

Review and Outlook

Second Quarter 2009

Overview

Portfolio performance rebounded strongly in the second quarter with market participants focused on the potentially beneficial effects of fiscal stimulus. In addition, data metrics released during the quarter generally pointed to a deceleration in the rate of decline of economic activity, prompting more than one observer to see “green shoots” sprouting across the macroeconomic landscape. Each of our sectors: utilities, energy, and telecom participated in the market advance.

ELECTRIC UTILITIES

Electric utilities produced strong returns across the sector. Generators with well-balanced, efficient fleets that included either wind or nuclear did particularly well. Utilities with significant coal-based generation also did well in the quarter, rebounding somewhat from their dismal performance earlier in the year. We think some of the fear about the impact of carbon legislation has subsided. The cap and trade bill recently passed by the House does not appear to be as immediately onerous to coal-generated power as investors had thought. The Senate version will be delayed until the fall, if not next year, and its provisions may be less burdensome to coal than the House version. Utilities with significant regulated assets in general fared well. Our view on the electrics continues to be selective with a regulatory focus. We favor regulated utilities over the generators; and among the generators we prefer those with significant nuclear or gas assets.

GAS UTILITIES

All of the gas companies in our portfolios posted positive returns – nearly the complete opposite of their performance in first quarter. Natural gas spot prices stabilized in the quarter -- at an admittedly low level. The Henry Hub spot price averaged \$3.71 per million BTUs. Natural gas markets in North America

are currently oversupplied for two reasons: production from shale formations, driven by new technology, has increased dramatically adding substantially to supply just as the economy turned sharply downward reducing commercial demand. We do not think this situation will persist. Rig counts are down, some production has already been shut in; and new wells typically have high decline rates. Industrial demand will recover and we think natural gas will take a larger market share as an electric-generation fuel. We are encouraged by the recent announcement, by a large Canadian producer, of fixed price hedges of \$6.21 on 35% of its 2010 gas production. As we have said often in this space, we remain bullish on the medium and long-term prospects of natural gas. We continue to favor the shippers because their revenue growth is more sensitive to volume growth than price.

ENERGY

The energy stocks in the portfolio substantially outperformed the overall portfolio performance, largely a result of the rising oil price during the quarter. The price of West Texas Intermediate rose from \$49.66 on March 31 to \$69.89 on June 30. As with gas, we remain bullish on oil, and believe that oil markets will recover with economic demand. More generally, we view our investment in oil and gas companies as a hedge against future potential inflation; and when some of those investments offer yields in the 4% to 5% range, so much the better.

TELECOMMUNICATIONS

The telecom portion of the portfolio also posted strong performance overall. Performance was not uniform. The rural carriers outperformed the national integrated carriers; European companies, with exposure to emerging markets, outperformed their American counterparts. Concerns about increasing wireless competition and flagging enterprise business kept the performance of the integrated telecoms flat.

We think the concerns are somewhat overblown and that wireless data in particular presents revenue growth opportunities to big telecom. We also favor selected smaller rural carriers able to grow by acquisition and committed to returning substantial cash to shareholders.

All of us at W. H. Reaves & Company remain committed to our investment process and disciplines which have served our clients well through many market cycles for the past 31 years. We appreciate your continued support.

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