Aquila Opportunity Growth Fund

PODCAST TRANSCRIPT

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Interviewer:

Hello. Thank you for joining this edition of the Aquila Group of Funds Podcast. I'll be your host today, Phil Felice, the Director of Internal Sales here at Aquila, and very excited to have Pedro Marcal with us. Pedro is our Director of Equities and High-Yield, as well as the Lead Portfolio Manager of Aquila Opportunity Growth Fund. We'll be discussing the Fund specifically, but also touching on what's going on in the markets in general. And first off, I want to say welcome, Pedro, and good to be sitting down with you.

Pedro Marcal:

Thanks, Phil. It's great to be here.

Interviewer:

So, let's dive right in. 2022, as we know, was a challenging period for equity markets and, really, for all markets. So, with that in mind, how is 2023 shaping up so far, in your view?

Pedro Marcal:

Well, so far in 2023, the equity markets are shaping up better than we would've expected. I would've expected higher interest rates to have had more of an impact on the broader economy and the tightening of credit. I mean, likely the impact's probably just delayed. In mid-March, problems became widely apparent.

For example, money moved from banks to mutual funds, reducing the level of deposits at banks because investors were able to get 4.5% to 4.75% in money market mutual funds versus the zero percent they were getting in their deposits and bank accounts.

Another example is the increase in the interest rate has caused losses on assets held by banks in the banking sector on their balance sheets, and I think it's probably in excess of $500 billion across the industry, according to the FDIC. And because of this, one of the most successful mid-cap banks, Silicon Valley Bank, needed to raise capital in March and was unable to do so. And this failure to raise capital led to a panic by their depositors, causing something on the order of $42 billion of deposits to flow out of their bank in a single day. And I think that was on a Thursday. The next day, it appeared that $100 billion was scheduled to leave and that really led to the collapse of this bank.

So, I see in this and other examples, the impact of higher interest rates on financial markets is sort of being recognized, and the market sees it at this point. I think what remains to be seen is the impact on the broader economy. And, as such for us, we're really focused on companies that have large moats around them that are benefiting from material positive change, and that are trading at very attractive valuations.

And so, let me give you some examples of where we're finding opportunities. We are overweight the Utilities sector because they're regulated businesses that enable them to deliver consistent earnings and cash flow almost regardless of the economic condition. We're also overweight the Consumer Staples sector because their products are inelastic. So, they're able to raise prices and more than offset any potential declines in volume. And they're currently benefiting, obviously, from the higher prices of inflation. I think they also are going to benefit as we move forward from lower raw material prices, which means their margins will expand. We are also positive about opportunities in the Energy sector, which is benefiting from stronger demand, as China reopens their economy following their zero-COVID policy. On the supply side, Energy is benefiting from underinvestment in energy infrastructure for the last decade-plus, recent supply reductions by OPEC, and the sanctions that have been put on Russia as a result of their invasion of the Ukraine.

Even in sectors where we're underweight, we're finding opportunities in individual companies that are attractive. So, for example, we're underweight REITs due to concerns about commercial real estate. That being said, we found unique opportunities in specialty REIT companies with narrow exposure to less cyclical market segments, such as cell phone towers. So, we own a REIT that has exposure to cell phone towers, and we also own a REIT that has exposure to healthcare facilities, which are not going to be so impacted by what's happening in commercial office real estate. We're also underweight the Industrials and Consumer Discretionary sectors, but we also have holdings in sub-sectors where we see very attractive opportunities on the equity side, even in those sectors.

Interviewer:

Thank you, Pedro. And that was a great comprehensive look. Maybe let's go broader now. What would you say are the key factors currently driving stocks going forward?

Pedro Marcal:

Well, we believe that earnings and cash flows are the primary drivers in stock prices. However, strength in the broader economy matters, the level of interest rates matter, and the liquidity that the Treasury and the Federal Reserve (the "Fed") create inside the system also play a role in driving stock prices and equity markets to some degree.

Interviewer:

So, switching gears a bit, we're perpetually in uncertain times. What are you seeing as the headwinds, and even the tailwinds, that you foresee for the equity markets?

Pedro Marcal:

Sure. So, our view on the equity markets, we're cautiously optimistic, and we're cautious about the macro economy because we're seeing a lot of mixed signals. But we're optimistic about the equity opportunities that we're finding at these valuations. Tighter credit is the headwind. We're focused on following these sort of mid-cap banks that have had issues in the crisis that we just talked about. However, the U.S. government's policy response is a tailwind, and it remains to be seen still how the Fed is going to respond to these evolving stresses in the banking system, but simultaneously addressing sort of the persistent inflation that they're combating right now.

Another headwind is the economic environment. A flowing economy leads to higher unemployment, as companies defend their profit margins by laying off workers. So, I think that still is ahead of us. And these headwinds are offset in part by the tailwinds in other areas. You have large investments being made in U.S. manufacturing, and they are benefiting employment, and they're benefiting demand. Similarly, these government policies, such as the Inflation Reduction Act, has really been helpful for green energy providers and it puts a lot of support in a number of these sub-sectors across a whole host of industries.

