Muni Market Update with Royden Durham

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AQUILA® Churchill Tax-Free Fund of Kentucky

This is Candace Roane with Aquila Group of Funds. Today is April 8th and I am joined by Royden Durham, lead portfolio manager of Aquila Churchill Tax-Free Fund of Kentucky. Royden has over 40 years of experience in the financial industry and has been managing the Fund since 2011.

Welcome, Royden.

Royden Durham:
Hi, Candace.

Candace Roane:
Prior to March, the original intent for this podcast in April was to discuss the benefits of tax exempt investing as we approach tax day. But considering that we recently just experienced one of the sharpest market declines in the past century, I would say let's talk about that and get your thoughts on what happened with municipals and what we should expect as we move forward.

So, to start, the municipal bond asset class is typically a place of respite for investors during economic unrest, but the volatility that we experienced last month took municipals on a ride along with other bond sectors and equities. Can you give listeners your insight on how investor sentiment may have changed and the impacts that had on the bond market?

Royden Durham:
Sure. So the best way for me to describe what's happened over the past few weeks is, is that my Y shares NAV on January 2nd, 2020 of the Fund was $10.82, on March 9th, it had gone up to $11.08, by March the 20th it was down to $10.15, and by March the 30th it was back at $10.84, which closed out that month of March. And then on April the 6th, just the other day, it closed at $10.70.

In essence, it's been a real rollercoaster ride. It had had us down for the year, but recoup most of that and year to date we were down fractionally. The Fund, due to its conservative credits and shorter duration has outperformed most of its longer duration peers in the Bloomberg intermediate quality index year to date. With some equities down over 25%, the fund performed as expected. Concern in the Muni market the third week of March centered around to the largest fund companies putting bonds out for the bid, just in one day, 700 million in face value, when normally a weekly bids total for the municipal market about 560 million. That, coupled with the problems in the short variable rate market, hung over 1 billion of short paper struggling to come up with cash in one day. So in any event, the Fed stepped in to help in the market turned up immediately.

Candace Roane:
You touched a little bit on the Fund and how it did. Would you say that the mandate that you manage to with intermediate high quality handled the volatility pretty well in general… not just to peers?

Royden Durham:
Well, our short duration and adequate cash position helped us weather what turned out to be a very small redemption. When our competitors were struggling to raise cash and leverage securities, or force to sell low quality securities into a volatile market, our Fund was not.

Candace Roane:
We know that most States and municipalities entered the year with strong revenue, including Kentucky, and that credit fundamentals remain relatively strong, but it's unknown when what's happening today will subside, and we'll be able to get back to our normal life. Are you concerned about revenue declines in the State, and are there sectors that you're watching closely?

Royden Durham:
Well, we certainly are concerned with certain areas like some of our private colleges, but have been pleasantly surprised by what we have found on certain credits. An example would be Louisville Jefferson County airports. They have over 105 million of unencumbered investments in government agencies. Their annual budget is 75 million and they can weather a fairly long storm.

Sources of concern, such as our Transylvania Center and Bellarmine private colleges can handle some stress by virtue of their endowments. I've always been a proponent that their real estate of those colleges is also extremely valuable and is worth far more than their total outstanding debt. From the state point of view, assuming this doesn't last very long, a frugal budget passed by the legislature just on March 31, plus a $1.7 billion emergency funding from the government should help Kentucky weather this situation.

Candace Roane:
Speaking of government funding, the CARES bill was recently passed, the COVID Relief Act, and it allows the Fed to come into the market and buy munis. What are your thoughts on what the Fed will purchase, if at all?

Royden Durham:
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?

Royden Durham:
I'm an immensely optimistic that the pandemic will end quicker than a lot of people believe. My concern if that happens is all the government money sloshing around and how it's going to be used. Long story short, is it could cause inflation. I know I can hear you howling on the other end of the phone now, but it finally could, and I believe that the Fund is well positioned with its short duration to handle that.

One other concern is muni finance calendar, which has slowed markedly. Hopefully that gets a jumpstart soon also, which apparently may show up in the newest proposed spending bill being floated in the Congress presently. Munis are very cheap to treasuries on a historical basis. We've seen the gap shrinking daily starting April the 3rd as the Treasury's retreat, so slightly higher yields, and then munis continue to rally or slightly lower in yields. So the spread is closing.

Candace Roane:
Thank you for joining me today Royden, and for giving us all of your insight.

Royden Durham:
Thank you, Candace.

Disclosure:

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Information regarding holdings is subject to change and is not necessarily a representative of the entire portfolio.

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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 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.