



Aquila Tax-Free Fund of Colorado

PODCAST TRANSCRIPT

April 2023



Interviewer:

Hello, everyone. Welcome to this installment of our Aquila Group of Funds podcasts. I'm your host, Matthew DiMaggio. Today, we'll be discussing the municipal bond market with Tim Iltz, Portfolio Manager of Aquila Tax-Free Fund of Colorado. Thanks for joining us today, Tim.

Tim Iltz:

Hi, Matt. Thank you for checking in.

Interviewer:

All right, Tim. So, let's just jump right in. It's no secret 2022 was a challenging period for municipal bond market and, of course, fixed income in general. Hopefully the worst is behind us. How would you say 2023 is shaping up so far, in your view?

Tim Iltz:

So far, despite recent headlines in the banking sector, and some volatility in the Treasury market, municipals have been relatively quiet. This month (March 2023), the 10-year U.S. Treasury yield has bounced around between 3.34% and 4.05%. While 10-year munis has been much more stable, with a much more narrow range of 20 to 25 basis points, some of the inaction in the municipal sector is a result of low new issuance levels, where reference points have been largely missing. But overall, we're experiencing much less volatility and more stability, and more attractive yields than we saw in 2022.

Interviewer:

I want to address interest rates. Rates have certainly had their effect on municipal bonds. As you look at the current yield curve, where do you see relative valuations and yields, and also potential opportunities, for attractive risk-adjusted returns?

Tim Iltz:

Recently, the municipal bond yield curve has developed a peculiar bowl-shape over the first 10 years. This is highly unusual for the municipal yield curve, which is typically positively slope to what we call "normal." However, after this initial bowl, the muni curve is upward-sloping, with a fairly significant gain of 50 basis points from the 10 to 15-year range, which is where we're seeing a little more value.

As a measure of relative value, municipal bonds are often compared to Treasuries, with tax-exempt municipal yields expressed as a percentage of Treasury yields. Currently, municipal bonds are relatively rich compared to Treasuries. The 10-year Municipal-to-Treasury ratio is about 69% right now, versus a long-term historical average closer to 85%, which demonstrates munis are a bit rich right now relative to Treasuries—and they become richer as you look at shorter durations.

We see more relative value a bit further out the curve past 10 years, where ratios approach 85%. However, given the stubbornly high inflation levels, particularly relative to the Federal Reserve's 2% target, we're cautious right now about meaningfully extending our duration.

Interviewer:

Great details there, Tim. As you look at the municipal bond market currently, what would you say are the key factors driving it?

Tim Iltz:

Low new issuance levels is one of the most significant factors affecting munis. Sourcing new bonds has become significantly more difficult this year than it has in the past. Nationally, muni issuance is down about 18% compared to last year at this time, and it was down 20% as of the end of the year. This broad drop reflects the slowest third to a year for sales since 2018. As the Federal Reserve's move to lift rates to tame inflation, it's dramatically increased borrowing costs for municipalities. It's not uncommon to see municipalization was dropped just before that announcement. We saw visible supply fall 68%. In the week before the last February rate hike, it was even steeper than the 54% drop that we saw last week.

Sales typically jump up again once the Federal Reserve (the "Fed") passed their decision. One of the reasons we are seeing lower new issuance is a positive credit trend, which is that many local governments are sitting on piles of Federal pandemic relief cash, and many are also running budget surpluses, so they simply don't need to issue bonds right now.

Interviewer:

Fantastic, Tim. And the other end of that supply issue is, of course, what's happening with demand. Can you talk further about new issue supply and what that might mean for investor demand?

Tim Iltz:

Yes, investor demand continues to be strong, which also makes it more challenging to source bonds. Here in Colorado, Delta County School District came to market with a \$27.7 million general obligation bond last week. Maturities were as much as five to eight times over-subscribed with fairly uniform demand throughout the first 15 years. What this means is that the school district could have theoretically sold five to eight times as many bonds and still sold the entire issue.

Interviewer:

Great. And since you mentioned Colorado, how about we speak a little bit about what's going on locally in the State? What are the latest developments impacting Colorado's local economy and its municipalities?

