Reaves Asset Management

Review and Outlook

Second Quarter 2019

Reaves Institutional Composite[1] had another strong quarter. The composite returned +4.1%, net-of-fees, in the second quarter of 2019, outperforming its benchmark[2] return of +1.3%. For the first half of 2019, Reaves generated a performance of +20.6%, outperforming both its benchmark (+13.2%) and the S&P 500 Index[3] (+18.5%).

Beating the S&P 500 Index is an aspiration but not our purpose. Our main goal is to provide downside protection without having to give up too much of the upside. We believe this combination has a good chance of outperforming the S&P 500 over an entire market cycle. Historically, Reaves has captured about 73% of the upside while avoiding 42% of the downside[4], and there are recent signs that this historic relationship with the market still holds. The S&P 500 dropped 6.4% in May amidst concerns over the Chinese trade war. Reaves lost just 2.1%. The S&P 500 recovered in June, rising 7.1%, while the composite returned +4.5%. These kinds of performances are generally what we would expect with a portfolio of defensive companies providing non-discretionary products and services.

The performance in May was particularly encouraging. Economic warning signs have emerged, and recent evidence of Reaves' portfolio having defensive qualities is reassuring. Global manufacturing PMI[5] went below 50 in May and June, a level that in the past has been a sign of a global economic slowdown. The U.S. yield curve inverted[6] in May, something that has happened prior to the last few recessions. Trade wars and impacts from potential tariffs also add to the uncertainty. None of this means a market decline is necessarily imminent, as declining unemployment, wage growth, and the S&P 500 at all-time highs say the recovery can continue, but the warning signs are flashing brighter.

In the last 10 years, through June 30, 2019, the Reaves institutional composite's annualized net-of-fee returns were 11.2% per year. The S&P 500 was up 14.7% annually, so Reaves' performance was 76% of the S&P 500's. In the previous 10 years ended June 30, 2009, Reaves outperformed significantly. The institutional composite was up 4.5% per year (net-of fees) while the S&P 500 lost 2.2% annually. That is the value we provide. Historically, Reaves has kept pace in bull markets while being able to protect and grow capital in bad markets.

Communications

The portfolio's investments in communications generated a return of +8.5% in the second quarter of 2019, comfortably outperforming the S&P Communications Services Sector Index[7] (+2.8%). Our investments in cable stocks and communications infrastructure REITs[8] were once again responsible for the outperformance.

Cable operators Altice USA (+47% year-to-date) and Charter Communications (+39% year-to-date) were particularly strong performers during the quarter. The significant pessimism that was an overhang on cable stocks in the second half of 2018 has largely reversed. Investors appear less concerned about a slow-down in broadband growth and have begun to discount improving cash conversion from better networks and a shift away from video to broadband exposure. Most notably, the bear narrative around increased competition to cable broadband from new wireless technologies has faced uncomfortable realities. Of course, aggressive share repurchases have also helped. We remain steadfast in our favorable outlook for growth and believe the stocks continue to appear inexpensive relative to other infrastructure assets.

Interest rate tailwinds undoubtedly benefitted our communications REIT investments during the quarter. However, the material outperformance of SBA Communications (+13%) and Equinix (+12%) relative to the S&P Real Estate Sector Index[9] (+2%) was idiosyncratic. SBA has notably paced tower stocks year-to-date as the purest play on elevated demand for space on domestic tower real estate. Investors are increasingly hoping that a couple large swaths of previously dormant spectrum assets might be deployed. The dynamics here are somewhat complex. It was once believed that regulatory approval of the proposed T-Mobile USA and Sprint combination was a worst-case scenario for tower investors. However, given Sprint's increasingly perilous standalone prospects, investors now hope a combination with T-Mobile catalyzes the deployment of Sprint's fallow spectrum assets to the benefit of towers. What's more, the notion that a deal with regulators could help DISH Networks enter the wireless business has captured investors' imagination. Like Sprint, DISH has an impressive arsenal of dormant wireless assets but an inability to deploy those assets thanks to a tenuous capital structure. An appropriately structured deal could drive new leases for tower companies. These complicated dynamics reinforce our investment thesis that towers have nearly unrivaled barriers to entry, and consumer demand for wireless broadband will force more spectrum assets to be deployed on tower real estate.

Equinix had another stand-out quarter as leasing growth was solid and concerns about a material slowdown in the business were largely put to rest. We continue to think we are in the early innings of a powerful secular tailwind for data centers. We believe that enterprise IT budgets will increasingly be outsourced to the cloud as chief investment officers seek efficiency and cost savings from shared economics.

