AQUILA®
GROUP OF FUNDS

AQUILA®
Tax-Free Trust
of Arizona

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

Matthew DiMaggio:
Welcome to another Aquila Group of Funds podcast. This is your host, Matthew DiMaggio. Today, we are speaking with Tony Tanner, a CFA Charterholder and a lead portfolio manager of Aquila Tax-Free Trust of Arizona.

Matthew DiMaggio:
Thanks for joining us today, Tony.

Tony Tanner:
It's a pleasure visiting with you today, Matt.

Matthew DiMaggio:
Let's get started. I'd like to briefly get your thoughts on a few topics from 2019 and then talk about the coming year.

Tony Tanner:
Terrific.

Matthew DiMaggio:
Since 2016, we have seen periods where muni investors have stayed in the sidelines notably from concern over tax reform and duration risk back when the Fed was increasing rates, but 2019 has turned out to be a pretty monumental year for investor demand for the asset class. What would you say contributed to what will likely be record inflows in a year where equity markets have also done well?

Tony Tanner:
Matt, the primary culprit for spurring the demand has been that 2019 was the first year of the limitation on the state and local tax deduction going into effect, and so nothing shines a light on the value of muni tax exemption for investors than does having to write a bigger check to your state government, and so the implementation of the SALT limitation and the impact to such a large swath of investors really shined a light on the value of the muni exemption especially in states like California and New York and Arizona where the state income tax rate matters, and it's really less about the tax rates and more about the fact that just more income is now subject to tax and investors are having a higher effective tax rate, and so munis and, in particular, single state munis provide one of the last genuine, authentic shelters for earning tax-free income. It also was helpful that the Fed initiated a new easing campaign. Investors no longer had to concern themselves as much with the prospect of rising interest rates and diminished value of their principal, but I think it's a situation that helps to remind us that there's always been value in the tax exemption. When we were sitting here a year ago, tax-free yields were at a much more elevated level in the three-and-a-half-plus-or-minus range and were very attractive when you took into account that inflation outlook had been softening. Unfortunately, investors have wanted to remain cautious until there was some clarity around the Fed, and so there were actually outflows this time last year, and it serves as a really good reminder to focus on the value of the tax exemption and the munis placed in an overall asset allocation plan and to avoid the tendency that maybe sometimes market time.

Matthew DiMaggio:
Very thorough insight, Tony. At the end of November, national municipal issuance was up 18% year-over-year, and Arizona's issuance was up an astounding 121% for the same period. Can you talk about any opportunities you found, and have you seen an increase in taxable issuance?

Tony Tanner:
Yeah. It's really been a tremendous year in Arizona in the new issue market. We've literally had a monsoon all year long in Arizona issuance.

Every month, it's literally been raining bonds in the state, and we've already surpassed the previous record in 2016 of seven-and-a-half billion, and so this year will be the highest year of issuance in the state for the entire decade, and so new municipal bonds in Arizona, to say the least, have been very plentiful, which has provided a great deal of variety in terms of different issuer sizes, issuers from across the state and giving especially an institutional investor like a mutual fund a lot of options and flexibility. During the year, I spent a lot of time collaborating with underwriters on a variety of smaller new issues where we were able to, in a lot of circumstances, craft a desirable coupon between three and 4% that gave us a more attractive yield than a 3% coupon or more attractive yield than a 4% coupon, but provided better defensive characteristics than a 3% coupon, so, with the glut of new supply, it really bred a lot of opportunity to be flexible in new issues. During the past calendar year, we had the opportunity to participate in a variety of really value-added small deals across the state. Many of these were for ongoing public works projects, roads, sewers and maintenance, updating of school facilities, and it included bonds in Bullhead City, bonds for school districts in the Mogollon Rim area of the state in Eagar and Pinetop-Lakeside, as well as the community college district and some smaller school districts in the southern part of the state and in Pima County, and that gives us a distinct advantage by being local because we're able to read into what the community support is for these projects and what essentiality is of this issuance to the communities, and so we're really happy to be able to accomplish multiple objectives of crafting a well-designed portfolio that also helps our shareholders support their communities.

