REPRINTED FROM SEPTEMBER 24, 2018

THE WALL STREET TRANSCRIPT

Connecting Market Leaders with Investors

# Managing an ETF Dedicated to the Utilities Sector

**JAY RHAME** is Vice President and Portfolio Manager at Reaves Asset Management. Mr. Rhame joined Reaves Asset Management as a full-time employee in 2005. He is an energy and utility analyst. He is a member of the portfolio management team and is on the risk management committee. He also is Co-Portfolio Manager of the Reaves Utilities ETF. Prior to his current role, Mr. Rhame was employed as one the firm's traders. Mr. Rhame received a B.A. from St. Mary's College of Maryland and is a CFA charterholder.

SECTOR — GENERAL INVESTING

**TWST: Do you work on a specific fund at Reaves Asset Management?**

**Mr. Rhame:** Yes, so specifically, I'm the Co-Portfolio Manager on our actively managed ETF. It's the Reaves Utilities ETF, and the ticker symbol is UTES. But generally, we have a team-based approach on all our portfolios.

**TWST: Is there a unique investment philosophy at the firm?**

**Mr. Rhame:** Yes. If I could first just jump into a little background here. The firm was founded in 1961 and was founded as a utility boutique research firm, and it was actually a sellside company for a while. And then, as our commissions became negotiable in the mid-1970s, the firm here realized that we couldn't compete at the price points needed. You had to scale up to stay in that side of the business. So the firm had actually been managing a portfolio in a profit-sharing trust. And a couple of clients wanted to look at the returns and were excited about what they saw, and our money management business started that way. We started managing money in January 1978, and we've been doing that since then.

We are traditional investors. We're long-only, equity-only, and we focus on the utility, communications and energy sectors. Since 1978, we've managed to beat the S&P 500 by a little over 100 basis points a year net of fees. By staying focused and concentrating on what we think are hard-to-understand sectors, that gives us a real opportunity. It's really hard to be a large-cap value manager and compete when ETFs are giving away the S&P 500 for free. It's hard to find a real sustainable edge.

For us, utilities are only 3% of the S&P 500. Each state has different regulations, and utilities are also regulated by regional power authorities and at the federal level. It's a complicated business but just a small part of the overall investment landscape. There are not a lot of firms that are dedicated to the sector because it's so small. We've taken the approach that in order to do well, you have to dive in, you really have to dedicate because the sector is so complicated, and that's what we've done, and our returns speak for that kind of focused philosophy.

**TWST: What's going on with the utility sector now that would interest investors?**

**Mr. Rhame:** Right now, it's interesting because utilities always have a correlation — I guess an inverse correlation — with interest rates. Certainly, a lot of people come to the market for income. So when bond yields go up, it makes sense to sell your utilities and buy bonds. What's happening below the surface is that the growth outlooks for a lot of these utility companies are about as good as it's been in a long time. Regulation generally has been stable and constructive. Except for a few cases with wildfires in California and nuclear projects in South Carolina, regulation's been good.

There's a lot of old infrastructure that has to be replaced, and the companies essentially spend the money on infrastructure, and they earn whatever the allowed rate of return is, which is typically around a 10% return on equity, and are able to grow based on the amount of infrastructure they put to work. The real benefit they've had is that power prices have come down a lot. Power prices 10 years ago, when natural gas was $10 a dekatherm, that was the main component of each customer's bill. Today, natural gas is cheap, and the price of power is lower, and what that's done is relieve a lot of bill pressure and enabled a lot of companies to invest heavily in infrastructure.

So just as background, utilities earn a return on the infrastructure they provide. Power is actually just a straight pass through to customers. So if power prices are high or low, the utility doesn't earn any money on that; they sell that power to customers at cost. So when costs are low, that enables the infrastructure part of the bill to take on a little bit more there. So we see power prices staying low; natural gas is cheap, and it's abundant. Renewable energy has gotten a lot cheaper, and it's very competitive in a lot of the country. And that creates a lot of headroom to replace a lot of wires and distribution systems, gas pipelines, water pipelines, stuff like that. So you're starting to have these kinds of long-term backlogs of projects, which is very different.

Utility industry growth historically has been lumpy. They would go out and build a big power plant, they'd spend a lot of money for a couple of years, and bill increases would be close to double digits. Customers can only take so much, so the utilities would have to spend a couple of years not really building anything, and you'd have this lumpy growth.

Today, growth is a lot steadier. Most utilities are able to grow earnings in the kind of 5% range, but when you combine 5% earnings growth with a 3% or 4% dividend and also a dividend that's growing at about the rate of earnings, the total return, it's pretty attractive. So overall, it's good. Interest rates will continue to be a factor, but I think it's more of a short-term impact. Longer term, growth looks good.

