The Case for Actively Managed Utilities

Understanding and navigating inefficiencies in the utilities index.

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Virtus Reaves Utilities ETF
NYSE Arca: UTES

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Key Points

- Amid record low interest rates, wrenching market volatility, and economic uncertainty, there may never be a better time to own utilities, which provide non-discretionary products to the mass market.
- Index rules have precipitated errors that time-tested fundamental security analysis and active portfolio management can potentially avoid.
- Utilities are an increasingly differentiated market that requires active management to discern management acumen, earnings growth, regulatory complexity, and dividend growth.
- The Virtus Reaves Utilities ETF (NYSE Arca: UTES) has delivered strong returns since inception outpacing its benchmark, the S&P 500 Utilities Index.

Utilities, Now More Than Ever

Everyone needs electricity, natural gas, and water; they are non-discretionary products from companies with relatively stable earnings and dividends. The good news: utilities have adjusted to the realities of COVID-19, and there hasn’t been any observable disruption to their supply chains or service levels. The bad news: demand is down between 5% and 10%, the result of the temporary lockdown in the United States. However, many utilities have not grown their earnings as a pure consequence of demand growth for over 20 years. These days, most utilities grow their earnings and dividends by improving service and reliability in the form of renewable energy and energy efficiency projects that increase potential profitability.

Valuations have fallen dramatically in these difficult times. Many investments appear cheap relative to the past. And while buying on the cheap isn’t foolproof, investing in quality companies with defensive characteristics may prove to be an opportunistic strategy in the current environment. The relatively high dividends historically paid by utilities also remain attractive in an environment where interest rates are low and yield is meager with the 10-year Treasury yield hovering below 70 basis points.

Deconstructing Passive

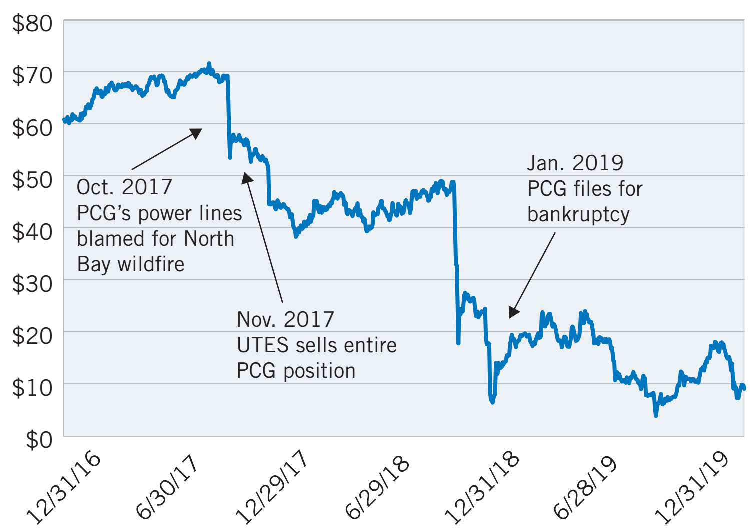
Over the past 10 years, there have been massive inflows to passive index funds. Trouble is, many cost-minded investors have poured into such stocks with no regard to valuation, fundamentals, or volatility. Take the case of Pacific Gas & Electric Co. (PG&E), for example.

On Jan 14, 2019, PG&E, a utility serving Northern California, announced its intention to declare bankruptcy. Liabilities from two disastrous wildfire seasons in a row proved too much to overcome. The next day, Standard & Poor's removed PG&E from the S&P 500® and the Dow Jones Utility Index. The stock had fallen 77% in the first 15 days of the year before the index pulled the plug. Adding insult to injury, index removal marked the bottom as the stock rallied 140% over the next few weeks.

At Reaves, we sold our position in PG&E after the first wildfire hit in 2017 because we understood that the regulatory situation was so bad that the utility would be liable for any damages whether the utility was at fault or not. Passive indexes, generally, held on to the stock until it was removed from the Index once the company announced its intention to declare bankruptcy. Index selling pressure plus active trading around the well-telegraphed exit marked the nadir, and once that passed, the stock rose dramatically over the next few months, but we stayed away, thinking (correctly) that the political and market risks (and potential volatility) were too high. (See Exhibit 1.)

EXHIBIT 1. DOWNHILL RACER: HOW PG&E DRAGGED DOWN ITS INDEX

Share price volatility between 12/31/16 and 3/31/20



Past performance is not indicative of future results.

Source: Bloomberg.

