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Tax-Free Trust of Arizona

Aquila Tax-Free Trust of Arizona
Podcast Transcript August 21, 2019

Interviewer:
Hello. This is Matthew DiMaggio. Today we're here talking to Tony Tanner, portfolio manager of the Aquila Tax-Free Trust of Arizona. Thank you for joining us, Tony.

Tony Tanner:
Thank you, Matt. It's good to talk about the Fund and the Arizona muni market.

Interviewer:
I understand summer is typically a time of higher redemptions in the municipal bond market. What is the environment like for individual bond buyers right now considering the scarcity of new issue supply and what advantages do you have as an institutional buyer?

Tony Tanner:
Well, it's a really interesting question because we have seen the typical seasonal contraction of existing supply from bond calls and redemptions. Arizona though is a state that has really bucked the trend from an issuance standpoint. Through the end of August, the issuance in Arizona was up 100% with $4.1 billion of new issues compared to only $2 billion of issues at this time. In fact, the last three months we've seen about $2.3 billion of new issuance in Arizona. And to me that's just a sign that Arizona's towns and municipalities are taking advantage of the opportunity to lock in very attractive borrowing costs. So, we're seeing a plentiful supply of individual bonds in the market and that is certainly helping us from a portfolio management standpoint.

In terms of where we're able to leverage our presence as an institutional buyer, we have on a number of occasions been able to collaborate with underwriters when there has been a small Arizona issue to craft or customize a particular maturity that's well suited to the Fund. Oftentimes these issues we'll have small par amounts and we can encourage the underwriter to combine those into one larger term maturity with better liquidity and then negotiate a coupon structure that is somewhat unique. Maybe we'll do a coupon with a three and three quarter coupon instead of the traditional three or five, and that gives us better coupon diversification and a better yield in the portfolio.

The other thing that it does is that it allows us to have, I think, greater breadth in our portfolio by having a much wider variety of issuers and bond structures. The thing that we have noticed with issuance year to date is nationally the volume of issues is relatively unchanged year over year. We think we've done 196 billion total issued nationally versus 193 billion. And I think it really represents the fact that the quote national muni market is really a market of small localized issuers, and that's where the value of having a portfolio manager within a single state is a benefit.

Interviewer:
All right. Great insight Tony. The Fed recently cut the target rate by 25 basis points. What are your thoughts on interest rates for the remainder of the year and what are your expectations for the yield curve?

Tony Tanner:
Well, when I take a look at the interest rate activity of the last year and Fed policy, the thing that sticks out for me is that the market itself has really done the bulk of the heavy lifting for the Fed. Since interest rates peaked in November of 2018, the yield on the 10-year US treasury bond has plummeted 50% from 3.2% to 1.6% and the yield on the 30-year treasury has dropped from 3.46% to where it's hovering today at just around 2%. And so, within that time we've only seen the Fed had to cut the Fed fund's rate 25 basis points. So, I don't know how much activity we're going to see from the Fed in terms of size of increases. I would expect that they're going to attempt an engineer to right size the Fed fund's rate so that we have a more normally shaped yield curve.

What we've observed in the muni market is that the municipal yield curve from 1 to 10 years is considerably less steeper than it was a year ago. A year ago we were taking advantage of that by adding some longer data maturities to our portfolio. Now we find that the yield curve has relatively flattened throughout, and so, I think we're going to take a wait and see attitude to see how the Fed policy and developments in fiscal and trade policy impact the yield curve. I think that if the Fed is able to engineer stronger economic growth, we could possibly see a re-steepening, but that is unlikely to happen until we get some clarity on the trade and economic front.

Interviewer:
We've had roughly a decade of economic expansion since the great recession. What are your thoughts on where we are currently in the economic cycle and what are your expectations as economic growth slows?

Tony Tanner:
Well, we are certainly at a point where we're part of a very long economic expansion. When you look at our economic expansion globally, there are instances where other countries and natures have experienced even longer uninterrupted periods of economic growth. Australia, I think, has had 27 consecutive years of economic growth without a recession. So, in looking at our economic expansion, one of the things that's important to keep in mind is that the trailing 10 year average annual growth rate of GDP has only been around 2.15%, which is substantially below the 200-year long-term rate that has been closer to 3.5% or 4%.

