Aquila Opportunity Growth Fund

PODCAST TRANSCRIPT

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Interviewer:

Hello, thank you for joining Aquila Group of Funds. I am Phil Felice, the Director of Internal Sales here at Aquila. And I'm here today with Pedro Marcal. He's our Director of Equities and High-Yield, as well as the Lead Portfolio Manager of Aquila Opportunity Growth Fund. Thank you, Pedro. Thanks for speaking with us today and being here.

Pedro Marcal:

Thanks for inviting me. It's great to be here.

Interviewer:

So, let's dive right in. Looking at the markets... In this case, we're going to look at the broad equity market. They're usually unpredictable, but it seems that new guidance comes out on a daily basis. We hear things like soft landing, hard landing, and everything in between. So, let's start with a very broad question. What is your assessment of the equity market so far this year, and what are some of the key things you're paying particular attention to for the remainder of the year?

Pedro Marcal:

The equity markets so far this year have delivered positive but very divergent returns. Through the close of business on October 12th, the NASDAQ Composite Index has returned approximately 30% year-to-date. The S&P 500 Index is up approximately 15%, and the major mid-cap indices are up about 3%. So far this year, parts of the market have really found the "wall of worry," and there's been a lot to worry about. Such as the U.S. Federal Reserve's interest rate tightening cycle we're in. We've seen a peak in corporate profits. We saw the Russian invasion and the ongoing war in the Ukraine, the accompanying U.S. and European sanctions against Russia for that invasion. And more recently, the situation developing in the Middle East, and clearly the impact on oil supply and oil prices that that may have. And trade relations with China and, basically, China's slowing economic growth.

So, balancing these risks is the enormous amount of governance stimulus in the pipeline by the U.S. government. High rates of employment and continued strong demand for goods and services in the U.S. Many of the supply chain issues companies faced over the last few years have been resolved and the fears created by the pandemic are, rightly or wrongly, already in the rear-view mirror. What's fascinating to us is the amount of change and innovation we're seeing in the economy and in society. There's some huge overarching changes taking place and we are identifying investing in very attractive opportunities in the mid-cap equity space.

Some of these huge changes include electrification, transformation of the defense industry, higher-than-expected demand for oil over the medium and longer term. In technology, there are opportunities driven by the adoption of artificial intelligence and the limitations of binary computing. We're optimistic about the individual investment opportunities that we're finding that are created by these changes, some of which we're going to discuss today.

Interviewer:

That's a great overview, Pedro. Let's kind of narrow our focus a little. Aquila Group of Funds' equity strategy, focuses primarily on mid-cap companies. So what is your view of mid-cap stocks relative to the broader markets?

Pedro Marcal:

We're fundamental investors, and we focus on high-quality individual stocks. The team believes the most attractive investments are those in companies benefiting from a material positive change, where companies have strong business models that enable them to monetize the change into higher earnings and cash flow and, really, where the impact of these changes is not recognized and valued by the market. So, what do we mean by material positive change? In our view, there are seven broad categories of material positive change, which can benefit companies. Positive material change can be internal and company specific. So, internal changes would include one, a new product development cycle. Two, an innovative new technology. Or three, a new management team/restructuring or four, an acquisition position or synergies.

Material positive change can be external to the company as well and driven by the environment in which the company operates. External changes include changing industry dynamics, pricing supply and demand, and government regulatory changes. So, that said, we look at the relative valuation from a 12- month forward earnings point of view for mid-cap stocks versus, say, large-cap stocks. And we're close to decade-lows in terms of the relative valuation.

But, more importantly, in a stock picking environment like the one we've entered where the macro and the geopolitical environment are very uncertain, mid-cap companies enable investors to get very specific exposure to individual themes, which is very important to us. For example, in the technology sector, consider the development adoption of artificial intelligence and the slowing of Moore's Law, and the combination of the two. So, if you recall, Gordon Moore was a pioneer of the semiconductor industry and a co-founder of Intel Corporation. And Moore observed that the number of transistors on a computer chip doubled every 18 months, and the cost of that chip halves in price.

