AQUILA® GROUP OF FUNDS

AQUILA® Tax-Free Trust of Oregon

Aquila Tax-Free Trust of Oregon Podcast Transcript December, 2019

I Matthew DiMaggio:
Welcome to another Aquila Group of Funds podcast. This is your host, Matthew DiMaggio. Today we are speaking with Chris Johns, Portfolio Manager of Aquila Tax Free Trust of Oregon. Thank you for joining us today, Chris.

Chris Johns:
Thank you.

Matthew DiMaggio:
Let's get started. I would like to briefly get your thoughts on a few topics from 2019 and then talk about the coming year. So, since 2016 we have seen periods where muni investors have stayed on the sidelines, notably from concern over tax reform and duration risk back when the Fed was increasing rates. But 2019 has turned out to be a pretty monumental year for the asset class. What would you say contributed to what will be likely record inflows in a year where equity markets have also done so well?

Chris Johns:
Oh, it's certainly true, Matt. The asset class has had tremendous attention this year and I would say that it's been largely driven by the passage of the Tax Cuts and Jobs Act a couple of years ago. And what that did, among other things, was it limited the amount of state and local deductions that individual investors can make on their tax return, and hence it increased the demand for tax-exempt investing. As it turns out, municipal bonds are one of the last income tax shelters that are available to investors and so they turn their attention to this market and invested very strongly throughout the year. The other thing I would say that's important, is something that you addressed there about what fears are in the market. And during 2019 there was much less fear of rising interest rates and so investors felt a little bit more confident putting money into municipal bonds and bond funds in general when they're not concerned about rates going higher. So, I think that really added to the attention on the asset class.

Matthew DiMaggio:
Great insight, Chris. So, at the end of November, national municipal issuance was up 18% year over year, and many of this year's deals were actually oversubscribed. Oregon's issuance was up as well. Has the Fund benefited from any of the tax-exempt issues? And have you seen an increase in taxable issuance?

Chris Johns:
Yes, we have. So, to answer both of your questions, new issuance this year has been different than a lot of previous years. For just the tax-exempt issuance in Oregon, we've seen an increase of about 13.5% over last year, the full year last year, and this is through November. But in total issuance we're almost 82% higher, because of a remarkable increase in taxable municipal bond issue. So good news is, yes, we saw more issuance and had more choices to select for the Fund. But the bad news is a lot of the new issuance was taxable and obviously we don't use that for the Fund. This increase in taxable issuance again was driven by the Tax Cuts and Jobs Act, which prohibits advance refunding of old higher interest rate municipal bond issues. So, issuers have had to use the taxable market to do any refinancing for older deals. Fortunately for the issuers, interest rates have been low enough on the taxable side that it still made sense to do. That won't always be true, but for 2019 it definitely was. And we think that could continue for 2020 as well.

Matthew DiMaggio:
Okay. Touching on rates, after increasing rates four times in 2018, the Fed reversed course this year and reduced the target rate by 75 basis points in three consecutive meetings. Would you say that the markets have started to price in recessionary conditions and what are your

thoughts on the credit markets?

Chris Johns:
Well, the answer to that question is yes and no. Earlier this year there was concern about recession, and interest rates had declined pretty remarkably because of that. As we speak today in the middle of December, I think recessionary fears have really faded a little bit, both by the investing public and the Federal Reserve. We just had a Federal Reserve meeting here a couple of days ago, and they've elected not to change short term Federal funds rates and they've kind of signaled that they may be on the sidelines as far as rate changes are concerned for the next year or so. So, the anticipation for the economy is kind of steady there. And I would say that, as far as the credit markets, which they have really been strong lately in that credit spreads have narrowed pretty dramatically over the last year.

Matthew DiMaggio:
Looking ahead from a macro perspective, do you think that munis tend to be sensitive to credit spreads in other markets? Also, are you keeping an eye on trade tensions, global growth and the upcoming election?

Chris Johns
Absolutely. Those are all things that we have to keep our eye on. As far as finishing the discussion about credit spreads in the muni market, we've seen credit spreads narrow pretty dramatically in the last couple of years. And I would say recently, most of that has been driven more by the demand and supply imbalance than anything. I don't believe that credit spreads have narrowed because lower rated issuers are stronger in credit. I think it's more a function of investors in this low interest rate environment really kind of focusing their buying on lower rated issues, to the point where we believe that risk is mispriced. And those lower rated issues aren't rewarding investors enough for taking the risk to invest in lower rated issues. In regard to your question about trade tensions, I think today, in the last few months and probably for the next several weeks anyway, trade tensions tend to move the markets a lot more than anything that the Federal Reserve is going to do. In the last couple of weeks, we've seen the 10-year Treasury bounce around in a 20 to 25 basis point range based on trade news stories. So, I think that's a real big impact and once we have more certainty there, whatever direction it's going to go, I think it will reduce the volatility in the interest rate markets and in munis. So as far as risks are concerned, I think that's really it. To our shareholders, the risks would potentially be rising interest rates and potentially be widening credit spreads and we feel that we've structured the portfolio to try and limit the impact of those two events.

