Aquila Tax-Free Fund of Colorado

Podcast Transcript

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Candace Roane
Hello, everyone. Welcome to another Aquila Group of Funds podcast. I'm your host, Candace Roane. Joining me is Chris Johns, Portfolio Manager of Aquila Tax-Free Fund of Colorado. In this podcast, we will cover Colorado's economic situation, the municipal market, the Biden Administration spending plans, and rates and inflation. Welcome, Chris.

Chris Johns:
Thanks, Candace.

Candace Roane
Let's start with an update on Colorado's economy. How has revenue fared over the past year through the pandemic?

Chris Johns:
Well, generally speaking, I would say that revenues in the State have come out much better than expected, and I would say that's generally true throughout the country. And it's largely due to surprising economic strengths, and then also significant CARES funding to state and local government. In Colorado, general fund revenues in fiscal year 2020 were at about $12.9 billion, which was actually an increase of 2.4% from 2019. Colorado legislative council is projecting a flat, or perhaps slightly negative, general fund revenues compared to 2020 or 2021 due to the pandemic impact. And then for 2022, a very robust recovery of about eight and a half percent growth in general fund revenues.

Candace Roane
Chris, looking back at the municipal market over the past year, where have you seen the most recovery?

Chris Johns:
In Colorado, probably the most remarkable area in recovery has been in retail sales tax. We have quickly returned to pre-pandemic highs and are at record levels in sales tax collections. The Colorado consumer's propensity to spend is pretty impressive. The other area that's been very strong in Colorado is, as any resident here knows, is the housing market. Housing market is up very strong to double-digit levels in the last year or so, and that's important to us because about 44% of our portfolio is backed by property taxes. And as, obviously, as housing prices go up, so do property taxes so that recovery has been very strong too.

Candace Roane
The Biden Administration has proposed a significant amount of spending this year with the Build Back Better Plan. The American Rescue Plan was signed into law in March, and Congress is currently weighing the American Jobs Plan. The American Family Plan is expected to be proposed shortly. Chris, how do you see this government spending coming together and impacting the muni market?

Chris Johns:
It could be a big deal. Obviously with trillions of dollars in spending that there could be an impact on the municipal market, but it's really kind of unclear yet. A couple of things we do know that I've mentioned already. One thing is that the direct funding of the CARES Act to state and local government is really kind of unprecedented. And so that has been, the impact on the muni market has been, it's probably been a net credit positive. In other words, it's helped the credit strengths of municipal bond issues. And we think with the future spending as well, that that still is going to exist a little bit. How it impacts issuance is really kind of another story. We're not sure about that yet. The Federal Government hasn't been clear as to whether they plan to, all these stimulus packages, that they plan to just spend cash on that. Or, kind of what we think is going to happen, is the reestablishment of Build America Bonds, which you may recall were issued a little over 10 years ago after The Great Recession. And basically, what a Build America Bond was, is it allowed traditional municipal bond issuers to issue bonds in the taxable market and then the Federal Government would subsidize them to the additional interest rate cost of issuing taxable

bonds so that their net interest cost was actually less than tax exempt financing. And we think they could come up with a structure like that to help fund some of this spending they talk about, but nothing is in stone yet. Another way it could impact the municipal bond market is there's, I think now, a high possibility that they will repeal the state and local tax deduction limitation, or cap, that has been in existence since 2017. We believe we also will repeal the prohibition of advanced refunding, or tax-exempt issuers, in the tax-exempt market. So those are two things that could definitely impact the municipal bond market.

Candace Roane
It's a lot to watch. Investors are certainly keeping an eye on interest rates and thinking about inflation. The 10-year U.S. Treasury is yielding 1.6% as we speak, with roughly 70 basis points since the start of the year. What are your expectations for the next several quarters around rates, inflation, set sentiment, and how do you have the portfolio positioned at the moment?

