Reaves Asset Management

Review and Outlook

First Quarter 2018

OVERVIEW

The ERISA Composite[1] returned -4.3%, net of fees, in the first quarter which trailed the -0.8% return of the S&P 500 Index[2]. Our investments in communications stocks struggled due to investor concerns about merger and acquisition activity and video subscription levels at cable TV companies. However, we were encouraged by the defensive performance of the portfolio in March. The ERISA Composite was up 2.0% for the month versus a decline of 2.5% for the S&P 500. The conservative nature of our investment strategy has historically been most beneficial during prolonged periods of market weakness.

ENERGY

The energy sector generated a return of -2.5% in the first quarter, outperforming the -5.9% S&P 500 Energy Index[3] return. Positively, the price of West Texas Intermediate[4] oil increased 7.5%. The strength in the commodity has been driven by fundamental supply/demand tightness. Global demand for oil has been very strong while economic conditions have improved over the past year. The International Energy Agency (IEA) currently projects oil demand to expand 1.5 million barrels per day in 2018. This would be the second straight year of strong demand growth. At the same time, global production growth has been minimal. The U.S. has been strong but offset by OPEC's production cap and natural declines in places like Mexico and Venezuela. While the production cap will not last forever, growth in the U.S. is not likely to continue at the same pace. The rig count in the U.S. has increased only marginally in the past year after doubling between the lows of 2016 into 2017. Drilling is getting more efficient, but it will be hard to replicate the last year's production growth without a massive increase in rigs. Many companies are limiting capital investment to reinvesting cash flow instead of taking on debt and stressing the balance sheet. This will improve returns and lower the cost of capital while limiting the amount of possible production growth.

Most equity valuations do not reflect the improving oil price outlook. Price/earnings multiples[5] have declined during the oil recovery as investors seem to distrust the market. We think this creates an opportunity to buy producers that can control costs and improve profitability, as the price of oil increases, but stay profitable and flexible if our bullish thesis proves wrong. Aside from producers, abundant light oil and natural gas have reduced the cost of producing gasoline, diesel, chemicals and lubricants in the U.S. and created demand for exports into global markets. Refining and chemical companies have a good future in the U.S. while infrastructure companies that serve export markets or focus on the few growing North American production basins should also continue to prosper.

UTILITIES

The utility sector generated a -3.5% return in the first quarter, narrowly underperforming the S&P 500 Utilities Index[6] return of -3.3%. Rising interest rates were the principal culprit as the 10-year U.S. Treasury note[7] yield curve rate[8] increased from 2.4% at the end of last year to a high of 2.9% on February 21st. Unsurprisingly, S&P 500 utilities declined during this period, dropping 7.3% from the first of the year through February 21st. For investors who buy utilities primarily for yield, it is not at all surprising to see stock prices weaken when interest rates increase. However, correlation to interest rates creates opportunity. By focusing solely on the relationship between dividend yield and interest rates, investors miss sizable differences in growth opportunities. Historically, we have taken advantage of this dynamic by positioning the portfolio in growth utilities that can outperform once interest rate-related market declines end. Consistent with previous experience, from February 21st through March 30th, interest rates stabilized and S&P 500 utilities outperformed the broad S&P 500 by 6%. The bulk of our utility dollars will be committed to companies that can grow earnings and dividends at an above average rate.

COMMUNICATIONS

The communications sector[9] produced a disappointing -8.0% return during the quarter, underperforming S&P 500 Telecommunications Services Index[10] by 52 basis points. Wireless towers contributed a positive return despite the increase in interest rates. Unfortunately, other real estate-based communications investments did not fare as well. The demand for space in data centers continues to increase, but concerns about oversupply occasionally surface, as they did during the first quarter. Over time, we expect that the compelling industry dynamics for this sector will produce quality results, but returns are likely to be lumpy.

Cable stocks suffered from a series of negative headlines in the past few months, none more consequential than Comcast's decision to bid for UK-based satellite and media firm Sky. The bid demonstrated Comcast's desire to build a more international media presence, and willingness to commit capital to content. The market punished this decision, as investor hopes for a large stock buyback were replaced by concerns as to why Comcast wanted to diversify away from its base business. Investors accordingly reassessed assumptions about the quality of the base business and cut valuations across the sector. Comcast's aggression may have ignited a bidding war given Fox has an agreement in place to acquire Sky, and Disney has an agreement, in turn, to acquire Fox.

Comcast's decision to bid for Sky is likely to have a lasting impact on the sector. Investors are concerned about a bidding war and a potential arms race in which distribution companies feel the need to buy content providers. Valuations reflect these concerns and should provide an opportunity for strong performance if management teams use free cash flow for stock buybacks and bolt-on acquisitions rather than strategy changing acquisitions. We feel good about the current positions but will be monitoring changes in spending plans closely.

OUTLOOK

We believe that the portfolio can produce solid risk-adjusted returns over the long term. Renewable power and battery storage have become cheap enough to compel utilities to invest aggressively in a new electric grid. These investments, together with investment in depreciated plant and equipment, can lead to years of earnings and dividend growth. On the communications side, customers continue to consume increasing amounts of data while purchasing better and faster services. Companies should be able to generate increasing amounts of free cash flow that can either be used to buy back stock or for M&A[11], either of which could lead to good outcomes with a skilled management team. Finally, the new focus on returns instead of growth for energy companies could be the beginning of a new era. At $60 oil, many companies can produce modest growth and increasing free cash flow that could change the way investors look at valuation. While early, this discipline is encouraging. We believe that the portfolio is well-positioned to take advantage of opportunities we see in each of our sectors.

[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 12/31/17 through 03/31/18.*

[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. An investor cannot invest directly in an index.*

[3] *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. An investor cannot invest directly in an index.*

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

[5] Price/earnings multiple *measures how expensive a stock is. Formula: Price of a share ÷ Earnings per share.*

[6] *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. An investor cannot invest directly in an index.*

[7] *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 U.S. Treasury note pays interest at a fixed rate once every six months and pays the face value to the holder at maturity.*

[8] *Treasury yield curve rates are comprised of real market yields that are calculated from composites of secondary market quotations obtained by the Federal Reserve Bank of New York. These rates are commonly referred to as "Real Constant Maturity Treasury" rates or R-CMTs.*

[9] *The communications sector includes securities from the telecommunications, consumer discretionary and equity real estate investment trusts (REITs) sectors. An investor cannot invest directly in an index.*

[10] *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. An investor cannot invest directly in an index.*

[11] *Mergers and Acquisitions (M&A) are transactions in which the ownership of companies, other business organizations, or their operating units are transferred or combined.*