Reaves Asset Management

## Review and Outlook

### Fourth Quarter 2019

We are pleased to report that the Reaves Long Term Value Strategy (LTV)[1] had a strong year in 2019 advancing by 31.4% gross of fees and 28.2% net of fees. Our more conservative, higher-yielding Reaves Current Income Strategy[2] gained 23.7% gross of fees and 23.0% net of fees.

The growth outlook for many companies in Reaves' investment universe improved throughout the year. In the utility sector, the push to decarbonize power generation creates billions of dollars in investment opportunities. Because the cost of renewable energy installation has fallen so much, customers and regulators are supportive. Additionally, we see ongoing need for grid investment simply to cope with the age of domestic infrastructure. In the communications sector, the insatiable demand for data and cloud computing services creates favorable secular tailwinds for many of the companies in our investment universe. Our confidence in long-term future growth across these segments is higher as a result.

The fundamental improvement we see as bottom-up investors can be lost on a market increasingly driven by short-term swings in news flow and macroeconomic factors. Much of daily transaction volume is due to quantitative algorithms[3] and ETF[4] flows, not changes in company specific fundamentals. Reaves' opportunities come from ignoring the noise and instead investing in companies that offer growth potential in a wide variety of economic conditions. This is where our investment advantage comes from and, we believe, it is the reason Reaves has been able to generate consistent and competitive total returns since 1978.

We are optimistic because fundamentals of many companies operating in these infrastructure-related sectors continue to improve. Secular tailwinds could power growth in earnings and dividends for the next decade, and we expect these positive characteristics to stay in place regardless of the economic environment.

## SECTOR COMMENTARY

### Utilities

The LTV's utility sector generated a gain of 28.5% in 2019, outpacing the gain in the S&P 500 Utilities Index[5] by about 2%. The sector was slightly down in the fourth quarter, with strong returns in large holdings like NextEra Energy and Sempra offset by poor performance in DTE Energy, Vistra Energy, and NiSource.

One feature of the year we would like to address is the underperformance of utilities in the natural gas distribution business, of which NiSource is one. Nearly all public gas local distribution companies (LDC) have decades of required capex ahead of them to replace aged bare steel or cast-iron pipe that no longer meet modern safety standards. Because spending needs are programmatic, many utility commissions have mechanisms in place that allow utilities to increase customer rates in tandem with utility capital spending, rather than through traditional rate case proceedings which can cause a lag between spending and regulatory recovery. The long-term nature of the spending needs and the immediate recovery on equity translated into high relative valuations verses electric peers over the last few years. In 2019 this premium dissipated and turned into a discount.

November appears to have been the nadir for relative performance of gas LDCs to electric utilities. Around that time there were multiple public comments from local governments in Toronto, California, and New York about potentially prohibiting natural gas connections in newly-constructed buildings in response to climate concerns. Investors started to question the long-term viability of the gas utility industry as a result.

While climate is an important investment driver that will likely prove to be a huge benefit to our electric utility investments, we do not think that it necessarily means the end of gas LDCs. The spending that underpins LDC growth is replacement and maintenance needs driven by public safety concerns. The spending is not underpinned by customer growth, nor would it change if customer growth turns into customer decline. In fact, the industry has dealt with declining volumes per customer for decades, and many companies have regulatory mechanisms in place that make them agnostic to changes in the number of customers. The investment proposition is a multi-decade opportunity driven by safety and reliability. While the group may no longer enjoy the historical premium valuation of the past, we believe, over time, recovery is likely as some of the recent fears erode and the group's earnings growth drives dividend increases.

**Communications**

For the year, our investments in communications[6] gained 43.2%, significantly outperforming the S&P 500 Communications Services Index[7] performance of 32.7%. The sector generated a gain of 3.3% in the fourth quarter.

Our real estate investments took a breather during the fourth quarter, as they were roughly flat in an up market. One of our large holdings, CoreSite Realty, a data center business that provides interconnection services enabling cloud commerce, lagged the group. The company traditionally has achieved persistently high returns on invested capital with a shareholder-friendly management team, but recently growth has been mitigated by limited excess capacity and isolated customer churn events. We expect growth will ramp back up throughout 2020 and remain enthusiastic owners.