**TWST: Did you want to highlight a company that you find interesting right now?**

**Mr. Rhame:** One of our long-term holdings is a company called **American Water Works** (NYSE:AWK). They're the largest publicly traded water utility right now. Their story is fairly simple. They have water utilities in 10 or so states, maybe 13 states. What they do is, they buy systems, and they replace water pipelines.

Water pipelines generally in the country are in horrible shape. The Army Corps of Engineers came out recently, and they always give a D or a D- grade to water and waste water systems here. And it's because the pipelines were laid down, in some cases, 100 years ago, sometimes more. And they're leaky, they're rusty, there's a real safety issue.

So **American Water Works** has 50, maybe more, years of just going in, tearing up old pipelines, replacing pipelines, making sure the water is safe, making sure it's clean, and they have years and years of work. The way that's played out in the stock market is investors have been much more willing to place a higher valuation on the company because they know that you have a 10-plus-year growth outlook, which is unique in the utility industry. So that's one.

We've seen some of the same stories play out on the gas utility side as well. A company like **Atmos Energy** (NYSE:ATO), we've owned for a while, and there, it's a safety thing. They've actually been encouraged by regulators to go in, replace at-risk pipelines and keep the system safe. Of course, there was an explosion out in California in San Bruno a few years ago, there was an explosion in Harlem in 2011 or 2012, certainly a few of the hurricanes flooded distribution systems, and all that showed the need to make the systems safer.

Regulators have created these programs where they're encouraging the gas utilities to go in, replace the systems and actually get automatic rate increases. Typically, utilities have to go through this fully litigated process of filing a case, having it spread out over a year, having many witnesses come in and answer questions. So to actually have a program that enables to have automatic increases is a huge step change for these companies. And so typically, the gas utilities are benefiting from that. Some of that exists for **American Water Works** as well, but certainly, we see long-time growth horizons for both those companies, **Atmos** and **American Water Works**.

**Highlights**

*Jay Rhame discusses Reaves Asset Management. Mr. Rhame co-manages the Reaves Utilities ETF, an actively managed fund. He believes that focusing on utilities, which he notes is a complicated sector, gives him opportunity and a sustainable edge. Mr. Rhame invests in companies that are going to be in business for a long time, which helps him avoid big blowups. According to Mr. Rhame, growth has historically been lumpy in the sector but is a lot steadier today. With lower power prices, companies are able to invest in infrastructure.*

*Companies discussed: American Water Works Company (NYSE:AWK); Atmos Energy Corporation (NYSE:ATO); DTE Energy Co. (NYSE:DTE); NextEra Energy (NYSE:NEE) and Duke Energy Corp. (NYSE:DUK).*

***"Today, growth is a lot steadier. Most utilities are able to grow earnings in the kind of 5% range, but when you combine 5% earnings growth with a 3% or 4% dividend and also a dividend that's growing at about the rate of earnings, the total return, it's pretty attractive."***

**TWST: For both of them, is there a positive outlook because a lot of communities are interested in infrastructure repair now, and there was some talk early on in the Trump Administration that they might be doing something along those lines too?**

**Mr. Rhame:** Yes. We haven't seen much in the way of a federal infrastructure plan yet, but certainly, there are possibilities. I think that's a little more present in **American Water Works**, and one of the things that's exciting there is there are 50,000 municipal water systems in the country right now. A lot of those systems are run by municipalities that really can't afford to replace water pipelines and make sure that the system is clean and safe for everybody. And that's why the Army Corps of Engineers gives such low grades to these systems.

