Reaves Asset Management

Review and Outlook

Third Quarter 2018

One of the main reasons for Reaves' historical outperformance is a contrarian investment philosophy – we look for growth in areas where investors typically focus on yield. When buying utilities, a manager is often making a macro decision, not a fundamental company decision. They want to buy the sector for income and safety. ETFs[1] and other passive products make it easy to do this, and performance in the short term is often impacted by whether macroeconomic conditions are positive or negative. Many investors usually do not take the time to understand individual company fundamentals because that is not the usual purpose of a utility investment; it is current income and safety.

This focus on current income means the highest yielding stocks tend to be overbought which can depress future total returns. To put this in perspective, the five, continuously traded, highest-yielding members[2] of the S&P 500 Utilities Index[3] at the end of the third quarter in 2013 all had lower total returns than the S&P 500 Utilities Index itself over the last five years:

Company	Yield 9/30/2013	Five-Year Total Return*
FirstEnergy	6.0%	27.2%
Entergy Corp	5.3%	61.6%
Southern Company+	5.0%	34.3%
PPL Corp+	4.9%	31.0%
Duke Energy	4.7%	48.8%
S&P 500 Utilities Index	**3.92 (Based on the XLU[4])**	**68.9%**

Source: Bloomberg *09/30/2013-09/30/18 +As of this report, Reaves' clients held shares in Southern Company and PPL Corp.

The popularity of income investing creates situations where higher growth companies can occasionally have similar, or even discounted, valuations despite better growth potential. Yield-starved investors routinely focus on the short-term attractiveness of a higher dividend yield at the expense of long-run opportunity. In the short term, income investments will always be correlated with interest rates because so much weight is given to current income, but in the long term, growth will make up most of our total return. The market anomaly that has investors overpaying for yield, while ignoring growth potential, means we should continue to have a good chance at finding strong companies at reasonable valuations.

PERFORMANCE

The ERISA Composite[5] gained 2.9%, net of fees, in the third quarter, underperforming the S&P 500 Index[6] return of 7.7%. Year-to-date, the ERISA Composite is up 4.9%, net of fees, versus the S&P 500 return of 10.6%. While disappointing through quarter end, the first two weeks of the fourth quarter illustrated the value we can provide in down markets. The S&P 500 dropped 5% in the first two weeks of October while the ERISA Composite declined by about half as much. Historically, we've generated competitive total returns over full market cycles by capturing 80% of the upside in bull markets while avoiding half the downside in bear markets. We hope to continue this type of performance in the future.

OUTLOOK

The ERISA Composite's investments in cable and telecom stocks performed well in the quarter, partially offset by mixed performance with telecom REITs[7]. Consistent with the theme highlighted in our second quarter letter, cable continued to be the most controversial sub-sector within our communications investment landscape. Back in July, we believed the market had become overly pessimistic about the ability of cable operators to grow their broadband businesses. We posited that while there are hurdles to maintaining subscriber growth rates, cable would continue to take share from telecom competitors.

We received a couple of data points supporting our thesis almost immediately in the third quarter. First, the rate of broadband subscriber growth accelerated for cable operators, seemingly due to slightly faster growth for the market broadly and continued share gains for the cable operators specifically. Industry growth will be challenging going forward as it will mostly depend on household formations. The market share dynamic, however, continues to point towards cable being a better product.

The second data point supporting cable operators was an update from Verizon on its launch of a fixed 5G wireless service[8] which is a potential competitor to cable broadband. The market seemed to expect a drastic impact from 5G but, in rolling out the service, Verizon's constrained rhetoric and the expectation for an unfavorable cost structure suggested muted near-term impact for cable. We will continue to monitor this developing technology, but in the near term we believe our cable thesis appears sturdy.

Utility stocks also generated positive performance during the quarter. Renewable energy is starting to be a major driver for selected companies. Prices have fallen so sharply that many utilities are able to replace coal and nuclear power with wind and solar generation and save customers money. Recent bids for new power generation, in places like Indiana and Colorado, consistently show wind and solar are cheaper than the operating expense of running existing coal and nuclear generation.

Utilities are always concerned with the impact on a customer's bill. No management team wants to ask for a rate increase that will be more than two or three percent per year. Traditionally this meant that a utility could only grow its asset base, and thus earnings, by two or three percent per year on a sustainable basis. Renewable power is changing this dynamic. The Public Service Company of Colorado recently filed a plan to shut 660 megawatts of coal and replace it with $2.5 billion of investments in renewables and battery storage. Amazingly, the utility believes the transition will save customers around $300 million. When a utility can grow its asset base and deliver savings to customers, a company's ability to grow is only limited by its own access to capital. As renewable energy prices continue to fall, earnings growth potential and regulatory relationships may benefit and ultimately could result in better valuations.

The composite's energy investments were mixed during the quarter. Permian Basin[9] producers were sold while investors rewarded other companies as commodity prices rose. The market seems to be fixated on the constraints to moving oil and gas out of the Permian Basin and the risk that companies will be forced to accept discounts for the next year or two. Oil in the region has been trading at a $10 to $20 per barrel discount to West Texas Intermediate[10] while natural gas is at a nearly 50% discount to Henry Hub[11]. There are many pipeline projects being planned to help alleviate this problem but it may be about 12 to 18 months before the constraints go away.

The energy portfolio is focused on companies we think can do well in any commodity environment. We choose companies that have what we believe are the best assets with the ability to decrease costs and improve returns, and importantly, remain profitable at low commodity prices. The Permian Basin investments, for example, are mostly fully contracted to move oil and gas to market hubs on the Gulf Coast. Exposure to the constraint-induced discounts is minimal, but the market sold all Permian companies indiscriminately.

Overall, we feel confident in the portfolio. It has performed about as expected in the bull market, and it was encouraging to see the portfolio perform relatively well in the early October sell-off. We are focused on providing a competitive total return over a full market cycle.

For further information contact:
Rowland O. Wilhelm, Jr.
Vice President, Director of Sales and Marketing
Reaves Asset Management
10 Exchange Place, Jersey City, New Jersey 07302
Telephone 201.793.2383
Fax 201.332.8593
rwilhelm@whreaves.com
reavesassetmanagement.com

[1] *ETFs or exchange-traded funds, are marketable securities that track an index, a commodity, bonds, or a basket of assets like index funds. Unlike mutual funds, ETFs trade like common stocks on a stock exchange.*

[2] *Three of the highest yielding utilities at the time, Pepco, Teco Energy and Integrys Energy were acquired before the end of the five-year period.*

[3] *The S&P 500 Utilities Index is a capitalization-weighted index containing 29 electric and gas utility stocks (including multi-utilities and independent power producers). Prior to July 1996, this index included telecommunications equities.*

[4] *The Utilities Select Sector SPDR ETF (XLU) provides investment results that track the price and yield of the S&P Utilities Select Sector Index.*

[5] *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. This quarterly commentary covers the period 06/30/18 through 09/30/18*

[6] *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.*

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

[8] *5G wireless service (5th generation mobile networks) denotes the next major phase of mobile telecommunications standards beyond the current 4G standards. 5G has speeds beyond what the current 4G can offer.*

[9] *The Permian Basin is one of the oldest and most widely recognized oil and gas producing regions in the U.S.*

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

[11] *Henry Hub is a natural gas pipeline located in Erath, Louisiana, that serves as the official delivery location for futures contracts on the New York Mercantile Exchange (NYMEX).*