



# Hawaiian Tax-Free Trust

## PODCAST TRANSCRIPT

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**Interviewer:**

Hello, everyone. Thank you for listening in to the Aquila Group of Funds Podcast. I will be your host today, Phil Felice, the Director of Internal Sales. Joining me from Bank of Hawaii is Reid Smith, Vice President and Portfolio Manager, as well as Stephen Dodge, Vice President and Portfolio Manager of the Hawaiian Tax-Free Trust.

We're coming out of the first half. Recording this, we're going to discuss all things municipal bonds, as well as the local Hawaii economy. And as always, welcome Reid. Welcome Stephen. Thank you for being part of the podcast.

**Reid Smith:**

Thank you, Phil.

**Stephen Dodge:**

Thank you.

**Interviewer:**

So, the first question I want to start off with—very direct. On a long enough timeline, there are downturns in all markets, pretty much. In the front half of this year, however, we saw all markets experiencing volatility along with some of the most severe and volatile muni markets in the last 40 years. So, what was the difference this time around?

**Reid Smith:**

Well today, this has been a very difficult year for fixed income investors. Actually, the major difference from previous cycles is the starting point at which the recent rise in yields began. The starting point began at such a low historical level engineered by the Federal Reserve's policy. The unprecedented accommodation from the Federal Reserve sent high-quality, short maturity interest rates close to zero. In fact, several foreign sovereign issuers experienced negative rates on their bonds. Back in the U.S., we also experienced an additional stimulus from the U.S. government with a fiscal deficit spending to support the economy during the COVID crisis. Some of the stimulus also found its way to support state and local government finances.

The moderate increase in rates came from a low level, heightened the impact on a percentage basis. However, the traditional cycle of rising rates is in place to slow the economy and rein in inflation pressure. In a tightening cycle, the impact on interest rates comes from more than just mechanics in an upward pressure of a federal funds rate. The market itself moves yields higher anticipating forward activity by the Federal Reserve and inflation. The bond market takes the forward outlook into the term structure of interest rates by raising intermediate and long-term rates even further. The long-term impact is to slow the economy down and reduce inflationary pressure, potentially moderating a further increase in rates.

The second factor specific to municipals is composition of the investors. The majority of tax-exempt investors are individuals. They access the market either directly or through conduits like mutual funds and ETFs. The market lacks a balance of other type of long-term bond investors. So individual investors redeem shares of mutual funds. Fund advisers then must sell portfolio bonds into a weak market demand, exacerbating the decline in market pricing. Usually, this type of activity causes tax-exempts to underperform, consistent to what we've seen this year. However, this type of market spiral is generally the best time to be opportunistic and add to your portfolio for the long term. We are already seeing the decline moderate as investors return to seeking the higher yields. Although the future may be choppy, long-term investors can find yields where they haven't seen for a number of years.

**Interviewer:**

Thanks Reid. So, with all that in mind, what is the muni market looking like in terms of relative value compared to treasuries and even the larger fixed income markets?

**Stephen Dodge:**

Well, that's a great question, Phil. We monitor the relative value of our munis very closely, and we see munis offering tremendous value to investors in 2022. And we're hopeful that the market will continue to provide opportunities to capture the relative values available in munis now. But first, we should discuss the ways that we can measure relative value. Two ways we do this is by monitoring the muni yield as a percent of U.S. Treasury yields. And the other way is by looking at the taxable equivalent yield.

Like most financial securities, the value of a municipal bond is commonly compared to the yield of a comparable treasury security. And this analysis is done by taking the yield of the municipal security and dividing it by the yield of the Treasury security, which will give us the municipal yield that's the percent of Treasuries. So, throughout 2021, we witnessed some outstandingly low ratios of meetings of percent of Treasuries. But fortunately, with the repositioning of the Fed and the sharp increase in Treasury yields, we've seen muni values compared to Treasuries move up very quickly at the beginning of the year. In 2022, munis have been trading much closer to their longer-term average ratios. In fact, according to Bloomberg data in May of 2022, munis in 5, 10- and 30-year maturities were trading at ratios that were higher than what they were in 2017, 2018, 2019 and 2021. Of course, we will have to exclude 2020 as an outlier for this analysis.

The other way to measure relative value is by looking at the taxable equivalent yield of muni securities. This method attempts to make the yield of a muni security comparable to taxable security like corporate bond. So, to do this analysis, we'd have to calculate what a taxable bond would need to yield to generate the same after-tax yield as a muni security. This is done by taking the yield of the muni bond, dividing it by one minus the relevant tax rates.

