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Aquila Churchill Tax-Free Fund of Kentucky Podcast Transcript March 5, 2018

Interviewer:
Today we're talking to Royden Durham, portfolio manager of Aquila Churchill Tax-Free Fund of Kentucky. Tax reform legislation, The Tax Cuts and Jobs Act, was signed in December, 2017. What are the most significant impacts of that legislation on the municipal bond market?

Royden Durham:
The tax reform legislation cut a major source of issuance in Kentucky, which involved advanced refunding bonds. This encompassed about 15 to 20 percent of the new issuance market in Kentucky in 2017. A flood of issuance took place in early December, 2017 to try to beat the clock before the old part of the tax law expired. One of the deals that came to market to take advantage of the old law was the Yum Arena refunding.

In general, people in the highest tax bracket should be even more eager to own state-specific munis, in my opinion.

Interviewer:
Nationality what are your expectations regarding investor demand for municipal bonds and the supply of bonds available to meet that demand; and, are there factors in Kentucky that produce distinctly local supply and demand expectations?

Royden Durham:
As in the prior question, the reduction of the advance refunding deals, coupled with an extremely conservative leaning in Frankfort, will limit this year's issuance in the state, which should materialize as an increase in transportation issuance such as Kentucky turnpikes and small infrastructure projects which would include bridges, secondary roads, and utilities. In President Trump's $1.5 trillion infrastructure proposal, a state issuer is supposed to pick up 80 percent of the tab. It remains to be seen how this will be financed, but the obvious is via tolls and fees.

Politically there has been fierce opposition to tolls as a finance option for the Brent Spence Bridge in the Kenton County / Cincinnati area, so it seems these financial proposals will run into problems almost immediately.

Interviewer:
After nearly a decade of a very low Fed Funds rate, the Fed has introduced several rate increases. How would you summarize the market activity you've seen related to changes in the yield curve and credit spreads?

Royden Durham:
The Fed is telegraphing their rate hikes, so people will feel confident about the direction and speed of the Fed moves. The only change would be adjustments by higher inflation and targeted numbers. In 2017, the yield curve flattened markedly, hurting performance of shorter duration portfolios while benefitting longer duration. In the coming months and years, we should expect a parallel shift in the curve which favors shorter and intermediate duration, like our single-state Aquila funds.

Over the past year credit spreads have compressed. This allowed stressed credit sectors like hospitals to outperform over the past two years. In a rising rate environment, history favors higher rated securities; which, once again, is an Aquila tenet.

Interviewer:
Given the high quality, intermediate maturity profile of the Fund, how are you strategically navigating this market?

Royden Durham:
With the Aquila Churchill portfolio, we have made a conscious effort to resist buying lower credit rated securities from inception. The state has been the source of credit concern, which resulted in our effort to stay upper-tier quality, anticipating the downgrades to a larger extent. From an interest rate perspective, our core strategy had been to pick a pivot point on the yield curve, making the assumption rates would rise, and manage our duration to that point.

We're anticipating, going forward, a parallel rising shift of the yield curve over some time where our four to five-year duration will become three to four years and insulate the portfolio to a degree from principal price erosion.

Fund performance will be aided by reinvesting principal maturities of higher yields, which aids in devouring much of that principal price erosion.

Interviewer:
Speaking of navigation, how is Kentucky doing in terms of managing public employee pension funding?

Royden Durham:
That is the elephant in the room here in Kentucky. Our media is splashed daily with that question. The legislators have been searching for a solution to present to both chambers in Frankfort for nearly two years. Every time something is mentioned as a solution, the political fallout is so immense they backtrack immediately. We're expecting the proposal to solve our $43 billion underfunding as I am speaking.

It apparently will be attached to an austere budget which has everyone upset also. It's going to be very unpopular, but necessary to save the state's credit rating. We do have the correct Governor and state Congress that can pull this together. They are trying to minimize their unpopularity and solve a problem at the same time.

Interviewer:
Thank you very much. For those of you listening, before investing in the Fund, carefully read about and consider the investment objectives, risks, charges, expenses, and other information found in the Fund prospectus; which is available on this site, from your financial advisor, and when you call 800-437-1020.

Thank you for listening to this podcast.