Interviewer:

So, you talked a bit earlier, you mentioned Silicon Valley Bank and mid-cap banks. Can you talk about your views on the banking industry as a whole?

Pedro Marcal:

Sure. I mean, it's divergent in the industry, and we were seeing this during reporting season. And I think the larger-cap banks are doing better than the mid- and smaller-cap banks. And if you go back a little bit and think about as a result of the great financial crisis that we saw back in '08 and '09 and '10, regulations were put in place to ensure major banks that were systematically important were well-capitalized. And, unfortunately, banks with less than $250 billion in assets ended up being exempt from many of these regulations. So, the current banking crisis is really centered around the mid- and smaller-cap banks, which in the U.S., it's actually still a fairly large bank. But, literally, there are thousands of them, and they're important, and they make up a large portion of lending to commercial real estate, and to medium and small businesses. So, the losses on the balance sheet of these smaller institutions were not a result of bad credit decisions that they made. Like they lent to a bad credit and they're being punished for it now. But they're a result of holding Treasury bonds and high-quality assets whose values fell because the interest rate rose, because the Fed rose interest rates, and as they rise, the value of the longer duration bonds goes down.

So, it's an unusual sort of crisis. And so, as deposits left the banks chasing these higher money market rates that they could get, that also really caused people to focus in a much more intense way on these unrealized losses. And it sort of further pushed some of the flight of the deposits. I mean, rates are still high, so we see this still continuing. We believe small and mid-size banks are going to face increased regulatory scrutiny moving forward. They're going to be encouraged to recapitalize and reduce the distributions, or basically their dividends, to their shareholders. And that's one of the reasons why we are significantly underweight mid-cap banks right now. Unfortunately, these stresses on bank capital causes thousands of banks in the U.S. to make fewer loans and that negatively impacts the real economy, particularly to mid and smaller-cap companies throughout the U.S., and it's spread out everywhere.

So, I think policy makers are aware of these problems and they've begun to implement programs to alleviate these stresses. And one example would be the creation of this bank term-funding program by the Federal Reserve, where banks can actually borrow from the Fed with the collateral that they have at par value, not the market value, which they can do at the discount window. But that's really helpful for these banks. And so you have this issue, but then you have a policy response to it. So, it's really not so straightforward how it all resolves itself. From a stock-picking point of view, we're interested in avoiding these smaller-cap banks because we think that they'll be challenged.

Interviewer:

Thank you, Pedro. The Fund that you and your team manage, Aquila Opportunity Growth Fund, focuses on mid-cap stocks. So, we're here, it's the third week of April. How are mid-cap companies faring and what's your take on that area of the market?

Pedro Marcal:

Sure. So, yes, we're in the beginning of April and mid-caps are still faring fairly well. If you think about through the end of the first quarter, year-to-date, during the first quarter, mid-cap companies were up about 4% versus the S&P 500® Index, which was up over 7%. But within that, there's a divergence by market cap, but there's also been a big divergence, really, by what sector you're in.

So, if you look at the mid-cap bank sector, it's down more than 30%. But when you think about other sectors, such as Information Technology or Communication Services, both of those are up over 13%, one 3%, and that was in the first quarter. But other sectors, like Financials, are down 6%, Energy was down almost 5%. So, we expect that these large variances between sectors, we think that's going to continue, and that this year is going to be a great year for stock-picking, and it's really going to be a stock-pickers market. We're excited about that.

Interviewer:

And with the Fund in mind, and maybe under the guise of a reminder, or even if there are new people listening in, can you talk a little bit about the Fund's disciplined investment style and its research process in general?

Pedro Marcal:

Absolutely. So, philosophically, we have two core beliefs about investing. First, growing earnings and cash flows lead to capital appreciation of stock. And second, markets are inefficient in how they recognize price and react to change. And there's compelling behavioral finance research, just a body of information that supports this view, and the view that markets have difficulty recognizing and reacting to change. We believe the most attractive investments are in companies benefiting from a positive material change, where companies have strong business models that enable them to monetize that change into higher earnings and cash flows, and where the impact of those changes is not yet recognized and valued by the market.

So, we use a four-step investment process:

- First, we identify the material positive change, which can be internal and company specific or external and driven by the environment in which the company operates. For example, a change could be a new product development cycle, a new management team or a regulatory change.
- Once we've identified a change, our second step is to analyze the company's business model to assess the sustainability of the change. So, we've found through experience that strong businesses generally have what we refer to as moats that protect their business from competition. And these protective business model characteristics generally fall into five categories: 1) a strong brand, 2) protected intellectual property, 3) protected licenses, 4) maybe a dominant market position, or a resource advantage, such as access to a commodity, or 5) natural resource, or even a unique distribution model. Some companies will have more than one moat, but typically, one is the most dominant and drives the business model.
- Our third step is to quantify the impact of the change by carefully modeling the financials of each company, and we build bull and bear case earnings expectations that may differ from our base case, and incorporate different scenarios for the amount of impact from the change.
- Fourth, we focus on valuation. We utilize our model that we've built, as well as historical sector trading information to build one, three- and five-year price targets. We determine if there is a potential material upside to our price target. We also review Street estimates of earnings and price targets to get a sense of whether the market expectations are similar to our own or we're very different. So, we consider adding companies to our portfolio only after they've passed through all of these steps in our evaluation process, whereby providing us with confidence that in our upside projections to the price targets. And it's very important for us that we do this.

