Reaves Asset Management

Market Commentary
Third Quarter 2020

REVIEW AND OUTLOOK

Performance as of 9/30/20	Q3 2020	YTD 2020
Reaves LTV Wrap Composite[1], gross of fees	8.70%	-2.38%
Reaves LTV Wrap Composite[1], net of fees	8.04%	-4.20%
S&P 500 Index[2]	8.93%	5.57%
Russell 1000 Value Index[3]	5.59%	-11.58%

INTRODUCTION

Reaves' LTV Strategy Wrap Composite returned 8.7% in the third quarter of 2020, improving the year-to-date return to -2.4%. Excluding any de minimus positions, all segments of the composite were positive in the quarter, led by railroads, cable broadband, and utilities focused on renewable energy development. This last group is something we focus on in more detail below.

ENERGY TRANSITION

Energy transition has been a primary driver of utility sector performance over the past 18 months. The performance of utilities actively developing renewable generation, and those with small carbon footprints, have diverged markedly from those that generate a significant portion of profits from fossil fuels related activity. This dispersion is as wide as it has ever been. As part of our research process, we track two groups of utilities companies: the first group contains low carbon renewable energy utilities and the second group has fossil fuel utilities. On average, over the last eighteen months, the companies in the low carbon group have outperformed the fossil fuel group by about 60%.[4]

As the cost of renewable energy continues to decline, we believe the next couple of decades will see accelerating growth. Additionally, there is increasing global policy support. The EU has committed to zero carbon emissions by 2050, while China's goal is to be carbon neutral by 2060.[5,6] In the U.S., there is no Federal policy but several states have set their own carbon targets. Hundreds of billions of dollars, if not trillions, will be required to reach these goals. Well-managed utilities may have higher growth potential and longer visibility of that growth than at any time in the sector's history.

Additionally, capital dedicated to sustainability has been ample and growing. To date 1,244 institutions collectively managing $14.5 trillion have committed to divest in some manner from fossil fuel companies.[7] We believe much of this money has been reinvested into companies leading the energy transition. These flows have caused the valuation gap between transitioning and fossil fuel utilities to widen, creating a cost of capital advantage for the greener companies. As the fundamental growth case for renewable power strengthens, institutions that were previously on the fence about divesting may well be incentivized to do so now.

This valuation gap, along with the scale of investment needed, is causing almost every company in the utility and energy sectors to evaluate renewable energy opportunities. Developers that have amassed knowledge and scale should be at an advantage, while others new to the space will face an increasingly competitive marketplace, especially from global oil producers and SPACs[8] looking for projects.

Lastly, over the past few months, a combination of accelerating growth plus near-zero interest rates has resulted in a sizeable increase in valuations for companies with long-dated growth. Utilities have been no exception, as companies that have multi-decade renewable investment opportunities are trading at premiums to companies with assets that, while still growing now, may be stranded in out years as many regions aim to reduce reliance on natural gas and coal. Several management teams have examined their own balance sheets and concluded that redeploying capital away from fossil fuel endeavors will add shareholder value. For example, Dominion is selling its midstream assets to Berkshire Hathaway, PSE&G announced plans to sell its fossil fuel power plants, and even DTE Energy is rumored to be selling its natural gas transportation and industrial power assets less than a year after buying midstream assets in Louisiana for $2.25 billion.

As more money goes into renewable development, economies of scale will increase as manufacturing does. This will help to lower costs and accelerate the pace of transition. As with any long-term investment cycle, there will be booms and busts along the way, but the twin drivers of policy support and attractive economics indicate that there may be significant growth opportunities. We expect more companies to position themselves to take advantage of what is likely to be a decades-long investment cycle.

COMMUNICATIONS

The composite's investments in communications[9] generated a return of about 8.9% during the third quarter of 2020. These results exceeded the 3.6% performance of the S&P 500 Telecommunications Services Index[10] and were helped by Charter Communications, the best performing stock in the portfolio this past quarter. Our other two positions in the cable broadband sector also performed strongly, rising by more than 15%.

Cable's strength was reasonably linear throughout the quarter. Mid-summer earnings reports revealed robust second quarter broadband results for cable operators, while channel checks throughout September indicated that first-half trends appear likely to persist. Cable valuations correlate well with improving consumer broadband growth rates, and cable is increasingly, and we believe correctly, being viewed as a stand-out in the unique economic environment that is 2020.

As a pureplay on the broadband theme, Charter shares were favorably bid throughout the quarter. Comcast shares also surged. Comcast generates a disproportionate percentage of cash flows from its cable broadband business, but it has been frequently dragged down by its media exposure. The gradual re-opening of the economy has helped media companies generally. For Comcast in particular, the broad and sudden return of professional sports, and a rapidly improving advertising environment propped-up by political spend, has helped catalyze the media segments.

The positive performance in communications was tempered somewhat by flattish results of two first-half of 2020 outperformers – CoreSite Realty and Crown Castle. CoreSite's co-location centric data center business has a long history of outsized returns, but its growth has been stunted near-term by lack of excess capacity. As new space for lease begins to come to market, we believe the long-term quality and growth outlook is currently mis-priced in our favor. For Crown Castle, the emergence of an activist investor called attention to longstanding investor frustration with the company's investments in fiber services. While we are skeptical that the company will materially alter its strategic direction and are not convinced that a new approach would drive a favorable re-rating, we continue to think that the core tower business driving Crown's cash flow is a very compelling economic model.

