



Aquila Tax-Free Trust of Arizona

PODCAST TRANSCRIPT

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Interviewer:

Hello everyone. Thank you for listening into the Aquila Group of Funds podcast. I will be your host today, Phil Felice. Joining me is Tony Tanner, Portfolio Manager of the Aquila Tax-Free Trust of Arizona. We'll be discussing the ever-timely municipal bond market, as well as the local Arizona economy. As always, welcome Tony, and thank you for being part of the podcast.

Tony Tanner:

Hey Phil, how are you doing? It's great to be a part of it today.

Interviewer:

Doing well. So, let's kick things off with the story that is not only in muni markets, but pretty much all markets, and that's the Fed and interest rates, as they look to tackle inflation. We've seen how the muni markets, and really all markets, sold off on the news of rate hikes. What do you expect from muni markets for the rest of the year in an anticipated rising rate environment relative to other fixed income markets, and also to other markets in general? And how has your Aquila Fund positioned accordingly?

Tony Tanner:

Well Phil, what's interesting is the selloff that we had in the muni market in January was one of the most significant monthly selloffs in the last seven or eight years. And in terms of an anticipation for the rest of the year, it's entirely possible that we have seen the lion's share of upward moves in municipal bond yields. Now, the selloff itself, I think, was somewhat interesting because I think it was also encouraged to a large degree by one of the things that didn't take place last year, which was the anticipated increase in marginal tax rates. And so, that helped return a lot of value to the muni market at the start of the year. And that was, I believe, one of the tailwinds that kind of faded at the end of the year and also contributed to the selloff.

In anticipating a rising rate environment and what the Fed is going to do, it's interesting to look at the history of how municipal bond yields have responded to Fed increases. And if you take a look at the 2-4 distinct interest rate tightenings we had in the early '90s through the end of 2018, what you find is that the increase in yield along the yield curve really diminishes as you move out the yield curve. And so, as an example, in the last cycle of Fed tightening, the cumulative increase in the Fed Funds rate was 200 basis points. But 10-year and longer municipal bond yields only increased about 49 basis points, whereas three-year bond yields increased 83 basis points. If you go back to the tightening cycle of June 2004—June 2006, when the Fed raised the Fed Funds rate 400 basis points, 10-year and longer municipal bond yields only rose about 30 basis points. Whereas, three-year municipal bond yields rose 130 basis points. So, it's not out of the realm of possibility that there isn't a meaningful and commensurate increase in long-run rates with what the Fed says and does. So, we think that this return of value and increased likelihood of fluctuation may breed some opportunity for investors going forward.

In terms of our positioning, one of the things that we noticed was this lack of a tailwind from higher tax increases in the Fall. And in Arizona, we responded by removing some of our long duration and long-dated maturities, which had helped us from an income standpoint. But, we did want to get a little more defensive. And so, since the end of September through the end of January, we've reduced our average maturity by about two years—from 12 to 10 years—and brought the duration in from just under six to about four and a half years. So, we think we're really well positioned for whatever the next stage is in Fed policy and interest rates. And the muni market is somewhat of a notorious "sell the rumor, buy the fact" market. And I would advise investors and advisors to, again, be on the lookout for and lean into opportunity when it presents itself.

Interviewer:

So, let's touch on sentiment from our advisors in the advisor universe. They're asking what makes munis compelling now. Clients are hearing about potential rate increases and they are asking their advisors to guide them. How do we help investors or advisors discussing the asset class with investors answer that question? And the question, "what makes munis compelling now?"

Tony Tanner:

Well, in answering the question, probably the best place to start is just to kind of conduct a refresher course on the nature of the asset class. And those main points being that the returns within the asset class are derived from the long-run accumulation of income over time. And because of that, price changes have a diminished influence as time passes. Municipal bonds are one of those asset classes that are really a great diversifier. And what I just described with the history of municipal bond yields in response to Fed Funds activity, you see that municipal bonds, especially intermediate or longer bond yields, really have a lot less correlation with what the Fed says and does. And that diversification is very important within building good asset allocations.

In terms of looking at the present opportunity, the good news is that value has definitely returned to the muni market. This time a year ago, we were looking at ratios of municipal bond yields to U.S. Treasury yields in 10 years of around, below 70%, and really not that attractive. But now, we find municipal bond ratios back in the low eighties, and so they present a lot more value. And one way to look at it is that you are now being paid more income to access the asset class at a discounted price. And that typically is a good value proposition. One way to gauge that value is to look at the taxable equivalent yield of your municipal bond investment, and compare that with the earnings yields that you see on a lot of the larger stock indices. If you look at stocks with multiples of 25 to 30, you're looking at earnings yields of 3½—4%. And now we're seeing municipal bond yields increasing to a point where we're seeing compelling taxable equivalent yields above 3%.

And so, it's important to recognize that sometimes rising rates can be your friend. And so, I advise investors and their advisors to, again, break down just the basics of the asset class to see where that value may be beneficial to your client.