Matthew DiMaggio:
Let's talk about pensions. Last year Barron's called the estimated $1 trillion in unfunded pension liabilities the ticking time bomb in the municipal bond market. Can you give us an update on PERS and do you think that the state's pension liabilities might impact the economy, potentially the muni market?

Chris Johns:
Well, of all the things that we worry about in managing municipal bond funds, I would say this one's pretty close to the top of the list. And I would say that one of the things that we do very, very well, is that we do individual credit analysis on each one of the issues we own. And this is one of the first things that we look at, and we look into it very deeply, on how pension contributions affect each individual issuer. In terms of condition of PERS at the state level, it's really not too bad. They hover around 80% funded ratio, which on a national basis is better than most, and a level that we're comfortable with. At the local issue, though, it's a much different story. The percentage of payroll that an individual issuer has to pay to PERS is an important part of our analysis.

Chris Johns:
And that can range anywhere from as low as 5% of payroll to as high as 30% or more of payroll. And so, we look very closely at each one of the issuers and see how they're impacted by that. And we tend to avoid ones that have a greater liability in terms of percentage of payroll. From a big picture standpoint, I would say that in Oregon, over the next two or three bienniums, which is how budgeting occurs in Oregon, we're starting to see some light at the end of the tunnel out there. And we think that these increasing local contribution rates that we've seen in the last few years is going to kind of level off, and at some point, head the other direction. So we're hoping that the improvement in those, or the lessening of those contribution requirements, will improve credit throughout the state.

Matthew DiMaggio:
So we're seeing a large demographic shift with baby boomers moving into retirement, and Business Insider recently ranked Oregon in the top 12 places for people relocating after retirement. Do you see this shift changing municipal demand in the State in the near future?

Chris Johns:
Yeah, I would say that it would impact the demand for municipal bonds. One of the things that's happening, both in our state and nationally, is that we're starting to see with these retiring boomer generation that you referenced, is more of a need for income-based investing, that becomes a larger and larger percentage of the investing public out there. So naturally, I think it's going to impact the demand for municipal bonds. Previously, we talked about the supply of municipal bonds and the demand and I think that technically speaking, the municipal market is very strong in that regard. There's still a growing demand for municipal bonds because of this, and so far, kind of a steady supply. And actually, if you look at just the tax-exempt bonds outstanding, it's actually shrinking a little bit because of this refinancing with taxable bonds and then the fact that more bonds are being called and maturing than are being issued. So, I think that will help the municipal bond in terms of its strength over time and the increase of income-based investing is going to be a trend that we're going to see for the next couple of years.

Matthew DiMaggio:
Thank you for the clarity there, Chris. So, as we wrap up, can you give us an overview of how the Fund is positioned as we enter the new year?

Chris Johns:
Sure. As I mentioned a little bit earlier, we're concerned more about the risk side of risk and return these days. As we mentioned, interest rates are probably closer to a cyclical low. We've seen credit spreads at their narrowest level that we've seen in really decades in the municipal market. And so, as a result of that, we are positioning the portfolio a little defensively, both on the interest rate side and on the credit side. We have always been an intermediate maturity fund. And I would define that by saying the average maturity in the Fund has been between, say, six and or twelve or thirteen years on the long end in our history, and right now we're more towards the shorter end of that. And we're going to stay in that range for the foreseeable future here, with the average maturity of around six or seven years, duration at around between, say, four and five years. And then on the credit quality side, extremely high credit quality, because of what we talked about on the spread side. So, we have an exceptionally high percentage of AA rated and above bonds in the portfolio and we'll keep it that way until we see opportunities that develop on the credit spread side. But that may not be for a little while yet. So overall, we're positioned to meet the expectations of investors in the Aquila Funds for really decades here. We tend to err on the side of caution and protect our shareholders in a more hostile interest rate environment or a hostile credit environment. And that's how we're positioned now, and we're going to stay that way until we can see opportunities that develop either in the credit or with a little bit longer maturity.

Matthew DiMaggio:
Thank you for your time today, Chris.

Disclosure:

Thank you for listening to this podcast. Before investing in the Fund, carefully read about and consider the investment objectives, risks, charges, expenses and other information found in the Fund perspective. The prospectus is available from your financial advisor when you visit www.aquilafunds.com or call (800) 437-1020.

Information regarding holdings is subject to change and is not necessarily a representative of the entire portfolio.

Mutual fund investing involves risk. Loss of principle is possible. Investments in bonds may decline in value due to rising interest rates, a real or perceived the chronic decline in credit quality of the issuer, borrower, counterparty or collateral, adverse tax or legislative changes, court decisions, market or economic conditions. Fund performance could be more volatile than that of funds with greater geographic diversification. The Fund seeks to provide a high level of income exempt from state and federal income tax as is consistent with capital preservation.

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