A Careful Approach for Today's Markets

Podcast Transcript

May, 2021

Rob Arnold:
This is Rob Arnold, Regional Sales Manager with Aquila Group of Funds. The title for today's podcast is "A Careful Approach for Today's Markets - Keeping Tabs on Interest Rate Risk and Credit Risk". In today's discussion, we'll tap into the knowledge bank of Portfolio Managers, Sandy Rufenacht and Dave Battilega. Today's agenda provides for updates on the economy, the high yield market and the Aquila Three Peaks High Income Fund. We'll cover topics such as new issuance, fund flows, default rates, along with addressing concerns over rising rates. I'd like to now introduce our guests, Sandy Rufenacht, Founder and Chief Investment Officer of Three Peaks Capital Management and Dave Battilega, Co-Portfolio Manager. Gentlemen, thank you for being here to share insight on what has been an eventful year-to-date, right on the heels of the inarguably wild ride in 2020.

Sandy Rufenacht:
Hi Rob, this is Sandy. Thanks.

Rob Arnold:
Let's tackle today's agenda in three parts. The economy, the high yield market, and the Aquila Three Peaks High Income Fund ticker ATPYX. First up, the economy. Sandy, after what seemed like a full market cycle in the highly compressed period of time during 2020, what tailwinds and challenges does the economy face as we reach the quarter way point into this year?

Sandy Rufenacht:
Yeah, Rob, well, with regards to tailwinds, there are certainly ample amount of tailwind at the backs of any of the credit markets and the high yield market would be one of those. Obviously the economy is improving and it's improving quite quickly. Frankly, it's picking up right where it was prior to the pandemic. We see it in all aspects, whether it's housing or autos or just purchases in general. It seems very robust. Another tailwind might be the low cost of capital and while rates have risen, it certainly is still a very low cost capital environment. We see that through the new issuance within the high-yield asset class. The market has been reasonably wide open for new issuance. And then obviously the administration, the current administration in the White House, along with the House and the Senate are all interested in potentially getting an infrastructure spending bill passed that would certainly add some fuel to the fire. And then I would argue that Operation Warp Speed has been immensely effective. Obviously we're seeing the benefits of this program in terms of vaccinations. And obviously as we continue to roll that out, it seems like the overall market could certainly benefit to the degree it already hasn't. And then lastly, from a tailwind perspective, it does feel like there's just extreme pent up demand from the consumer. Frankly, the consumer just wants to spend and we see it in all aspects of the economy. From a challenge perspective, and obviously this is always a concern when we believe that perhaps the markets are priced at least pretty fairly, if not for perfection, we certainly have to look at all of the potential risk. And these are what we've learned in the past that always kind of surface one time after another. And obviously we'll start with rates. Interest rates have moved higher and perhaps they're even going to go higher. Although we've seen a little bit of a kind of movement around in a little bit of a range recently. The thoughts are that interest rates could go higher, that would certainly not be necessarily good. Fuel cost has risen, this serves as a hidden tax on the consumer and then taxes are set to rise on corporations, and perhaps on the wealthy. All of those serve as taxes or a hidden tax on the consumer. And certainly something we want to pay attention to down the road.

Rob Arnold:
Let's shift our focus specifically into the high yield asset class, several of the more common questions we receive relative to high yield encompass rising rate, new issuance, macro level fund flows, and defaults. Dave, regarding rising rates. The ten-year treasury has risen from a record low closing level of 52 basis points last August, up to 93 basis points at year end, to 1.74% as of March 31st. How has the high yield index performed during the same time period? And how does the high yield, or how has the high yield performance compared to treasury aggregate and investment-grade indicies year to date?

Dave Battilega:
Yeah, thanks Rob. The Bloomberg Barclays High Yield Index has performed well throughout this period of rising treasury yields. The index not only outperformed treasuries, the investment grade index, and the aggregate index, since those August lows and treasury yields,

it's actually produced a positive return, unlike those other indices and many other fixed income markets. Historically, that has been the case that when treasury yields are rising due to improving economic activity, high yield performs relatively well across the fixed income landscape. As it is a market that is a bit more dependent on economic activity, corporate earnings, some of the factors that kind of drive the equity market. During the first quarter, the ten-year Treasury was down a little over 7%. The Bloomberg Barclays Investment Grade Index was down just shy of 5%. The Aggregate Index was down nearly three and a half percent, while the high yield index, again, Bloomberg Barclays High Yield Index, was up just shy of 1%. So it's held in very well against the rise in treasury yields. If yields continue to rise over the near term or throughout the balance of the year because of continued economic strength, we believe high yield can continue to fare relatively well.

Rob Arnold:
With respect to high yield new issuance. During 2020, there was a record setting $450 billion of high yield new issuance compared to $287 billion in 2019. Dave, what did the magnitude of such high new issuance signify and how has the 2021 new issue supply look year to date?

