

Review and Outlook

Third Quarter 2008

Overview

The events witnessed by equity- and bond-market investors during the third quarter were unprecedented: effective nationalization of Fannie Mae, Freddie Mac and AIG; the virtual demise of the investment banking industry; the collapse of Wachovia and Washington Mutual; the “breaking of the buck” by and subsequent liquidation (in progress) of the Reserve Primary (money market) Fund; and the rapid passage of the \$700 billion federal bailout. We believe we have observed forced liquidation by professional investors as market participants sold securities indiscriminately, either to reduce leverage or seek the safety of cash. We believe the liquidity of the large capitalization, New York Stock Exchange traded securities in our portfolios made them prime candidates for sale by investors to raise cash in times of market turbulence.

Events in the financial sector were accompanied by material and rapid declines in the price of oil and natural gas. Overall portfolio performance suffered in the third quarter. Each portfolio sector experienced negative returns as broad based selling produced a material contraction in price earnings ratios. The markets appear to be discounting a recession both in the United States and abroad.

GAS UTILITIES

During the quarter, the price of natural gas declined by 45.5% from \$13.18 per million BTU's (Henry Hub) to \$7.18 on fears of a slowing economy and over-supply, at least in the short term. This rapid and steep decline of the commodity price led to sharp declines in the share prices of many of the companies in our portfolio. We generally expect the price of pure exploration and production (E&P) companies to respond rapidly to changes in the underlying commodity price. But, frankly, we were surprised by the sharp decline in the price of companies which have significant pipeline, processing, and retail distribution operations in addition to E&P activities. As with the electric utilities, fears about counter-party risk and liquidity associated with commodity trading operations led to significant pressure on the stock prices of companies that participate in futures markets in the normal course of business. We think significant

value continues to emerge in the natural gas/gas utility sector, especially among companies with integrated gathering, storage, processing, and transmission operations.

ELECTRIC UTILITIES

Price weakness in the electric utility sector was wide spread. A near halving of the price of natural gas contributed to an expectation of lower electricity prices. Acutely deteriorating conditions within banking and finance near the end of the quarter suggested to many market participants that the economic slowdown is likely to be deeper and longer than previously expected, further contributing to expectations of lower prices. Many utilities actively purchase natural gas for their own use and as a service to commercial and industrial customers. The interplay between gas and power prices during periods of market volatility raised concerns about some utility companies' earnings stability. Generators (and there were some in our portfolio) that rely less on natural gas as an input typically do worse than generators that use relatively more natural gas during periods of rapid decline in the commodity price. Additionally, some generators (again including some in our portfolio) have extensive commodity trading operations. As the financial crisis became more acute in September, fears about counter-party risks reached extreme levels. For example, in one day, at the time of the Lehman bankruptcy and widespread speculation that AIG would also be forced into bankruptcy, the intraday stock price for a major utility ranged from a high of \$ 47 to a low of \$13, closing at \$ 30.75. Faced with mounting liquidity requirements, the utility agreed to be bought by Berkshire Hathaway for a bargain price of \$4.7 billion. It is noteworthy that some view the value of its nuclear plants alone to be in the range of \$4 billion, suggesting that Buffet struck quite a bargain.

ENERGY

The prevailing opinion is that global economic growth will slow as the world economy de-leverages, leading to a decline in the demand for oil accompanied by a decline in the price of oil. To provide some perspective it should be noted that while West Texas

Intermediate (WTI) closed the quarter at \$100.64/bbl, the Q 3 2007 closing price was \$81.66/bbl and the Q 3 2006 closing price was \$62.76/bbl. What tends to be overlooked in the face of volatile short term fluctuations in the oil price is the presence of two “800 pound gorilla consumers” in the world economy: India and China. Combined, these two economies consume approximately 11 million barrels per day, and their consumption has been growing at a roughly 7% annual rate. Their consumption growth may drop to 5% in a recession. Consequently, we expect the growth in China and India’s consumption to underpin the long term uptrend for crude oil prices. The need to replace production will drive investment spending for oil services. We believe the energy and oil service companies in the portfolio are generating excess cash sufficient to fund meaningful dividend growth and stock buy-backs at both the current and our expected future price for oil.

TELECOMMUNICATIONS

Telephones exhibited their defensive characteristics during the quarter declining by less than half of the overall portfolio decline. Preliminary reports for the quarter suggest that pockets of revenue weakness persist in regions of the South and Southwest, most severely impacted by the housing crisis; specifically financial services and construction. Generally, prices continue to be stable, supported by strong demand for internet and data services in both the wireline and wireless segments. Competition with the cable companies in the consumer wireline space remains intense. Both of the major telcos continued their rollouts of fiber-based internet and video services. The telephones have historically performed relatively well during periods of economic slowdown. While their service offerings may be a little more discretionary than in times past (we are thinking of wireless internet access, ring tones, and very high-speed broadband), we still expect the telephones to be relatively defensive.

Outlook

What gives us confidence in these turbulent times is that we know that your (and our) investments are in companies that provide services and products that are non-discretionary, economic essentials. Although there is some earnings uncertainty in the current economic environment and price earnings ratios are fluctuating widely, the quarterly dividends paid by each investment are considered sustainable and in many cases they are expected to be increased: recession or no recession. Berkshire Hathaway’s recently proposed acquisition of a major utility substantiates our investment thesis; that sharply lower equity prices can and will create unusual value opportunities for those who are both patient and prepared.

There is little doubt that we are facing a challenging economic environment. Investors should keep in mind that stock markets are discounting mechanisms that tend to price events well in advance of the reality. Thus, markets don’t tend to go down a lot *during* recessions; they tend to recover. The worst market upheavals generally occur *before* the recession starts. We encourage you to consider the extent of your investment horizon and financial requirements and “take a few deep breaths.”

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 30 years. We appreciate your continued support.

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