Reaves Asset Management

Review and Outlook

First Quarter 2019

The first quarter of 2019 was Reaves' third best quarter in our 41-year history of managing equity portfolios. Our institutional composite returned 15.8%[1], net of fees, with all sectors generating positive double-digit performance. Better still, exceptional quarterly returns have historically been a sign of strong performance to come. While past performance is no guarantee of future results, our returns for the 12-month period following the previous nine highest quarterly periods have averaged 11.6% with just one negative period.

Time Period	Quarterly Return[1]	Next 12 Months[1]
1980 Q2	23.3%	19.6%
1985 Q4	19.6%	26.2%
2019 Q1	15.8%	?
1984 Q3	15.4%	21.3%
2000 Q3	15.2%	-7.1%
1999 Q2	14.6%	0.6%
2003 Q2	14.3%	14.8%
2009 Q2	13.8%	7.0%
2010 Q3	13.6%	10.1%
1980 Q4	12.6%	11.7%
Average	**15.8%**	**11.6%**

What makes the most recent quarter somewhat unusual is that Reaves also outperformed the S&P 500 Index[2]. Since 1978, this has occurred in just seven of the 27 instances in which the S&P 500 returned 10% or higher in a single quarter. Again, the good news is that historically this has portended solid future results on both an absolute and relative basis.

			Next 12 Months	
Time Period	Reaves[1]	S&P 500 Index[2]	Reaves[1]	S&P 500 Index[2]
1985 Q4	19.6%	17.2%	26.2%	18.7%
2019 Q1	15.8%	13.7%	?	?
1980 Q2	23.3%	13.5%	19.6%	20.6%
2010 Q3	13.6%	11.3%	10.1%	1.1%
1983 Q2	11.1%	11.1%	12.5%	-4.7%
2010 Q4	11.3%	10.8%	10.2%	2.1%
2013 Q1	10.7%	10.6%	15.2%	21.9%
Average	**15.1%**	**12.6%**	**15.6%**	**10.0%**

In the fourth quarter of 2018, Reaves outperformed just as one would expect a low beta, defensive portfolio to do. A portfolio built to perform relatively well in poor markets requires a special set of economic circumstances to then also outperform in strong markets like in the first quarter of 2019. Investors are clearly still worried about the state of the global economy. Bonds rallied globally, and the notional amount of negative-yielding government bonds rose to a record amount. The Federal Reserve halted its interest rate hiking program out of fear of a slowdown. Brexit, concerns about a hard landing in China, and the yield curve[3] inverting all added to the angst. Spot Brent[4] oil gained 33% in the quarter, helping the energy portion of the portfolio but giving investors more reasons to worry about non-fuel consumer spending with wage growth remaining low.

The stability and consistency of earnings and cash flow growth generated by companies in our portfolio, particularly the utility and communications investments, is attractive in economic conditions like these. Investors appear confident that these companies will achieve their growth targets, and that has resulted in improving valuations relative to companies where that kind of confidence is hard to have. We continue to look for companies with highly achievable growth plus improving fundamentals and believe that Reaves should be able to provide competitive returns throughout the cycle.

Energy

Energy equities rebounded in the first quarter following a rise in the price of oil. The energy portion of the composite generated a return of 17.3%, slightly better than 16.4% return of the S&P 500 Energy Sector Index[5] but lagging the 33% gain in the price of Brent spot oil.

OPEC[6] announced production cuts in the fourth quarter that came into full effect in January, reducing global inventories. Apart from Chinese import trends that continued to suggest economic weakness, global demand was healthy. The rally was helped by the futures strip entering backwardation, a condition where the near month futures trade at a premium to longer dated contracts, suggesting near term tightness.

The longer-term outlook is less certain. Companies in the United States figure to continue to grow production from the 12 million barrels per day produced cumulatively today. Advancements in technology allow those companies to grow profitably. The problem for non-U.S. producers is that U.S. shale is so prolific, and costs are declining so much, that U.S. production will satisfy almost all demand growth globally. Balancing the market depends on OPEC policy and commitment on the part of the Saudis to maintain production curtailments. Complicating the longer-term outlook are electric vehicles. Timing and whether enough vehicles are driven to cause demand to decline (something that has only previously ever happened in deep recessions) remains to be seen, but in the meantime, investors are grappling with the potential impacts.

All this signals that investor sentiment is poor and valuations have become depressed. For countercyclical investors like ourselves, who prefer to invest on facts rather than unrealistic gloom and doom scenarios, this often means opportunity. During the 2014-2016 downcycle many companies reduced debt, reduced complexity, and adopted policies prioritizing return of capital to shareholders over growth. We think companies with low cost acreage and infrastructure will continue to prosper.

