Aquila Tax-Free Trust of Oregon

Podcast Transcript

September, 2020

This is Candace Roane with Aquila Group of Funds. Today is September 3rd, and I'm joined by Chris Johns, Portfolio Manager of Aquila Tax-Free Trust of Oregon, which he co-manages with Tim Iltz. Chris also manages Aquila Tax-Free Fund of Colorado. Welcome, Chris.

Chris Johns:
Thanks for having me, 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 for the municipal markets since March?

Chris Johns:
Well, we've seen a remarkable recovery in the muni market after a brief week or two of a very tumultuous price movement in the muni market. We've seen yields decline to new low levels, so I would say it's been very strong., Most of that has been led by investor demand and we also saw the return of banks and insurance companies to the municipal bond market, where they had been absent for a couple of years since the Tax Cuts and Jobs Act reduced corporate taxes. Banks and insurance companies didn't have as much need for munis. but when the interest rates between municipal bonds and treasuries is really kind of disconnected, and we saw muni rates much higher than taxable rates, those two sectors, banks and insurance companies, came back in a very strong way and remain in the muni market.

All that was happening early on in the second quarter, when there was kind of limited supplies, issuers were nervous about bringing new deals in that uncertain market, but since then we've seen supply pickup pretty remarkably and demand has remained very, very high because tax-free rates are still in the two, five and 10 year area, slightly higher than they are in the treasury market. So demand is still very hot for munis. So that's a good sign of strength.

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

Chris Johns:
Well, over the past two or three years in our Fund, our management style has really recognized the fact that risk was becoming mispriced. What we mean by that is we have seen the yield curve get a little flatter where the difference between long rates and kind of intermediate rates was narrower and narrower. Then probably even more importantly, credit spreads. The difference between high rated bonds and lower rated bonds had reached some of the narrowest levels that we've seen in decades. So, for us, over the last two or three years, we had really increased the credit quality of our portfolios and shortened the maturity and duration slightly in the portfolio. When risk presented itself through the form of a pandemic and all the uncertainty associated with that, that style that we use, the lower risk style that we use, held up very well in that kind of market. The sectors that we've invested in over the last couple of years and the quality of bonds that we've invested in held up very well because the revenues behind them are a little bit more certain than some of the more speculative sectors out there.

So, I think the shareholder experience for our Fund was reasonably good. The Fund did what it was supposed to do. We've always been a little less volatile than most of our competition, and then that held true in the very tumultuous times we saw, in particularly March and April.

Candace Roane:
Always good when your planning pays off. Shifting to the Fed's response to events this year, after offering no assistance during the previous financial crisis, the Fed stepped up this year and offered some aid to the municipal market. What was different this time? Can you give us an update on how the CARES Act and the municipal liquidity facility have offered assistance to state and local governments?

Chris Johns:
Well, you're exactly right about that, Candace. That is something that is different this time. In previous market disruptions. The Federal Reserve, even in the last 15 or 20 years, has been very active in the taxable market, but never so much in the municipal bond market. This time they fully recognize the challenges that state and local government was going to have and so they came up with some specific plans to help state and local government. In Oregon, specifically the CARES Act has generated about $1.6 billion in direct funding to the state. The City of Portland receives about $114 million. The airport, Portland International Airport receives about $72 million and our bus and light rail system is receiving about $185 million. Other counties and cities and local governments are receiving direct funding as well. And so that is a new thing that we've seen in the muni market versus other market disruptions.

And then going back to the general, we think that this federal funding has made a difference in state and local finance. It hasn't made up for all the revenue losses that these various sectors are experiencing, but it's definitely made a difference in easing the way a little bit. Our concern will be more a year from now to see what kind of shape the economy is in. If it's not growing at the level that we hope for, will it be a situation where we receive additional federal funding to these various sectors or not? So all this CARES funding has been a great thing for, of course, state and local government, but will it continue?

As far as the Municipal Liquidity Facility, that allows big muni issuers of certain state, cities and large local issuers to borrow money on a short term basis that needs to be repaid to the Fed. So far, that has not been really accessed that much despite some of the lower quality issuers, I believe State of Illinois and then the MTA in New York is the only issuers that have accessed the liquidity facility. So there I would say that it's probably more of a ... it's good that they're there for that, but practically speaking, the pricing of it is a little expensive for most issuers to actually use Municipal Liquidity Facility unless the structure of interest rates changes dramatically over the next few months. We expect that to probably continue. We won't see a lot of use of that facility.

Candace Roane:
Chris, you have extensive experience managing munis, and you've managed them through many market cycles. I want to get your thoughts on the rumors around default. Municipalities appear to be resilient and prepared to sustain any temporary revenue shortfalls, but we're still hearing rumors about default risk. Do you consider those rumors valid?

Chris Johns:
Well, default's a very strong word, Candace. In the Aquila Funds, we've always had a mandate of using investment grade quality in our portfolios. In that space, the instance of default is going to be exceptionally low. So for our Funds, not so concerned about that. I think the way we would describe it is more concerns about potential credit rating downgrades. In any kind of economic slowdown, whether it's a recession or even 10 years ago, the great recession, any kind of economic slowdown, you would expect to see some credit deterioration. We think that will happen. I mean, obviously with revenues being impacted as much as they are in certain sectors, you could see some credit rating downgrades. But you have to remember that before the pandemic started in our State, we were operating at an exceptionally high level of economic performance. I mean, we had record levels of tax collections and the economy is doing very well, real estate is doing very well. So we were coming from a position of strength, which is a real important thing to understand when this hit. So although we may see some ratings downgrades, it's not going to be something that we're concerned about issuers not being able to pay the principal and interest on their bond. Nothing like that. So yeah, there could be credit deterioration, but I think default is a pretty strong word. You will see a nationally for certain enterprise sectors, particularly retirement and assisted living homes and other enterprises that don't have any form of credit support. But that's not the type of things that we use in our Funds.

