Aquila Churchill Tax-Free Fund of Kentucky

Podcast Transcript September, 2020

This is Candace Roane with Aquila Group of Funds. Today is September 3rd, and I am joined by Royden Durham, Portfolio Manager of Aquila Churchill Tax-Free Fund of Kentucky. Royden is also Co-Portfolio Manager of Aquila Tax-Free Fund For Utah and Aquila Tax-Free Trust of Arizona. Welcome, Royden.

Royden Durham:
Good morning/afternoon, Candace.

Candace Roane:
Thank you for joining me today. We last spoke in April following the outbreak of the pandemic and the dramatic market events that occurred at the end of the first quarter. What has transpired in the Kentucky municipal market since March, Royden?

Royden Durham:
Well, Candace, in Kentucky, the major occurrence was the widening of the AA to A spreads, which happened to hurt total return for most of the weaker state credits. We did get a couple of days of outperformance coming in the form of an increase security prices in July after some major trades in Kentucky state props and turnpikes took place. Overall, I would say that Kentucky is undervalued from a pricing spread relationship to the national market. Supply recovered, but we were seeing many more taxable deals due to the Trump tax law changes that did away with many tax-free advanced refunding deals. These taxable deals have attracted many foreign buyers due to lower interest rates abroad.

Candace Roane:
Focusing specifically on the strategy, Aquila's municipal funds have a relatively conservative investment mandate. How did this management style impact your shareholders' experience through the volatility this year?

Royden Durham:
The Fund outperformed the index, the Barclays Quality Intermediate Muni Index right at the end of March as the market dislocations had investors running for the sidelines. The outperformance subsided when reality took hold and the market started looking at credits. Since Kentucky is tied for 41st by Moody's out of 49 states, they do not rank Wyoming, lower-rank credit suffered total return performance losses. Our peers did perform in line with Aquila Churchill Tax-Free Fund of Kentucky. Although as we know, past performance does not guarantee future results.

Candace Roane:
Let's talk macro, shifting to the Fed. After offering no assistance during the previous financial crisis, the Fed stepped up this year with aid for the municipal markets. What do you think was different this time and can you give us an update on how the CARES Act and the municipal liquidity facility have offered assistance?

Royden Durham:
Well, Kentucky seems to defy gravity during the pandemic. The really bad unemployment rate of 16.6% in April declined to 10.9% in May and 4.4% in June and the preliminary numbers for July is up a little bit at 5.7% versus the estimate for the US at large at 11.2%. The worst revenue number the State had, okay, was in road revenues for the fourth quarter, which were down 27%. The State made budget, however, for the fiscal year ending June 30 and actually added money to the rainy-day fund, which now stands at about $400 million. In July, the first month of revenue for the first fiscal year, both the road fund and general fund were up 7%. I think all of this great news can be attributed to our major industries of auto manufacturing and logistics working through or starting back to work early. We have many hourly workers in Kentucky employed by these two industries.

In addition, I'd have to say, we seem to have had a light caseload of COVID in comparison to our neighbors. Obviously, the State CARES money of $1.5 billion helped, but there was no need to take advantage of the municipal liquid facility. At this time, only two entities that I know of have used it, that would be Illinois and the New York City MTA, Metropolitan Transit Authority. Our depleted unemployment Fund could possibly use a federal handout. We're waiting to see how that works out.

Candace Roane:
I want to get your thoughts on the rumors around defaults, also. Municipalities appear to be resilient and prepared to sustain temporary revenue shortfalls, but we are hearing concern around muni default risk. Do you consider that concern valid for Kentucky?

Royden Durham:
Well, as I mentioned before, the State seems to be in a good position so far. We're watching certain credits closely. Sectors under scrutiny are airports, hospitals, and public and private education. We only own Louisville airports, our other airports are pre-refunded. With federal health, they seem to be in good position since they are reaping benefit from freight increases from the likes of Amazon Logistics, et cetera. Hospitals, when you dig into the financials, are in a better position than they would have you believe. U of K had a record enrollment and Rupp Arena is fully funded for three years. Our small college debt in Bellarmine, Transylvania, and Centre, all have enormous public support and major endowments. The Fund has made conservative investments which we believe are paying off in a credit-obsessed market.

Candace Roane:
What do you expect going forward regarding stimulative monetary policy? The Fed has stated that rates will remain low. Do you expect to see other accommodative measures taken?

Royden Durham:
I think it's very, very difficult to see what they could do next. I'm surprised that they had thrown out the inflation cue of 2% and say that will keep rates low for a specific period of time. I think you could make a case for food and housing inflation with rates so low. I have had one millennial after another telling me there are no houses for them to buy. Apparently, this is sort of localized, but we're sort of an indicator. The only thing available seems to be one-to-$3 million mansions, which are being subdivided to supply the lower cost housing in our local market. The outcome of the presidential election may have more to do with how interest rates behave than anything that Fed currently has in their toolbox.

Candace Roane:
To wrap things up today, I want to get your outlook for the muni market as we head into the last few months of 2020. Are there any sectors that you're watching closely as we face a potential resurgence of the virus and an election that may shake up Washington?

Royden Durham:
Well, no doubt there will be some hiccups through the election, but the Fund is positioned with short duration and relatively short-weighted average maturity, which we hope will help it weather any upheaval in the Kentucky market. I had my eye on Kentucky higher education, alternative minimum tax bonds. They're trading cheap in the secondary markets with national funds playing higher education. The bonds are collateralized 135% of face value and backed by moral obligations of the State.

Candace Roane:
Royden, as always, thank you for joining me today and offering your insight and expertise on the Kentucky muni market.

Royden Durham:
My pleasure, Candace.

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.