Aquila High Income Fund

PODCAST TRANSCRIPT

October 2023

Interviewer:

Hello, thank you for joining us on this Aquila Group of Funds Podcast. I will be your host today. I'm Phil Felice, the Director of Internal Sales here at Aquila, and today I have David Schiffman. He's sitting down with us. Welcome, David.

Dave Schiffman:

Thank you, Phil.

Interviewer:

Thanks for being with us. David is the Lead Portfolio Manager of Aquila High Income Fund, and he's going to give us an overview of the high-yield market, and I feel it's a good time. There's so much in the news on fixed income in general, and Treasuries are a big topic, and they've been really driving the story. But there hasn't been much left headline-wise for the high-yield markets. So, I want to dive right in. I want to start broad with your current assessment of high-yield corporate bonds. How would you describe the present state of the high-yield market?

Dave Schiffman:

Great question, Phil. So, why don't we begin with an overview of the Federal Reserve's monetary policy and our thoughts on upcoming FOMC (Federal Open Market Committee) decisions? Recent economic data, Phil, including the resilient labor market combined with inflation that remains well above the Fed's target at 2%, leads us to believe we may see one more rate hike between now and the end of the year. Certain components of inflation remain sticky, and the recent spike in energy, along with the likely wage gains we may see that could be the result of recent union labor negotiations, could really keep inflation data elevated. Aside from our view on at least one more rate hike by the Federal Reserve (the "Fed") this year, we think investors really should begin to shift their focus towards the length of time the Fed may leave rates at these restrictive levels. We anticipate rates will probably be higher for longer than the current market is projecting, and that could lead to what we're calling a "rolling recession."

The higher rate environment, heightened geopolitical uncertainty, and political gridlock here at home really all lends itself to potential pockets of weakness in certain sectors of the economy. However, we feel the higher-rated credits within the high-yield market really continue to exhibit stable credit metrics. And many of those issuers have been really opportunistic in refinancing upcoming maturities, Phil. Therefore, with absolute yields right now, believe it or not, hovering right around 9%, and relatively short duration of the asset class, high-yield bonds really offer a compelling opportunity for investors, we think. However, now more than ever, I would say an actively managed approach to high-yield investing is really important. There could be a real minefield of deteriorating credits to avoid, while there could really be pockets of strength that may add incremental performance for investors.

Interviewer:

Thank you, David, and that's a great overview. And is there anything within that that you would say are the market drivers that investors may wish to pay attention to, looking at the high-yield market going forward?

Dave Schiffman:

Well, as I mentioned earlier, we feel the focus for investors should really rotate towards how long rates may stay at these elevated levels. Aside from the Federal Funds rate (the interest rate that banks charge each other to borrow or lend excess reserves overnight) nearing a potential peak, recent moves higher in longer duration Treasuries has surprised some market participants. It was apparent that other portions of the yield curve really needed to go higher after Federal Reserve Chairman Jerome Powell suggested short-term rates would stay higher than most people had previously thought. Reinforcing this view, recent economic data have really shown more strength than most would've expected, especially with such an aggressive Fed policy stance.

Demand for Treasury bonds has really been tempered as well, especially for overseas buyers, while the runoff of the Fed's balance sheet has really reduced the buying power of what we would consider the biggest indiscriminate buyer. Finally, a large increase in upcoming supply really has driven buyers to seek higher yields to compensate for the perception of increased risk and uncertainty. Where yields eventually settle in, it's an important question. If they move too high, then the economy could risk going into a tailspin. Yet, if they appear too low and inflation remains entrenched, then the Fed has to do more. Either way, it's uncertain times for the markets and we expect near-term volatility to really remain elevated.

Interviewer:

Thank you. I want to kind of switch gears, because you mentioned earlier that higher credits offer a level of stability. But what's your take on credit fundamentals and the underlying credit strength of high-yield bond issuance?

