Hawaiian Tax-Free Trust

PODCAST TRANSCRIPT

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Interviewer:
Hello everyone. Thank you for joining us for this Aquila Group of Funds Podcast. I'll be your host, Matthew DiMaggio. Today, we are speaking with Reid Smith and Stephen Dodge, the Portfolio Managers of Hawaiian Tax-Free Trust. We'll be discussing the ever-timely municipal bond market, as well as the local Hawaii economy. Welcome, Reid and Stephen, and thank you for being on the podcast.

Stephen Dodge:
Thanks for having us.

Reid Smith:
Thank you.

Interviewer:
Let's start right off with a story not only in the municipal markets, but all the markets for the start of 2022. That would be the Fed and interest rates, as the Fed tries to tackle inflation. We've seen how the municipal markets, and really all the markets, sold off on the news of potential rate hikes. What do we expect from the market for the rest of the year with anticipation of rising interest rates relative to other fixed income markets, and other markets in general? And also, could you tell us how Aquila is positioned accordingly?

Reid Smith:
Coming out of the pandemic, we've seen a vibrant economic recovery. Unfortunately, as economic activity restarted, we also have experienced inflationary price increases ignited by supply and labor bottlenecks. Although many thought that these were transitory, they remain embedded enough for the Federal Reserve Board to begin to end their commutative policy. The shift from stimulative to inflation-fighting, restrictive policy threw the bond markets into turmoil early this year. Before the Federal Reserve has raised any rates, the interest rate markets increased deals. This has effectively factored in multiple rate increases over the course of this year and next. During this time, we also saw negative mutual fund flows for municipal bond funds, which pressured the market, as funds sought to facilitate those outflows by selling bonds. In contrast, our Fund has maintained a conservative stance for many years. Although still affected by the negative impact of rising rates, Hawaiian Tax-Free Trust holds a lower risk exposure to events in the current market.

Interest rate and credit quality risk are the two most important factors for portfolio performance. We measure rate risk through duration and credit risk through average quality. Currently, duration, or rates risk, has been held lower than the Hawaii benchmark, and credit quality is very high against the overall municipal market. A third item is liquidity. Liquidity prepares the Fund to facilitate shareholder activity, if needed, without forced selling into poor market environments. Importantly, it provides "dry powder" to seek the opportunity of higher income from the market through new purchases. We currently have over 12% in liquidity available through short-term bonds maturing over the next year. To date, our shareholders remain focused on the long-term benefit of tax-exempt income, free from Federal and State taxes. For new shareholders, the higher yield represents opportunity. The portfolio is in a good place to ride out the current volatile market conditions and opportunistically add value by buying into higher market yields. As the year moves forward, we anticipate a reduction in market volatility. Municipals continue to be sought after for their state and local tax exemption. Anytime we see a reduction in volatility, we usually see demand pick up for municipals.

Interviewer:
Thank you, Reid. So, there's a sentiment from our advisor community asking what makes municipals compelling now. Clients are hearing about potential rate increases and asking their advisors to guide them. How do we help investors or their advisors discussing the asset class?

Stephen Dodge:
Sure. We're hearing this a lot as well. But when having these discussions, it's important to remember the role that fixed income plays in a portfolio. High-quality munis are generally used to generate tax-exempt income with a lower price volatility then one would get in something like equity investments. While rising interest rates will put pressure on bond prices, rising rates also provide the exciting opportunity of reinvesting income and maturities into higher yielding securities. This reinvestment can help to lock in yields for the long-term, which can help to make the income stream more durable. Rising rates also create the opportunity for us to reposition the portfolio in a tax-efficient manner.

