Why High Yield?

Podcast Transcript

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Three Peaks
High Income Fund

Rob Arnold:
This is Rob Arnold, Regional Sales Manager with Aquila Group of Funds. This podcast segment is titled Aquila Three Peaks High-Income Fund, a different approach to high yield. Today I'm joined by the Portfolio Management team of Three Peaks Capital Management, the Sub-Advisor of the Fund. In this podcast segment, we will cover topics such as why high yield, why now, and why the Aquila Three Peaks High-Income Fund. I'd like to introduce Three Peaks Capital Management Founder, CIO and PM Sandy Rufenacht, who has been managing the strategy for over 25 years. Alongside Sandy today is Co-Portfolio Manager, Dave Battilega. They will discuss Aquila Three Peaks High Income Fund, Ticker ATPYX. Gentlemen, thank you for being here to share insight on this time tested high yield strategy.

Sandy Rufenacht:
Hello, Rob.

Rob Arnold:
To get started, let's talk about the high yield asset class, then we'll dive deeper into the stylistic nature of the Fund. The high yield asset class elicits a wide range of opinions from advisors and investors alike. Sandy, at a high level, why is the $1.9 trillion high yield market worth a closer look?

Sandy Rufenacht:
Rob, and I think you touched on it already. One it's a large market, $1.9 trillion, as you mentioned. So it's a very large asset base in terms of its scope. And of course it has larger coupons than other fixed income instruments. The upside comes from the potential of being tendered out of your bond and/or a call feature. Obviously there's more income generation relative to other fixed income sectors, so that would be an attractive feature of the asset class. And then I think probably most important that relative to the equity markets, it's less volatile than the overall equity market.

Rob Arnold:
Yeah, and on that note, a lot of advisors and investors may be surprised to hear some of the names of companies that have finance growth in the high yield market. You have Dell computers, Netflix, and T-Mobile to name a few. Dave, what other well-known highly recognizable names within the high yield space come to mind?

Dave Battilega:
Yeah, hi Rob. It's true that the high yield market is a wide ranging market from an industry perspective and no doubt a lot of well-recognized names. Many people are often surprised to hear that Amazon actually started out as a high yield company way back in the day. In addition to financing growth, the high yield market is also a place where companies can come to reinvent themselves. The poster child for this would be Apple, who was a high yield rated company in the late 90s as they began their journey from a legacy PC company to what we know them as today, they're the largest company in the world. More broadly from an industry perspective, many of the major hospital operators and home builders have grown in the high yield market. Same to for the large casino operators, many lodging and leisure companies have also used the high yield market to finance growth over the years. There's also been a lot of widely recognized retail and restaurant concepts that most people would certainly recognize. A few names in today's market to add to those three that you just mentioned above would include MGM, Hilton, PetSmart, Yum Brands, which owns KFC, Pizza Hut, Taco Bell, and maybe a few others that might surprise people would be Twitter, Carvana, and Uber.

Rob Arnold:
I come from the school of thought, which says there are primarily two levers portfolio managers can push or pull in terms of managing fixed income. A credit lever and a duration lever. Looking at high yield right now, compared to a broadly based index, like the Bloomberg Barclays Aggregate Bond Index, or even the Bloomberg Barclays Investment Grade Bond Index. What would you say to an investor or advisor regarding credit and duration?

Dave Battilega:
We would definitely agree with that thought. In today's environment, fixed income is in a bit of a tough spot with regard to duration, risk, or interest rate risk with the prospects for elevated economic growth and inflationary measures expected to rise. There is certainly a great deal of concern about where treasury yields will go and how that might affect a fixed income portfolio. Historically, the high yield asset classes performed relatively well in a rising rate environment, as it is a market that is more aligned with economic growth in corporate earnings improvement, like the equity market, in that sense. We believe that will continue to be the case in the current environment and think that having an allocation to high yield can help dampen volatility created by further rise and treasury yields, which may continue to adversely impact those indices, such as the aggregate or investment grade index. We've seen this play out in recent quarters with the high yield index, certain high yield market outperforming those other asset classes as treasury yields have risen. And I will caveat that by saying that not all high yield strategies are created equal. It is important for investors to understand that in the current environment as the maturity curve and the credit quality curve, which is the yield or spread differential between higher quality, high yield bonds and lower quality high yield bonds are both relatively flat, which suggests to us that even though we have a favorable view on the asset class currently, one should be mindful that getting too aggressive with credit risk can create a lot of volatility.