Dave Schiffman:

Well, in-depth credit analysis is really the foundation of our philosophy and that, Phil, really can't be underestimated. As I've mentioned to many shareholders when I've spoken to them, I really tell them it's not always the money you make, but the money you don't lose in fixed income investing. I mean, that's something really important for folks to really remember. Our mantra of, "Do no harm." You've heard it many times from me. That highlights our dedication to this philosophy, and the need for comprehensive credit due diligence will really come to the forefront in coming months and quarters. As mentioned earlier, credit metrics appear stable for now for many high-yield issuers, yet the higher rate environment is really beginning to take a toll on lower-rated credits.

This is especially true for those issuers with a large percentage of floating rate debt outstanding. Some lower-rated, CCC-rated companies were opportunistic during the pandemic era in refinancing their debt at historically low interest rates. Many of these issuers tapped the floating rate market to take advantage of short rates near zero. Yet, now those coupons, believe it or not, have reset to over 500 basis points higher. This is really putting an enormous amount of pressure on their balance sheets and weakening their underlying credit fundamentals. Hence, as we approach what we're calling a "rolling recession" like I mentioned earlier, we continue to be opportunistic in really moving up in credit quality, while maintaining a duration that's about a year short versus our benchmark.

And just as a reminder, duration is a measure of interest rate risk, hence a shorter duration could help mitigate the potential price decline if we're in a rising rate environment. But keep in mind also, it could be beneficial if credit spreads move wider from the current levels. We still feel there's good relative value in the energy sector, as many of the current companies in this area have improved their credit metrics and continue to benefit from the current level of oil prices. Meanwhile, we still think the consumer appears to be spending, although there has been a shift from goods to services. Therefore, we like sectors like casinos, higher-end hotels, and certainly credits in the cruise industry look very interesting as well.

Interviewer:

You've alluded to the answer to my question, but I did want to ask it directly. What's your view on credit spreads at this point in time?

Dave Schiffman:

As you may suspect from my comments on "up-in-quality trade" and shorter duration, our view is there is some potential for credit spreads to widen out— to rise. With the option-adjusted spread, the high-yield index (Bloomberg U.S. Corporate High Yield Index) just above 400 basis points, the market doesn't really appear to be pricing in any weakening in credit fundamentals, and certainly not anticipating a potential recession. Yet, as the long and variable lags of monetary policy work its way through the economy, we do expect the labor market will experience some pressure from companies right-sizing their workforce in order to maintain their margins and adjust for potential pullback in the overall consumer demand. Therefore, we constantly monitor all the various industry sectors, Phil, and lean on our decades of experience in our bottom-up approach to opportunistically allocate portfolio assets within and among various areas of the high-yield market.

We really have been opportunistic in adding quality names in the portfolio at attractive levels, and have begun to really mitigate some of the potential reinvestment risk that's been created recently by the inversion of the yield curve. And the way we mitigate that is by creating a bit of a barbell in our maturity ladder. I mentioned this in a recent article I wrote on this, what we call "forgotten risk." Short maturity positions offer investors a relatively attractive rate of return right now if they are held through maturity, while intermediate/long maturities could help lock in historically high yields for an extended period of time. In addition, as rates eventually decline, it doesn't feel like they will right now, but eventually rates will come down, the reinvestment risk realized by putting short maturity proceeds back into the market at lower yields could be offset by appreciating prices of investors' longer-term positions. As a reminder, bond prices move inversely to rates and yields, meaning bond prices will increase as yields decline.

Interviewer:

So, the supply of new bond issuance remains relatively low, but we did see an increase a bit recently. What kind of impact does that supply generally have on the market?

Dave Schiffman:

Well, Phil, during the summer months, the new issue supply in a higher market was actually fairly muted, as companies really were reluctant to issue bonds during an initial spike in the option-adjusted spread along with overall yields. However, by September it appeared the floodgates had opened up. We saw 38 bonds priced, but I think it was a little bit over $24 billion in new issuance. That's the highest monthly volume since January of '22, according to J.P.Morgan Credit Research. This compares

to a year-to-date monthly average of a little bit over $15 billion, and a monthly average of about $11.5 billion since the start of the last year.

