Aquila Tax-Free Trust of Oregon

Podcast Transcript

January, 2021

This is Candace Roane Director of Marketing with Aquila Group of Funds. Today is January 21st. I am joined by Chris Johns, Co-Portfolio Manager of Aquila Tax-Free Trust of Oregon, which he co-manages along with Tim Iltz. Chris also manages Aquila Tax-Free Fund of Colorado. Welcome, Chris.

Chris Johns:
Thank you. Good to be here.

Candace Roane:
Now that we know the Democratic Party will control both the Executive and Legislative branches for at least the next two years. What are your thoughts on policy changes that may impact the municipal market?

Chris Johns:
Well, there's a couple of things I think that will be different here, even in the short run. I think, first of all, the relationship between Washington DC and State Governments will be a little less contentious than it was under the previous administration. So, we think that's probably good for a municipal bond credit quality. Anytime there's a little bit more certainty on Federal funding for various local State and local projects and in a more partnership type of approach towards funding, it's generally a better credit event for municipal bonds. The other part that could be important to municipal bonds as well it's tax policy. We'll have to wait and see how that shakes out. I would say that it's likely that we could see corporate taxes go a little bit higher, but if there's a change in individual tax rates it's less certain. If there is, it's only going to be at the highest brackets. And even then that's probably a net positive for municipal bonds as well. So I would say net-net, from a credit standpoint and from a value of tax-exemption standpoint, we would expect to kind of a constructive environment here for the couple of years.

Candace Roane:
Chris, I want to get your thoughts on issuance as well. The market has seen an increase in taxable issuance. Would you say taxable munis are gaining popularity with investors and issuers? And do you expect to see that trend continue?

Chris Johns:
Yeah, that's really been a growing asset, fixed income asset sector in the last couple of years. As you know, in 2017, the Tax Cuts and Jobs Act eliminated the ability of municipal issuers to refinance their debt using the tax-exempt market. And so happily for the issuers over the last few years, taxable rates have been very, very low, and it has made sense for them to refinance older, higher interest rate tax-exempt debt with a taxable debt.

The other thing that's happened is as you point out, it's not only the issuer side of it, but it's the investor's side of it as well. And investors have been very interested in taxable municipals over the last couple of years, because it was also kind of a growing and new asset class that taxable investors really liked, particularly the credit characteristics to municipal bonds. And so there has been demand for taxable municipals. Whether it continues or not, it's going to depend on a couple of things. It's possible that the no refunding rule and the tax-exempt market could be eliminated. There is a Bipartisan Group that's talking about bringing back the ability to refinance in the tax-exempt market, because it's a great tool for state and local issue. So that could change and that would obviously reduce the supply. But until it does, I think issuers will still use that technique as long as it makes sense for them to do that from an interest rate perspective. In recent weeks, we've seen taxable rates go up faster than tax-exempt rates. And so it's less attractive for an issuer to borrow in the taxable market to be finance old tax-exempt. Can still be done, but it's not nearly as positive to the issuer as it was a few weeks ago.

Candace Roane:
What are you seeing with credit ratings and potential downgrades? Do you expect to see more stress on certain muni sectors as we continue to address the pandemic?

Chris Johns:
Well, the pandemic is really the key factor here. I mean, it affects all economic activity and obviously that impacts several different sectors in the municipal bond market. So, I would say that for certain types of issuers, there will still be stress on their credit as long as the pandemic conditions continue to exist. A couple of things I would say about that though, I would say overall nationally, we've seen credit in certain areas remain relatively strong, better than I think people expected. First of all, in any kind of property tax backed bonds, which represent a large percentage of the market as much as 40% or 50% of the market now, real estate prices have done very well in most parts of the country and so that credit has held up well. Sales tax backed bonds that have done better than people expected as people continue to spend, only just in a different way. So, it hasn't been as bad as it was expected. There's other sectors such as in transportation, higher ed, hospitals, where the pandemic has been felt far more seriously. And so for those, like in any recession, it's like we already have seen some ratings downgrades. It's likely we could see some more. But overall, the funding they are getting from the CARES act and with the new administration. Even today, they're announcing direct funding to some of these sectors that have been hurt more than others due to dependent more direct funding from the Federal Government. So that really makes a difference. Doesn't make up for everything, every revenue that they're losing, but it does help ease the way a little bit. So, it's going to be really important to keep close track of credit developments, which is something that we've always done anyway, and have very strong credit research to kind of avoid any problems here.

In Oregon, the credit quality of the portfolio is exceptionally high right now and has been for the last year or so. We have over 90% of the portfolio rated AA or better. We've structured it that way over the last couple of years, because it's in this low interest rate environment, as interest rates have declined and credit spreads have narrowed, we felt that the risk premium associated with lower rated bonds was not appropriate. So, we moved to higher rated bonds. And so, the credit quality in Oregon has held up very well.

One thing that we always get questions about is the PERS Program in Oregon, the retirement benefits, and we continue to track the PERS impact on each individual issuer and our portfolio as we do credit reserves. And one of the positive developments there with PERS is that the contributions that individual issuers have to make to the PERS Plan in the 2021 and 2023 biennium, it's actually going to go down a little bit. And that's largely because of a Senate Bill 1049, which was adopted by the State Legislature in 2019 and upheld by the State Supreme Court last year. So we'll see that stress on issuers that have to make pension contributions reduce a little bit because their contributions will go down. But overall credit is very high in that portfolio.

Candace Roane:
Let's close with your outlook for the muni market over the next few months. Where do you think yields might go from here?

Chris Johns:
Well, we think that a couple of things as I mentioned a minute ago. One, we've seen interest rates on treasury securities kind of edge up here in the few weeks, because there's concern about the massive amount of debt that the US Government is taking on. And you would expect that, you would expect rates to go a little bit higher. So far, they really haven't pulled the municipal bond rates along with them yet. So the relationship between tax-exempt and US Treasury rates still favors probably the treasury rates at the moment. At some point that'll change, I think rates will have to edge a little bit higher in the muni space as well. We've had very strong demand from munis in the last several months. And that's really been the main force in keeping tax-exempt rates low. So. we think that throughout the year, rates might edge a little bit higher, nothing very dramatic by any means, but slightly higher in terms of credit quality. We think that some areas are going to be just fine, other areas could be subject to some STRIPS, something that we will watch very closely.

Candace Roane:
Chris, you always provide a wealth of information for our listeners. Thank you for joining me today and sharing your expertise.

Chris Johns:
You're welcome. It's good to be here.

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.