Rob Arnold:
Sandy, is there anything specific to what we witnessed in 2020 or what we've seen so far in 2021, which bolsters the case for high yield?

Sandy Rufenacht:
Hey Rob, while it was hard to escape volatility, generally speaking in 2020, the asset class did perform quite well on the downside relative to stocks. The market also functioned quite reasonably. I mean, it didn't really come unhinged despite it being the so-called junk bond market. Furthermore, once the high yield asset class reaches an attractive level, it doesn't take long for that to happen in terms of attracting interest. And that usually comes in the form of fund flows. And I would say that 2020 was a year whereby default candidates that might've been a default candidate even before the pandemic, simply used the pandemic as a reason to pull the default forward. In other words, anybody that was a potential candidate probably ended up going bankrupt in 2020. The rating agencies were quick to downgrade many names. I think they learned their lesson back in the '07, '08 time-frame. Again, they downgraded quite quickly. And then I think by April, May, June, we were already seeing, this is back in 2020 again, we were already seeing record inflows in terms of those fund flows. And obviously that's a function of the asset class looking reasonably cheap from a spread or a yield to worst basis. And then as I mentioned, the fund flows come rushing in and that obviously leads to performance. And so overall the trough to peak period happened quite quickly. And the performance by year end was positive. 2021 has been off to a great start in terms of a lot of different issues. Fund flows continued, but probably more important is the new issuance, it remains very robust and I think that's good for all markets. It demonstrates that capital markets are working and they're working efficiently. We would think that given the rapid downgrades last year, that many names could potentially be mis-rated and then subject to an upgrade this year. So, we have that to look forward to. And then I think, that generally speaking, we have a low yielding environment in all fixed income sectors, and that'll certainly favor the high yield asset class, given the higher yield than other fixed income asset classes. And then as the theme has played out this year, the rising rate environment has certainly led to a great deal of volatility for anything duration or interest rate sensitive, such as the Treasury or the Barclays Aggregate, as you mentioned earlier. And the high yield asset class just simply isn't as duration sensitive. In fact, it's more correlated with the stock market and therefore the economic environment, than it is with interest rates. So overall 2021 looks, as Dave kind of mentioned, to be poised to be a reasonably good year for high yield.

Rob Arnold:
Thank you both for providing insight on the high yield asset class. You know, we've covered why high yield and why high yield now, let's move our discussion to the Aquila Three Peak High Income Fund. Again, that's Ticker ATPYX. Sandy, this podcast is primarily for those listeners who haven't heard of the Fund or who need a deeper understanding of the strategy. As an industry veteran, share the background on why you came up with this particular approach to investing in the high-yield asset class.

Sandy Rufenacht:
Well, in general, I just felt that there was perhaps a group of investors that didn't want to invest in an asset class nicknamed the junk bond asset class. So I set out to try to limit or tame the volatility associated with the overall high-yield market. And frankly, what we're up to every single day is the challenge of reducing risk, that's of utmost importance to us. And of course there's two types of risk, there's interest rate risk or duration risk, and that's the risk of rising interest rates, of course, and then there's credit risk, which is the risk of default. We attempt to balance those two risks out less than credit risk on the one hand while kind of balancing out interest rate risk on the other hand, is our challenge. This gives the investor a reasonably predictable fund product in times of extreme duress. So overall we were really just trying to create a product that would provide stability, regardless of what might be happening, a rising rate environment or something