So, essentially you got twice the computing power for half the price. And this growing efficiency accelerated the adoption of computers and electronics as they became faster and cheaper. But after decades of miniaturization, the size of the transistors became so small, they became constrained by the length of a wavelength of light. So, in the past, companies had significant gains in product price performance by just shrinking the existing process that they had to fit more transistors on a chip for electronic companies or computer companies, they could just ride Moore's Law. So, now you can't because it's not economical because the improvement in price performance is not enough.

So, now they have to develop chips that are bespoke for each use case, whatever that use case might be. We call them application specific integrated circuits, or ASICs, and they're basically integrated circuits that are developed for a specific use rather than for general purposes. And they've always been around, but they've become much more prevalent because of the end of Moore's Law. And it used to be that only semiconductor companies were making application specific designs, but now Tesla is doing it, Apple is doing it, and Microsoft is doing it for their own specific use cases. So, the electronic design automation companies like Cadence and Synopsys, which we've owned in the portfolio for quite some time, are beneficiaries of these trends.

So, now that you throw AI on top of this and the demand for general computing goes up massively, it's like these artificial intelligence, AI, large language models that require massive amounts of computing power and memory in order to run. And so, there's a whole host of mid-cap semiconductor companies and mid-cap software companies that benefit from these changes. And we're invested in more than half a dozen companies in those two areas that have material exposure to this evolving opportunity.

Interviewer:

Okay. So, now let's switch gears just a bit onto the specific running of the portfolio. So, markets are up this year, but as usual, they get there with plenty of volatility, and plenty of divergence. With all that in mind, how do you and your investment team manage through the turbulence?

Pedro Marcal:

In general, we try to take advantage of the volatility. If a stock with strong fundamentals is impacted by a general selloff in the market and there's no change in those fundamentals, then we will add to the position. So, since we've been defensively positioned, we have a lot of dry powder, and in the event that there is a correction, we have the ability to rotate more into larger positions in some of these best opportunities that we see longer term.

It's a really strange time, which is ideally-suited for our change focus and core equity investment process. If you take the energy sector, for example, which is an area of my specialization and expertise, we're overweight by almost 5%. So, we almost have a double weighting of the benchmark in that area.

An important trend that we've been seeing is the under-investment in oil and gas infrastructure, particularly in places like the U.S. and Europe. And in the coming years, we think supply is unlikely to meet what the future demand is, and this may result in higher prices for oil and gas. This situation is further exacerbated by the sanctions against Russia as a result of their invasion of the Ukraine, and the recent developments in the Middle East with these horrific attacks by Hamas in Israel, and the likely response by Israel and some of the members of the global community.

So, we've liked a company and own in the portfolio, Pioneer Natural Resources ("Pioneer"). You've probably seen them in the news recently, along with ExxonMobil, who was in the process of buying them. Pioneer is an independent oil and gas exploration company. It is still right now. Pioneer is the largest acreage holder in the Permian Basin with a huge acreage footprint in the Midlands Basin, one of the most productive basins in North America. And these resources provide an advantage versus their competition, the oil companies, and provide a large "moat" around their business. Pioneer is a beneficiary of higher oil prices. It's well-managed, it's raised dividends, and it's been buying back shares, as they move forward and basically develop and monetize their drilling inventory.

So, our view has been and is, that these factors are underappreciated by the market, and it appears now that that they've been bought by Exxon that at least Exxon probably shares those views. But, we also like other independent oil and gas producers in the Permian Basin, which we'll probably likely be discussing with you at some point in the future.

Interviewer:

So that's interesting because you mentioned, Pedro, you said your specialization. So, let's shift gears a little bit and talk about the investment team specifically. The roles of the team in terms of sector coverage, they're clearly defined. Can you take us through the group that manages the Fund on a day-to-day basis and what their specific roles are?

Pedro Marcal:

Sure. Our team consists of four seasoned investment professionals and combined, we've been saying that we nearly have 100 years of financial experience researching and analyzing securities. Frankly, we were saying that a few years ago. We're over 100 now, unfortunately. Importantly, our team's experience and expertise are complementary and that enables us to cover all 11 industry sectors. I cover energy and consumer staples, which as I mentioned earlier. On the energy side are two areas which I have the most experience.