**1-Year Daily Chart of American Water Works Company**

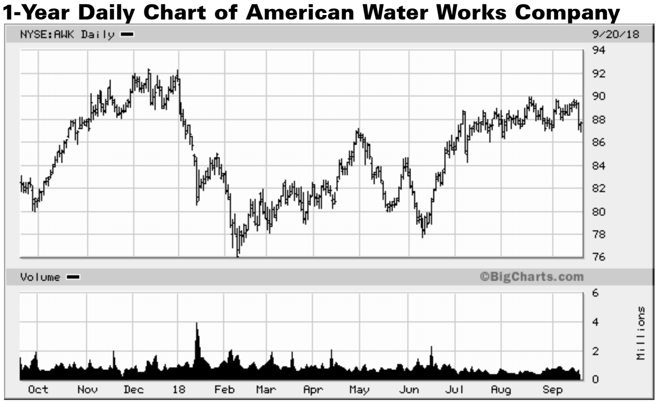


**Chart provided by www.BigCharts.com**

**1-Year Daily Chart of Atmos Energy Corporation**

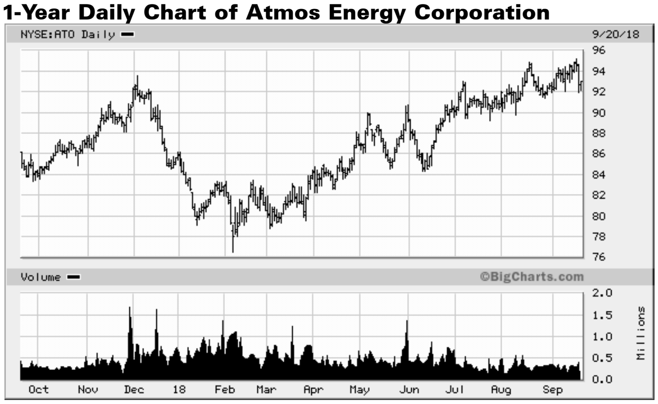


**Chart provided by www.BigCharts.com**

The potential benefit for **American Water Works** is that they can come in, they can purchase these systems, which gives struggling municipalities access to cash. The munis can spend on firemen or policemen or whatever kind of emergency services or education or whatever. Meanwhile, **American Water Works**, they have better access to capital markets. They can spend the money needed to upgrade the systems, and they can socialize those costs across all their customers within that state. So it actually works out to be a good proposition, and a lot of states have actually started encouraging the water companies to come in — the publicly traded water companies to come in — and purchase some of these municipalities.

***"They've been hiring, they've been hiring a lot, and utilities are often the one or two largest employers in their state. So infrastructure programs or anything that provides some kind of financing for these companies to be able to do pipeline replacement, water pipeline replacement, stuff like that, really helps with jobs too."***

So that's starting to be a positive catalyst. That plays into that infrastructure theme — as hopefully we'll see some more details of the federal plan — but I think that would be the perfect example of real private-public partnership and making some funds available that, say, **American Water** could tap it for low-risk financing and be able to upgrade a municipality system at a lower cost seems to be a pretty good way to do that.

One thing about all these pipeline replacement programs is that utilities know they need the work. They've been hiring, they've been hiring a lot, and utilities are often the one or two largest employers in their state. So infrastructure programs or anything that provides some kind of financing for these companies to be able to do pipeline replacement, water pipeline replacement, stuff like that, really helps with jobs too. I would assume it's an area where the government is looking, and we'll wait to see what happens.

**TWST: So most of it now is on the local or utility or maybe regional or state level as opposed to the federal level for something like water infrastructure?**

**Mr. Rhame:** Yes, mostly on the state level. In particular, we've been watching what New Jersey has been doing. And one of the problems with water, of course, is everybody needs it, right? And people view it as a right, and so when a company like **American Water Works** or whatever publicly traded water company, when they come in and they replace the infrastructure and they raise rates, it doesn't sit well with a lot of people. And so it's a very politically charged thing to go in and buy a municipality system. What's happening now is, often, the water costs are subsidized a lot by that municipality. And so many times, the customer's not really paying the fair cost of what a real clean, safe system would be.

And what New Jersey has done is, one, they figured out how to kind of automate how much a water system is worth. They have a third party that comes in and looks at all the assets and everything, and so they know what a sale price could be. That's obviously one of the big sticking points, and they have done that to ease the transaction a little bit, so at least the municipality could know what they could get, right?

Second, the state has said that if you fail certain water-quality standards, you might be forced to sell to a publicly traded company. And it's really one of the first laws that require these municipal-run systems to hold to high standards. And certainly, some other states are looking at the bill and how it will play out across, in practical terms, but certainly exciting there. We haven't seen something like that from the federal government yet, but certainly bears watching to see if stuff like that does happen.

**TWST: Did you want to mention another company?**

**Mr. Rhame:** Yes, sure. So on the real electric side, especially coming out of the latest earnings season, one of the better calls we heard is another big holding of ours,

**DTE** (NYSE:DTE). It's one of the best-managed utilities in the country. They have strong regulation. They have a very good proactive relationship with the regulator. They do their best to lower their own expenses, so the bill increase to customers is confined.