in the credit markets. We do this by focusing on a higher quality portfolio, a portfolio that is generally really keen on finding companies that are free cash flow generators and paying down debt. And then when we look at that company's cap structure, we try to find a shorter dated bond within the cap structure, so that interest rates don't swing the portfolio around as well. Generally speaking, this was an effort that was targeted towards pension accounts, bank trust, insurance companies, high net worth individuals and the like, recognizing that perhaps they didn't need equity type of risk. On the other hand, it was tough to live with the low yielding environment that we've been facing for a number of years now, going all the way back to the mid to late 90s in general, just, "Hey, how can I find a product that gives me an equity like return potential, but without the duration risk?" And that's why we came up with the strategy.

Rob Arnold:
So now that our listeners have a basic understanding of why you created this strategy, let's walk them through the four investment themes of the Fund, which are limit cyclical industries, limit equity-like securities, conservative risk management, and finally focus on free cash flow. What type of cyclical industries do you tend to limit exposure and why?

Sandy Rufenacht:
By definition, a cyclical company tracks the economic environment. And during periods of more volatile unrest, you can have the cyclical nature of these industries or sectors become quite volatile. This is brought on generally by a rising rate environment that is kind of led or directed by the Fed. And in other words, they raise interest rates and all of a sudden it slows the economy. And if you're an industry or sector in general that tracks the economy, this can be very difficult, especially in terms of supporting leverage. So we want to make sure that we're really not too tied to the economic cyclicality of the overall economy, but rather finding just individual bonds that do what they say they're going to do. And in our case, that's just generally using their free cash flow to pay down debt. The types of industries that would be most known for direct cyclicality would be steel, paper, chemical, autos, restaurants, retailers, and airlines that come to mind. Those are generally sectors or industries that you won't see in our portfolio.

Rob Arnold:
Sandy, regarding the second theme, can you elaborate on a few examples of equity like securities and what are the benefits of limiting them?

Sandy Rufenacht:
Well, Wall Street's notorious for coming up with different types of structures, whether it's a pick bond, a zero coupon bond and the like that really become risky types of structures, and frankly should be more of an equity type of financing. In other words, it's financed in the stock market. But nonetheless, they come up with these types of structures that in my opinion, create a great deal of volatility and they look more and act more like an equity. And again, that would be like a zero coupon bond, a pick bond, a convertible bond, a preferred stock, even emerging market debt. So, generally speaking, we avoid those types of structures because of the fact that when things do become unrest or are not as smooth as we would like to see the economy moving, we all of a sudden see these types of structures look more like the stock market than they do a fixed income instrument. So, therefore we just generally avoid those types of structures to not get caught up in buying securities that are frankly, more equity-like versus bond-like.

Rob Arnold:
That makes sense. According to JP Morgan data, as of 12/31/2020, the triple C segment of fixed income carries greater volatility and less return than the S&P 500 over the last 15 years. Dave, as we look at the third investment theme, conservative risk management, how does the Fund specifically aim to manage credit risk, interest rate risk, and market risk?

Dave Battilega:
Thanks, Rob. We believe having a relatively conservative risk management profile helps limit volatility throughout various economic and interest rate cycles as Sandy has mentioned. The figures are particularly important in an environment like today where current credit yields and credit spreads are relatively low and you're not really getting paid for incremental risk taking on the curve. In addition to Sandy's prior answers, another way we look to manage credit risk is by seeking out management teams that have a desire to reduce debt and want to improve the company's credit rating profile over time and shying away from those management teams that may have a more aggressive policy when it comes to the use of debt and financial leverage. Interest rate risk is a reasonably controllable measure that we use that can really help limit performance volatility. While high yield as a class exhibits less interest rate sensitivity than most other fixed income asset classes. We generally take that a step further by having an even lower maturity and duration profile within the asset class. Additionally, we do look to have a reasonably broad industry diversification while managing both industry and individual name

exposure, so as to not become overly concentrated in any one area. In general, we believe this strategy is constructed year in and year out, more conservatively from both credit risk and interest rate risk perspectives within the asset class. This can be seen in years or periods of increased volatility and stress such as 2007, 2008, 2011, 2015, the fourth quarter of 2018, and then obviously last year - years where the markets got a little volatile and our strategy performed relatively well within asset class. And as Sandy has mentioned, we've focused our efforts on these measures to limit volatility to the extent possible, thereby providing a relatively stable fixed-income product.

