



# Aquila Tax-Free Fund of Colorado

## PODCAST TRANSCRIPT

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### **Interviewer:**

Hello, everyone. Welcome to another Aquila Group of Funds podcast. I am your host, Matthew DiMaggio. Today, we are joined by Portfolio Manager Chris Johns and Credit Analyst Tim Iltz of the Aquila Tax-Free Fund of Colorado. We will be discussing the current municipal environment, both broadly and on the state level. Thanks for sitting with us today, gentlemen.

So much has happened this year in the fixed income markets, and really beyond. Can you gentlemen speak to how the municipal bond market has transformed this year?

### **Chris Johns:**

Well, the biggest transformation, as everyone knows, has been a significant rise in interest rates, that's been driven by the Federal Reserve's reaction to lingering inflation in our economy. Inflation was driven by kind of post-pandemic pressures, supply chain disruptions and other things. And finally, the Federal Reserve ("the Fed") has convinced the market that they're going to continue to raise short-term interest rates until they see some progress on the inflation front. One of the big changes this year in interest rates has been that the U.S. Treasury market and the municipal bond market don't always necessarily move in the same magnitude in a particular direction, and many times don't even move in the same direction.

Overall, we've seen interest rates rise on munis a little bit less than we have in the Treasury market on certain parts of the yield curve, but they're very different. We still see a significant inversion in the Treasury yield curve, where the two-year yield is roughly 65 or 70 basis points higher than that of the 10-year yield, whereas in the muni space, there's still a pickup of 30 basis points or so from maturities of two years to 10 years. So, the shapes of the curve are very different, driven by different demand and supply reasons in those two markets, and the tax exemption of munis. So, these days, like many times in the past, when you talk about interest rates changing and rising, you really have to define which interest rates because they can be different. Relatively speaking, municipal bonds are probably fairly valued right now. The percentage of municipal yield to Treasury yield in the three-year maturity range is about 70%, maybe slightly lower than average. The five-year range: 75%, 10-year range: 81%, and 30-year range: 95%. And those are over the last 10 years or so. In particular, the 10- and 30-year is about fairly valued in that range.

### **Interviewer:**

Thanks, Chris. So, you touched a bit on the headline topic for fixed income markets this year—of course, interest rates and inflation. Do you have any thoughts on the Fed's current position?

### **Chris Johns:**

Sure. First of all, what the Fed tries to do, they have two tools in their hands right now, that they're using to try and control inflation. The first one is the federal funds rate, which is an overnight rate. It is just a monumental task for the Federal Reserve to try and to control interest rates and inflation by just changing short-term interest rates, and that's a very, very difficult thing to do. The other tool they have and have been using is quantitative tightening, where they are allowing their portfolio to roll off into the market. The Fed is really committed to beating inflation right here. I think many times more committed to beating inflation than the market wants them to be, but they're going to need to see several data points, several months in a row of slowing inflation before they change their approach towards the amount in frequency of short-term rate increases. So, I think that the Fed is going to continue to raise interest rates. We happen to think that the worst is behind us. We think rates have risen more in the past than they will in the future, and there are some signs of slowing inflation in the economy right now. So, we tend to believe that rates may go a little bit higher, but we think the worst is behind us.

### **Interviewer:**

Yes, and it's been a year with such uncommon circumstances here. I feel it's understandable for investors to be a bit turned around at this moment. Can you address what are the key market drivers currently at play in the municipal bond market?

### **Chris Johns:**

Well, very simply, the biggest driver in the market is interest rate fears. I mean, investors are very concerned about rising interest rates. This is a circumstance that we haven't seen in decades really for the amount of increases that we've seen this year. So, that's the primary driver. Right now, investors' expectations really conflict between two things. They expect that interest rates could continue to go up and stay higher for a longer period of time as was originally thought. But on the other hand, there's also a fear of recession, and those two things are kind of conflicting on their impact on the interest rates. So, what also creates a lot of week-to-week and month-to-month volatility in the fixed income markets is that as emotions ebb and flow over time. Sometimes higher interest rates seem to be the driver, and sometimes a recession seems to be the driver, so that's created a lot of volatility.

Our observation would be that this could present an opportunity as a pretty good entry point into the fixed income markets given the last 15 or 20 years. We haven't seen rates at this level, so we think that now, you may not be hitting the absolute peak in interest rates. But boy, it sure looks a lot better than it did a year ago. And so, we think that represents some opportunity.