The other role fixed income plays in a balanced portfolio is to provide returns and/or stability during times of volatility. During times of trouble, there's generally a "flight to safety." This flight to safety means people sell equities and purchase "haven" assets like high-quality fixed income. This increases the demand for bonds, which can consequently increase the price. Furthermore, the current interest rate environment is such that the ratio of muni yields as a percent to treasury yields makes muni bonds attractive relative to treasuries, especially for high-tax bracket investors. This means for individuals in high tax brackets, municipal bonds can yield more than treasuries on an after-tax basis. This provides a unique opportunity for any clients you had that were worried about an increase in their tax rates. This was a bigger concern in 2021, but it's not currently reflected in the pricing. So, if tax rates were to rise, it would make double tax-exempt income, an even bigger benefit for investors.

Interviewer:
Thank you, Stephen. Moving on to the next question. We talk in great detail here at Aquila with regard to managing locally, and the idea that because of our footprint within our states, we are better suited to tackle the state's municipal environment. And you both have great insights. So, we want to ask, what are you seeing on the ground that someone looking at your market from a national perspective may miss?

Reid Smith:
Well, being in the State offers a tremendous opportunity. We're focused and have an up-close understanding of the local market. Both from a bond availability and credit insights, a local perspective is difficult to beat. We know the issuers, and we know the economy. We have the same national market contacts as mainland investors, but our investors participate in a competitive and best execution market. The market knows this is what we do. On an average day at work, I receive calls, emails, and text messages from around the country of offerings and opportunities. Across the market network, participants know who to contact with Hawaiian bonds. We also have a great relationship with underwriters of new issue tax-exempt debt, and they routinely contact us for our thoughts and opinions on new issuance. At the Bank of Hawaii, we are a major local bank that cares for the community. We manage the portfolio from the perspective of a local manager who wants to keep the investment in Hawaii.

Interviewer:
And staying on the state level, but more of a macro sense, are we seeing anything of note on the State's economy?

Stephen Dodge:
Well, all things considered, the prospects for the State are looking quite good. At the very least, the State is continuing to outperform expectations that were set in 2020 and 2021. The Council on Revenues met in early January 2022 and increased their expectations—with their expectations for 2022 increasing from 6.3%, to 15% in increased revenue. The Council also increased their 2023 expectations from 4% to 6.9%. This comes on the back of unprecedented fiscal support from the Federal government in 2020 and 2021, as well as surprising resilience in the general excise tax, the income tax, and the property tax in 2021.

But the biggest surprise of all has been how quickly the tourism industry has rebounded. While international travelers have largely not made it back to Hawaii, domestic travelers have been in line with 2019 levels, which was a record-setting tourism year. And that's been true since about the beginning of Q3 2021. This is despite Omicron. Property values, real incomes, and employment numbers also appear to be increasing, which should help increase tax receipts for the State and its counties. A bill is also before the legislators, which would aim to add $1 billion to the State's emergency budget reserve fund. This would be nearly a 300% increase over what the fund had in 2019, and a great example of how the Hawaii muni market is doing. Looking forward, we are hoping to see municipalities taking on projects to help update our aging infrastructure, issuing bonds which should help increase supply, as well as a return of our international tourists. This should help open back up the duty-free stores, which would be a big boon for airport revenues. And it should help bring back some of the jobs and spending that have been yet to recover at the international tourists' absence.

Interviewer:
For the last question, let's discuss municipal demand, which had been strong for some time. We did notice demand for municipals start to wane as tax reform became less likely. Can you speak about that, and really, anything else that might be affecting demand?

Reid Smith:
Well, I think the relative attractiveness of higher yields in the municipal marketplace will create stable demand for the year. Many conservative investors have done well over the last number of years by seeking more risk, as rates have stayed low. Keep in mind, there is greater risk in many portfolios that can surface. Perhaps a higher risk approach isn't entirely consistent with personal risk tolerance or investment objective. Investors should take another look at municipals. We don't expect a reduction or increase in taxes in the near term, but with higher interest rates and the current ratio of municipal yields to taxable equivalence, it's an attractive point.

Interviewer:
Reid and Stephen, thank you both for your time today, and for your insights—not only on the local Hawaii market, but the broader municipal bond landscape. We always appreciate it.

Stephen Dodge:
Thank you.

Reid Smith:
Thank you very much.

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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.

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