John McPeake, my co-manager for Aquila Opportunity Growth Fund, covers all of technology communication services and some of the consumer non-durables. And John has covered technology and communication services for almost 30 years. Dave Schiffman covers the interest rate-sensitive sector, so that would be banks, insurance companies, real estate and utilities, where he has really decades of specialized research experience. Steven Yang, who is a CPA and a CFA®, covers healthcare, industrials, materials and consumer durables. And he has worked in or covered those sectors for two decades.

So, our team has very broad comprehensive coverage across all industries, sectors and companies. And that's really important because, remember, we're looking for change. We're focusing on the individual fundamentals of companies. So, we really need to understand our industries. We need to understand how the companies compete in those industries in order to implement our process.

Interviewer:

If it's any consolation, you guys don't look like you're 100 years old, so don't feel bad. One more question: We talked about people. Let's cover process a little bit and potentially how you've used the process to identify investments worthy of an allocation inside the portfolio?

Pedro Marcal:

Sure. So, we use a four-step approach in our investment process. First, we identify a material positive change, which can be internal or external, and we talked about that a little bit ago. And 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) a protected intellectual property; 3), a protected license; 4) a dominant market positioning; or 5) a resource advantage, like Pioneer, we just talked about, or which would be commodity like oil in the ground in the Midland Basin in Texas.

So, some companies have more than one moat, but typically, one is most dominant of these five and drives the business model. Our third step is to quantify the impact of the change by carefully modeling the financials of each company. We build a bull and bear case earnings expectation that may differ from our base case and incorporate different scenarios for the impact of the change. And our fourth step relates really to valuation. So, we utilize our model that we built, as well as historical sector trading information to build one, three and five-year price targets. Potential material upsides are our price target really, and we also review Street estimates of earnings and price targets to get a sense of whether the market expectations match our own. We only consider adding companies to our portfolio after they've passed through all these steps in our evaluation process and we are confident of our appreciation projection.

So, let me take you through a quick example of a position in a technology company that supplies network fabric infrastructure and software for the Cloud. The company's called Arista Networks and it's benefiting from a new product cycle. So, that's sort of the main beneficiary. The company's clients are big social media and Cloud computing firms. Clients would be companies like Facebook and Microsoft, which are two of their large clients.

The change we identified is their new product, which is an infinitely scalable software-defined routing and switching network, which we believe is years ahead of the competition. And the company has patents and intellectual property, and an incredible brand, which creates a large moat that makes their business model sustainable, in our opinion. And so, we anticipate the increased earnings and cash flow from this new product cycle. So, you've got this network company that's growing their earnings and benefiting from a major change, which is material, which is a new product cycle, and then also a change in the environment, which is demand for Cloud computing and artificial intelligence.

Interviewer:

Thank you, Pedro. A lot there. A lot to digest and unpack. If you could, and just briefly, can you summarize a few takeaways for our listeners? What would those takeaways be?

Pedro Marcal:

Sure. We're cautiously optimistic about stocks, but more specifically, we like mid-cap stocks because we're finding great long-term investment opportunities that we believe are attractive, compelling opportunities. But investors should be prepared for potential volatility along the way. We take a fundamental, bottom-up active approach to portfolio management and employ a disciplined, change-based investment process. The investing companies benefiting from a material positive change were companies that have strong business models that enable them to monetize that change into higher earnings and cash flow, and where the impact of this change is not recognized and valued by the market..

Interviewer:

As always, thank you for your time today, Pedro. We always appreciate your view on where things are, where they may end up, and of course, the process of Aquila Opportunity Growth Fund. So, thank you again. Have a great rest of the year, and I appreciate it.

Pedro Marcal:

Thank you very much.

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 9/30/23: Pioneer Natural Resources: 3.33%; Cadence Design Systems, Inc.: 1.27%; Arista Networks.: 1.17%; and Synopsis, Inc.: 0.83%.

The Nasdaq Composite Index is a market capitalization-weighted index of more than 2,500 stocks listed on the Nasdaq stock exchange. 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.