Aquila Opportunity Growth Fund

PODCAST TRANSCRIPT

April 2024

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 Pedro Marcal, Lead Portfolio Manager of Aquila Opportunity Growth Fund. Thanks for being here today, Pedro.

Pedro Marcal:

Thanks for having me.

Interviewer:

So, I want to open here by speaking about Aquila Opportunity Growth Fund. Could you tell us a little bit about your current positioning in the Fund and how you're managing in this environment?

Pedro Marcal:

Let's start with a recap of 2023, which was a roller coaster year. The equity markets delivered strong positive total returns across all capitalization ranges in the U.S. in 2023.

Last year started with a banking crisis resulting in several bank failures, which led the Federal Reserve (the "Fed") to inject the financial system with over $400 billion in liquidity and helped rally stocks for much of the first half of the year. As the Fed then began draining some of this liquidity, the markets experienced a correction in the third quarter of the year, only to rally again in the fourth quarter, largely driven by more favorable inflation levels, as well as the decline in yield. Equity prices also received support from positive corporate earnings during the year, and employment data, lower energy prices—particularly in oil and gas prices—and improving inflation data. Tempering these were geopolitical situations that persisted in Ukraine, and the heightened tensions in the Middle East, and fear of further escalation in both those conflicts.

The fourth quarter was really a site to behold, particularly after the weakness in the third quarter. Equity markets produced strong and positive returns across all capitalization ranges during the fourth quarter of the year. Where we are now as we enter the first quarter of 2024, the Federal Reserve and the Treasury are continuing to exert an enormous amount of influence on markets. And while the Fed's official policy, their sort of stated policy, continues to be one of quantitative tightening or "QT," the reality is a little more complex with QT only impacting the Fed's balance sheet. Overall, the Fed, in conjunction with the Treasury, is pursuing a policy of what we at Aquila are calling quantitative neutrality, or "QN." And that's measured by domestic liquidity and equal to bank credit reserves, or bank reserve credit, less the U.S. general account of the Treasury at the Fed, and less the Federal Reserve reverse repo program. So, when you examine the data, you find that domestic liquidity in the U.S. financial system has actually increased by $254 billion, from $5.89 trillion since the Fed began reducing its overall balance sheet in the middle of 2022 to $6.14 trillion at the end of 2023, so that's like December 31, 2023. And that's pretty remarkable. They shrunk the balance sheet and increased liquidity in the financial system.

So that said, in the past 12 months, the Treasury and the Fed have increased domestic liquidity during the year by $332 billion, from $5.81 trillion at the end of 2022 to $6.14 trillion at the end of 2023. And impressively, the Fed was able to achieve this increase in liquidity while shrinking its balance sheet of securities held by over one and a quarter trillion dollars. So, it may be that the Treasury and the Fed will finally begin implementing their stated policy of quantitative tightening, or they may end the shrinking of the balance sheet before quantitative tightening really begins. From a liquidity point of view, this could be positive for risk assets and mid-cap equities. So, while we continue to take the view that the Fed will pursue a more quantitative neutral-oriented policy in the near-term, we're watching the data and monitoring the situation closely. So, while we're cautious about the overall equity markets, we are optimistic about prospects for 2024.

Interviewer:

Fantastic detail on the markets, Pedro. So, where are we today? Are we still cautiously optimistic about the equity markets and what does that really mean?

Pedro Marcal:

We're cautious overall about equities, but we're very optimistic about mid-cap stocks. So, during the fourth quarter of 2023, the Fund's investment management team increased positions in Healthcare, in Information Technology and Communication Services sectors, while reducing our weights in Utilities, Energy and Consumer Staples. And we're still fairly overweight Energy.

But we basically during that quarter increased economic-sensitive areas and growth-oriented areas, and decreased Utilities and Consumer Staples—more defensive sectors. So, you can see by the movement of the portfolio that we are more optimistic. At present, we remain overweight Energy, as we believe there may be an upward move in oil prices related to that sort of factors. We talked about the war in Ukraine and the heightened instability in the Middle East. In 2024, in the first quarter, we've seen some of that. We're currently underweight Financials in anticipation of these sort of continued elevated interest rates and ongoing tightening cycle by the Fed. In the fourth quarter, we increased our position in the Healthcare sector too, as we believe valuations were very attractive, and they still are. We favor companies in that sector that are taking cost actions to adjust to the lower demand that they've seen post-COVID, thus improving their long-term earnings profile. And separately, we remain underweight the Industrials sector and prefer companies that are benefiting from manufacturing moving onshore, something that people are calling re-shoring, and the electric grid network upgrades that are taking place. For the Materials sector, we are overweight and favor companies that benefit from, again, manufacturing moving domestically, which would include things like steel and aggregate, and also lithium producers. While we're concerned over the electric vehicle growth resulting in weak demand for battery-grade lithium, we see the market really quickly rebalancing and it will adjust to this. So, we're actually adding to our positions in lithium. Finally, we're overweight on Information Technology and the Communications sectors. We continue to overweight Semiconductors, software communications equipment companies that are leveraged to artificial intelligence, vehicle electrification, cloud infrastructure and cybersecurity. We think the systems and software that run on increasingly diverse and complex silicon will result in more sustainable growth than the market is currently discounting. So, we're overweight or optimistic about those areas.

Interviewer:

Pedro, let's talk now about Aquila's disciplined investment and research process. Can you give us the details behind that?

