Aquila Tax-Free Trust of Oregon
Podcast Transcript August 23, 2019

Interviewer:
Hello, this is Matthew DiMaggio. Today, we are talking to Chris Johns, portfolio manager of the Aquila Tax-Free Trust of Oregon. Thanks for joining us, Chris.

Chris Johns:
Thank you.

Interviewer:
I understand summer is typically a time of higher redemptions in the municipal bond market. What is the environment like for individual bond buyers right now considering the scarcity of new issue supply, and what advantages do you have as an institutional buyer?

Chris Johns:
Well, that's true. I think we experience every year, in the summertime, we experience a high degree of bond maturities and bond calls as well as high interest payments in the municipal bond market. So we have seen a lot of bonds being retired here this summer, and one of the things that's really been driving municipal bond prices is that there hasn't been enough new issue supply to replace all those bonds that are being retired. So the demand and supply situation is fairly tight right now. And so, when you look at the fact that there is a scarcity of new issues and there's still a high demand, I guess you could say that from a technical standpoint, the municipal bond market is pretty healthy.

In Oregon, we've seen total issuance so far this year, lower than last year. We've had a good couple of years, but issuance is still a little tight so far this year. We think it'll be about the same as last year, but we expect to see a change in the type of issuance. For the second half of the year, we expect to see more issuance by the state and state agencies and little less by state and local government in school districts, where we saw the previous couple of years, those were the primary borrowers. This year, we think the second half of the year will be more state and state issuances.

The advantages we have as an institutional investor are pretty significant in this kind of market. For an individual bond buyer, it's very difficult to source municipal bonds in this tight market. And as an institution, we deal with every major wire house and all the regional firms that underwrite municipal bonds on a daily basis. And so, we're constantly seeing everything that's available in the market and that really gives us an advantage over an individual investor when it comes to defining bonds. It's still been hard for us. But the fact that that's what we focus all our energies on all day long, we're able to get the bonds we need for the mutual fund.

Interviewer:
All right. The Fed recently cut target rate by 25 basis points. What are your thoughts on interest rates for the remainder of the year and what are your expectations for the yield curve?

Chris Johns:
Well, that's the $64,000 question, Matt. The 25 basis points cut by the Fed was kind of an insurance cut, the way they explain it. They were concerned about the economy, maybe slowing down a little bit, and perhaps the last increase shouldn't have taken place. And right now,

the market is pricing in three more cuts to the federal funds rate. You have to remember that the federal funds rate is just a short-term overnight rate. By far, the greater impact on interest rates has been the uncertainty about the trade situation and about the economy, where we've seen a significant drop in interest rates for longer-term securities. 5 and 10-year treasuries and munis and everything else, there's been a significant drop in those interest rates, and that has a much greater impact than just 25 basis point moves by the Fed.

It's also important to note that in the municipal bond market, we don't see the same interest rate movement that we do in the US treasury market right now. The yield on a two-year treasury is basically exactly the same as a 10-year treasury, so it's very flat. In the world of municipal bonds for AAA securities, you see yields that are 30 to 40 basis points or almost a half of a percent higher to go from a 2-year to a 10-year. So there's still some reward for extending maturities a little bit in the muni space. So interest rates have moved differently in munis versus treasuries.

As far as our expectations for the yield curve in the treasury market, it sure looks like it's going to remain pretty flat with rates being the same out to 10 years for the next several weeks or months, perhaps through the end of the year. As far as a significant move in interest rates in either direction from here, it's our feeling that they're going to trade in a pretty tight range for the next couple of months, unless there's some major development that we don't foresee at this point. So needless to say, it's been a challenging environment in terms of the volatility of the market. And we expected at this point moving forward, hopefully, it will calm down a little bit.

Interviewer:
All right, great insight. We've had roughly a decade of economic expansion since the great recession. What are your thoughts on where we are currently in the economic cycle and what are your expectations if economic growth slows?

Chris Johns:
Yeah, we've had a very long recovery here, although it's been a much slower growth recovery than in previous recoveries. So a lot of investors and financial pundits are concerned about the age of the recovery, but the point is it hasn't been a great guns runaway growth type of recovery. It's been very slow and steady. Given that, I still think we're probably closer to the end of the economic expansion in the beginning. And so, we think that all signs seem to be pointing to a slight slow down. We don't think that we're anywhere near a significant recession, like we saw in 2009 and '10. The consumer is still very strong in terms of spending. Corporate earnings are starting to slow a little bit, but you have to remember that the consumer spending is roughly two-thirds of the economy, and that still seems to be going quite well. So we may see a slow down, but we're not too concerned about a significant recession anytime in the near future.

