



# Aquila Tax-Free Trust of Oregon

## PODCAST TRANSCRIPT

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AQUILA<sup>®</sup>  
Tax-Free Trust  
of Oregon

**Interviewer:**

Hello everyone. Welcome to another Aquila Group of Funds podcast. I'm your host, Phil Felice. Joining me is Chris Johns, portfolio manager of the Aquila Tax-Free Trust of Oregon. We'll be discussing Oregon's post-stimulus economic situation, infrastructure, municipal spreads, and rates. Welcome Chris, and thank you for being on the podcast.

**Chris Johns:**

Thanks for having me.

**Interviewer:**

So, let's kick things off. We're six months down the road from the American Rescue Stimulus Plan. How is Oregon fairing in the economic recovery?

**Chris Johns:**

Well, like many places around the country, Oregon struggled right out of the initial stages of the pandemic. Originally, the Oregon General Fund, the outlook for the current budget, was revised downward by almost \$2 billion. But since that time, there's been a pretty strong recovery in Oregon, and the State's June 2021 forecast has that shortfall more than filled, and actually, revenues higher than they originally called for a couple years ago. Some of the areas of strength have been, manufacturing hours has rebounded very nicely, consumer confidence is high, tax collections of every type are very strong, and then probably one of the strongest parts of the economy has been residential real estate. Anybody that owns a home or has tried to buy one in Oregon knows what's going on there. And that's important to us because approximately somewhere between 60 and 70% of our portfolio is backed by residential property tax. And so, when we see a strong residential market, that's very good for our portfolio. Couple areas of concern that we're looking at, the private colleges in the higher ed sector. Even with the Delta variant, we have concerns about headcount there, and then the other sector would be Leisure & Hospitality. Which, like most places around the country, has not fully recovered yet, but there is improvement there in the last several months. So, that's getting better, but obviously at a much slower pace.

**Interviewer:**

Switching gears to demand. It's high across all muni paper with supply being somewhat moderate. How does it affect the municipal markets, and can we see demand continue at these levels for much longer?

**Chris Johns:**

That's a good question. I've been surprised at how strong the demand has been, but I think that when you consider that we've been in a very, very low interest rate environment for a long period of time, investors really had been starved for yield. And so, the asset class of municipal bonds has been a place where they want to be. Technically speaking, the municipal market is in very good condition in that there is high demand, and the supply so far this calendar year has been, I guess what we would refer to as modest. It's been okay, but it hasn't been great. So, how long will the demand remain? It's hard to say. In the last 15 years or so, municipal investors have shown to be kind of a fickle group. They're either all in or all out, but right now people really like the muni market, and there's good reason for that as time goes on. So, we think it'll be okay for at least the rest of this year and into next year.

**Interviewer:**

Regarding supply, an infrastructure bill recently passed through the Senate and is awaiting a vote in the House. If passed, how will it affect supply and how will it affect the muni markets in general?

**Chris Johns:**

Well, that's a developing situation still. There's a number of infrastructure bills being talked about. One, a bipartisan bill that has been changed a number of times, and then there's also the possibility for the Democrats to pass something from a reconciliation standpoint. If it were to go that direction, it would be a much bigger bill than what we're seeing on the bipartisan side. But to the point, how that affects municipal issuance is, it's likely that we see a return of something like the Build America Bond structure from 10 or 12 years ago, where the Federal Government allowed traditional tax-exempt issuers, state and local government, to ac-

cess the broader investor base of the taxable market. And then the favor that the Federal Government did to the state and local issuers is, they offered a subsidy on the difference between what the taxable interest was and the going rate on tax-exempt interest. So, it was a great deal for the issuers. They got to access a big market. Didn't cost them any more money, and that's been talked about a lot in terms of how the new infrastructure will be financed. For us, the traffic in the tax-exempt market, the taxable structure doesn't do us a whole lot of good, but if you're an existing bond holder, it may create some scarcity value to existing munis, and may actually improve credit quality in the long run. So, we'll have to see how that affects supply. It really depends on how the final bill is crafted, but I suspect we'll see these direct pay subsidy bonds in some form to pay for the infrastructure. It may not affect any other part of the municipal market or the normal financing that goes on, and this could just be additional financing, but probably on the taxable side.

**Interviewer:**

Staying at the Federal level, if tax overhaul could be the next big story coming out of Washington, is it too soon to start thinking in these terms and how would a broad increase in taxes directly affect the muni markets?