For my analysis, I'm going to only be looking at the state and federal income tax using the highest tax rates of 37% federal tax and 11% state tax, giving us the combined tax rate of 48%. So, if we put this into practice and we analyze a five-year muni using data from June 23rd, 2022, we could take our muni yield, five-year muni yield at 232 and calculate the taxable equivalent yield of 446. We can then use this to compare to a number of corporate volumes. If we look at the AA credit curve, which is the rating where the fund has most of its credit risk concentrated, the five-year AA corporate is yielding 374. So, a 72-basis point spread on a taxable equivalent yield basis compared to the relevant muni. Even comparing the five-year yield to the lowest rating of investment grade bonds, BBB bonds, which is 4.66, the higher quality Hawaiian Tax-Free Trust is lagging by about 20 basis points. If we move further out the curve to 10-year maturities, we have a muni yielding 2.81%. Calculating a taxable equivalent yield, 5.4%, which compares to an AA of 4.12% and a BBB yield of 5.12%. So, we have over 138 basis points over AA yield curve and 38 basis points relative value over a lower quality credit investment. So that just shows that as we go further out in maturity or duration, we see even more relative value in munis.

So, for clients in that highest tax bracket, munis look like an attractive relative value compared to corporate bonds. The attractive pricing relative to credit securities and the current treasury yields are the reason that we're seeing this is as great opportunity to add duration to the portfolio and a great opportunity for investors to step into the muni market.

**Interviewer:**

Great. Thank you for that, Stephen. So, the next question is on issuance. Essentially, what are we seeing from an issuance standpoint heading into the second half? Are we being presented with yields that are more appealing than we saw coming into the year?

**Reid Smith:**

Well, Phil, this year has been unusually a good year for available supply of Hawaiian bonds specifically. The ability to buy Hawaiian tax-exempt bonds comes from two separate sources. First, is the new issue primary bond market. That's where tax-exempt, municipal borrowers issue brand new bonds to the market. And the second is the secondarily-traded bond market. That's where investors trade existing bonds with each other.

Overall, through the end of May, national issuance of new bonds was down eight and a half percent over the same time period last year. In contrast, Hawaii new bond issuance was up 158%, or positive 158% from the same time period last year. Additionally, in the secondary market, as national funds suffered outflows from shareholder redemptions, we saw net selling. Often the mainland-based funds were selling Hawaii bonds to raise cash. In addition to a higher level of local new issuance, we have also been able to return existing bonds to the Hawaiian Tax-Free Trust investors from the national mainland institutional investors. Along with the current ample supply of Hawaii bonds comes higher interest rates from rising rates, as well as availability of supply. All of this allows us to be a selective in purchasing diversifying credits and offers higher tax-exempt income for the shareholders of the Hawaiian Tax-Free Trust.

We expect supply to slack in the new issue market for the remaining months of the year. Issuers have slowed borrowing in the environment of higher interest rates. But the supply of secondary bonds has also dropped as investors have returned to snap up the attractive yields. As long as interest rates remain elevated, we think there is an opportunity for investors to put a toe in the water to benefit from the current environment. We would recommend to utilize and experience local advisor managed fund like Hawaiian Tax-Free Trust.

**Interviewer:**

So, we've been speaking about all things muni markets, but we are Aquila. And we know that advisors and even the clients of our advisors look to us as the local subject matter expert. So, what are we seeing locally in terms of the Hawaiian economy and economic growth?

**Stephen Dodge:**

Well, Hawaii's growth prospects continue to improve as the state continues to open up. We're seeing modest improvement in international tourism, which is the largest remaining segment of the Hawaii tourism market that has yet to substantially recover. Most of the increase came following the removal of the Safe Travels program on March 25th. An increase in international travelers would help to increase the general excise tax, as well as the trans-accommodations tax. But it would also help the Hawaii airport system, as they're able to open back up the duty-free stores, which accounted for a large portion of airport revenues. Meanwhile, we continued to see strong demand from our domestic travelers. The travelers are continuing to arrive at a level that is at or above 2019. The most exciting development in the international traveler is the propensity to spend. In 2019, travelers spent \$3.7 million from December through April. But in 2022, domestic travelers have spent just shy of \$5.1 million, which is great for bolstering the local economy and tax receipt.

The bill to deposit an additional \$1 billion into the emergency budget and reserve fund that I have discussed in previous podcasts was deferred by the finance committee, but this was not because the state lacked the funding. In fact, the State is still flush of cash. Tax receipts are ahead of where they were last year. Just to put some numbers on it, April year to date state tax revenues are up 39.7% from the same period last year. And outside of tourism, there are a few recent developments that are likely to impact Hawaii's economic growth. On June 22nd, the governor signed into law, a piece of legislation that will put money in the hands of residents with \$100, \$200, \$300 tax refunds. Furthermore, the governor signed into law legislation that would increase state minimum wages to \$12 by October 2022, which is a substantial increase from the current \$10.10 per hour. The bill also establishes future increases every two years, finishing at \$18 per hour in 2028. It does remain to be seen how these wage increases will impact the overall economy. But on the surface, higher wages mean higher income taxes and more consumer dollars means more spending to increase GEP revenues. So, it seems like it would take a substantial pullback and tourism demand to shake the local economy from its steady climb to a full recovery.

**Interviewer:**

Thanks for the update. A lot of information for us to chew on there. So, Reid and Stephen, thank you both for taking time out of your day. I know I found this incredibly insightful, and I hope that our clients feel the same way. Thank you both and have a great rest of your day. Mahalo.

**Reid Smith:**

Thank you. Mahalo.

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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 principal 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.

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