So, although the economic expansion is of considerable age, I find it hard to characterize it as being overheated. For example, while we have full employment, the labor participation rate of around 63% is near the lowest it's been in 40 years. So, I don't see significant risks to meaningful economic slowing. In terms of expectations around economic growth, we don't really see a discernible impact of interest rates or credit events impacting economic growth. Clarity around trade policy will probably have the biggest impact on economic growth. And currently, with economic growth still mired around 2% and inflation well contained under 2%, I don't see a lot of risk for any sort of meaningful or discernible retrenchment in the economy.

Interviewer:
What is the overall health of the municipal bond market nationally as well as in Arizona? And what are the benefits of investing in a state specific versus national funds?

Tony Tanner:
Well, state and local economies nationwide continue to benefit from the long economic expansion that's been best exemplified by continued across the board growth in state and local revenues, whether it be from excise taxes or property taxes. Here in Arizona, the state just passed a budget with a forecast budgeted revenues record of a little over $11 billion. That's up from less than $8 billion at the outset of the credit crisis 10 years ago. And that included a structural balance of $300 million and the contribution to the state's rainy day fund that takes that to $1 billion. So the overall health of that market continues to be good and I think is supported by very healthy basic fundamentals with little indication of speculative excesses that were a precursor to the last recession in 2007.

In terms of state-specific versus national funds, state-specific funds continue to provide the benefit of double tax free income that in most cases, and in particular in the case of the Arizona Fund, exceeds the rate of inflation. So, on an after tax after inflation basis, you're getting returns from income that are positive, and that's very important. Compared to national funds, I think one of the unique opportunities that single state funds present now versus 20 or 30 years ago is that advisors and investors have a much broader - many to select from when it comes to products that provide exposure to other fixed income sectors and asset classes. And so now an investor and their advisor can better pair and better assemble a portfolio of fixed income instruments that provide high after-tax levels of income and a single state-specific municipal bond fund can be really be that foundational piece in that overall asset allocation.

The other thing that single state fund benefit brings to me is a sense of civic pride and community support. Our Arizona Fund has over 220 different holdings, an average holding size of just over $1 million. And that's because we have a much wider variety of the state smaller issuers. So an investor in our Fund can look at the Fund's holdings and see the impact that they're having on their state and on their community.

Interviewer:
Tell us about your current strategy and positioning in the Fund. Are there any sectors where you found value this year, 2019?

Tony Tanner:
Yeah, in 2019 we continue to find good value in the healthcare sector. We picked up a couple additional names earlier in the year. Healthcare is the Fund's largest exposure at around 18%, and that reflects the ascension of healthcare as a very important driver to economic growth in the state. By a variety of measures, whether it's population growth or income growth or GDP, Arizona's population is growing in a way that a robust 21st century healthcare infrastructure is vital to maintaining the quality of life here. And the municipal bonds that we own have funded several meaningful important hospital projects and healthcare project expansions that contribute to the continued prosperity of the state.

We also continue to find great value in the smaller school district that are throughout the state. The governor's commitment to teacher salaries and providing the 20% overall teacher salary increase that was in the budget has continued. We like those values and we like how the Fund is positioned across those sectors.

Structurally, we've begun to take a more cautious tone from a duration of maturity standpoint with the remarkable bull drop in market yields and tightening of the yield curve such that we have reduced the Fund's average duration by about 1 year to 4.8 years and average maturity from 12 to about 10.5 years.

We believe that the Fund is well positioned for the next phase of events in the shifting interest rate landscape and the continued Fed policy. Now compared to how much farther actual individual bond yields have dropped in the market this year, the Fund's distribution yield and maturity interest rate risk profile may provide investors a very good value proposition for maintaining exposure to fixed income and for being prepared for the next phase of the interest rate cycle.

Interviewer:
Thank you very much, Tony.

Tony Tanner:
Thank you, Matt.

Interviewer:
For those of you listening, before investing in the Fund, carefully read about and consider the investment objectives, risks, charges, expenses, and other information found in the Fund prospectus, which is available on this site from your financial advisor and when you call (800) 437-1020.

Thank you for listening to this podcast.