Tim Iltz:

In Colorado at the State level, revenue collections have consistently outperformed forecast expectations since the beginning of the pandemic. Higher inflationary pressures and stronger-than-expected wage gains are expected by the State to boost sales tax and individual income tax collections. And although we're waiting to see if there's an impact from slower-than-expected economic activity in response to the Fed's monetary policy tightening, sales tax receipts are up 10.5% year-to-date through February. Both job openings and "quits" have fallen from mid-2022 peaks, but they remain well above pre-pandemic levels. Of greater significance to our strategy at the local level, property tax collections that support general obligations remain elevated.

Interviewer:

Tim, I have one final question for you. It would be great if you could briefly summarize a few key takeaways for our listeners.

Tim Iltz:

Our portfolio positioning of shorter duration, higher credit quality, and higher-than-average coupon bonds has been relatively advantageous during the current dynamic market conditions. We continue to resist the temptation to meaningfully extend portfolio duration. But if the yield curve were to steepen, we would take advantage of the higher rates by slightly extending our portfolio duration to our target portfolio duration of 4 ½, to 4 ¾ years.

Most importantly, credit research continues to be the cornerstone of our strategy. With our overall defensive strategy, 90% of the portfolio is rated AA or better due to narrow credit spreads and the lack of reward for taking risk in the current market, particularly for longer maturities. We continue to review market conditions and are prepared to assume additional credit risk when we feel it's sufficiently rewarded.

Interviewer:

And that's all I have for you today, Tim. Thank you again for joining us. And, of course, thank you to our listeners.

Thank you for listening to this podcast. The information is general in nature and is not intended to provide investment, accounting, tax or legal advice. It is not intended to represent a recommendation or solicitation related to any particular investment, security or industry sector. The opinions shared are those of the portfolio managers and do not necessarily reflect those of the Investment Adviser of the Fund.

The Fund seeks to provide a high level of income exempt from state and federal income tax as is consistent with capital preservation. Past performance does not guarantee future results.

Information regarding holdings is subject to change and is not necessarily representative of the entire portfolio. A complete list of the Fund's current holdings, including percentage allocation, is available on our website and by contacting Aquila Group of Funds.

For certain investors, some dividends may be subject to federal and state income taxes, including the alternative minimum tax referred to as AMT. And for certain investors, net investment income tax, known as NIIT may apply. NIIT is a 3.8% tax established by the patient protection and affordable care act that applies to the lesser of, the net investment income, or a taxpayer's modified adjusted gross income above an applicable threshold amount. Please consult your tax professional.

Independent rating services such as Standard & Poor's, Moody's, and Fitch assign ratings which generally range from AAA highest to D lowest, to indicate the creditworthiness of underlying bonds in the portfolio. Where the independent rating services differ in the rating assigned to an issue or do not provide a rating for an issue, the highest available rating is used in calculating allocations by rating. Pre-refunded or escrowed bonds are issued to retire or regain an outstanding bond issue at a specific call date. Until the call date, the proceeds of the bond issuance are typically placed in a trust and invested in U.S. treasury bonds or state and local government securities.

Modified and effective duration both measure the value of a security in response to a change in interest rates. Effective duration also takes into account the effect of embedded options. The weighted average life, also referred to as weighted average maturity, is a reflection of the quickness with which the principal of an issue is expected to be paid.

A credit spread is a difference in yield between two bonds of similar maturity, but different credit quality. Taxable equivalent yield is the return that is required on a taxable investment to make it equal to the return on a tax-exempt investment.

Yield is expressed as a percentage based on the invested amount, current market value, or face value of the security, and includes the interest earned or dividends received from holding a particular security. The yield ratio represents the comparison of the expected yield of one bond to the expected yield of another. A yield ratio is important when deciding whether to invest in one bond or another. Generally, the higher yield is considered better.

Mutual fund investing involves risk. Loss of principal is possible. Investments in bonds may decline in value due to rising interest rates, a real or perceived decline in the credit quality of the issuer, borrower, counterparty or collateral, adverse tax or legislative changes, court decisions, market or economic conditions. State-specific fund performance could be more volatile than that of funds with greater geographic diversification.

Before investing in a Fund, carefully read about and consider the investment objectives, risks, charges, expenses, and other information found in the Fund prospectus. The prospectus is available from your financial advisor, when you visit www.aquilafunds.com, or by calling 800-437-1020.