Reaves Asset Management

Review and Outlook

Third Quarter 2019

Reaves Institutional Composite[1] appreciated for the third consecutive quarter thanks to strong performance from holdings in the utilities and communications sectors. The portfolio returned 3.6%[2] during the quarter and is up 24.9%[2] for the year-to-date with all areas of investment delivering positive total returns.

Historically, Reaves has provided clients with significant value by avoiding the worst of investment disasters like Enron and WorldCom. Our position as industry specialists helps us to assess risks accurately and determine whether an investment has merit. Our experience in California over the last two years is the latest example. From the onset of the wildfires in 2017, we adopted the posture that it would be best to avoid investing in California utilities until the risks had been largely resolved. We quickly sold out of positions in PG&E and Edison International. Our goal is to create a portfolio that can deliver consistent returns which means only buying riskier situations when the odds are in our favor. We are often late to the party when re-investing, but this conservative strategy means we miss the drawdown in the first place.

The situation progressed towards resolution with the passage of wildfire legislation this summer. The bill does not fix the basic problems of California's policy of inverse condemnation: the assignment of strict liability for all wildfire damages to utilities started by their equipment, regardless of negligence. It does help, though. The portion of the bill that grabs the most headlines has been the establishment of a new $21 billion fund to cover potential wildfire liabilities. Utilities will contribute half while the balance will come from ratepayers.

The more important component of the bill to us is the language changing how the California Public Utility Commission (CPUC) considers recovery of wildfire expenses. Under the law, each utility will be subject to an annual safety certification. If the utility has passed the test, the CPUC can allow the utility to recover their liability unless there is "serious doubt" that the utility acted prudently. "Serious doubt" is a threshold that has been well established in Federal Regulation and we think will provide an acceptable margin of safety to California's utilities.

Today, PG&E remains a bridge too far for our risk tolerance as the company remains mired in a contentious bankruptcy proceeding. We know that for the good of the state it must emerge as a healthy utility, but the amount of value that will be retained by existing shareholders remains uncertain.

Edison International, the parent of Southern California Edison, is a different story. It has a much stronger balance sheet than PG&E and a service territory that is less prone to wildfires. We felt comfortable returning to the stock after the bill passed this summer, and longer-term, we believe

California utilities have the potential for growth due to the state's aggressive environmental plan.

Sector Performance Discussion

The portfolio's investments in utilities returned 8.4% in the quarter though it underperformed the S&P 500 Utilities Index[3] 9.3% performance. The driver of both the strong absolute returns and the benchmark underperformance was the decline in interest rates. Most utilities benefit when rates decline though the largest capitalization and most liquid names tend to outperform. As an example, the largest company in the benchmark, and our largest utility position, NextEra Energy, was up 14.4% in the quarter.

Moves related to changes in interest rates can be temporary and unpredictable. Long-term growth, on the other hand, is becoming a lot more secure. At a recent industry conference in New York, management team after management team talked about the opportunity with renewable energy. The rate base can continue to grow for many years at high single-digit rates as wind and solar replaces coal power. Costs have declined enough so that this replacement can happen without having to raise customer bills. In the past, utility growth always had to be moderated by the impact on consumers. If the impact of the grid becoming greener is minimal, investors can have much more confidence in future growth. Ultimately this can lead to higher valuations.

NextEra, more than any other utility, is benefitting from an improved growth outlook. Management is confident it can grow its investment base in the high single-digit range over the long-term without having to burden its customers with excessive rate increases. Its renewable energy development business will also improve as utilities around the country invest in making generation greener. Investors can be confident in the company's ability to grow over the next five to ten years, and that confidence has helped to boost valuation.

DTE Energy underperformed in the quarter despite a strong utility growth outlook. At issue was the company's investment in gathering pipelines in the Appalachian Basin. Production companies in the region have struggled with low commodity prices, and analysts took down numbers following poor second quarter earnings updates. While the gathering pipelines make up just 10% of total net income earned by the company, the volume outlook in the basin held back the stock. The underperformance seems overdone. Revenues for the pipeline business are underwritten by long-term, minimum-volume commitments, and relative valuation is now attractive. Though a worsening volume outlook will no doubt continue to pressure valuation, it remains a core holding.

In communications[4], the portfolio returned 5.5% in the third quarter of 2019, underperforming the S&P 500 Telecommunications Services Index[5] 10.2% return. Our core cable, towers and data center investments continue to perform well and have driven our outperformance versus the index year-to-date.

Altice USA and Equinix were two of the largest positive contributors to the portfolio's overall performance in the quarter. Perhaps the most interesting thing about the strength in Altice USA is that nothing especially spectacular has happened – the stock was simply washed out due to a combination of technical factors and investor uncertainty about the go-to-market strategy. Rock-solid execution, highlighted by a slow-but-steady increase in revenue guidance and characteristically rigorous cost-controls, has driven strong cash-flow growth. This dynamic, together with an aggressive share repurchase program, from a well-aligned management team, has resulted in outsized returns. We continue to think valuation seems reasonable in the context of the robust cash flows, a favorable revenue mix-shift to broadband, and the strategic importance of its asset base. We also admire the innovative structure of Altice's recently-launched wireless relationship with Sprint.

For Equinix, the quarter got off on the right foot, as investors approved of the long-anticipated hyperscale data center joint venture announced on July 1. Fitch noticed as well, becoming the second rating agency to upgrade its debt to investment grade. The structure of Equinix's partnership with Singapore's sovereign wealth fund enables Equinix to participate in one of the growthier sectors of the data center universe while mitigating any potentially dilutive impact of diversifying away from its core retail business. A characteristically solid quarter, with a commensurate increase in guidance, and a favorable interest rate backdrop helped to continue to push shares higher during the quarter.

In energy, our investments returned -3.6% outperforming the S&P 500 Energy Index -6.3% performance[6]. This happened primarily because of a shift in strategy. Over the past nine months we have focused our investments on companies with greater current income generation and less sensitivity to commodity prices. We have always invested at the lower end of the risk spectrum and favored businesses that generate free cash and have strong balance sheets, and the sector's long-term challenges from climate-related regulation and electrification of propulsion have only furthered this conviction. Income producing characteristics for select companies with strong balance sheets and modest growth potential have become attractive, so our investments have become increasingly concentrated in the major integrated oil and midstream pipeline companies.

Our investments in transports were mixed as the positive impact of self-help efforts in our rail investments were offset by a worsening volume outlook. 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, have reduced global growth and impacted the amount of volume shipped through the U.S.

Summary

The companies we invest in continue to be well-positioned in the current market environment. The outlook for earnings and cash flow growth is strong, and importantly, not overly reliant on economic activity. We believe that many of these companies will be able to grow earnings and dividends in the mid-to-high single-digit range over the next year. Investor demand for companies with these characteristics could continue to expand as investors grapple with slowing economic activity, political uncertainty, and low interest rates.

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[1] *The Reaves Institutional (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 and does not reflect all of Reaves' assets under management. This quarterly commentary covers the period 06/30/19 through 09/30/19.*

[2] *The portfolio performance provided is net of fees.*

[3] *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.*

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

[5] *The S&P 500 Telecommunications Services Index is a capitalization-weighted index comprised of companies included in the S&P 500 Index that are classified as members of the telecommunications services sector.*

[6] *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.
Past performance is no guarantee of future results.