Hawaiian Tax-Free Trust

Podcast Transcript

April 9, 2020

This is Candace Roane with Aquila Group of Funds. Today is April 9th, and I am joined by Stephanie Nomura, Portfolio Manager of Hawaiian Tax-Free Trust, and Stephen Dodge, Senior Investment Analyst for the Fund.

Prior to March, the original plan for this podcast was to talk about taxes and tax exempt investing with municipal bond funds, but considering that we have recently experienced one of the sharpest market declines in modern history, I want to get your thoughts on what happened in March and what we should expect as we move forward.

To start, the municipal bond asset class is typically a place of respite for investors during times of economic unrest, but the recent virus-induced market volatility took municipal bonds on a ride along with other bond sectors and equities. Stephen, can you give our listeners insight on how investor sentiment changed and the impacts that had on the bond markets?

Stephen Dodge:
Thanks, Candace. I'm glad we can address this one right at the beginning. COVID-19 has been one of those rare events. The effects that it has had on healthcare, daily life, and the financial markets have been as profound as they have been quick. It's important to note that the municipal market did not move in lock step with the equity market. Municipal market actually held up quite well as the equity market began selling it off in mid-February. The typical reaction from a sizable equity sell off is a flight to quality assets, like the ones held in the Hawaiian Tax-Free Trust. However, in the middle of March, the municipal market experienced one of the largest sell-offs in its history. The end of this municipal sell-off coincided with the March low in the S&P 500. So now, we must ask ourselves, why did the municipal market see such a shock as the stock market folded up? Shouldn't we see bonds rally as investors seek quality investments?

The answer is yes, we should, but there were other factors at play here that had little to do with municipal fundamentals. You have to remember that during the sell-off, there was no rash of municipal downgrades. Municipalities weren't stuck with any market conditions that weren't impacting all other areas of the market, but the difference was supply. Many investors sought to sell their high quality bonds to raise cash, rebalance their portfolios or meet margin calls. Dow Jones Newswires estimates some $28 billion was pulled from municipal bond funds through March 25th. There was this sudden enormous shift in the supply dynamic that moved municipal so strongly. As more and more municipal investments were sold, brokers and dealers were forced to offer cheaper and cheaper prices to buy them as they could not hold any more municipal investments on their books.

Usually, when someone receives a bad price on the sale slows the pace of selling, but the level of fear in the market prevented this from happening as investors continued trying to sell their municipal investments at any price. The move was so exaggerated, the Fed opened up its liquidity facility to begin transacting municipal paper to help alleviate the selling pressure and need. Now, you have to realize that this sell off made municipals very attractive to investors looking to buy. Many investors were able to buy municipals, yielding 100% of what treasuries were yielding, in some cases, yielding almost three and a half percent tax free on a one year security. As investors realized that there was value in municipals and that they still had solid fundamentals, municipal investments, particularly short munis, had stabilized and increased in value since the end of March. You can see this price in the sharp rebound of Hawaiian Tax-Free Trust NAV. And currently, municipals are still attractively priced.

Candace Roane:
Thanks, Stephen. Stephanie, can you cover how the Fund handled the recent volatility and if you were able to locate any opportunities among price dislocation?

Stephanie Nomura:
Our investment approach held up quite well despite the market volatility. As yields spiked and prices have gone down, the Fund performed better than the index due to our shorter duration and our higher quality. Our investment approach is really built to help our investors weather storms just like this. In fact, we were very fortunate to not see anywhere near that outflows that many other municipal managers experienced. We think this speaks to a level of confidence our investors have in our principal protection focus. This all will help to preserve

the value of the Fund as we are not forced to liquidate assets when pricing was bad. In fact, we have been able to add to the portfolio during this time to capture some of these elevated yields that Stephen just talked about and there has been numerous buying opportunities throughout March.

In particular, there was one new Hawaii issue that came to market at attractive yields. Despite the buying opportunities, the Fund was already fully invested and we didn't have to sell in the low prices in the market. So we didn't have to undergo any large scale repositioning during this time, but we were just able to capture opportunities and lock in some hard to find names at great yields. We actually are still able to find opportunities in the month of April and we're excited.

Candace Roane:
That's great to hear. Let's talk about Hawaii. The State entered the year with strong revenue growth and at this point, credit fundamentals remain solid, but it's unknown when activity in the State will return to normal. Stephen, are you concerned about revenue declines in Hawaii and what muni sectors are you monitoring closely?