Interviewer:

It's a great overview, Pedro. And, I think, let's stick with material positive change. I know I learn sort of through example. Can you give us an example of maybe two companies that are currently undergoing material positive change?

Pedro Marcal:

Sure. So, there are many different types of change, internal and external. Let's pick a stock in the Energy sector, because in the Energy sector there has been under investment. I think that's a big overarching change, under investment in oil and gas infrastructure, particularly in the U.S., and in Europe. So, supply of energy is unlikely to meet future demand, and this may result in higher prices for oil and gas in the medium and long-term. The situation is further exacerbated by the sanctions against Russia, as a result of their invasion of the Ukraine and, more recently, by OPEC's decision to cut 1.1 million barrels of oil per day out of production.

We like a company called Pioneer Natural Resources, its ticker is PXD, as a beneficiary of higher, medium and long-term oil prices. Pioneer is an independent oil and gas exploration company in the U.S. They are the largest acreage holder in the Permian Basin in Texas. They have a huge acreage footprint in the Midland Basin, which is one of the most productive basins in North America.

These resources provide them with an advantage versus the competition, and provide a huge moat around its business. So, Pioneer is a beneficiary of the higher energy crisis. That's an external material positive change. It's a well-managed company, and we expect them to raise their dividends. They've been returning more than 100% of cash flow to shareholders, earnings back to shareholders in the form of dividends, which are greater than 10% over the last four quarters. And we look for them to continue to monetize their grilling inventory. So, our view is that these factors are underappreciated by the market, as it's trading around 10 times P/E.

Another example in the Technology sector, we have invested in a company Splunk, Inc., ticker symbol SPLK. Splunk provides infrastructure software that gives organizations a real-time view of their most mission critical information technology assets. So, as core IT systems become increasingly complex due to a mix of on-premise and cloud-based application architectures, keeping these systems is much more important, and becomes much more difficult.

Splunk is benefiting from a new management team. The new CEO of Splunk, Gary Steele, is an executive that we've known for more than 20 years. And in his prior CEO role at Proofpoint, Inc., he grew the company from a million dollars to over a billion dollars in revenues, and then eventually sold it to private equity at a huge premium. Mr. Steele is already making his mark on the company, with the current consensus estimates for 24 EPS, up almost 80%. Mr. Steele is really focused on what we believe are primary drivers of stock price, which is the earnings and the cash flow.

So, their market position, they're the industry leader, and they have a massive amount of intellectual property around their technology, which is just a huge moat. There's a lot of free cash flow coming off the company, and we view the valuation here as being highly compelling. Splunk has the material change, it has a huge moat throwing lots of earnings and free cash flow, which we feel is undervalued. And so we have that in the portfolio as well.

Interviewer:

Really, really great insights. I've taken a few notes here. If I was to overview, or to give a few takeaways, I have: we're cautiously optimistic about stocks, especially when looking at mid-cap stocks. And while we believe that stocks are attractive and represent compelling opportunities, investors should be prepared for potential volatility along the way. We take an active approach to portfolio management on the Fund level. And then, lastly, we employ a disciplined investment and research process. Anything you'd like to add to that? Anything you want to, kind of like, last words?

Pedro Marcal:

I think one of the other things I would say is that we're entering a period of stock-picking and we are still finding very attractive investment opportunities despite the sort of short-term macro environment. So, we're extremely excited. We think that this is really the time for stock-picking, and that's what we do. Thank you for your time.

Interviewer:

Thank you, Pedro. We're happy to be passing this along to our clients and the advisor universe. I know I always get a lot out of our discussions, and I'm happy that we're passing this along to clients. Thank you for your time today and looking forward to the next one.

Pedro Marcal:

Great. Thanks.

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 manager and do not necessarily reflect those of the Investment Adviser of the Fund.

The Fund's investment objective is capital appreciation. The Fund's investment strategy focuses on factors specific to each investment such as an improving balance sheet and an improving leverage ratio. Equity holdings could be described as growth or value, small-cap, mid-cap or large-cap.

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. Securities of the companies referenced were portfolio holdings of Aquila Opportunity Growth Fund, represented as a percentage of the Fund's total portfolio as of 3/31/23: Pioneer Natural Resources: 2.22%; Splunk, Inc.: 1.41%.

The S&P 500 Index is a stock index, weighted by market capitalization, representative of the 500 largest U.S. companies. An investment cannot be made directly in an index. Performance of an index does not reflect management fees and expenses, which are reflected in Fund performance. Past performance does not guarantee future results.

Please refer to the Fund's prospectus for a complete description of risks associated with an investment in the Fund. These include, but are not limited to, potential loss of value, market risk, financial risk, interest rate and credit risk, and investments in highly-leveraged companies, lower-quality debt securities, foreign markets and foreign currencies.

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, and when you call 800-437-1020 or visit www.aquilafunds.com.