Hawaiian Tax-Free Trust

Podcast Transcript

September, 2020

This is Candace Roane with Aquila Group of Funds. Today is September 1st, and I'm joined by Hawaiian Tax-Free Trust Portfolio Manager, Janet Katakura, and Stephen Dodge, Senior Investment Analyst. Welcome Janet and Stephen.

Janet Katakura:
Thanks, Candace.

Stephen Dodge:
Thanks, Candace.

Candace Roane:
Thank you for joining us today. We last spoke in April, following the outbreak of a pandemic and the dramatic market events that occurred in March. Janet, can you cover what occurred in the municipal market throughout the remainder of the second quarter?

Janet Katakura:
Sure. Yeah, March was quite a time to be in the markets. It's quite possible that investors will look back on the early part of 2020 as one of the best buying opportunities in a decade for our [Hawaii's] high quality municipal bonds. Entering the second quarter, the muni market had recovered from its mid-March extreme selling pressure, which led to valuations where municipals yielded four to five times more than other quality fixed income alternatives. The beginning of April continued to be volatile as investors tried to determine the length and breadth of the pandemic, hoping it would be short lived, yet overwhelmed by virus related economic data and media stories. The injection of unprecedented liquidity by the Federal Reserve Bank via the CARES Act, as well as credit support by the Fed for both corporate and municipal issuers, gave the market support. While the municipal bond market had a slight negative return for April, in May, investors returned to the municipal market, recognizing value and realizing that fears were exaggerated and that issuers were prepared.

Most high quality municipal issuers, including our local Hawaii issuers, were well positioned due to substantial reserves and the practice of setting aside rainy day funds during the previous decade long economic boom. Muni bond issuance dwindled during markets volatility, and this coincided with increasing demand, due to the value of the high quality issues available in the secondary market. Demand for municipals was also elevated in July, as many look to reinvest coupon payments and maturity. And there were even cross market buyers who traditionally buy taxable bonds, but they were looking to buy municipals as they yielded more than treasury securities. This summer, the city and county issued tax exempt and taxable bonds in July, and the State recently issued taxable bonds in August. Both deals were well-received and over-subscribed, meaning that there was more demand for the bonds than there were bonds issued. We are anticipating that more issuers will come out in the fall, as many municipalities would like to refund outstanding issues in this rate environment.

Candace Roane:
Janet, focusing specifically on the Trust, Hawaiian Tax-Free Trust has a relatively conservative investment mandate, how did this management style impact your shareholders' experience through the first half of this year?

Janet Katakura:
Well, as we previously mentioned, 2020 has been a wild roller coaster for all asset classes. Despite that, Hawaiian Tax-Free Trust still generated a positive total return during the first and second quarters. During this time, Hawaiian Tax-Free Trust has been consistent with an overall higher quality and shorter duration than its benchmark. And that's commensurate with the Fund's objectives of capital preservation. This conservative stand proved to be a positive for the Fund's performance for the first quarter, but we did lack the index in the second quarter, as investor's appetite for lower quality bonds returned. I would like to point out, performance is still positive for the Hawaiian Tax-Free Trust, and net asset value is still near it's high for 2020. Hawaiian Tax-Free Trust continues to be 100% invested in Hawaii municipals, which is especially beneficial for the Trust's high tax bracket Hawaii resident shareholders who are exempt from federal and state taxes on their income distributions.

Candace Roane:
Stephen, let's switch to the Fed. Janet mentioned the CARES Act and the municipal liquidity facility earlier. Can you give us an update on the support that Hawaii has received?

Stephen Dodge:
Sure. The state of Hawaii's Office of Federal Award Management estimates the State of Hawaii has received about $5.5 billion in Federal Funds from the CARES Act, and from other sources, to address the financial challenges of the pandemic. Of the $1.25 billion in CARES Act funds, about $560 million was distributed to our counties to be used for COVID related expenses that weren't included in their budgets, which were already determined before the pandemic. Some of the funds were allocated to the Department of Defense for response activities, to the Department of Transportation for thermal screening at the airports, and to the Department of Health for tracing and control of COVID, as well as the purchase ample personal protection supplies and cleaning products. Additional specified funds have been received for health, social, and economic aids, including funds for hospitals and community health centers, Department of Education, job training, childcare and welfare services, food banks, and low income energy and housing assistance, among many others.

Although the CARES Act requires that all funds received must be spent by December 31st, 2020, not all of the funds received have been distributed. That balance has been deposited in the State's general fund. The governor is waiting for the Federal Legislature to agree on additional funding for COVID relief. After that legislation is determined, we expect that the balance of the funds will be spent to support local governments' economic costs of the pandemic. The municipal liquidity facility has not yet been tapped. Although, in recent meetings we had with the State budget officials, they indicated they may use that facility later on in the year, if necessary.

