Aquila Tax-Free Trust of Arizona

PODCAST TRANSCRIPT

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Interviewer:

Hello, everyone. Thank you for joining us for another installment of the Aquila Group of Funds podcasts. I'm your host, Matthew DiMaggio. Today we are accompanied by Tony Tanner, Portfolio Manager of Aquila Tax-Free Trust of Arizona. Thank you for being here, Tony.

Tony Tanner:

Hey, thank you for having me today, Matt.

Interviewer:

So, I want to touch on a big topic upfront. The Federal Reserve (the "Fed") decided to sit tight on short-term interest rates early this year. It seems the sentiment is kind of the same here in March now. What are you thinking about that and is it affecting how you're managing the portfolio?

Tony Tanner:

It's not having a large effect on how I'm managing the portfolio. The managing of interest rates based on what the Federal Reserve is doing in short-term rates is really different from managing an intermediate or long-term portfolio for the long run. And so, I'm paying close attention to how the inflation numbers are behaving. It's my observation that since May or June of last year, inflation has been solidly under 4%. And so, although the Fed's timing for interest rate cuts may be pushed out, it seems that we're still at the peak of the interest rate cycle. And the downdraft we had in prices and the increase in yields we saw back in October, from which we've rallied, show a demarcation where, as time marches on with any slowdown in the economy or hints of the Fed becoming more dovish, we expect to see rates begin to continue and moderately recede. And so, we're focused on positioning the Fund for generating long-term attractive levels of income and staying within that intermediate range.

Interviewer:

Great answer, Tony. And as always, there's just a lot more going on than meets the eye, so thank you for that.

So, I want to touch on an important topic for municipal bond investors, which is the Municipal-to-Treasury ratio. It's been below average for some time here. It seems that the only part of the ratios, or the curve rather, is at the long end. What's your take on that, and what's it going to take to see a big change there?

Tony Tanner:

Well, the interesting thing about yield ratios and the yield curve are just the shape of the yield curve right now. This has been going on since 2022, and that's this unusual bowl shape in the yield curve. And if I'm looking at high-quality AAA municipal yield indexes today, especially that 5–10-year part of the curve where yields are two-and-a-half percent or less, it's a very different place from the long end of the curve out 15 years or longer where you're solidly above 3% or closer to those one-year levels. Municipal-to-Treasury ratios are, to me sometimes, less a guide for what to do than what not to do, and the shape of the yield curve suggests that being broadly diversified across the curve—which means maybe having a longer duration or longer maturity consideration than one might think given the focus on the Fed, I think would be prudent.

I think that you're right, that the long end of the bond curve is somewhat cheaper in the low to mid-80s, and not as cheap as it used to be. But again, if you have put this in the context of long-run inflation and inflation expectations, where we're solidly in the 3%s, we're a long way from the 6%, 7%, 8% inflation we were suffering in 2022. And the truth is, 3% isn't that much further from the Fed's 2% target. And so, I do think that while ratios might seem expensive, I think they're expensive against a benchmark that's considerably cheap compared to the level of inflation and provide some opportunity to generate real yields, or an opportunity to generate yields that'll compensate you for the rate of inflation and the trend in the inflation rate. And that's really important for income-oriented investors that are evaluating their overall asset allocations.

Interviewer:

And that's exactly the take I was looking for. Great, Tony.

It's my observation that since the bottom of the market a few years ago, we haven't really seen a confident municipal market. Do you agree with that and is that the same observation you're making?

Tony Tanner:

I think we've seen a municipal market that's developing some growing conviction. I think that if you look at this cycle of interest rates and the current Fed tightening cycle, one of the things I want to point out is if you go back to mid-May of 2022, which is when 10-year high-quality municipal bond yields first approached 3%, and at the time, the federal funds rate had only been increased to about 1% or 1.5% at that time. Well, in the convening 21 months, the municipal bond market, in particular the high-quality, intermediate municipal bond market, has been in positive total return territory 90% of the time, even with the retrenchment of yields to the cyclical highs back in past October. And over that 21-month period, for the most part, prices are relatively unchanged, and most of the return has come from income. And so, it's been a decidedly normal income and return environment for municipal bonds. Investible yields in the 3% range with some fluctuation up or down 3% or 4%. And so, I'm hoping that investors will begin to notice and pick up on that normalization of the behavior of the market because we're 400 basis points higher in terms of the federal funds rate in that time. And the focus on what the Fed is saying and doing has really been a distraction to investors and advisors from the risk and return attributes that have grown much more positive over the past 20 months or so.