As prudent investors, we wanted to see some tangible improvement before getting back into the stock. After the California governor signed comprehensive wildfire prevention and mitigation legislation, we re-initiated exposure to PG&E with a 1% position in January 2020. We added another 2% in April following the governor's approval of PG&E's restructuring plan. The company is expected to emerge from bankruptcy in June, and it is our view that it will get added back to the S&P 500® Index all over again.

Exploiting Inefficiencies in the Utilities Index

Ongoing transformation of the utility sector cannot be understated. Utilities have been repeatedly challenged by deregulation, globalization, restructuring, and environmental change. As a result, the market has become increasingly differentiated, and the most resilient companies have come up with real long-term growth plans, specifically with regards to renewable energy. It's our view that this environment requires active management to discern management acumen, earnings growth, regulatory backdrop, and dividend growth. In other words, not all utilities are alike.

To drive home this point, look no further than Exhibit 2, which shows the best and worst performers in the index over the last five years. Generally speaking, companies with higher dividend growth and lower yields outperformed those with lower dividend growth and higher yields. And while dividend growth matters, so does business and management acumen. Dominion Resources, for example, grew their dividend aggressively, but the company's asset quality dropped significantly, a result of several poorly executed acquisitions, and returns suffered. Recent volatility in energy markets provides yet another example of differentiation. The index is vulnerable to cyclical and structural changes in commodity prices that may alter the economics (and attractiveness) of certain utilities (e.g., coal-fired generation vs. cheaper natural gas, nuclear or solar/wind powered generation). Again, it is our opinion that these risks need to be actively managed.

EXHIBIT 2. NOT ALL UTILITIES ARE ALIKE!

Share price total returns, dividend yield and dividend growth

Best Performers in the S&P 500® Utilities Index	**Annualized 5-Year Total Return**	**Current Dividend Yield**	**5-Year Dividend Growth**
NextEra Energy	21.2%	2.06%	11.51%
American Water Works	20.6%	1.63%	10.03%
Atmos Energy	17.6%	2.06%	8.07%
CMS Energy	16.0%	2.43%	7.21%
XEL Energy	15.7%	2.55%	6.19%
Worst Performers in the S&P 500® Utilities Index			
Dominion Resources	5.8%	4.43%	8.87%
Edison International	6.2%	3.38%	8.83%
Duke Energy	6.3%	4.14%	3.52%
PPL Corp.	6.3%	4.60%	2.06%
CenterPoint Energy	7.7%	4.22%	3.90%

Past performance in not indicative of future results.

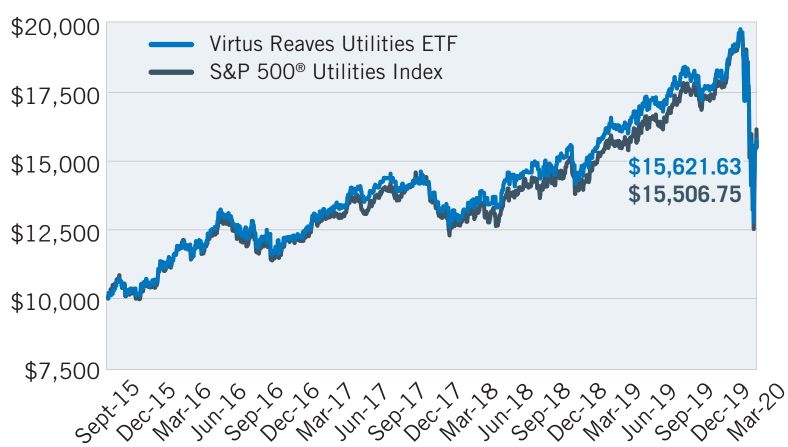
Source: Bloomberg, all data as of 12/31/19, securities selected from the 28 stocks which comprised the S&P 500® Utilities Index.

Active Management

It takes years of experience to understand the complexities of the utilities sector. We believe our team of industry specialists focused on utilities can create an investment advantage which over time leads to competitive risk-adjusted returns. Experience, skill, and judgement needs to be exercised when investing in the sector, this becomes apparent when you consider: each utility is unique (operating in distinct markets with differing business fundamentals), utilities operate in 51 regulatory jurisdictions (including federal), and because technological innovation is rapidly changing the utilities landscape.

Against that backdrop, a number of retail and institutional investors have come to rely on experienced active management and rigorous fundamental security analysis. They do so in order to find the strongest management teams, discern bad regulatory dynamics from the good, and identify securities with stronger earnings and dividend growth potential. Exhibit 3 shows how active management has been able to exploit fundamental and structural flaws in the S&P 500® Utilities Index.