**Chris Johns:**

Well, I don't think the muni market thinks it's too soon to talk about that. I would suggest that the yields in the municipal market right now really kind of reflect higher taxes in the future. If you look at the ratio between U.S. Treasury yields and municipal yields over the last, whatever, 10 years or so, it's been between 80 and 100%. In other words, muni yields have been very close to what taxable yields are. Well, recently that number has dropped all the way to 70%, and depending on the maturity, even below 70%. So, muni rates are anticipating higher taxes right now. Another way that could impact the muni market is that we're not sure exactly what's going to happen with individual tax rates. They've talked about only the highest tax bracket or the high tax bracket—those making \$400,000 and above—having increased tax rates. But the other place it could make a difference is on the corporate side. We saw a pretty significant decrease in corporate taxes in the Tax Cuts and Job Act of 2017, and if we go the other direction on corporate taxes, it could bring back investors into the muni market that have been absent for a while. And the most likely sectors that would return to the muni market are banks and insurance companies. They've historically been strong participants in the muni market. So, it could increase demand for munis from corporations, and then, obviously, for those individuals at the highest tax bracket, the tax exemption would be more worth more to them too. So, I think demand would definitely remain strong for the municipal bond asset class.

**Interviewer:**

Thank you, Chris. Switching gears, municipal credit spreads are at incredibly narrow levels. What does this tell us about the mindset of investors?

**Chris Johns:**

Well, this is one of our greatest concerns right now. I think what it tells us about investors is that their attitude towards risk has changed. Historically, when you look at any investment, whether it was a corporate bond, a municipal bond, or even if you were a banker making a loan, you would expect to receive a higher rate of interest from those borrowers that were less able to make principal and interest payments over time. But in today's interest rate-starved environment, credit spreads have almost disappeared. They're at their narrowest levels in the last 30 or 40 years, and that's because people thought that's where they could get yield, and they don't seem to worry about credit. And we still do a little bit. Even though the pandemic, with the CARES Act and with the American Rescue Plan, state and local government is in reasonably good shape. There are still plenty of smaller issuers that don't have audited financials yet for the whole time period of the pandemic. And that will be forthcoming between now and say, over the next six months or so. So, there's still some things we have to watch closely. So, we think credit spreads are really too narrow. You're not getting paid for the risk that you take. That's been important to us. We've moved our portfolios to higher quality levels because you're just not getting paid for the risk. And so, we do worry about that a little bit. We think that it's inappropriately pressed right now.

**Interviewer:**

Thank you. A lot of great information to dissect there. I have just one more question. What are your expectations for the rest of 2021 and heading into 2022 around rates, inflation, and how do you have the portfolio positioned currently?

**Chris Johns:**

Right now, we still believe that the greatest risk to our shareholders is higher interest rates. We talked about credit a minute ago—spreads being too narrow, and that's true too, but we think the greater risk right now to shareholders is rising interest rates. So, we've been, and continue to be, fairly defensive in our positioning. We've kind of reduced interest rate risk by our portfolio duration, which is around four and a half years. Average maturity is in the seven-year range. Ninety percent of our portfolio is rated AA or better. So, extremely high credit quality right now. And then the other thing that kind of stands out about our portfolios

right now is we have an overweight position in pre-refunded bonds. And those are bonds that, just like you and I would refinance our home to a lower interest rate, municipal bond issuers refinance older, higher interest rate bonds with new issues, and then take the proceeds of the new issues and buy government and agency securities to pay off the old issues. Well, we own plenty of these older issues that have been pre-refunded, and the cool thing is that they maintain their original yield that pays out to our shareholders. So, they offer an excellent current yield in the portfolio. Obviously, they're very safe because they're backed by treasury and agency securities. And these days, one of the other great benefits is they're very, very liquid. So, in the event that we have to sell the bonds, that pre-refunded part of our portfolio is real liquid. Those bonds have hurt us a little bit on the total return side, because they don't move much in price as you would expect. And in a market where interest rates decline and credit spreads narrow, those type of bonds don't really take advantage of that. But the other benefits we think are more important to us, and meeting our perspectives mandate, providing a tax-exempt yield with low risk. So, that's how we're positioned right now. I think if we saw change in credit spreads, change in the shape of the curve, we might look to really use the credit analysis ability that we have. We would love to add some lower-rated securities once we get paid to do that. We have some of the best credit analysts around, and we really want to take advantage of that. But so far we haven't gotten that opportunity. And if we see rates move up a little bit, we may extend the portfolio a little bit as time goes by. So, overall, we're sticking with our meeting at the moment, not moving too much from a defensive position until there's a reason to do it.

**Interviewer:**

Chris, thank you for joining us today, and it's always a pleasure to get your invaluable insight on the municipal markets. Thank you for joining us.

**Chris Johns:**

Thanks.

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Thank you for listening to this podcast. The opinions shared are those of the portfolio managers and do not necessarily reflect those of the Investment Adviser or Sub-Adviser of the Fund.

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

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 AMT. 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 creditworthiness of underlying bonds in the portfolio. Where the independent rating services differ in the rating 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 to retire or regain 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 U.S. 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 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. The acronym PERS, stands for Public Employee Retirement System. The acronym PERA, 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. 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.

The 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.