**1-Year Daily Chart of DTE Energy Co.**

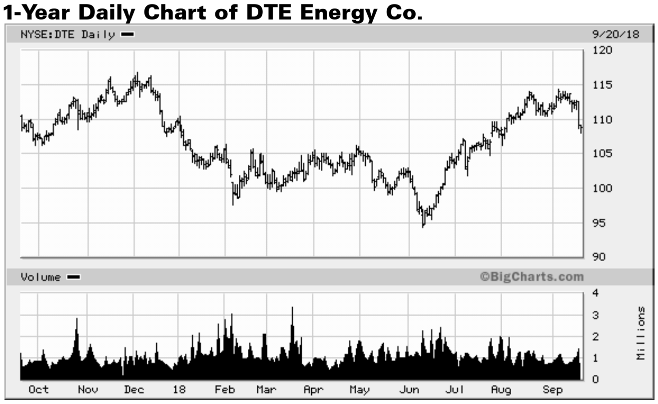


Chart provided by www.BigCharts.com

One of the things they do really well is if you just look at their O&M, their operating expense, they have basically kept their operating expenses flat over the past 10 years. That's something almost no other utility has been able to do. And customers are the ones that benefit from that. On the utility side, that enables them to go and invest more in infrastructure, invest more for the long term.

And the general way to think about a utility is, you never want to raise bills more than 2% or 3% a year. If you can keep the customer bill growth rate to about inflation, that's really the sweet spot. And so if your expenses are already growing 5% a year, that gets passed through to the customers, and that doesn't enable you to invest a lot. You're not going to be able to recover those investments. So **DTE** has done a great job.

The second part of their business, which is really interesting, is they have a midstream energy business. They've been buying some gathering pipelines in the Marcellus region, kind of the Western Marcellus region, and they are just about to finish a gas pipeline, which goes from that Marcellus region up into Michigan, called the NEXUS pipeline. They have been able to come into the space, while a lot of energy companies struggle.

Certainly, with the downturn in late 2014 and through 2015 and 2016, there was a lack of capital. The big MLPs were really struggling to raise money, they certainly couldn't issue equity like they have been in the past, and **DTE** was able to come in and offer real value proposition to the gas companies there. Not only where they build quality gathering and processing, but they could take that gas and send it out to their utility where their utility would buy a large portion of it, so it gave a good outlet point for the gas too.

And so they want to continue growing that business. They think there's still acquisition opportunities there, and so you really have it on two fronts that the utilities got strong growth, probably a little above average in that mid- to high-single-digit per year range. And the midstream business, it's a strong cash flow generator, probably closer to that 10% growth per year, although it really depends on their acquisition opportunities. But what the utility does, it gives them a much stronger financial base than some of the MLPs, which are more volatile and paying out a ton in dividends, so they have to rely more on the capital markets. **DTE** is more stable, and I think that the E&P gas companies really appreciate that. So that's been a long-time holding for us, and still, we really like that stock.

**TWST: Did you want to mention one final company?**

**Mr. Rhame:** Sure, yes. The largest holding in the Reaves Utility ETF is **NextEra Energy** (NYSE:NEE). It's the biggest company in the utilities index, but they're really one of the best. Florida has some of the best regulation of any state out there. And **NextEra** — I should say — half the business is owning utilities in Florida.

The other half of the company is a renewable energy business. They are the largest wind developers in the country, largest solar developers in the country too. They think that wind is essentially economically viable, especially in the middle part of the country, without any tax credits today. Solar is viable in the sunniest parts of Arizona and Nevada and California today without any tax credits. And batteries are actually getting cheap.

They think that within five years — really in that early part of the next decade — power, which is kind of solar plus battery storage or wind plus battery storage, is going to be cheaper than running a nuclear plant today. And so their opportunity is to go in and essentially replace a lot of our existing power plants in the country right now and save customers money doing it, which is spectacular.

If you think back to what I was saying before, how a utility tries to limit its rate increases to inflation or better, well, if you're building a solar plant and it costs less than the existing operating expenses of your coal or nuclear plant, you can shut down that coal or nuclear, build solar and actually save customers money and reduce that bill. The opportunity is unlimited for the company, and so it's a great outlook.

Certainly, other companies develop renewable resources, but **NextEra** is the biggest. And I think the scale really helps and certainly helps with purchasing. And as you get into batteries, I think there's a lot of debate about how big the battery should be, what kind of technology the battery should

***"If you think back to what I was saying before, how a utility tries to limit its rate increases to inflation or better, well, if you're building a solar plant and it costs less than the existing operating expenses of your coal or nuclear plant, you can shut down that coal or nuclear, build solar and actually save customers money and reduce that bill."***

use, whether it's lithium or something else, where the battery should be located for optimal kind of electric grid maintenance and then how long it should last. Should that battery last for four hours, so that you can match the solar peak with the peak when everybody comes home and puts on TV and turns on all the lights at night, or should that battery be 36 hours so that you can deal with a cloudy day essentially?