Communications

The portfolio's investments in communications generated a return of 19.8% in the first quarter of 2019, comfortably outperforming the S&P Communications Index[7] of 14.0%. Our investments in communications-centric REITs[8] and cable operators each generated positive returns of 24% in the quarter, driving the outperformance.

As mentioned in our fourth quarter review, we believed the market's violent sell-off to end 2018 disproportionately punished data centers and cable operators relative to the durability of these business models. Our confidence in the high quality of our investments in these sub-sectors was rewarded with an outsized rally to start 2019.

Growth concerns and financing needs weighed on shares of data center operator Equinix in the fourth quarter. However, steady results, a confident outlook, and a successful equity offering that resulted in the S&P upgrading Equinix' debt to investment grade led to a rally in the company's shares. We view Equinix as a unique set of assets that collectively have unimaginably high replacement value and powerful network effects.

Cable strength in the first quarter seemed to be the result of pent-up demand and a strong fourth quarter reporting season that reinforced the virtues of cable's leveraged-equity model. Namely, while subscriber metric quality continued apace, managements at Charter Communications and Altice USA reiterated declining costs as a percentage of revenue. This growing revenue and falling cost dynamic has encouraged repurchase activity to reaccelerate following a bit of a pause in 2018. We continue to like the setup for the remainder of the year.

Utilities

The composite's investments in utilities returned 13.4% versus 10.8% for the S&P Utilities Index[9]. Utilities remain on a roll, providing more upside capture during the first quarter than historical averages while providing less downside in the previous quarter. Dispersion remained elevated, but below the fourth quarter. The main source of the difference remains the level of exposure to California.

Fortunes improved a bit for the beleaguered California utilities. Governor Newsom appears to be showing some willingness to make hard choices to solve the problem. Unfortunately, public perception of PG&E remains dreadful. We believe this prevents a substantive debate on fixing the root cause problem of inverse condemnation. Further, time is not on the side of the government. If there are no signs of a resolution, the rating agencies may downgrade the remaining investment-grade utilities to junk in the next few months. We expect that the California Wildfire Crisis to be resolved, but it is likely to take a long time. We have opted for investments with a modest exposure like Sempra or where overreaction to PG&E counterparty risk have created an opportunity to capture value like Nextera Partners and Clearway Energy.

Utility performance outside of California has been consistent. Companies are enjoying a virtuous cycle of deploying capital to pursue public policy goals like renewable energy and enhancing the customer experience. At the same time, low inflation and power prices are helping to keep bills down. Regulators remain supportive.

Conclusion

A cautionary final footnote: PG&E Corp., once one of the largest U.S. utilities in terms of market capitalization, lost 77% of its value in the first 18 days of the year before S&P's Index Committee[10] decided to remove it from the S&P 500 due to its announced intention to file for bankruptcy. Tragically for index investors, the shares rallied 140% from the day of removal to the end of the quarter. Indexes are not passive vehicles – they make active decisions on whether to include or exclude companies. In this case, an index provider's decision cost investors enormously.

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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 net of fees. This quarterly commentary covers the period 12/31/18 through 03/31/19.

[2]The S&P 500 Utilities Index is a capitalization-weighted index containing those electric and gas utility stocks (including multi-utilities and independent power producers) in the S&P 500 Index considered to be members of the utilities sector. However, Reaves' portfolios are far less diversified, resulting in higher sector concentrations than found in the broad-based S&P 500 index.

[3] *A yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality but differing maturity dates. This yield curve is used as a benchmark for other debt in the market, such as mortgage rates or bank lending rates, and it is used to predict changes in economic output and growth.*

[4] *Brent Crude is a major trading classification of sweet light crude oil that serves as a benchmark price for purchases of oil worldwide.*

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

[6] *OPEC (Organization of Petroleum-Exporting Countries) is an organization formed in 1961 to administer a common policy for the sale of petroleum.*

[7] *The S&P 500 Communications Services Index is a capitalization-weighted index containing those companies in the S&P 500 Index that are considered members of the communications services sector.*

[8] *REITs are real estate investment trusts. They are companies that own, and in most cases, operate income producing real estate.*

[9]*The S&P 500 Utilities Index is a capitalization-weighted index containing those electric and gas utility stocks (including multi-utilities and independent power producers) in the S&P 500 Index considered to be members of the utilities sector.*

[10] The S&P Index Committee maintains the S&P 500 Index and is comprised of economists and index analysts.

An investor cannot invest directly in an index. Past performance is no guarantee of future results.
All investments involve risk and loss of principal.