AQUILA®
Three Peaks
High Income Fund

AQUILA®
GROUP OF FUNDS

AQUILA®
Three Peaks
Opportunity Growth Fund

Investment Commentary

Period ending October 31, 2018

- After the stock market reached new all-time highs during September, there was a sharp reversal in risk sentiment in October, as the S&P 500 ended the month down -6.84%. The high yield market also experienced increased volatility, as spreads widened by 56bps in October. The weaker performance in the markets was driven by concerns around China/U.S. trade relations, higher interest rates, and uncertainty ahead of the midterm elections in the U.S. Tensions between President Trump and China continued to escalate throughout the month, with President Trump continuing to threaten additional tariffs on Chinese goods. Throughout October, the equity markets also experienced a greater rotation out of the popular growth stocks and into more defensive value names. These moves were only exacerbated by the rhetoric from Washington regarding trade and other campaign rhetoric ahead of the midterms. At the end of October, risk assets had a modest bounce off of the lows, but still ended the month much lower than September. The start of corporate earnings season was fundamentally strong in October, with the majority of companies posting better than expected sales and earnings; however, results were generally met with cautiousness by investors as indicated by many stocks trading lower on earnings. Globally, there were also increased concerns around an Italian debt crisis, as well as testy Brexit negotiations. The Fed was relatively quiet throughout the month following the late-September meeting, and investors continued to put a high probability on a December rate hike. The U.S. 10-year Treasury yield also hit a 3.25% early in the month, which was the highest yield since 2011. In light of these issues, we remain focused on discerning signals from the high yield market and finding high-quality companies who are using their free cash flow and balance sheet to generate value for investors.

- The Bloomberg Barclays High Yield Corporate Bond Index produced a total return of -1.60% in October. Higher quality bonds tended to outperform during October, with BB-rated bonds returning -1.37%, B-rated bonds returning -1.46%, and CCC-rated bonds returning -2.46%. Returns were negative across duration segments as well, with 6+ years duration declining by -2.28%, while 3-4 years duration was -2.09%. For the year-to-date period through October, the Bloomberg Barclays High Yield Corporate Bond Index returned +0.93%, as weak October performance only slightly offset the strong third quarter performance. During the year-to-date period, the lower-rated CCC segment of the Index remains the best performing category, with a +3.39% YTD return, while the BB-rated segment continues to be the laggard, down -0.87% YTD. The weakness in the BB-segment has primarily been driven by the higher yields for the U.S. Treasury securities. Within our high yield strategy, we remain underweight lower credit-quality names (the CCC-rated weighting of the Barclays Index was 14.5% of the Index at 10/31/18) and across the more-cyclical industries. We also continue to look for opportunities to further shorten the maturity profile and reduce the interest-rate sensitivity of the strategy, while maintaining a relatively high credit-quality.

- After the U.S. equity market had its strongest quarterly performance since 2013 during the third quarter, the equity market in October had its worst monthly return since 2011, as the S&P 500 declined -6.84% in October. The small cap indices underperformed large caps, with the Russell 2000 declining -10.86% compared to the Russell Top 200 Index decline of -6.60%. The Russell Midcap was down -8.31%. Within midcaps, value outperformed growth during the month by 270bps, as investors sold the momentum-driven growth names and rotated into more value-based defensive names. The strongest sectors for the S&P 500 were the defensive Consumer Staples and Utilities sectors which were both positive in October, while the weakest sectors were Energy, Consumer Discretionary and Industrials. The Aquila Three Peaks Opportunity Growth Fund underperformed its benchmark during October due to weaker performance across our positions in the Consumer Discretionary sector, as well as our underweight position in Utilities, which were partly offset by better relative performance in our positions in the Industrials sector. Please see the Aquila Three Peaks Opportunity Growth Fund Fact Sheet for performance information. We remain focused on finding companies that can utilize their balance sheets and cash flow to create value for shareholders throughout the economic cycle.

- The 10-year U.S. Treasury yield increased 8bps sequentially to 3.14% and briefly rose above 3.25% in early October, which was the highest yield since 2011. The 10-year U.S. Treasury yield had previously spent most of the year within a pretty tight range of 2.80% to 3.00%, so the trading activity in October represents a breakout above this range. The 5-year Treasury yield ended October 2bps higher sequentially to 2.97%, but touched a high of 3.09% during the month. Year-to-date, the 5-year Treasury yield has increased 76bps while the 10-year Treasury yields has increased 63bps. The yield curve, as measured by the spread between the 10-year and the 2-year Treasury, was relatively flat in October, increasing by 3bps sequentially to 27bps in October. This compares to 52bps at the end of 2017. As we mentioned in our commentaries thus far in 2018, we have held the belief that Treasury yields would move higher during the year as current market and economic conditions appear to support the case for continued Fed Funds rate hikes. As we see this thesis play out, we continue to position our high yield strategy with this in mind, by maintaining a shorter maturity and higher quality portfolio.

- The average yield spread of the Barclays U.S. High Yield Index widened by 56bps during October to end the month at 389bps. Year-to-date, the average spread of the Index has increased 25bps from 364bps at the end of 2017. The average yield-to-worst of the Index increased sequentially to 6.86% at the end of October compared to 6.24% at the end of September and 5.72% at the end of 2017. The average bond price of the Index decreased to $96.61 at the end of October from $98.77 at the end of September and $100.91 at the end of 2017. New issuance activity in the high yield primary market remained well below typical seasonality in October. A total of $11.0 billion of new issuance priced during the month compared to $18.2 billion in September of 2018 and typical October average issuance of $25 billion. This was the ninth consecutive month of new issuance activity coming in below typical seasonal issuance. Year-to-date new issuance totals $179.3 billion, which is down 36% versus the same time period last year. Refinancing proceeds accounted for 62% of October issuance and 62% of the YTD issuance, compared to 63% for all of 2017. Acquisition proceeds accounted for 27% of October issuance and 21% of YTD issuance, compared to 18% for all of 2017. There were four defaults in October (which we did not own) impacting $4.9 billion of high yield bonds and leveraged loans, which compares to the past six months default activity of $3.8 billion, which was the lightest 6-month average default activity since 2011. We expect credit trends will remain stable over the foreseeable future, but we are monitoring them closely, as we believe they are important indicators not only for the direction of the high yield market but also for the equity market and our equity strategy.

- We continue to focus our research efforts on finding companies that operate in relatively stable industries and with management teams that are exceptionally communicative and focused on maintaining a reasonably strong balance sheet or strengthening the balance sheet while growing operations. We remain committed to finding companies and securities that we believe will exhibit less price fluctuation should market volatility increase. We continue to believe our relatively higher-quality and lower-duration positioning is prudent within our high yield strategy. We also believe our approach to selecting companies who are using leverage prudently to support free cash flow generation will continue to benefit the performance of our equity strategy over time.

- Thank you for your continued support and investment.