**Interviewer:**

Fantastic coverage, Chris. Tim, you have a great handle on credits within the country. Can you talk about credit strength in the municipal bond market? For anybody who may be concerned about the condition of our economy, how would you address the condition of the credits?

**Tim Iltz:**

Thanks, Matt. I would say that both nationally and locally, credit is quite strong. And a lot of this is due to the massive stimulus funding by the Federal government through the American Rescue Plan and the CARES Act. Another thing that I would mention though, and I don't think this gets the credit that it deserves quite often, is the local budgeting process that local governments use, where they involve citizen committees. They're engaging the citizens from throughout whatever the local jurisdiction is, and then the months of strategic planning that local governments put into their budget process.

We talk about recession and other economic concerns. Local governments have been preparing for some type of economic downturn for the last couple years. And so, as a result, we're seeing fund balances and cash reserves that are higher than what we've seen in the past. But we do have some limited areas of concern. There are certain areas that we're concerned about, including private higher education and assisted living. The other thing that I would note is that we've seen credit spreads shift around a little bit over the past year. And what I'm talking about with credit spreads is the difference between high-rated bonds, AAA bonds, and at the lower-end of the investment-grade spectrum—single-A, B, AA types of credits.

During the previous interest rate cycle, which was marked by declining rates, we saw spreads tighten, as investors stretched down the credit ladder for yield. And in our opinion, it got to the point that we weren't getting paid for the risk, and we started to abandon some of those riskier sectors, as the credit spreads weren't paying us for the risk that we would have to take in order to put those bonds in the portfolio. But now that interest rates are rising, we're seeing the opposite happening, and credit spreads are widening. So, as a result, we've been selectively adding some credit risk where we feel that we're getting paid. A good example of this is the healthcare sector, where we saw credits spreads tighten significantly, and now we started to see them widen out. They're not quite to the widest levels that they had been, but they're now at levels where we feel like there's some reward for the risk.

**Interviewer:**

Amazing coverage, Tim. Thanks so much. I want to address the State of Colorado, specifically what's happening more locally in the municipal bond market in the State.

**Tim Iltz:**

The big story right now, Matt, is the Colorado election. The Colorado election was a success by just about any measure. Of the 20 bond measures that were presented, 80% passed, which is close to a billion dollars in new bonds that were approved by the election. Over half the measures on the ballot were for local schools, and the big winner there was Boulder Valley School District, which approved a \$350 million bond. But not everything passed. On the other side, Douglas County's \$450 million bond didn't pass. And this is a big deal right now because supply's been very tight over the past year.

**Interviewer:**

Thanks, Tim. I know our listeners will appreciate the coverage of the local bond results in the mid-term elections—always an important topic. So, I want to close out today's podcast. Can you cover the Fund strategy and outlook?

**Chris Johns:**

Sure, I'll take that one. The first thing I'd say is that for long-time users of the Aquila Funds, our investment objective has remained constant for over three decades. We seek to provide a double tax-exempt yield with a little bit lower volatility than other options out there. We do that with intermediate maturities and investment-grade bonds, which is designated in the prospectus. For us, over the last three years or so, we have been defensive with our portfolio positioning by being at the shorter-end of our duration range. And as Tim mentioned, we had very high credit quality in the portfolio. And at present time, we're looking to add a little bit of credit, as Tim mentioned, where we can find more attractive spreads. And then probably the most important thing we've been doing lately is to exchange some of the lower book yield bonds in the portfolio that were purchased when interest rates were much lower than they are today and replacing them with bonds with higher interest rates that are available today. So, there are really two ways that we're trying to improve the shareholder experience here. One is to reduce volatility by being at the shorter end of our duration range and the higher end of credit quality. And then the second one is to improve the yield of the Fund by these bond exchanges that we're talking about, where we can improve the yield on bonds significantly given the way the market has moved. And we can do that without adding a ton of interest rate risk or duration risk because the municipal yield curve is relatively flat, so we don't have to extend real far to pick up significant yield from where these bonds are in the past.

And then finally, we will continue to keep a very close eye on credit. That is our major strength with this Fund and what we think serves investors well.

**Interviewer:**

Alright. And with that, that is all for today's podcast. Gentlemen, thanks again as always for taking the time to discuss the municipal bond market with us.

**Chris Johns:**

Thank you, Matt.

**Tim Iltz:**

Thank you, Matt.

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