Aquila High Income Fund

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 today, Matthew DiMaggio. Today, we are accompanied by David Schiffman, Lead Portfolio Manager of Aquila High Income Fund. Thanks for being here today, David.

Dave Schiffman:

You're very welcome, Matt.

Interviewer:

I was just recently reading about the changing makeup of the high-yield market due to some downgrades, but also some upgrades out of high-yield entirely. It seems like good news for the upgrades, but bad news for high-yield in general. Can you speak to that?

Dave Schiffman:

Absolutely, Matt. As you know, there have been a number of high-profile names in the high-yield market that moved up in credit quality in recent quarters. Specifically, names like Ford and Occidental Petroleum moved back to investment grade. And as you remember, both of these names were known as "fallen angels," which means they were downgraded from investment grade to high-yield during the height of the pandemic. These are extremely large issuers and represented a big portion of the high-yield market when they were downgraded. However, it seems like they got "religion." Both companies worked really diligently to improve their credit quality profile, and eventually they met the criteria of the rating agencies to move back into the investment grade space recently. Although these names represented a really large portion of the high-yield market since they were such large issuers, if you look at it in terms of the actual number of issuers upgraded versus downgraded, we see a really different picture. Because Ford and Occidental Petroleum were such large issuers, it may have skewed that movement from high-yield to investment grade and vice versa. But thinking just in terms of the number of issuers, as I mentioned, it's a little bit of a different picture.

As the corporate bond market bounced back from the depths of the pandemic, underlying credit fundamentals really improved pretty dramatically, and this really drove the upgrade to downgrade ratio. That's kind of the ratio that we look at in terms of the movement in credit fundamentals. So, that really improved pretty dramatically after the pandemic, and this drove the upgrade to downgrade ratio to a two-to-one ratio in 2022, If you compare that to the ratio of about 0.3 in 2019 and 0.2 in 2020. However, since we peaked in 2022, we've seen a steady decline in the upgrade to downgrade ratio from that large two-to-one ratio, as companies begin to struggle with slower consumer demand and higher interest expense. Yet it seems like the ratio of upgrades to downgrades is kind of settling in over the last few months on either side of one-to-one. So really, it's been the even match between upgrades and downgrades, and I suspect the majority of these downgrades will likely be in the lower-rated sector of the market, especially in high yield.

Interviewer:

Great color. And it just seems like there's so many moving parts here within the high-yield market, so I know you have your job cut out for you.

I want to touch on high-yield spreads, which is something we monitor from time to time. I've been watching them and they seem to be trending steadily downward. What's your read on the meaning behind that?

Dave Schiffman:

Overall, as I hinted towards, credit fundamentals have remained fairly stable over the last few quarters. Hence, we're seeing again that upgrade to downgrade ratio hovering right around one-to-one. Yet the option-adjusted spreads, as you rightly mentioned, especially in the high-yield market, continue to grind tighter. It's kind of a head-scratcher. We currently stand in the high-yield market with an option-adjusted spread of about 300 basis points, and that's down from 323 at the beginning of the year. However, since we've seen an uptick in underlying U.S. Treasury yields, as markets price in Federal Reserve (the "Fed") rate cuts, the overall yield to worst in high-yield has actually moved up, and stands at about 770 overall for the high-yield market in terms of yield-to-worst. And if you compare that to about 760 at the end of December, we have seen a little bit of a slight tick-up in overall yields, although spreads have compressed. So, as investors look to lock in rates, that's still what I would consider very compelling absolute levels, combined with a lack of net new supply in the market. We could expect to see spreads continue to move slightly lower in the coming months.

Interviewer:

I want to touch a little bit more on the CCC portion of the market. It looks a bit different in terms of spreads and how it's behaving. Of course, rates are high at the moment for investors at around 12%, but for the risk-averse people, we want to make sure they're aware that there's added risk for that portion of the market. Is the CCC portion, in your opinion, full of risk at this time?

Dave Schiffman:

Well, I guess it really depends upon, Matt, how you define risk. Let's look at some of the numbers, because you do highlight that CCCs in absolute terms hovering right around 12% in terms of the yield-toworst. It seems like those types of levels are pretty compelling, especially compared to Bs and BBs. That 12% level looks really pretty interesting. And Bs, if you compare that 12%, Bs are offering you a yield of about 7.5%. Meanwhile, BBs are hovering right around 660. So, it's almost as though you can gravitate to CCCs versus a BB, or a B. But of course it's all about risk and return. So, you are adding that incremental risk, and it's really up to investors to decide, or portfolio manager specifically to decide, whether or not it's worth it to dip down in credit quality to get that incremental yield. And you're not getting it for free; you are taking on that additional credit risk. But it seems like people have done that over the course of the year so far. Through the middle of March, CCCs have been the best-performing area of high- yield. The returns on the CCC sector are a little bit over 2% year-to-date, compared to about 0.9% for Bs, and about 0.4% for BBs. Obviously, there's a gravitation towards the CCC portion of the market, and some of that, I would say a good portion of that performance we've seen in CCCs has to do with the grind tighter as you mentioned earlier.

