Aquila Tax-Free Fund For Utah

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 Fund For Utah. Thanks for being here today, Tony.

Tony Tanner:

Hey, good afternoon, Matt. Thank you for having me on today.

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. 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 2 ½% 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 3s, 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 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:

So, we've observed this year supply levels that are a little bit elevated year-over-year. Obviously, we're still very early on in the year here. What's it going to take to pop in 2024, and will the demand side be able to support it?

Tony Tanner:

Well, Matt, the two primary things that will drive issuance and tend to drive issuance are, obviously, lower interest rates and more attractive borrowing costs, and we may see that as the year progresses if we do get some easing in Fed policy. The other is, of course, state budgets and the need to borrow for capital expenditures. And we're a few years removed from the tremendous COVID stimulus packages of 2020 and 2021, and many municipal towns and governments and entities received significant infusions of cash, some of which they are still working off. As that starts to wind down, you're going to see a greater return to traditional municipal finance for capital projects and other ongoing investment needs in communities.

Yes, this year, we've seen a small increase of about 20% on an absolute basis. It's not a lot in dollars, but in 2023, the decline in issuance was only about 3%. And the truth is for us, as active portfolio managers, canvassing the secondary market is really a primary driver of opportunities for active portfolio management. The municipal market trades on a "trade-by-appointment" basis because only 2% of it ever trades daily. And so, consistently canvassing the dealer community to share what you're looking for in managing the Fund is really important to sourcing and unearthing opportunities to actively manage the Fund. So, supply can help, if you get a spike in issuance. And last year in Utah, we didn't see a very large decline in issuance. And this year, I think we're up 20% year-to-date. And so overall, Utah issuance has been very sufficient for us in actively managing the Fund and optimally situating the Fund.

Interviewer:

I'm glad you touched on Utah, Tony. It's worth noting that supply is usually documented on a national level, but that doesn't necessarily mean it trickles down evenly to each state. Can you talk about how Utah is looking for supply so far this year?

Tony Tanner:

Well, so far, Utah for supply and for issuance is looking very attractive and good for us as active portfolio managers. Issuance is up about 20% this year, and the State typically ranks 26th or 27th in the nation in issuance. It's sort of a midsize amount, but we've seen some good breadth across revenue and general obligation bond issuers and the rating spectrum of investment grade issuers. And that really reflects one of the advantages of managing in Utah, because the breadth of issuers is really strong. Although the State itself is a natural AAA-rated state, there are a wide variety of issuers that issue bonds in the AA and A-rated categories, and that's important for portfolio managers. They have the chance to build genuinely economically diverse portfolios. And somewhat different than we see in some of the other states we manage, like Arizona, where there's a much lower preponderance of A-rated issuers. And so we think the issuance and supply backdrop is actually very favorable right now, and we expect it to continue to be throughout the year.

Interviewer:

Great, Tony. Let's continue to talk about Utah. Is there anything else happening in the state and local landscape that's worth mentioning?

Tony Tanner:

Well, I think it's important to look at Utah from the standpoint of it's a very compact and resilient and almost self-contained economy. It's always historically had an unemployment rate that's below the national average, and while the unemployment rate has creeped up from 2.4% to 2.8% in the last half of 2023, we're not finding that worrisome. Partly because outside of the pandemic-generated employment shocks, unemployment in the State of Utah has been at or below 3% since early 2018. And so, Utah's workforce tends to be young, the State's got a very high labor participation rate. And so, it's really somewhat insulated from the vagaries of the much broader national economic cycle. So, you combine that with the breadth and diversity of the economy, and it is really a wonderful economy in which to operate. The one other thing I think that's noticeable is that with the population growth that it's experienced over the last 20 years, it's moved up the rankings among states, and now what used to be a small state is now a solidly mid-sized state with a very diverse economy. And it's not just the population growth. Like Arizona, Utah has become a magnet for wealth. And one of the interesting things that I saw in a 2016–2021 study of shifts in adjusted gross income and tax filers among the states, Utah has attracted some of the wealthiest tax filers in the nation. Over that five-year period, it attracted a net 30,000 tax filers within a combined adjusted gross income of $5.5 billion. That's an average adjusted gross income of almost $180,000. So, those types of larger demographic trends are really supportive to the economy. And we are seeing economic development initiatives around important developments in downtown Salt Lake City, like the Power District, and longer term, the State of Utah, and Salt Lake City in particular, are entering the conversation for pro sports expansion. So, it's a really dynamic economy that has a lot of momentum right now.

Interviewer:

So, I want to close out our last question here by speaking about the Fund itself—of course, Aquila Tax-Free Fund for Utah. Could you tell us about the current positioning of the Fund and how you're managing in this environment?

Tony Tanner:

Sure, and since we have transitioned the portfolio management team following JT Thompson's recent retirement and the fantastic 14-year tenure he had in shepherding the Fund, we've been focusing on adding incremental value. And one of the interesting things we've been able to do is, despite the increase in the Fund's net asset value since the beginning of October and the overall increase in bond prices, we've actually generated a slight increase in the Fund's distributable yield by conducting bond swaps that have enhanced the Fund's level of income. And so, we've been able to add some good incremental value to the Fund.

Where it's currently positioned is solidly in the intermediate and high-quality area. About 75% of the portfolio is within the 5–15-year maturity range, which has performed well but has become somewhat expensive. And so, we're looking for opportunities to allocate to longer maturities and longer data maturities that will help continue to support the Fund's income. The Fund is pretty conservatively positioned with an effective duration of around 4.1 years and a final maturity of around 9.5 years. So, very good risk and return value with the level of income we're getting. Again, very high quality with over 76% AA-rated. More of a tilt toward revenue bonds at 90%. That's more a function of the nature of the breadth of issuance we see in the State.

And so, moving forward, we would expect to, again, look for some of those high-quality issuers in the general obligation space where we are finding the yield ratios to still be very attractive, being north of 80%. And that'll just continue to be the focus of incremental value that capitalizes on the breadth of the State's inherent economic diversity.

Interviewer:

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

Tony Tanner:

Thank you again for having me, Matt.

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.

Independent rating services such as Standard & Poors, Moody's, and Fitch assign ratings which generally range from AAA highest to D 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 a security in response to a change in interest rates. Effective duration also takes 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 principle of an issue is expected to be paid.

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

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