Interviewer:

Thank you, Tony. There's a lot of great info there on the muni markets. I want to switch gears a bit. We do talk in great detail here at Aquila in regards to being local, and the idea that because of our footprint in a state like Arizona, we're better situated to tackle the State's muni environment. You always do a great job of discussing that, so I do want to ask it of you. What are you seeing on the ground that someone looking at your market from a national perspective may miss?

Tony Tanner:

Living here, it's really hard to overestimate just how strong the revenue and jobs recovery to the pandemic has been, that was generated by the State's response to the outset of the pandemic. And in looking at our portfolio and what we do, because we have the opportunity to live through the local economy, it enabled us to take advantage of some opportunities, as well as stick with some holdings that had worked for us very well. One example is one of our largest holdings: Sky Harbor Airport. And it's important to know that the essentiality of the airport has much less to do with tourism than for the fact that for 5 million Phoenix metropolitan area residents, you really can't get there from here without the airport. And so, even though the airport essentially closed down for a good 3—6 months, that essentiality was going to be supportive to its municipal debt and its finances. I had a conversation with the Chief Financial Officer of the airport. And one of the things he pointed out to me was because Sky Harbor is such a major hub and not a connecting location, so to speak, the strength of its gate leases and those accordant revenues are very iron clad. And that was one of the things that enabled the airport to weather the pandemic and to make its debt service payments very easily.

If you take a look at some of the things that we responded to at the outset of the pandemic, we found some great opportunities in the secondary market, in high-quality flagship hospitals, in some of the State's higher education issuers, and in some student housing bonds. And you might ask yourself, with a pandemic coming on and an economy closing up, why would you buy those issues when the airport is closing, the campuses are vacating, and hospitals are beginning to fill up? Well, one reason we did that was because, understanding the inherent nature of the local economy and some of the longer-term demographic trends, we thought that the essentiality of those facilities would carry the day, and they've turned out to be very good investments for us.

And several years ago, we began increasing our stake in a lot of the flagship healthcare issuers because of the population migration. And we've witnessed some of those projects come online, including Honor Health's North Valley Facility, and the new medical school for Creighton University. And so, being situated locally really allows us to take the temperature of the essential nature of a lot of these issuers. One of the best examples that I can give is, we have a lot of friends here in town who also have fellow students and classmates in college. And, you'd be surprised at how much information you can glean on a parent's Facebook page about what's going on in student housing at a college. And so, again, being local and living through the economy really helps us to find some trends and supporting research that would be hard to glean from a distance.

Interviewer:

That's great stuff. And so, I guess staying at the state level, or maybe even perhaps higher up, anything of note at the state economy level, whether it's employment or tourism, or anything like that?

Tony Tanner:

Well, the big evolution that's taking place with the Arizona economy is its emergence as the "smart manufacturing hub of the nation." And it's been pretty well publicized in the last two years. Several large multi-billion dollar wins in the semiconductor industry—Intel and Taiwan semiconductor, collectively—are building three new chip manufacturing plants with a capital investment combined of about 32 billion dollars. And this area is starting to become a hot bed of high-tech innovation. And this is a result of the confluence of several trends. One, of course, is the out-sized population growth. Arizona had the third largest absolute population growth in the nation last year, behind Texas and Florida. And so, west of the Mississippi and outside of California, Arizona is really beginning to separate itself from the western and mountain region as a destination economy. We're seeing that in the increase in relocations of corporate headquarters here. And with those headquarter relocations, you are seeing decision makers and high wage jobs come to the market that are also helping to support the long-term growth of the State.

And we're also seeing this growth begin to diversify well beyond the borders of the Phoenix metropolitan area, and I've described a lot of it in the high-tech sector. But, an example is a recent announcement that Kohler, the manufacturer of plumbing and bathroom products, is opening a new plant in Pinal County bringing 400 manufacturing jobs. And so, a lot of the growth in the State is beginning to seep into all the regions of the State, which is really important. And what this really means in total is, this isn't your father's golf and leisure economy that it was even as recently as 15 years ago. We're much less dependent on very cyclical tourism and leisure industries. Both are still very vital parts of the economy, but they're no longer the cyclical drivers that have sometimes led to less desirable boom and bust cycles.

So, to summarize, we're really evolving quickly into a 21st and 22nd Century economy. And with that comes great strength for local municipal tax bases, because of all these manufacturing facilities being built and the additional taxes they create for those towns and municipalities.

Interviewer:

Tony, thank you for your time as always. And thank you for the insights, not only on the local Arizona market, but for the broader municipal bond landscape. And we always do appreciate your time.

Tony Tanner:

I'm happy to bring a lot of this information to the surface for our advisors and investors in the local community.

Interviewer:

Thank you.

Thank you for listening to this podcast. The opinions shared are those of the portfolio managers and do not necessarily reflect those of the Investment Adviser or Sub-Adviser of the Fund.

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