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Tax-Free Trust of Oregon

Aquila Tax-Free Trust of Oregon Podcast Transcript March 1, 2018

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

Chris Johns:
Well, there's a couple of things that really impact the municipal bond market with the new tax reform law. The first thing is, is that the new law prevents municipal bond issuers from doing advance refundings on existing bonds outstanding. And all that means is, in the past, municipal bond issuers were able to refinance their debt if interest rates declined and pay off older, higher rate debt and issue lower rate debt; similar to how you and I would refinance our homes. That now has been eliminated from the market.

So in the last few years, that refunding debt represented anywhere between, say, 10 percent and 40 percent of total new issue supply. So it's taking supply out of the market. To offset that a little bit, the other impact on the municipal bond market is that we've seen a pretty dramatic decline in corporate tax rates. And in recent years, we have seen increased participation by banks and insurance companies in the municipal bond market, to the point where they own approximately 28 percent of all municipal bonds outstanding. But with this dramatic drop in corporate tax rates, munis aren't going to be as attractive to banks and insurance companies as they have been in the past. So we expect that form of demand to be reduced a little bit.

So those two offsetting factors, hopefully, will mitigate each other, but that still kind of remains to be seen. In terms of how tax rates have changed for individuals, which is primarily what the muni market is for, it's really very little. There are different tax rates, but it's not going to be a significant enough difference to impact how individual investors buy municipal bonds.

Interviewer:
Looking at the markets from a national perspective, 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 Oregon that impact local supply and demand expectations?

Chris Johns:
Yes, there's an important factor in Oregon. We have a relatively high income tax in Oregon. This change in the ability to deduct state and local income taxes, or the limitation of that, will make Oregon bonds more attractive to Oregon residents. So we think that will increase the demand for Oregon bonds over the next couple years. It might take a year or so before investors realize that, but we think, either later on this year or certainly next year, demand by Oregon residents is going to go up.

Interviewer:
After nearly a decade of a very low Federal 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?

Chris Johns:
This is a real important concept. You have to remember that the Federal Reserve really only controls very short-term interest rates. The Fed Funds rate you mentioned is an overnight rate. What we've seen happen is the very short end of the yield curve – bonds that mature in, say, two years or less – we've seen, as you would expect, interest rates rise on those during this period where the Fed has raised rates.

But on the longer end of the curve – say five years on out, 10 years, 20 years – rates have remained, until very recently, rates have remained about the same and, in some cases, actually declined a little bit. So what we've seen is flattening of the yield curve. The other thing that's

happened is that throughout 2017, in a low interest rate environment, investors were kind of starved for yield. So they tended to reach for yield by buying lower quality bonds. Similar to a flattening yield curve, we've also seen a narrowing of credit spreads to the point where we believe that risk is mispriced. The lower quality bonds aren't offering enough yield for the amount of additional risk that you're taking.

I think that's really the main changes in the market that we've seen since the Fed has started to raise rates.

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

Chris Johns:
Well, I think you just answered your own question. We use high quality intermediate bonds, but what I would say is that what's happened over the last year and a half is that, in the portfolio, we've continued to shorten our average maturity and shorten our duration and increase our quality. And all those things, shorter maturity, shorter duration, higher quality; it's considered a defensive approach.

We still believe that the biggest risk to our shareholders is rising interest rates, so we're trying to reduce the amount of interest rate risk exposure that we have and then improve our credit quality, because usually in a rising interest rate environment, we see higher credit quality bonds hold their value a little bit better than lower credit quality bonds. So we're being very, very careful right now.

One other thing I would mention is that, in the Fund we have roughly 20 percent of the securities invested in pre-refunded securities. What those are, as I mentioned before, are bonds that have been refinanced to a lower interest rate. But in our portfolio, they continue to maintain the original yields that they were purchased at, except now the bonds are backed by US Treasury securities and they're very, very safe and they're very, very liquid.

In the Fund, we have roughly 20 percent of our fund invested in these things so that in the event that rates rise, these short-term, safe securities will hold their value better. They'll provide liquidity to the Fund and also, hopefully, provide us the chance to take advantage of higher interest rates, should they present themselves.

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

Chris Johns:
The state of Oregon is one of the better funded pension plans in the country. We in Oregon – the b PERS plan is funded at just under 80 percent of its actuarial assumption. For us here in Oregon, the greater concern is, we expect contribution rates by local issuers to go up in the next couple of years because of recent changes in legislation. For us, we have a process in place in our credit analysis that we look at, for each issuer, what their contribution to the PERS plan is. And then we make a determination on whether that's an issuer that we want to participate in, if we believe that they can continue to make those contributions.

But because of these legislative changes, those contributions are all going up for local issuers. Many of them have reserve funds which will defray some of this increase, but some don't. So we're going to have to watch each local issuer very closely to make sure that they're handling their PERS liabilities effectively.

Interviewer:
The President introduced his $1.5 trillion infrastructure initiative on February 12th. How might the plan impact the municipal bond market?

Chris Johns:
Well, that really remains to be seen. $1.5 trillion sounds like a lot of money, but really what the federal portion of that recommendation is, is roughly $200 billion. So it's really just a fraction of the total, and the rest of that money is supposed to come from state and local governments and private entities in public/private partnerships. So it's going to be a while before we can really tell. I think everyone agrees

that we need infrastructure improvement in the country and in the state, but with this plan it's going to take a while before we can figure out how we can get all the different players to combine to create this financing.

Most state and local governments have borrowed as much money as they can borrow, and they need these federal grants to continue to service debt, particularly if they're going to take on more debt. So time will tell. Generally speaking it should help issuance in the muni market, but I think it's going to be a little while before we actually feel that in the market.

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.