Candace Roane:
Speaking of budget, overall state and local governments appear to be resilient and prepared to sustain temporary revenue shortfalls. What is the situation in Hawaii where tourism accounts for a larger percentage of the State's economy?

Stephen Dodge:
Yeah, that's true, the State does appear to be resilient. With the previous decade's strength, the State entered the 2020 fiscal year with general fund carry forward balance of $747 million. This, plus other reserve balances from the emergency budget and reserve fund, and the hurricane relief fund, and the elimination of unstaffed government jobs, will help offset the anticipated budget deficit. Additionally, the State received money under the Coronavirus Aid Relief and Economic Securities Act, or the CARES Act, from the Federal Government in March, 2020, as well as other federally directed payments. It is the popular perception that Hawaii's economy is almost entirely tourism. But fortunately, this is not true. In fact, in 2019 tourism spending represented less than 20% of the state's GDP. The rest of our economy is what our local residents spend their money on, and it's imperative that the State first establishes ways for this segment to be up and running safely.

Fortunately, once it became apparent that the country was facing a pandemic, the State was quick to take definitive steps to protect its citizens by limiting travel into the State, closing non-essential businesses, and imposing stay at home orders for residents. With the lockdown, however, the state's unemployment rates soared to almost 24% in April. The accommodations and food service industries, which represented about 20% of the workforce, were hardest hit. Most other industries lost proportionally fewer jobs. We were happy to see the preliminary unemployment numbers for June were surprisingly lower for all counties. While the quarantine will remain in effect for trans Pacific travel from outside the State until at least the end of August, authorities are focused on developing processes to safely and gradually reopened tourism. The goal is to make Hawaii a safe destination for visitors and residents.

With all that said, we understand that COVID has severely curtailed the tourism activity. That is one of the key components of the economy, but what a lot of people don't realize, as an additional layer of protection, is that principle and interest of our GO bonds for the State and counties are first charged at the respective general funds and have the pledge of their full faith and credit. What that means is that the other expenses would need to be cut to address any budget shortfalls. Another thing to consider is most of Honolulu and other county revenue is derived from property taxes at rates that are incredibly low compared to many mainland costs of the assessments that are 18 to 24 months in arrears of real market activity, making it substantially less exposed and better positioned to respond to economic decline.

Our real property prices have steadily climbed since the financial stresses of about 10 years ago. And thus total property taxes have increased with the real estate value. Our holdings that are more closely associated with tourism, such as the airport systems, had exhibited good credit fundamentals through high levels of reserves prior to COVID to support the lower revenues resulting from the decline in the tourism sector, as well as receiving substantial funds from the CARES Act.

Candace Roane:
Janet, let's turn back to you to wrap things up today. What is your outlook for the muni market as we head into the last few months of 2020? We are facing a potential resurgence of COVID-19 and an election that can change the control in Washington. And Stephen touched a bit on sectors, but I'd like to hear from you if there are any particular muni sectors that you're watching closely.

Janet Katakura:
With the Federal Reserve's recent meeting minutes, indicating that they are planning on keeping treasury rates low, we believe munis will continue to provide taxable investors with good relative returns, versus treasury and corporate bonds of similar characteristics. That being said, many municipalities budgets are in distress from the challenges of the pandemic. So, we continue to favor higher quality bonds, such as most of the issuers within our State. We may see some minor credit downgrades, but local issuers were well capitalized when the pandemic broke out. The Federal Reserve's municipal liquidity facility provides a backstop for issuers, although we've only seen two mainland issuers access that facility since it was announced.

Direct aid from Congress would help. But at this time the timing and amount of support is uncertain. We expect that issuers will have to tighten their belts and cut expenses, possibly enact furloughs and other budgetary measures. You know, debt service, which is paying the bond principle and interest payments on time, is a very high priority with the issuers.

As far as sectors, well, you know, the markets are cautious about healthcare bonds. Fortunately, although we have seen spikes in the buyers recently, our local hospital still has sufficient capacity to take in patients. We have also received specific Federal aid to compensate them for lost revenue from a decrease in elective surgery. Higher education bonds, such as those issued by the University of Hawaii, have also been a concern. Again, these institutions have not only been recipients of targeted Federal support, but they're in session as we speak, with a lot of remote learning.

The state airport system had about two and a half years of cash on hand to cover operational expenses as we entered 2020. And they've also received significant Federal funding under the CARES Act. Essential services, such as water, sewer, and electricity should be stable. And the supply demands of the characteristics of the muni market have also been favorable. There've been a lot of tax rule issues. Most recently, the state's lodge issue, which saw demand from institutional investors with no tax concerns.

Candace Roane:
Janet and Steven, mahalo for joining me today and for lending your invaluable insights.

Janet Katakura:
Thanks for the opportunity, Candace.

Stephen Dodge:
Thank you.

Janet Katakura:
And Aloha.

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. 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 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.