.31 per mcf was largely unchanged from the beginning of the quarter. The price is virtually unchanged since January 2009.

Investment in new transmission is a growth opportunity for selected utilities and for companies engaged solely in the transmission of electric power and transmission investment. Our expectation is that the investment in new transmission will be done in smaller projects rather than, for example, the proposed 275 miles long PATH transmission line from West Virginia to Maryland.

TELECOMMUNICATIONS

Investment in the telephone sector lagged in the quarter and underperformed the S&P 500 Telecom Index. The sub-par results were driven largely by rural telecom equities. It appears these rural telephone companies participated in a general market rotation out of defensive, higher-yielding names into riskier trades. Developments in the wireless sector dominated the headlines for most of the quarter. In January Verizon made its long-anticipated announcement that it would offer the iPhone, ending the three and one half years of exclusivity enjoyed by AT&T. On March 20th, AT&T announced its acquisition of T-Mobile for $39 billion.

OUTLOOK

The 10-year U.S. Treasury began the quarter yielding 3.31% and closed the quarter at 3.45%. The Federal Reserve's quantitative easing (QE2) policy is expected to terminate on June 30th as the economy continues to improve. The relatively high and generally rising dividend yields of telecom and utility equities should help mitigate the impact of rising interest rates upon termination of QE2.

The price of Brent crude rose to $115.16 per bbl and WTI closed at $106.72 per bbl even though oil supplies are currently adequate. The risk is that continued unrest in North Africa and the Middle East could reduce current global production further reducing spare capacity from an estimated 5 million bbls per day before the loss of Libyan production. Saudi Arabian promises of increased spending on social welfare are likely to require a sustained level of higher oil prices to fund the country's expenditures. A reduction in spare capacity to less than 2 million bbls per day combined with an ongoing global economic recovery would support high oil prices.

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