Our cable investments were mixed during the quarter. Investors took profits in Altice USA after guidance underwhelmed and share repurchases were paused. At the same time, shares of peer Charter Communications soared as the long-term cable bull case of steady growth, rising margins, and accelerating return of capital bolstered multiple-expansion in a risk-on environment.

Lastly, we want to highlight our continued enthusiasm for traditional telecom incumbents in Canada. Specifically, shares of Telus were solid in the quarter after shaking off concerns related to new marketing schemes. We have long admired Telus for differentiated network quality and customer care, the two most important pillars of a wireless business. As capital intensity declines, we think the company is well-positioned for solid, durable growth in the years to come.

**Energy and Transportation**

Our investments in transports and energy generated a 26.5% gain in 2019. The benchmark, the S&P 500 Energy Index[8], returned 11.8% for the year while the S&P 500 Transportation Index[9] returned 21.2%. In the fourth quarter, these sectors added 5.2%.

Both sectors benefited from trade agreements that boosted hopes of improving economic conditions in 2020. This was especially positive for expectations of rail volumes and demand for fossil fuel. The price of WTI[10] ended the quarter above $60 per barrel for the first time since April 2019.

In rail transportation, the positive impact of company self-help efforts had been offset by a worsening volume outlook as the year progressed. Rail margins have been improving because of industry efforts to modernize logistics and implement precision railroading principles into their operations. However, trade issues, particularly the trade war with China, had reduced global growth, imports, and ultimately the amount of shipped volumes through the U.S. Initial trade agreements between the U.S. and China and the finalization of the USMCA[11] raised hopes that negative trends will reverse in 2020.

In energy, we have always invested at the lower end of the risk spectrum, favoring businesses that generate free cash and have strong balance sheets. The sector's long-term challenges from climate related regulation and electrification of propulsion have only furthered our conviction. However, as expectations have tempered and valuations became depressed, income-producing characteristics for select companies with strong balance sheets and modest growth potential have become more attractive. Thus, our investments have become increasingly concentrated in the major integrated oil and midstream pipeline companies. This strategy worked well throughout the year as the portfolio produced strong gains without a lot of volatility.

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[1] *The Reaves Long Term Strategy (LTV) is represented by the Long Term Value Strategy SMA Wrap Composite. This composite contains those LTV discretionary portfolios with wrap (bundled) fees. This bundled fee includes the wrap sponsor fee, as well as, Reaves' investment advisory fee. We are unable to identify the transaction costs included in the fee; therefore, net-of-fees returns would be net of the highest wrap fee provided to Reaves (300 basis points through 12/31/16 and, effective 1/1/2017, 250 basis points). The inception date of the composite is December 2002; however, the composite was created in January 2013. This composite has been managed in a similar manner to the Reaves Long Term Value Strategy ERISA Composite which ended in December of 2019. The LTV SMA Wrap Composite does not represent all of Reaves' assets under management.*

[2] *The Reaves Current Income Composite has a strategy whose objective is to provide a high level of after-tax income and total return consisting primarily of tax advantaged income and capital appreciation. This strategy*

*anticipates periodic withdrawals of earned income. The inception date of the composite is January 2008 and it does not represent all of Reaves' assets under management.*

[3] *Quantitative algorithms are used for trading to look for repeated patterns with the help of vast databases available for investing.*

[4] *Exchange Traded Fund (ETF) is an investment fund traded on stock exchanges.*

[5] *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) in the S&P 500 Index that are classified as members of the utilities sector.*

[6] *Communications investments include Communications Services and Real Estate Investment Trusts (REITS).*

[7] *The S&P 500 Communications Service Index is a capitalization-weighted index comprised of those companies included in the S&P 500 Index that are classified as members of the communications services sector.*

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

[9] *The S&P 500 Transportation Index comprises those companies included in the S&P 500 Index that are classified as members of the transportation sector.*

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

[11] *United States-Mexico-Canada Agreement (USMCA) is a trade agreement recently passed by the U.S. Senate*.

Reaves' portfolio characteristics, holdings and sector weightings are subject to change at any time and are based on our *Long Term Value Strategy SMA Wrap Composite* portfolio. Holdings, sector weightings and portfolio characteristics of individual client portfolios may differ, sometimes significantly, from those shown. This information does not constitute, and should not be construed as, investment advice or recommendations with respect to the securities and sectors listed.

An investor cannot invest directly in an index.

Past performance is no guarantee of future results.