Utilities

The portfolio's investments in utilities generated a positive return of 4.0%, outperforming the S&P 500 Utilities Index[10] (+3.5%). Our investments in utilities, that we believe can grow at an above average rate, continue to work well for the portfolio.

The biggest development during the quarter came when the Los Angeles Department of Water and Power announced it would seek approval for a solar energy plus battery storage project. The prices, 1.997 cents per kilowatt-hour for solar and 1.3 cents per kilowatt-hour for storage, would both be the lowest in the U.S. At these prices, solar energy is about half the cost of fossil fuel and nuclear power. The battery is the key component since it will be able to extend the usage of low-cost solar power through the evening peak, removing the need to fire up costly natural gas peaking plants. It can also be used to reduce the variability of the electricity produced, allowing the plant to be dispatchable like coal or natural gas.

If these prices are true, the U.S. may be on the verge of a massive buildout of solar and storage. Almost every utility will be able to build these projects, shut down existing fossil fuel plants, and save customers money. A utility's growth rate is constrained by its customers' willingness to accept bill increases, so any investment that can reduce costs is a priority. Incentives are aligned between the customer and regulator who want cleaner air and lower bills and the utility that wants to invest and grow.

The 35% investment tax credit for solar and storage expires at the end of 2020 so there is some pressure on companies and regulators to move quickly. Expect companies around the country to take notice of this announcement and push forward with aggressive plans of their own.

Energy

The portfolio's investments in energy generated a quarterly return of +0.6%, outperforming the S&P 500 Energy Sector Index[11] (-2.8%). Chevron (+2.0%) and Pioneer Natural Resources (+1.0%) contributed to the outperformance.

From a macro standpoint in oil, not much changed in the quarter. OPEC[12] maintained production cuts instituted in the fourth quarter 2018. This was offset by Chinese import trends suggesting economic weakness and strong growth out of U.S. shale producers. The net of this was a slightly weaker commodity backdrop, but not materially so.

Chevron shares improved after management held firm and declined to increase its offer price to buy Anadarko Petroleum. Investors applauded the capital discipline as well as the $1 billion breakup fee that will augment the share buyback. The total payout to investors, including both the dividend and buyback, will result in a yield of nearly 6%. The company can now concentrate on executing its growth plan laid out in its recent analyst day.

Pioneer Natural Resources performed well, especially relative to other exploration and production companies, after describing a plan to reduce costs, cut capex, sell assets, and generate free cash. The company's focus on returns and capital discipline will help lower break-evens and allow for accelerating share buybacks and dividends.

OUTLOOK

Our utility sector investments are focused in companies that have above average growth opportunities. Water and gas pipeline replacement and renewable energy are particularly attractive areas of growth. Companies involved in these businesses should be able to grow earnings and dividends at a measured pace and provide stability to the portfolio.

In communications, we will continue to look for companies with durable revenue streams and compelling valuations. Given the high fixed-cost nature of the industry, topline growth and stability tends to lead to disproportionately large cash conversion and capital returns. These dynamics have led us to focus our investments on cable and communications infrastructure.

In energy, a forecast published by the IEA[13] raised concern that supply growth in the U.S. will outstrip global demand growth in 2020. Either OPEC will be forced to expand production cuts or inventories will build, the report said. On the demand side, given concern about the impact fossil fuels have on climate, we expect that regulation will eventually reduce growth. We see the sector primarily as a source of income and look to keep our exposure to companies directly correlated to the price of oil and gas low.

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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 03/31/19 through 06/30/19.*

[2]*Reaves' institutional custom equal-weighted benchmark is comprised of three industry sectors that are most closely aligned to the sectors employed in the ERISA Composite: 1/3 S&P 500 Utilities Index, 1/3 S&P 500 Energy Index and 1/3 S&P 500 Communications Services Index.*

[3]*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.*

[4]*The Upside Capture Ratio measures the manager's overall performance to the benchmark's overall performance, considering only quarters that are positive in the benchmark. The Downside Capture Ratio is the ratio of the manager's overall performance to the benchmark's overall performance, considering only quarters that are negative in the benchmark. Both are calculated using monthly-returns data.*

[5]*Purchasing Managers' Index (PMI) is an economic indicator derived from monthly surveys of private sector companies.*

[6]*An inverted yield curve is when the yields on bonds with a shorter duration are higher than the yields on bonds that have a longer duration.*

[7]*The S&P 500 Communications Services Sector Index comprises those companies included in the S&P 500 index that are classified as members of the communication services sector.*

[8]*REITS are real estate investment trusts.*

[9] *The S&P Real Estate Sector Index is comprised of those companies in the S&P 500 that are classified as members of the real estate industry.*

[10] *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 considered to be members of the utilities sector.*

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

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

[13] *The IEA is the International Energy Agency.*

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