Chris Johns:
Well, there's a lot to unpack there, Candace. First of all, I would say that in regards to interest rates, I mean the one thing we know for sure right now is that the Fed is standing very strong in what they're saying. They projected they're going to keep interest rates low, at least through 2022 and into 2023, and they're going to do everything that they can to make sure that the economy recovers. I think that it's important that they do that, so investors have some confidence in what the Fed is going to do. But what happens many times is the market kind of determines where interest rates are going to go. And there are some forces out there right now that we think could push rates a little bit higher towards through the end of the year. We mentioned housing prices earlier, that continues to be inflationary. Commodities of many types, chips, microchips rather, lumber, copper, fuel, and just about anything out there that has a supply chain have all been up in price. And so that could lead to a little bit of inflation. Which the Fed says is okay, and I think they really want, but it's hard to say how much that will actually be.

The other thing to look at is gross domestic product. I mean, the first quarter we were at growth of six and a half percent or so. And then the projections for the second quarter are 10 to 12%. And we haven't seen growth like that in a long, long time, and the impact that that could have on inflation and interest rates is really unknown yet. And although we haven't really seen wage pressure yet, we are starting to see some labor shortages in certain parts of the economy as we reopened here. So, I think we want to watch wages very closely because that could definitely lead to some inflation.

And then finally, the U.S. Treasury is going to have massive issuance of treasury securities to fund all the spending that is in our futures here. And like any market, when there's a greater supply of something, you could see interest rates go a little bit higher because of that. So due to that, due to those factors, we're positioned fairly defensively right now. We are at the shorter range of our duration range, around four and a half years. Average maturing with the bonds in the portfolio is around seven years. And then the credit quality is exceptionally high in our Fund right now with a little over 90% of the bonds being rated AA or higher. We've done that for a number of reasons. One is credit spreads are very, very narrow right now. And although we're not afraid to take credit risk, we just want to make sure we're getting paid for it and with spreads being so narrow we don't feel that the risk is being priced adequately. And then the other feature of our portfolio right now is that we're over-weighted in legacy pre-refunded bonds, bonds that we've owned for years that have a fairly high book yield to them and we've held onto them because they, they generate a high current income, higher than we would get in today's market. And then they also offer tremendous liquidity as they're backed by U.S. Treasury security. So, so pretty defensive. Shorter, shorter duration, high credit quality, and then high liquidity is where we're positioned right now.

Candace Roane
Chris, thank you for joining me today. It is always a pleasure to get your invaluable insight.

Chris Johns:
Thanks a lot, Candace.

Disclosure:

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

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 principal is possible. Investments in bonds may decline in value due to rising interest rates, a real or perceived decline in the 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. Past performance does not guarantee future results. For certain investors, some dividends may be subject to federal and state income taxes, including the alternative minimum tax referred to as AMT. Please consult your tax professional.

Independent rating services such as Standard & Poor's, Moody's and Fitch assign ratings which generally range from AAA highest to D lowest, to indicate the creditworthiness of underlying bonds in the portfolio. Where the independent rating services differ in the rating assigned to an issue or do not provide a rating for an issue, the highest available rating is used in calculating allocations by rating. Pre-refunded or escrowed bonds are issued to retire or regain an outstanding bond issue at a specific call date. Until the call date, the proceeds of the bond issuance are typically placed in a trust and invested in US treasury bonds or state and local government securities.

Modified and effective duration both measure the value of a security in response to a change in interest rates. Effective duration also takes into account the effect of embedded options. The weighted average life, also referred to as weighted average maturity, is a reflection of the quickness with which the principle of an issue is expected to be paid.

A credit spread is a difference in yield between two bonds of similar maturity, but different credit quality.

Taxable equivalent yield is the return that is required on a taxable investment to make it equal to the return on a tax-exempt investment.

For certain investors, net investment income tax, known as NIIT may apply. NIIT is a 3.8% tax established by the patient protection and affordable care act that applies to the lesser of, the net investment income, or a taxpayer's modified adjusted gross income above an applicable threshold amount.

The acronym PERS (P-E-R-S), stands for public employee retirement system. The acronym PERA, (P-E-R-A), stands for public employees' retirement association. CARES Act Stands for Coronavirus Aid, Relief, and Economic Security Act.

Yield refers to the earnings generated and realized on an investment over a specific period. Yield is expressed as a percentage based on the invested amount, current market value, or face value of the security, and includes the interest earned or dividends received from holding a particular security.

The yield ratio represents the comparison of the expected yield of one bond to the expected yield of another. A yield ratio is important when deciding whether to invest in one bond or another. Generally, the higher yield is considered better.