EXHIBIT 3. A HISTORY OF BEATING THE INDEX



Past performance is not indicative of future results.

Source: Morningstar, since UTES inception 9/23/15-3/31/20.

Why limit yourself to the 28 constituents of the S&P 500® Utilities Index when highly experienced active investors can glean greater potential opportunities from a universe of 67 securities? Active strategies can improve diversification by utilizing securities outside the index for a greater active share and by minimizing, if necessary, risk factors such as excessive exposure to particular types of utilities or geographical regions. For example, American Water Works (AWK) was purchased at inception of the portfolio in September of 2015, at which time it was an out of benchmark position. It was added to the Index in 2016 and we continue to hold it today with a top ten position in the portfolio. AWK has rewarded investors with a 10% dividend increase each year we've owned it, allowing the stock to heartily outpace the Index and the broader market, as measured by the S&P 500® Index, over this time. AWK is the largest investor-owned U.S. water and wastewater utility, serving millions of customers across dozens of states.

Finally, and most importantly, managed strategies that focus their research on companies with solid fundamentals, can dynamically navigate events that may affect changes in a security's price.

Reaves Active Management

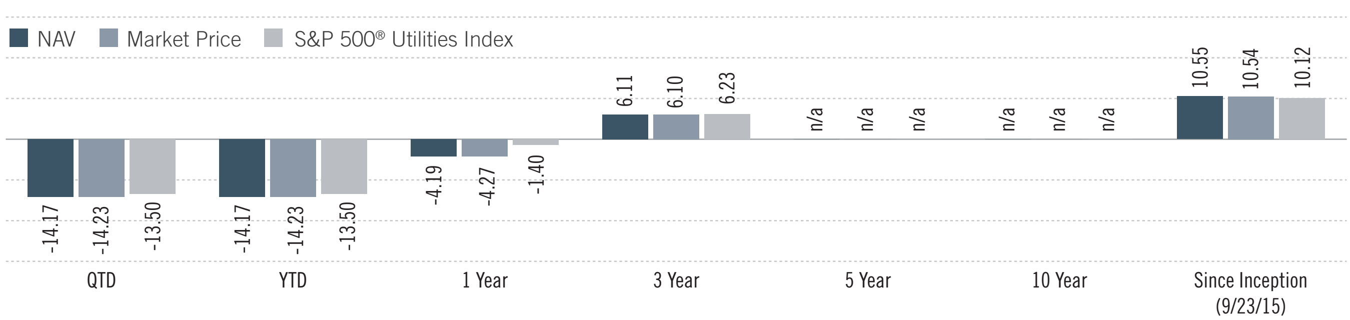
The Virtus Reaves Utilities ETF has delivered superior risk-adjusted returns as evidenced by a 5-Star Morningstar rating. Historically, it has a below-average risk profile, as measured by standard deviation relative to both its benchmark, the S&P 500® Utilities Index, and its peer group, Morningstar's Utilities Fund Category. Reaves attributes long-term performance to their focus on companies that demonstrate the ability to consistently grow their earnings and dividends. In other words, the portfolio has a distinct focus on quality and growth, as evidenced by the portfolio's higher levels of dividend growth compared to the Index. After all, a strong history of dividend growth is powered by profitability.

UTES – By the Numbers

Morningstar Rating[1]	A Distinct Focus on Quality and Growth[2]	Total Expense Ratio[3]	Active Share[4]	Low Beta[5]	Below-Average Risk Morningstar Risk Risk vs. Category
★★★★★	6.90% vs. 9.24%	0.49%	46%	0.45	Below Average

[1]As of 3/31/20 the Fund was rated 5 stars out of 54 funds within the Utilities category for the 3-period. Morningstar ratings are based on risk-adjusted returns. Strong ratings are not indicative of positive fund performance.
[2]S&P 500® Utilities Index 5-Year Dividend Growth vs. UTES
[3]The Total Expense Ratio represents the Fund's Total Annual Fund Operating Expenses, which includes the management fee and other expenses where applicable, except for certain payments that are paid directly by the Fund, as described in the Prospectus.
[4]Relative to the S&P 500® Utilities Index
[5]Beta relative to the S&P 500® Index, 3-year
Source: Reaves Asset Management, Morningstar, all data as of 3/31/20.

AVERAGE ANNUAL TOTAL RETURNS (%) as of 03/31/20



Returns for periods of less than one year are cumulative total returns.

Performance data quoted represents past results. Past performance is no guarantee of future results and current performance may be higher or lower than the performance shown. Investment return and principal value will fluctuate, so your shares, when redeemed, may be worth more or less than their original cost. Please visit Virtus.com for performance data current to the most recent month-end.