Dave Battilega:
Yeah, it certainly was an active year for new issuance of many companies, now post pandemic period, putting liquidity on their balance sheet in April and May and June, just due to the uncertainty that everyone was facing. And then kind in the second half of the year, once things started to normalize a little bit, we saw extremely heavy refinancing activity as companies became more opportunistic as yields decline. The quality was generally very high in 2020 with a very heavy refinancing component. The elevated pace has continued into this year with March setting a record month of nearly $65 billion and the first quarter setting a quarterly record of nearly $160 billion. I chuckled because last year we were doing monthly record settings and quarterly record settings consistently, so it is continuing. The quality generally remains very good with significant refinancing activity. I think actually close to 80% of that new issuance this year has been for refinancing purposes, but we are starting to see a bit more aggressive issuance to fund acquisitions and levered buy-outs, which is something that we'll have to monitor closely as the year progresses. There's a thought that we could see this activity pick up throughout the year, which may signal elevated risk taking. It's something that when you want to be careful of. But in general, this elevated pace of new issuance over the last year has been a positive for many high yield companies. And really, we think for the overall capital markets, as companies have been able to extend debt maturities, reduce interests costs and create more balance sheet flexibility. This is starting to be noticed by rating agencies who have begun upgrading companies in recent months.

Rob Arnold:
Regarding fund flows, in similar fashion as new issuance, 2020 brought forth a record $44 billion of high yield fund inflows compared to just under $19 billion of inflows at the year prior. But of note May and April 2020 are the two largest months of inflow on record, respectively. Sandy, what does this level of fund inflows tell you about the asset class and further, what does it mean for investors who haven't yet deployed dollars into this space? Are they late to the party?

Sandy Rufenacht:
Well, in general, the asset class became fairly attractive once spreads widened and the yield-to-worst became more attractive from an overall perspective. And the asset class is an asset class whereby on the one hand, you compare it to the Treasury or Barclays Aggregate Markets. And on the other hand too, perhaps the S&P 500. And when it widens out, you compare it perhaps to the stock market, because all of a sudden its yield-to-worst looks perhaps very attractive to the historical return of the S&P 500. On the other end of the spectrum, when spreads tighten and the yield-to-worst is not as generous, the asset class can then be compared to the fixed income asset class, which as we all know has low yielding instruments in almost every other asset class within fixed income. So it's really the attractiveness of the asset class that attracts the fund flows in, and as we just mentioned, you wouldn't have the record setting new issuance in the high yield asset class, if you didn't have the fund flows to fund those new issues. So one leads to the other. The asset class is a very tough asset class to time. It's very difficult, even having done this for a number of years, to figure out when the asset class is too wide or wide enough, or if the asset class is tight or too tight. You just never really know. The asset class looks attractive to fixed income asset classes when spreads are tight, but it looks, as I mentioned, very compelling when spreads are wide relative to the equity market. So, generally speaking, there's always a reason in my opinion, to be involved with the high yield market, especially in a product that perhaps isn't trafficking in the riskier segments of the high-yield asset class, perhaps the CCC bucket, for example. That segment of the asset class can become very unhinged in periods of unrest and frankly, look more like stocks. So if you've got a product that can tame that, in my opinion, it's never necessarily too late to traffic in this asset class.

Rob Arnold:
Dave, let's talk a little bit about defaults. The high yield default rate ended 2020 at just under 6.2% as compared to 2.6% at the end of 2019.

We saw nearly 50 high yield bond defaults in 2020 compared to a total of 27 for all of 2019. And I might add, the Aquila Three Peaks High Income Fund as of most recent quarter, it has never had a bond default. How is the 2021 default landscape shaping up?

Dave Battilega:
Yeah, the market did experience a bit of a default cycle last year, which ended up being much more benign than I think most people were thinking at the onset of COVID. Interestingly, many names that defaulted were already stressed or already had issues prior to the pandemic hitting and use the weakness of the pandemic to go into and restructure. We didn't really see good standing companies that were impacted by the pandemic have issues. Those companies were generally able to access the capital markets to the extent they needed to, to get through the shutdowns. A lot of lodging companies and travel and leisure related companies come to mind in that sense, where there were not very many defaults in those industries. The default rate began to stabilize during the fourth quarter and has improved year to date with the current outlook positive for continued decline in default activity. Reasons for this are improving economic activity and corporate earnings, obviously help alleviate solvency concerns. A strong new issue market has allowed many companies to push out any sort of near term debt maturities and/or create some balance sheet flexibility. Credit rating actions have started to move positive in recent months and distressed debt is at multi-year lows. These are all positive indicators relating to any sort of near term solvency issues. Many high yield strategists believe the default rate and default activity will continue to climb throughout 2021 and into 2022. And we generally would agree with that thought currently.

Rob Arnold:
Finally, let's take a look at the Fund. Retouching upon the topic of default rate, maybe the better question is Sandy, how have you managed to avoid holding a single defaulted bond over the last 25 years?