Interviewer:
All right. What is the overall health of the municipal bond market nationally and locally, and what are the benefits of investing in a state specific versus a national fund?

Chris Johns:
Well, as we talked about before, the health of the municipal bond market, because of technical conditions... I mean, the fact that there's lower supply and high demand, the health of the municipal bond market nationally is really quite strong as measured by those technical measures. If you want to measure it by credit, in other words how strong financially are municipal bond issuers?, they are quite strong right now. They've all recovered very nicely from the recession and have been managing their budgets with some notable exceptions. But generally speaking, the health of the market from a credit standpoint is very good.

In Oregon, we've seen improvement in credit quality across the board the last couple of years. The economy there has been driven by the housing market as we all know, and that backs a lot of municipal bond borrowings, the property taxes on real estate, and we know what's happened there. We've seen real estate values, both commercial and residential, growing rapidly, so that helps credit.

And as far as the benefits of investing in state versus out of state, in Oregon here, it's a pretty significant advantage. We're a relatively high-tax state in Oregon. And because of the Tax Cuts and Jobs Act, which limited the amount of state and local deductions you can take, the need for double-tax exemption is greater now than it was prior to the Tax Cuts and Jobs Act. So that's really an advantage of buying in state right now, is that the after-tax yields are good.

And then, I think for the Tax-Free Trust of Oregon, probably the greatest benefit that an investor gets right now is our credit research that we do in this state. We do in-depth credit research on every single issue that we own. We write reports on every single issue we own. We have ongoing monitoring. We talk directly to the issuers. We talk to officials of the state of Oregon at virtually every level. So that credit research is really a benefit to the shareholders now because the credit condition of issuers can change much more rapidly these days. And keeping an eye on them and knowing what you own is a critical importance right now. So I would say that's really a big benefit.

Interviewer:
All right. Tell me about your current strategy and positioning of the Fund. And also, are there any sectors where you found value this year?

Chris Johns:
So our current strategy in the Fund has been the same as it's been really since its inception. I mean, the objective of the Fund has been to maintain a relatively stable share price and provide an above average double-tax exempt yield. So that remains the same. How we're positioned right now, we've always been intermediate and maturity. And to quantify that, the average maturity of the Fund has been between, oh, say 6 years on the short end and maybe as long as 12 or 13 years on the long end in terms of the average. And right now, we are towards the shorter end of our maturity range, and it's really a function of risk.

What we've seen right now is a flattening of the yield curve, which we talked about earlier. You're not being rewarded as much to buy longer-term bonds. So we're not doing it. And then, more particularly on the credit side, with this high demand for bonds and low supply, people have really invested a lot of money in the lower-rated bonds, thus squeezing out all the incremental return from the lower-rated bonds. So for us, when investors are willing to accept lower returns for higher-risk securities, that's a warning side. So we've moved the portfolio to an extremely high credit quality level. It's as high a credit quality as it's been in the last 5 years or so. And we're going to keep it that way until we see a little bit more value in some of the lower-rate sectors. So safety is the name of the game now, both in terms of interest rate exposure and credit exposure.

In terms of have we found any value this year, that's pretty much next to impossible in this market. I mean, there are times when you can look at certain sectors and they trade cheap to their historical range or cheap to other sectors. And with the demand supply situation that we've seen in municipal bonds and within the state, the difference between sectors is very narrow right now.

Probably one of the best ones to use as an example is the healthcare or hospital sector, where people have really shown a lot of attention to that sector because that's historically where you get more yield. And the difference in yield between what is considered to be a little higher-risk sector in healthcare to a less-risky sector, say like water revenue bonds or state general obligation bonds, the difference in yield is very, very small. So we've moved away from those riskier sectors into the safer ones because you're not being rewarded for the risks that are in those sectors. So it isn't so much a matter of value; it's really more avoiding risks that you're not getting paid for.

Interviewer:
Thank you for your insight, Chris. 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.