As the only fully transparent actively managed ETF launched in the utilities space, the Virtus Reaves Utilities ETF (NYSE Arca: UTES) leverages Reaves Asset Management's deep industry expertise, accrued over the firm's four-decade-long track record of investing in the utilities sector. UTES seeks to invest in high-quality, well-managed utilities, including mid- and small-cap companies not found in many of the market-cap weighted passive index funds. Reaves' eight-person investment team consists of two portfolio managers with a combined 40 years of experience in the utilities space with the research analyst team averaging over 20 years of industry experience.

VIRTUS ETFs

To learn more about Virtus ETFs, visit virtus.com or call 1-800-243-4361.

The **S&P 500® Index** is a free-float market capitalization-weighted index of 500 of the largest U.S. companies. The index is calculated on a total return basis with dividends reinvested. The **S&P 500® Utilities Index** is a free-float market-capitalization-weighted index of 500 of Utilities Index is a free-float-market-capitalization-weighted index comprised of companies included in the S&P 500 Utilities sector. The index is calculated on a total return basis with dividends reinvested.

Glossary
Active Share is a measure of the percentage of stock holdings that differs from the benchmark index. **Dividend Growth** is the annualized percentage rate of growth that a stock's dividend undergoes over a period of time. **Standard Deviation** measures variability of returns around the average return for an investment portfolio. Higher standard deviation suggests greater risk.

RISK CONSIDERATIONS
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. **Market Volatility:** Local, regional or global events such as war, acts of terrorism, the spread of infectious illness or other public health issue, recessions, or other events could have a significant impact on the fund and its investments, including hampering the ability of the fund's portfolio manager(s) to invest the fund's assets as intended. **Prospectus:** For additional information on risks, please see the fund's prospectus.

Morningstar Disclosures
The Morningstar Rating™ for funds, or "star rating", is calculated for managed products (including mutual funds, variable annuity and variable life subaccounts, exchange-traded funds, closed-end funds, and separate accounts) with at least a three-year history. Exchange-traded funds and open-ended mutual funds are considered a single population for comparative purposes. It is calculated based on a Morningstar Risk-Adjusted Return measure that accounts for variation in a managed product's monthly excess performance, placing more emphasis on downward variations and rewarding consistent performance. The top 10% of products in each product category receive 5 stars, the next 22.5% receive 4 stars, the next 35% receive 3 stars, the next 22.5% receive 2 stars, and the bottom 10% receive 1 star. The Overall Morningstar Rating for a managed product is derived from a weighted average of the performance figures associated with its three-, five-, and 10-year (if applicable) Morningstar Rating metrics. The weights are: 100% three-year rating for 36-59 months of total returns, 60% five-year rating/40% three-year rating for 60-119 months of total returns, and 50% 10-year rating/30% five-year rating/20% three-year rating for 120 or more months of total returns. While the 10-year overall star rating formula seems to give the most weight to the 10-year period, the most recent three-year period actually has the greatest impact because it is included in all three rating periods. Ratings do not take into account the effects of sales charges and loads.

The Fund is an exchange-traded fund ("ETF"). The "net asset value" (NAV) of the Fund is determined at the close of each business day, and represents the dollar value of one share of the Fund; it is calculated by taking the total assets of the Fund, subtracting total liabilities, and dividing by the total number of shares outstanding. The NAV of the Fund is not necessarily the same as its intraday trading value. Fund investors should not expect to buy or sell shares at NAV because shares of ETFs such as the Fund are bought and sold at market price (not NAV) and are not individually redeemed from the Fund. Thus, shares may trade at a premium or discount to their NAV in the secondary market. Brokerage commissions will reduce returns. NAV returns are calculated using the Fund's daily 4:00 pm NAV, and include the reinvestment of all dividends and other distributions (reinvested at the Fund's NAV on distribution ex-date). Market price returns are calculated using the 4:00 pm midpoint between the bid and offer, and include the reinvestment of all dividends and other distributions (reinvested at the 4:00 pm bid/offer midpoint on distribution ex-date). Market price returns do not represent the return you would receive if you traded at other times. The Fund is an actively managed exchange-traded fund and does not seek to replicate the performance of a specified index. The Fund may have a higher portfolio turnover than funds that seek to replicate the performance of an index.

Please consider a Fund's investment objectives, risks, charges, and expenses carefully before investing. For this and other information about any Virtus Fund, contact your financial representative, call 800-243-4361, or visit virtus.com for a prospectus or summary prospectus. Read it carefully before investing.

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