Stephen Dodge:
Sure. Although we are monitoring our investments closely, we are not particularly concerned with the credits in our portfolio. This is largely due to the safety of our strategies investing in high quality credit. Local issuers started the year with a strong position. 2019 was a record year of strength in the local economy. Record revenues allowed issuers to set aside additional rainy day funds just in case they encounter challenges such as the one we are in now. For example, at year end 2019, the State closed the books with $752 million cash surplus. They also had a balance of $400 million in the emergency relief fund that they have been building for events just like this. Additionally, there were reserves set aside in the $180 million Hurricane Relief Fund. Although we do expect that Hawaii and the rest of the world will experience some lower growth for at least the next few months, we believe that once COVID-19 has been constrained, the economic recovery will be quick.

Even though tourism is likely to suffer a hit until travel restrictions are released, it's important to remember that it's estimated to only be about 22% of the Hawaii economy. The State of Hawaii was also quick to implement social distancing measures long before community spread was a problem. Furthermore, a large portion of our Fund is invested in proven funded securities, which are mostly backed by treasuries and no longer require further funding from the individual municipalities. The general obligation bonds we hold must be paid from the local general funds before any other charges and group of funds can be made. We also have consistently invested in strong and stable credits in the State of Hawaii. All of our credits are essential services of the State. We do not expect that the global slowdown will compromise the ability of our municipalities to pay back their debt on time, as we residents still need to pay a taxes, water and electrical bills.

One issuer or that has been getting a lot of attention due to the impacts of COVID-19 is the Hawaii state airport system. We're not concerned with its liquidity position; it is very well capitalized. Recent liquidity research reports from Moody's Investors Service, which is a nationally recognized rating agency, noted that the Hawaii State Airport System has over three years where the cash on hand to cover ongoing costs. It's our belief that this is more than enough support to support operations throughout the duration of the travel lockdown.

Candace Roane:
Can you give us your thoughts on how the recently passed CARES Act will support Hawaii?

Stephen Dodge:
The CARES Act added additional support to the municipal market as well as many other areas of the economy, and a lot of funds to support the ongoing operations of local government. For example, the State will receive at least $1.25 billion to split between the various counties and divisions and state funds. They have to also allocate the dedicated funds to some of the areas that are feeling the brunt of the COVID-19 outbreak, such as hospitals and airport. We feel that these moves by the Fed and the federal government will help to stabilize the municipal market and help restore any faith that may have been lost during the liquidity crunch that happened in March.

Candace Roane:
Stephanie, let's close it out with you. While we continue to operate under an extreme amount of uncertainty with our healthcare situation and what's going to happen in the markets as we move into a recession, can you give listeners your thoughts on future volatility, how the Fund is currently positioned and your expectations for the next few quarters?

Stephanie Nomura:
The only thing you can really say about this is it's going to be really, really interesting. From the point of view that few muni issuers issue large size, which the Fed tends to prefer in the treasury market. Some examples in Kentucky would be put bonds primarily in gas related bonds, which were issued in mostly in 2018, some in 2019, to the tune of about two and a half billion. And some of those pieces would be 50 million plus, and they're put bonds, so they have relatively short maturities. The Treasury shouldn't favor one State over another, either by only buying California and New York bonds. All in all this is going to be very interesting, as I said. Perhaps the only way they would only buy securities when there's liquidity needed maybe, and hopefully it's not limited to just short maturity.

Candace Roane:
Thank you for that. Considering that we're still operating with a tremendous amount of uncertainty with our healthcare situation, we're not sure what's going to happen with the markets going forward as the healthcare situation plays out, could you give us your thoughts on future volatility and how you're currently positioned, and your expectations as we move forward?

Stephanie Nomura:
Given the unprecedented global event, we believe that volatility will be elevated in the near term and we can probably expect varying degrees at institutional changes to the way people work, infrastructure shifts in supply chains, and changes in the way people interact going forward even after the threat of the global pandemic phase. That being said, we don't think that the event alone will deteriorate the value of the global economy beyond a couple of rough quarters. With this unprecedented amount of global stimulus, it is clear that the world governments do not intend to let their citizens and the economy goes through this without support.

We believe that Hawaiian Tax-Free Trust is particularly well positioned to weather the storms because we have continued to adhere to our mandate of principal protection through our shorter duration and our high quality investments and high levels of current income. We do not see elevated levels of risk in the names we hold due to our well-structured bank balance sheets, our rainy day funds and our stability of their funding.

Candace Roane:
Thank you Stephanie and Stephen for joining me today and for your valuable insights.

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.

For certain investors, some dividends may be subject to federal and state income taxes, including the alternative minimum tax referred to as A and T. 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 credit worthiness of underlying bonds in the portfolio. Where the independent rating services differ in the rating fee 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 for the purpose of retiring or regaining 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 the 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 in excess of 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 of time. 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.

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.