In terms of spreads, we have seen a dramatic tightening in option-adjusted spreads and CCCs. To give you an example, at the end of last year, the option-adjusted spread just on the CCC sector of the market was 775 basis points over comparable Treasuries. That's tightened 53 basis points, and now we're right around 720 basis points over comparable Treasuries. We have seen a pretty substantial tightening in spreads in the CCC sector, and that's really driven the performance. Because, as you know, underlying Treasuries have actually jumped up a good amount due to the repricing in the market of potential rate cuts. The five-year treasury, which we can kind of use as a benchmark for high-yield, because of the fact high- yield has a fairly short duration. The five-year treasury started the year at 3.85% and now is trading about 4.30%. So, five-year Treasuries have actually gone up in yield about 45 basis points. Meanwhile, the yield on CCCs has actually gone down because of that spread-tightening and really has given that sector of the market that good performance. And I suspect that if we do see a bit of a downturn in the economy and rates stay a little bit higher for longer, what we're going to see in terms of where the cracks begin, it's likely going to be in the CCC sector of the market—because that extra interest expense that these more speculative companies are having to pay starts to become more and more onerous in terms of putting pressure on their balance sheets. And it seems as though if we get any tightness in the market, it may be more difficult for that CCC sector of the market to refinance their debt, and they may actually have to pay even more in terms of new coupons on the debt that they come with.

So yes, it's compelling. Yes, 12% seems very interesting, but it's all about risk and reward. And we think that probably being a little bit more conservative might be the right approach as we stand in this part of the rate cycle because we could see some pressure first and foremost in that CCC sector.

Interviewer:

Really just fantastic detail there, David. Thank you for all your insight.

You touched on the rate cycle, so let's touch on that big topic there in the fixed income market, which of course is the Fed and their decisions. The Fed decided to sit tight on short-term rates early this year. Seems the sentiment might be the same here in March. What is the high-yield market thinking about the rate landscape?

Dave Schiffman:

That's a great question, Matt. As I mentioned earlier, it appears market participants have kind of moved closer to Fed projections related to the federal funds rate. Although the Fed's dot plots indicated about three rate cuts in 2024. At the end of 2023 markets were really building in a much more aggressive easing cycle in 2024, really anticipating probably close to six cuts priced into the market for 2024. That's a big difference compared to what the Fed was kind of implying to the market. However, we entered 2024, economic data has been more robust than expected, and inflation still remains stubbornly high. Hence, rates have bounced higher, as the market is kind of now adjusting to the incoming economic data, and that's really driven high-yield rates a bit higher as well.

With the labor market showing no signs of weakness, I would say, and underlying credit fundamentals remaining quite stable for most sectors of the market, we may experience a longer period of high absolute yields as the Fed stays vigilant in its desire to at tame inflation without damaging overall economic conditions. In other words, Matt, we may actually see this "soft landing" that the Fed has kind of hinted that they expect. I know last year a lot of people were skeptical of the Fed being able to pull off that soft landing, and the likelihood of a recession was approaching 60% or 70%. If you look at what economists are saying now, I think more and more people are in the camp that they may actually be able to walk this tightrope and get into a soft landing that I think people were skeptical of but hoping for. And now, I think we're likely getting a bit closer to that.

Interviewer:

Great coverage on all these topics.

And I would really like to close here, David, by speaking about Aquila High Income Fund. Could you tell us about the current positioning of the Fund and how you're managing in this environment?

Dave Schiffman:

Sure. So, as you know Matt, we manage the Fund a little bit more conservatively than your traditional high-yield mandate. We do have a slightly shorter duration and an "up-in-quality" bias. We feel with that kind of strategy and philosophy, especially now, we believe the Fund is well-prepared to weather the uncertainties we may experience in the coming quarters. Although we may see credit spreads tick a bit tighter in the near-term, a higher for longer environment, as I mentioned earlier, likely puts a bit more pressure on underlying credit fundamentals, as well as putting pressure on the overall consumer.

I don't have to tell you that the housing market has suffered a bit with higher mortgages. And as consumers carry more and more credit card debt, that interest expense is going to put pressure on consumers as well. And car loans, personal loans, everything related to where rates are in absolute terms, is going to grind through the economy. So, at some point we may see a bit of a downturn, although probably not the full-blown recession that people are expecting in 2023. In addition, we have geopolitical risk overseas, and don't forget, we have the upcoming presidential election. So, a combination of all these things could cause some unexpected volatility. Hence, I really feel comfortable that our shorter duration, as I mentioned earlier, that higher-quality portfolio could mitigate some of these risks. And over the course of 2024, we might see coupon-like total returns for the year, as we feel this truly rewards active management that has the ability to navigate the aforementioned uncertainties.

Interviewer:

Thank you, David. That sums up our podcast for today. Thank you for the wonderful insight as we navigate these markets, David, and thank you for joining us today.

Dave Schiffman:

My pleasure, Matt.

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 opinion shared are those of the portfolio manager and not necessarily reflect those of the Investment Adviser of the Fund.

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 a hundred percent 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. Securities of the companies referenced were portfolio holdings of Aquila High Income Fund, represented as a percentage of the Fund's total portfolio as of 12/31/23: Ford Motor Company: 1.89%; Ford Motor Credit Company LLC.: 1.07%; and Occidental Petroleum Corporation: 1.20%.

The Bloomberg U.S. Corporate High Yield Index is an unmanaged index considered representative of the universe of fixed rate, non-investment 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. An investment cannot be made directly in an index. Performance on 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 risks, 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 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, and when you call 800-437-1020 or visit www.aquilafunds.com.