Pedro Marcal:

Philosophically, we have two core beliefs about investing. First, that growing earnings and cash flow lead to capital appreciation of stock. And second, that markets are inefficient in how they recognize price and react to change. So, there is a compelling amount of behavioral finance research that supports our view that markets have difficulty recognizing and reacting to change, and it really centers around the concept of hysteresis, or a delayed response to change. So, we believe the most attractive investments are in companies benefiting from a positive change, where companies have a strong business model that enables them to monetize that change into higher earnings and cash flows, and where the impact of this change is not recognized and valued by the market.

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 identify a change, our second step is to analyze the company's business model to assess the sustainability of the change. We found through experience that strong businesses generally have what we refer to as "moats" that protect their businesses from competition. These protective business model characteristics generally fall into five categories: 1) a strong brand, 2) protected intellectual property, 3) protected licenses, 4) dominant market positioning, or 5) a resource advantage. And that can be a commodity or natural resource in the ground, or even just like a unique distribution channel. Some companies have more than one moat, but typically one moat is 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. We build bull and bear case earnings expectations, that may differ from our base case, and incorporate different scenarios for the impact of the change.
- Our fourth step relates to valuation. We utilize our model, as well as historical sector trading information to build one, three and five-year price targets. We determine if there is 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 match our own. We consider adding companies to our portfolio only after they have passed through all of these steps in our evaluation process, thereby providing us with the confidence in our upside projections to the price target.

Interviewer:

I think we can all appreciate how thorough the team's process is. To take it a step further, could you give us an example of what your last point looks like in practice—maybe a story of a stock you currently own?

Pedro Marcal:

Sure. So right now, at time of taping, we own a position in Arista Networks, which is a technology company that supplies network fabric infrastructure and software for the Cloud. We began actually investing in this company in October of 2021 after we began managing the portfolio. The company's clients are big social media and Cloud computing firms. The change we identified is their new product is an infinitely scalable software defined routing and switching network, which we believe is still years ahead of the competition. The company has patents, intellectual property and an incredible brand, which creates a large moat and makes their business model sustainable, in our opinion. We anticipate that the increased earnings and cash flow from this new product cycle may lead to share price appreciation in excess of our current target threshold. So, this networking company is growing their earnings benefiting from change, both at the company level, the new product cycle, and in the environment, which is increased demand for cloud computing and the rise of Artificial Intelligence, or "AI." And it's a position in the portfolio.

Interviewer:

Pedro, thank you for speaking about Arista Networks, specifically. In addition to what you're buying and what you have, it would be great to hear about your sell discipline and what kind of triggers that.

Pedro Marcal:

Well, we have a strict sell discipline. There are generally three reasons why we'd sell a company:

- The first is the investment has succeeded and it's fully valued, so we take profits. A really great way of doing it.
- The second is the stock is unseated by a more attractive investment opportunity, because we run fully-invested. So, in order to buy a stock, you have to sell a stock. So, every new idea challenges all the holdings in the portfolio, and drives the portfolio towards strength and away from weakness.
- And the third is a negative change in the company and it no longer meets our investment criteria.

So, those would be the three reasons we'd sell a company.

Interviewer:

Simple but thoughtful. Thank you. What's your process for identifying new ideas for the portfolio?

Pedro Marcal:

We typically source ideas from three places:

- First, we utilize sector specific screens to review the entire investible midcap universe.
- Second, the analysts find ideas through their regular readings and conversations with management teams and industry contacts.
- And third, we also identify sources of larger overarching changes or sort of big picture themes that we think are going to drive opportunities over time.

And a few of these big picture ideas that we're investing in for Aquila Opportunity Growth Fund are, for example, the electrification of transportation. And that's sort of one of the themes that led us to initiate a position in Coherent. And electrification requires electronics and batteries. And so, the electronics for high voltage applications like electric vehicles require silicon carbide chips both inside the traction inverter or the motor, as well as for the charging stations. So, a typical wall socket that we plug into is 120 volts of electricity, but fast-charging car stations require 480 volts, and it gets really hot when that much power passes through the circuit. And so, chips made from silicon carbide are able to function efficiently at high temperatures with less cooling and smaller sizes, and a longer life. And, therefore, they are ideal for these types of uses. So, inside charging stations, and inside cars that are electric, there's a huge demand for them. And Coherent is a profitable, well-run company in this area, and they're a huge beneficiary of the sort of rapid adoption of electric vehicles.

Another beneficiary is the battery, obviously, and electric vehicles require batteries and that requires lithium because people are using lithium-ion batteries. And so, the Fund invests in a company called Lithium Americas, which is currently in the process of developing a huge resource by far the biggest in the United States, one of the biggest in the world at Thacker Pass in Nevada here in the U.S.

Interviewer:

Pedro, you've shared so much today. Of course, we appreciate the level of detail and really thorough answers. Could you summarize a few of your answers for a few key takeaways for our listeners?

Pedro Marcal:

Sure. Well, we're cautiously optimistic, but I think our caution is more about the overall equity markets. We're very optimistic about many of the companies that we've been investing in. I think part of that is driven by seeing many of these companies being acquired in the last year. So, cautious about equities, optimistic about mid-cap equities. I think, while we believe there are a lot of attractive and compelling opportunities out there. Investors should be prepared for continued volatility as the Fed shrinks its balance sheet. And liquidity changes. And rates remain high. And there's still a lot of uncertainty out there. So, expect it to be a roller coaster like it was last year.

We at Aquila on the Opportunity Growth Fund take an active approach to portfolio management. We have a disciplined investment and research process. And we believe that the most attractive investments are companies benefiting from a positive change, where companies have a strong business model that enables to monetize that change into higher earnings and cash flows, and where the impact of that change is not recognized and valued by the market.

Interviewer:

Well, that sums up our questions for today. Thank you to our listeners, and thank you as always, Pedro, for joining us.

Pedro Marcal:

My pleasure. Thank you very much for your time.