Sandy Rufenacht:
Well, we'll start with what we don't do. We stay away from risky structures, like PIK bonds, zero coupon bonds. Those are structures that are just telling you the company doesn't have the cash flow to support the leverage to begin with. So we avoid those. And then again, we go back to one of those pillars that we kind of abide by, and that is to avoid the cyclical types of industries or sectors that can become very volatile in periods of economic unrest. In other words, those business models are directly tied to the economic environment and if the economic environment is slowing, or it goes a recession, let alone a pandemic, then it becomes very difficult to support that leverage. So, we avoid those cyclical types of companies. When you combine that with what we do do, and that is to narrow the investible universe down to those industries that we know can support leverage, while focusing on free cash flow and debt pay down, of stories of companies who have articulated a deep desire to pay down debt, you end up with a pretty solid portfolio by weeding out the things that we don't do. And then combining that with what we do do, and that is to try to find a portfolio full of names that have articulated a deep desire to pay down debt.

Rob Arnold:
So, looking back at 2020 and the volatility seen across virtually all asset classes, Sandy, are you pleased with the way the Fund performed?

Sandy Rufenacht:
Yeah. In 2020, the fund performed pretty much exactly as expected. We always structure the portfolio for a slowdown or a recession possibility. Never would have thought that we would hit a pandemic, but that only exacerbated the argument that the way we weed our way through the asset class is very prudent. There are years in the past that we would point to that perhaps were even better. Again, last year was expected just given the shorter duration, higher quality portfolio, but there are years in the past whereby we've seen great deal of volatility and our product performed well. In fact, there's one year whereby the Fund was actually positive in a year where the index was negative. And that's an example of what I'm talking about, just trying to put a portfolio together that can weather storms and obviously a pandemic was quite a storm, and the Fund performed exactly like it would have been expected to last year.

Rob Arnold:
Your year-end commentary highlighted several key areas you were watching. Specifically, an indication that upward pressure on yields may continue, and thus you focused the portfolio in shorter dated bonds of companies, which you believe operate in relatively stable industries. Dave, how has the Fund's positioning responded so far year to date?

Dave Battilega:
Yeah, we believe the Fund has performed well in the first quarter, especially considering the strong out-performance from the CCC

segment, stress names and lower quality names within the index during the quarter. There was very much a continuation of a risk on feel as managers and others dip down to lower quality, higher yielding stuff. The Bloomberg Barclays High Yield Index was up 85 basis points during the quarter with the BB segment of the index actually slightly down, largely due to interest rate sensitivity. And the CCC segment of the index up a little over three and a half percent. During the rising treasury yield and due sell off period that we saw within high yield during the back half of February and the early part of March, the Fund performed well due to our shorter duration focus and targeting bonds that we believe have less than interest rate sensitivity. In the current environment with a reasonably flat maturity curve and credit quality curve, we remained focused on stable credit and industry selection and diligent maturity and duration management. Our hope is that this will continue to provide a relatively stable return profile as we progress through the balance of the year.

Rob Arnold:
And as we approached the crystal anniversary of the Aquila Three Peaks High Income Fund turning 15 years old this coming June, Sandy, what are you watching across the capital markets? And how is the Fund positioned in the current environment?

Sandy Rufenacht:
Well, the capital markets are operating quite efficiently. We've seen pretty robust activity, certainly in the credit markets, whether it's the high yield asset class, the convertible bond market, or the stock market, everything's firing on all cylinders. Obviously the interest rate environment's been a bit of a headwind for duration sensitive or interest rate sensitive asset classes. And that's something that all markets will have to pay attention to as we believe that over the course of time, if interest rates continue to rise, it'll certainly have an impact on other aspects or other asset classes outside of just the duration sensitive types of asset classes. So, certainly something we need to watch. In our case we just simply position the fund on a day-by-day basis, very conservatively which doesn't really change. We've mentioned different types of cyclical types of sectors that we don't traffic in. We eliminate the types of structures that we believe give you undue volatility in periods of unrest. And when we combine that with the great desire to eliminate interest rate risk, we think we've got a pretty compelling product. We took advantage of the pandemic last year in terms of lengthening our duration, perhaps in names that we own shorter duration bonds that we sold and then rolled down to the maturity curve to find bonds that had fallen more precipitously and offered therefore more upside to the degree the markets were to rebound, and that certainly was the case. We've since taken the opportunity to shorten the maturity profile back up from where we were perhaps in the middle of last year and of course the quality is always generally pretty high. So overall, just more of the same. Nice, solid approach, trying to balance out interest rate risk on the one hand with credit risk on the other.

Rob Arnold:
Sandy and Dave, once again, thank you both. It's always a pleasure hearing from you. For standardized performance, updated Fund material and other information, please visit Aquilafunds.com to find more information on the Aquila Three Peaks High Income Fund.

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.

NOT FDIC INSURED | NO BANK GUARANTEE | MAY LOSE VALUE | NOT NCUA INSURED
Aquila Distributors LLC | 800-437-1020 | www.aquilafunds.com