UTILITIES

The composite's investments in utilities generated a return of 5.6% during the third quarter, slightly worse than the S&P 500 Utilities Index's[11] return of 6.1%. Returns followed themes mentioned in the opening section, with low carbon favorites, American Water Works and NextEra Energy, generating double-digit returns and natural gas distribution companies, Nisource and Atmos Energy, delivering negative returns.

Alliant Energy, a recent purchase that generated a return of 8.8% during the quarter, is a regulated utility that highlights how quickly the industry is changing. In 2005, 44% of its generation fleet was coal-powered while just 5% was wind-based. Today, thanks in part to the tremendous wind resource in its service territory in Iowa, it is the third largest owner operator of regulated wind assets in the U.S. Today, wind makes up 34% of its generation fleet with coal down to 25%. In September, the company pledged to eliminate all coal from its asset base by 2040, ten years sooner than its previous target. Investors applauded the environmentally friendly changes.

Edison International, on the other hand, was the worst performing stock in the portfolio with a -4% decline during the quarter. It may have been impacted by the emergence of Pacific Gas and Electric from bankruptcy as locked-up shareholders may have placed hedging trades using Edison International stock. More importantly, the company, like all California utilities, has been plagued by an early start to the fire season. We felt comfortable owning the stock coming into the season because of a confidence that legislative actions to protect utilities from catastrophic fire losses would be sufficient. However, investors have decided that waiting to see if legislation works as intended was too risky. If the company can get past its fire troubles, it has a lot of growth potential as California pursues one of the most aggressive carbon reduction plans in the world.

RAILROADS

Railroad investments returned 19.6% in the quarter. The highlight was a rumored acquisition attempt for Kansas City Southern, but all major North American railroads generated double-digit returns in the third quarter. Investors have bid up the stocks industry-wide as continued strong execution on cost management was buoyed by optimism about economic recovery. Transport volumes are down year-over-year, but as we have seen with technology stocks and utilities leading the renewable transition, long-dated assets such as nationwide rail networks have benefited from low interest rates and higher valuations.

IN CLOSING

In summary, we believe that the portfolio is well positioned as we enter the fourth quarter of the year. The companies we invest in have proven how essential and defensive they are with most growing dividends as expected, despite operating in one of the toughest economic environments ever. On the other side of economic recovery, energy transition as well as increase in data consumption will drive investment and growth for years to come.

If you have any questions about our investment management services, please do not hesitate to contact us at any time.

[1] *Reaves' Long Term Value (LTV) Strategy Wrap Composite contains those Long Term Value Strategy discretionary SMA 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 Wrap Composite does not represent all of Reaves' assets under management.*

[2] *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.*

[3] *The Russell 1000 Value Index a broadly diversified index predominantly made up of value stocks of large U.S. companies.*

[4] *The two groups of utilities have been created and are tracked by Reaves, for representative purposes only, using performance from Bloomberg and internal resources. These groups do not contain all those companies considered to be part of the utilities sector nor do these groups of securities characterize all those securities in Reaves' portfolios.*

The group of low carbon renewable energy utilities contains American Water Works, Atlantica Sustainable Infrastructure, Avangrid, Clearway Energy, Eversource Energy, NextEra Energy, NextEra Energy Partners, and XCEL Energy. This basket contains a sample of low carbon utilities and does not contain all the low carbon utilities in the group.

The group of fossil fuel utilities includes Atmos Energy, Centerpoint Energy, Dominion Energy, DTE Energy, New Jersey Resources, Nisource, Northwest Natural Holding Company, NRG Energy, OGE Energy, One Gas, Sempra Energy, South Jersey Industries, Southwest Gas Holdings, Spire, and Vistra. This basket contains a sample of fossil fuel utilities and does not contain all the fossil fuel utilities in the group.

[5] *https://www.bbc.com/news/world-europe-50778001*

[6] *https://www.nytimes.com/2020/09/23/world/asia/china-climate-change.html*

[7] *https://gofossilfree.org/divestment/commitments/*

[8] *A special purpose acquisition company (SPAC) is a company with no commercial operations that is formed strictly to raise capital through an initial public offering (IPO) for the purpose of acquiring an existing company.*

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

[10] *The S&P 500 Telecommunications Service Index is a capitalization-weighted index which is a subset of the S&P 500 Communications Services Index and is comprised of those companies included in the S&P 500 Index that provide wireline and wireless telecommunications services.*

[11] *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.*

Reaves' portfolio characteristics, holdings and sector weightings are subject to change at any time and, unless otherwise noted, 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 in an index.

Past performance is no guarantee of future performance. Further, the investment return and principal value of an investment will fluctuate; thus an investor's equity, when liquidated may be worth more or less than the original cost. This document provides only impersonal advice and/or statistical data and is not intended to meet the objectives or suitability requirement of any specific individual or account.

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