So generally speaking, we think that issuers are behaving responsibly, they're adjusting their budgets, some of them significantly due to the uncertainty and those adjustments in budgets may come in revenue projections, some have already targeted a certain amount of layoffs that they may have for their department or organization. So they're going to react quickly to this as they have in the past, probably even more so because it's been so abrupt. So issuers, generally speaking, are behaving in a rational, responsible fashion. We think that they'll do the best they can to maintain the credit ratings that they currently have.

Candace Roane:
Let's shift to the Fed now, what type of stimulative monetary policy do you expect going forward this year? News from the Fed this week seems to signal that we'll see more accommodation soon, potentially this month.

Chris Johns:
Well, it's no secret that the Fed has said that they're going to do whatever it takes. So I think it's likely there could be another round of some

type of stimulative activity. It's difficult at this time of year with an election coming up on how exactly that's going to come together, but I think it's likely that there'll be something else. I also think that the Fed has made it very clear they plan to keep interest rates lower for longer this time around and be as accommodative as they can. Some of you may have heard of the concept of yield curve control where what the Federal Reserve would do is target the interest rate on certain maturity in the treasury curve. Say a two year will be at this rate and a five year we want to target this rate and a 10 year and so on.

It's possible they do that, but I think it doesn't speak today. I think that that's unlikely. I think that with all the other measures they're doing, they're going to wait and see how that turns out, but you can be certain that they have committed to keeping the financial markets operating in a rational fashion, and the economy has the ability to recover by their lending. So we think they're going to be on the side of recovery for the foreseeable future.

Candace Roane:
What is your outlook for the muni market regarding new issues and supply and demand as we head into the end of the year?

Chris Johns:
Yeah, that's been probably one of the most important factors that's impacted the muni market this year and I think for the rest of this year. As I mentioned a little bit earlier, a lot of new issuance was kind of put on the sidelines during March and April as issuers were concerned about trying to bring debt to the market at a period when it was very volatile and uncertain the reception they would get. But since then, as interest rates have really declined to new lows in the muni space, we've seen supply pick up pretty quickly and pretty dramatically. We think that will continue for the rest of the year. There's a couple of things that impact that supply. In the state of Oregon, so far this year, we have seen issuance slightly outpace the same time period from 2019. And that's been largely due to several large school bond measures that came, including the big Portland school for a $141 million deal obtained in April and a couple other large school bond issues.

The bigger impact about supply in Oregon really has been the preponderance of taxable issuance in the municipal space. We have seen roughly half of all municipal issuance in Oregon this year as being in the taxable market. And that's driven by the fact that the Tax Cuts and Jobs Act prevented issuers from doing advanced refundings or refinancings of old higher interest rate deals. They were prohibited from doing those in the tax exempt market. So we've seen this dramatic increase in taxable issuance, which for those of us in the tax exempt space makes it harder to get bonds. There's fewer bonds being issued there.

So although the total issuance has been okay, half of it's been taxable, which we do not do use. And we expect that trend to continue. So issuance in Oregon is going to be impacted by that. And we also may see some new bond elections in November that could provide a little bit of relief there. But overall, we think that supply is going to remain tight and demand will remain very, very high for the next six months or so.

Candace Roane:
Let's wrap things up. After everything we've talked about today, are there any sectors that you're watching closely?

Chris Johns:
Yes, Candace, there are. As you know, we think one of our greatest strengths is the credit research that we do in the state. In Oregon, that has really paid off over the last several years. As I mentioned before, when we've moved to the higher quality end of the spectrum, we have remarkably few issuers that are directly impacted by the COVID-related credit challenges. In Oregon, probably the sector we're looking at the closest right now is higher-ed. Now the challenges they face are perhaps reduced state funding, perhaps reduced head counts, which seem to be true as college gets underway again this fall, and then tuition controversies about what they can charge if they're doing online versus in person. So there's a number of challenges, higher ed faces. So we're watching that sector very closely.

And then obviously in Oregon, we also look at transportation, find that agencies got the direct funding I mentioned and are starting to recover in terms of use. And then also healthcare. Healthcare is kind of a hospital by hospital analysis. And so far, the larger hospital systems in Oregon are bearing okay. Also direct funding that they received for COVID related expenses has helped them.

An important distinction to note in the municipal bond issuance area is a general obligation versus revenue bonds. For those issues in our portfolio that are tax backs, which is largely property tax back, those issues hold up very nicely throughout this pandemic. In our portfolio, around 40 to 50% of the portfolio is represented by these tax back issuers. For those in our State, real estate has remained very strong. The value of homes is actually increased from a year ago, and so the credit strength of those issuers is doing just fine as long as real estate values continue to hold up, and we believe they will. So it's important to note that that big percentage of our portfolio in tax back fund is largely unaffected by this pandemic, and that's important to understand.

Candace Roane:
Chris, thank you for joining me today and offering your insight and valuable expertise.

Chris Johns:
My pleasure, Candace, talk with you soon.

Candace Roane:
Absolutely. And I'd like to let all of our listeners know that the articles that Chris and his team provide on the municipal market can be found on the Aquila Group of Funds website at acquilafunds.com. Thank you for listening.

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.