Interviewer:

Very insightful. If we could shift gears a second to talk about supply and demand. This year so far has shown some elevated supply year-over-year. Still early on, of course. What will it take for the supply to really pop and stay there in 2024? And then how will the demand side be able to support that?

Tony Tanner:

Well, the two things that would drive higher issuance are lower borrowing costs, which issuers can't count on or anticipate, and just normal structural capital needs for ongoing projects and where budgets are. There is some likelihood the further we get away from the massive COVID stimulus of 2020 and 2021, that municipalities and towns and governments will increasingly have less of that to turn to, and we'll be turning to the bond markets. Supply overall the last year and this year… last year was only down a couple of percentage points. We're up maybe 20% this year, but it's a period when issuance is relatively low. Issuance in terms for us as investors really hasn't been problematic or that influential. Here in Arizona, we've had an annual turnover rate of 35% plus or minus the last two and a half years. The municipal market is a "trade by appointment" market where only 2% of it trades on a daily basis. So, really effectively canvassing the secondary market, consistently being in contact with dealers and situations, is really what drives the opportunities to actively manage a portfolio. Spikes in issuance can sometimes lead to more opportunities. And certainly, if there's a lack of issuance, it makes it a little bit harder to find bonds. But we're not finding here in Arizona that issuance is a challenge at all in terms of conducting the active portfolio management that's benefiting the shareholders.

Interviewer:

So, I'm glad you mentioned supply in the State of Arizona a little bit. Typically, supply is documented on the national level, but that national supply doesn't necessarily trickle down evenly to each state. So, talk more specifically about what's going on in Arizona and how it relates to supply.

Tony Tanner:

Well, in Arizona last year we were down about 30%, from $6.5 to $5 billion, but we had several large well-known issuers come to market. The Salt River Power Authority came to market with a couple large issues in February, in the fall. Phoenix Civic Improvement Authority had a $350 million issue in October as well. And so, issuance in Arizona I would've still characterized as being fair in terms of the opportunities that it created. It's interesting when you bring up supply because I reflect on, again, the impact of the COVID stimulus—the $6 trillion of CARES package funding in 2020 in particular.

And I remember in an interview I did at the outset of the pandemic in May where I pointed out that if I was forced to own a two-bond portfolio, I would want to own the bonds for the airport in Phoenix, and for the subway system in New York City. And my rationale was that New York City isn't New York City without the subway, and the solution to the pandemic long run would not be putting half of the MTA's former ridership in rideshares in Midtown. And the reason that's interesting is that in August, the U.S. Government was downgraded because of the large amount of deficit it's running because of a borrowing for things like the CARES package. And a few months later, the New York City MTA was upgraded. And so, that's not a coincidence because it represents the impact of intergovernmental transfers on a lot of the activities that municipalities do when it comes to their financing. So, I think that municipal credit is coming out of this really in a good position. It's been very resilient given the economic shocks we've had in the last four years. But I do think that ongoing supply in the future is going to be more than sufficient to help active portfolio managers deliver good value for shareholders.

Interviewer:

And I want to stick on Arizona here for a second. Is there anything else worth mentioning happening in this state and local landscape?

Tony Tanner:

Probably one of the most interesting things going on in Arizona is, we're digesting the last two or three years in what I characterize as Arizona becoming the nation's smart manufacturing hub. It's well-known the large chip manufacturing investments being made by Intel and Taiwan Semiconductor, but there's a host of peripheral economic development going on in autonomous vehicles and aerospace. LG is building the world's largest battery manufacturing facility here in Arizona as well. That's a $5 billion investment, and we're starting to see a lot of peripheral development around those projects. So, we're taking a bit of a breather in absorbing those projects. The other interesting thing is that Arizona state income tax rate over the last couple of years has been revised, and it's now down to a flat 2.5% tax rate. And not surprisingly, we've begun to see a bit of a budget deficit occur generated by reductions in individual income tax holdings. I think fiscal year-to-date through the first seven months, individual income tax holdings are down around $500 million, and the budget's running about 14% below where it was last year—although close to budget for what had been anticipated. And the reason that's important is, while the lower taxes and lower tax revenues might appear problematic, Arizona's wealth and population growth is dramatically increasing the tax base on which those taxes are levied. An interesting study was out looking at not just population migration, but the migration of adjusted gross income among the states. And this report pointed out that between 2016 and 2021, Arizona attracted the third largest amount of adjusted gross income in the country. So, to put some numbers to that, over that period, over 200,000 tax filers moved to the State, with a combined adjusted gross income of $22 billion. Now that compares to states in the mountain states here, like Utah and Nevada, that attracted about $5–to $5.5 billion. And on a per capita basis, that's $3,000 per resident. In Texas, they attracted $30 billion over that time. But spread across its population of 30 million, that's only $1,000 per capita. And so, these budget deficits are concerning because the State's wealth base and tax base is growing very attractively. I do think that there is going to be some friction around whether or not these tax rates will hold and that we might even see some rescission or modest bump in the State's income tax rate over the next few years, which for Arizona tax-free investors would not be a bad thing because it would enhance the value of the tax exemption and the value of their investment in the State's municipal bonds.

Interviewer:

Great insight all around. I look forward to watching Arizona's continued growth.

I want to close here with our last question by speaking about the Fund—Aquila Tax-Free Trust of Arizona. Could you tell us about how the Fund is currently positioned and how you're managing in this environment?

Tony Tanner:

Well, it's been managed with an eye towards the economic backdrop, and interest rate fundamentals and yield curve positioning. And so, what that means is, I had alluded to the unusual bull shape in the yield curve. So, we've been making sure that we're broadly diversified across the yield curve to ensure that we've got good exposure to areas of the curve that are less expensive and avoiding overexposure to portions of the curve that appear to be expensive. So, right now, the Fund's holdings of 5–15-year maturities are only around 34% or 35%. Whereas we've built up a good exposure to the 15–30-year part of the curve that is around 22% to 23% of the portfolio, and barreled that with shorter maturities under five years and closer to one or two years. So, if we do begin to get a more easing mindset with the Fed and cuts in short-term rates, we'll be able to deploy those funds quickly into longer-term securities with better yields. And also, we would expect that those longer data holdings that we own would respond positively to an easing and backdrop in the interest rate policy. And because of that, we've allowed our duration to continue to drift into the 5-5.5-year range. We let it extend out to 5.5 years back in October, which was very beneficial when the large rally came at the end of the year. And so, we're focusing on being broadly diversified across curve exposure, bond structure, owning a wide variety of coupons to ensure that, again, we own coupons and structures that will respond favorably irrespective of Fed policy. And so, I think that broad, genuine economic diversification is going to be beneficial for the Fund moving forward.

We're only about 15% or so in A or lower-rated bonds because the AA sector has appeared to be unusually cheap. But we do have some good exposure within Arizona's high-quality A-rated hospital sectors and some shorter put bonds for issuers like Intel that give us broad exposure to the State's economy.

Interviewer:

And that sums up our podcast for today. Thank you to everyone for listening. And as always, thanks again, Tony, for joining us.

Tony Tanner:

Hey, thanks again, Matt. Look forward to chatting you up during the baseball season.

Thank you for listening to this podcast. The opinions shared are those of the portfolio manager 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. For certain investors, some dividends may be subject to federal and state income taxes, including the alternative minimum tax, referred to as AMT. Please consult your tax professional.

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 following securities referenced were portfolio holdings of Aquila Tax-Free Trust of Arizona, represented as a percentage of the Fund's total portfolio, as of 12/31/23: City of Phoenix Civic Improvement Corp.: 14.01%; and Salt River Project Agricultural Improvement & Power District: 4.09%.

Independent rating services such as Standard & Poor's, Moody's, and Fitch assign ratings, which generally range from AAA, which is the highest, to B, the lowest, to indicate the credit worthiness 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 the security in response to a change in interest rates. Effective duration is also taken 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.

Yield refers to earnings generated and realized on an investment over a specific period. Yield is expressed as a percentage based on the investment amount, current market value, or face value of the security, and includes the interest earned or dividend 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.

The CARES Act stands for Coronavirus Aid, Relief, and Economic Security Act.

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

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