Through the end of the third quarter of this year, the high-yield markets priced a little bit over $130 billion in new issuance in 2023, and that's compared to just about $90 billion over the first nine months of '22. So, we certainly have seen an increase in issuance this year compared to last year. But normally an increase in supply would put added pressure on credit spreads in order to make it more attractive, that the markets absorb those new issues. However, believe it or not, a dearth of new issue activity earlier in the year, and attractive all-in yields, have allowed these issues to price without much effect on overall credit spreads. As maturity walls in 2024 and '25 quickly approach, it'll be really interesting to see how receptive investors are to the increased supply required to refinance these issues.

Interviewer:

So, clearly, there's a lot of factors to consider in your day-to-day, when navigating the high-yield bond markets. How do you navigate it all, the uncertainty, the macros, the risk for return? How do you navigate that?

Dave Schiffman:

Phil, you know what? You've rightly mentioned there are a huge number of factors to consider when managing a high-yield portfolio—whether it's the macroeconomic environment, geopolitical uncertainty, especially right now, or the traditional idiosyncratic credit risk, our top-down and bottom-up approach allow us to be nimble and proactive to what I call the "three Ms." We monitor, manage and mitigate these various risk factors, through our "do no harm" approach. Again, you're going to hear this more and more from us. That really is going to serve our shareholders well as we navigate the volatility and uncertainty of these unexpected and unprecedented events.

Interviewer:

As usual, David, great insights. If you can, we're at the tail-end here of our conversation. Could you briefly summarize a few key takeaways for our listeners and what those might be?

Dave Schiffman:

Absolutely. Just again, to summarize, we feel high-yield bonds have really demonstrated resiliency, despite the volatility we just talked about and the uncertainties in fixed income. With year-to-date returns still well into positive territory, the asset class has been one of the best-performing sectors of the fixed income market. We believe absolute yield levels and overall valuations continue to look relatively attractive in the current environment. And keep in mind, high-yield bonds may provide valuable diversification as part of a well-rounded investment portfolio, and really could act as a nice complement to other fixed income allocations.

Aquila Group of Funds' high-yield strategy is based upon a proactive approach to portfolio management, and we really do have that discipline, investment and research process. Our team of investment professionals, keep in mind, we have a combined years of experience of well over 100 years. We seek to deliver high current income, as well as a potential for capital appreciation for our shareholders, and we really do pay careful attention to those risk management policies, and truly adhere to what we call the three Ms, as I mentioned earlier. It's monitor, manage and mitigate those risks, and that really does, Phil, support our "do no harm" philosophy.

Interviewer:

Well, David, as always, every time I talk to you, it's great information. There's a lot there to consider as we approach the year-end. A lot to consider on the high- yield front, a lot to consider really in fixed income. So, just thank you for your time today, and have a great rest of your day, and a great rest of your year.

Dave Schiffman:

Thanks very much, Phil. I really enjoyed our conversation.

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The Fund's primary objective is to obtain a high level of current income. Capital appreciation is a secondary objective when in line with the primary. The Fund invests at least 80% of net assets in income producing securities, and as much as 100% in high-yield, lower rated or unrated debt securities. The Fund is suitable for long-term investors seeking higher potential returns than more conservative fixed-income funds and who are willing to accept the higher risks of price and income fluctuations.

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.

The Bloomberg U.S. Corporate High Yield Index is an unmanaged index considered representative of the universe of fixed-rate, noninvestment grade debt. The Bloomberg U.S. Aggregate Bond Index is an unmanaged index considered representative of the universe of fixed-rate, investment grade taxable debt. Performance of an index does not reflect management fees and expenses, which are reflected in Fund performance. Past performance does not guarantee future results.

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