I think they have a head start. **NextEra** has a head start experimenting with a lot of that stuff, and they're generating a much bigger data set. And I think that's going to enable them to really be the strongest-positioned company as we head into the next decade.

**TWST: Looking at utilities, in general, do you think a lot of investors don't think about utilities as one of the sectors that they might want to invest in as much as maybe some other sectors, like pharma or energy?**

**Mr. Rhame:** Sure. I think generally utilities are thought of as defensive. And so the big money managers are going to come in and buy utilities when they're worried about the rest of the market. And you have that. And the secondary is, you buy it for yield, and so you have kind of risk-on times where you sell utilities, you sell yield, and you buy the tech or the pharma or biotech or whatever, and when it's risk-off, people come back into the sector.

What's interesting, though, is that because of this growth we see out there, what's happening is that often the utilities with the highest yield actually present the lowest total return opportunities going forward. Because people come in for defensive reasons, they come in for yield, the highest-yielding companies are somewhat relatively overvalued compared to the lowest-yielding companies that don't have those same kind of defensive characteristics but grow the quickest.

So if I'm looking at **NextEra Energy** right now, **NextEra** yields 2.5%. And I think **Duke** (NYSE:DUK), which has average utility growth somewhere in that 4% to 5% range, yields 4.5%. So investors are much more likely to look at a **Duke** rather than a **NextEra** just for that yield. But what we found over the last 40 years is that investors often ignore that growth potential of the lower-yielding utilities. There's a structural anomaly where we think that growth arbitrage, if you will, is sort of always present, and that's what we try to do. We try to find the ones that have not just growth for a year or two but sustainable growth for a long time and look for those.

**TWST: Is there anything we didn't talk about that you care to mention, either about the firm or some trends out there?**

**Mr. Rhame:** Yes, I think just getting back a little bit about the philosophy of the firm. It's about being focused and thinking that outperformance can only come from having real expertise. If we invest in nondiscretionary sectors, no matter what happens with the economy or a presidential election or whatever, people are still going to turn on the lights. They're still going to drive their cars to work and stuff like that. And so there's always going to be a need for energy and power and utilities. And as long as we're finding the companies that we know are going to be in business for a long time, that helps us to avoid the big blowups, and that has underpinned our returns for a long time, and I think it will underpin them for a long time going forward too.

**TWST: Thank you. (ES)**

**JAY RHAME**
**VP & Portfolio Manager**
**Reaves Asset Management**
**10 Exchange Place**
**18th Floor**
**Jersey City, NJ 07302**
**(800) 975-8395 — TOLL FREE**
**www.reavesassetmanagement.com**



Top 10 Holdings as of September 30, 2018

| Security Description | % of Portfolio |
|---|---:|
| NEXTERA ENERGY INC | 15.32% |
| DTE ENERGY COMPANY | 8.17% |
| SEMPRA ENERGY | 7.07% |
| AMERICAN WATER WORKS CO INC | 5.12% |
| DOMINION ENERGY INC | 4.59% |
| PINNACLE WEST CAPITAL | 2.87% |
| SOUTHWEST GAS HOLDINGS INC | 2.74% |
| ATMOS ENERGY CORP | 2.73% |
| VECTREN CORP | 1.04% |
| EDISON INTERNATIONAL | 1.00% |

**You should consider the Fund's investment objectives, risks, and charges and expenses carefully before investing. Contact Virtus ETF Solutions at 1-888-383-0553 or visit www.reavesetfs.com to obtain a prospectus which contains this and other information about the Fund. The prospectus should be read carefully before investing.**

**Exchange-Traded Funds (ETF):** The value of an ETF may be more volatile than the underlying portfolio of securities it is designed to track. The costs of owning the ETF may exceed the cost of investing directly in the underlying securities. **Equity Securities:** The market price of equity securities may be adversely affected by financial market, industry, or issuer-specific events. Focus on a particular style or on small or medium-sized companies may enhance that risk. **Utilities Sector Concentration:** The Fund's investments are concentrated in the utilities sector and may present more risks than if the Fund were broadly diversified over numerous sectors of the economy. **Industry/Sector Concentration:** A fund that focuses its investments in a particular industry or sector will be more sensitive to conditions that affect that industry or sector than a non-concentrated fund. **Prospectus:** For additional information on risks, please see the fund's prospectus.

**Virtus ETF Advisers LLC serves as the investment adviser and W.H. Reaves & Co., Inc. (d/b/a Reaves Asset Management) serves as the investment sub-adviser to the Fund. The Fund is distributed by ETF Distributors LLC, an affiliate of Virtus ETF Advisers LLC.**