Rob Arnold:
The final investment theme of the Aquila Three Peaks High Income Fund focuses on free cash flow, which also entails the use of covenants and an eye toward debt pay down. Sandy, what can you share about why these are important and what it means to the Fund's overall strategy?

Sandy Rufenacht:
Yeah, Rob, good point. Free cash flow is the overriding theme of our efforts in terms of finding companies that have articulated a deep desire to use free cash flow to de-lever the balance sheet. All kinds of good things happen when leverage goes lower - ratings upgrades, the lower cost of capital to the company, and perhaps even the company becomes an acquisition target of a bigger, better capitalized company. Covenants are very important. It's one thing for a management team to suggest they want to de-lever or pay down debt. It's another to agree to a set of covenants that forced that issue. So, they're very important. And as I mentioned, a covenant is something that could force the company to have to take out the checkbook and write a check to pay off bank debt, perhaps, to de-lever the balance sheet. This free cash flow generating type of company that we look for, obviously uses that free cash flow then to meet that covenant requirement. And as I mentioned earlier, improving free cash flow and reducing debt can lead to credit upgrades and a lot of good things and covenants are one way to force that issue. So again, we look for those free cash-flowing companies that have agreed to a set of covenants that forced the de-leveraging aspect. And then again, we believe good things will happen thereafter.

Rob Arnold:
Sandy and Dave, thank you both. It's always a pleasure speaking with you.

Sandy Rufenacht:
Thanks, Rob.

Dave Battilega:
Thanks, Rob.

Rob Arnold:
You bet. For more information on Aquila Three Peaks High Income Fund, please visit www.Aquillafunds.com.

Disclosures:

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

Before investing in a Fund, carefully read about and consider the investment objectives, risks, charges, expenses, and other information found in the Fund prospectus. 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 representative of the entire portfolio.

Mutual fund investing involves risk; loss of principal is possible. Investments in bonds may decline in value due to rising interest rates, a real or perceived decline in the credit quality of the issuer, borrower, counterparty, or collateral, adverse tax or legislative changes, court decisions, market or economic conditions.

Aquila Three Peaks High Income Fund will typically include a high proportion, perhaps even 100%, of high-yield / high-risk securities rated below investment grade. High-yield corporate bonds generally have greater credit risk than other types of fixed-income securities and may be *especially sensitive to economic and political changes or adverse developments specific to the company that issued the bond.*

Risks associated with Aquila Three Peaks Opportunity Growth Fund include but are not limited to, potential loss of value, market risk, financial risk, interest rate, and credit risk, and investments in highly leveraged companies, lower-quality debt securities, foreign markets, and foreign currencies. Please refer to the Fund prospectus for a complete description of risks associated with an investment in the Fund.

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 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 a difference in yield between two bonds of similar maturity, but different credit quality.
Yield-to-worst measures the average of the lowest potential yield that could be received on issues in the Bloomberg Barclays U.S. high-yield Corporate Bond Index, without the issuer actually defaulting.

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.

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.

The Russell Mid Cap® Index is representative of mid-cap stocks. The Bloomberg Barclays US Corporate High Yield Index is an unmanaged index considered representative of the universe of fixed-rate, non-investment-grade debt. The Bloomberg Barclays US Aggregate Bond Index is an unmanaged index considered representative of the universe of fixed-rate, investment-grade taxable debt. The performance of an index does not reflect management fees and expenses, which are reflected in Fund performance. An investment cannot be made directly in an index.