Matthew DiMaggio:
Let's touch on rates for a bit, the Fed reversed course this year, and it reduced the Fed funds target rate by a total of 75 basis points, and some market analysts said that the rate markets have started to price in recessionary conditions. Do you agree with that assessment and would you say that credit markets have as well?

Tony Tanner:
The market is certainly pricing in the prospect that we're not going to see an acceleration of GDP to 3% any time soon. In the last 10 years, the average growth rate in GDP has only been around two-and-a-quarter percent, and, in 2020 and 2021, the economy is expected to grow at a slightly slower rate, around 1.7 to 1.8%. I don't see, and we don't really observe significant recessionary concerns. It's hard to have a steep fall-off when you haven't gained very large new heights when it comes to growth, and we continue to see inflation and inflation expectations really in check, which is a huge positive for bond investors because it enables them in many respects to preserve their purchasing power. Again, 12 months ago when yields were much more elevated, we saw a lot of signs that inflation was under control. In particular, the Fed chairman's, one of his favored inflation gauges, personal consumption expenditures were beginning to weaken, and we took advantage of that by extending some maturities to capture those more attractive long-term yields, and we find 12 months later that it's helping us in sustaining our monthly income over the long run. The most current round of cut that we've seen has taken the Fed funds rate back to where the Fed had raised rates in March of 2018, so I think it's really a resetting of expectations that are more in line with the real economic growth and inflation conditions that we're seeing.

Matthew DiMaggio:
There have been several global headlines that have created a fair degree of uncertainty for both the US economy and the outlook for long-term interest rates. Do you see trade tensions, global growth and an election year impacting your market and the Fund, and, also, are there any other risks that you are currently watching?

Tony Tanner:
Those three issues, collectively, we'll probably not see any resolution until we get beyond the election, and until we get some clarity on those three, I expect to see both the economic growth and interest rates to be relatively benign in terms of volatility and fluctuation. Once we get beyond the election where we're going to have some resolution of the trade tensions that we've seen and, hopefully, a resumption of our global growth, there is some potential that we could get an acceleration in the growth of GDP and some firming in inflation, and I think that that would result in what I see as a very healthy steepening of the yield curve. I don't think we'd see short-term rates moving very much as the Fed has kind of telegraphed that it wants to stay on hold for another year, but a modest uptick in long-term rates would be of a positive for the economy and a positive for investors, and we've taken the time in the last 12 months, as we have seen the economy slow and interest rates drop, to better position the fund for that kind of an outcome.

Matthew DiMaggio:
Here's an interesting observation, and we are seeing a large demographic shift with Baby Boomers moving into retirement, and Arizona ranks as the sixth most popular state for relocating retirees, which is only part of Arizona's rapidly growing population. You have recently written about Arizona's population growth and impacts on healthcare. Would you give us an update on the sector in Arizona as well as any other notable trends in the state's economy?

Tony Tanner:
Healthcare and healthcare service continue to be a significant driver of economic growth in the state, and it's very consistent with what we're seeing in population growth. We just had our fourth consecutive year of adding more than a 100,000 new residents, and the state is forecast to add another 105,000 new residents next year. About 85% of those new residents are people relocating from another state, and the people that are relocating here, especially those that are near retirement age, they retire here because they want to be outside in the sunshine and play golf for 20 or 25 years and, in order to do that, they expect and demand a high-quality healthcare infrastructure, and so the trends in the demographics of the state and the economy are very supportive of our holdings within the healthcare sector. But we're starting to see, I think, a more impactful and positive shift in the state's economy, and that is that it's increasingly diversifying and seeing growth in the manufacturing and technology sector.

In the first six months of the year, the state added 2,600 new technology jobs at an average salary of $80,000. The growth rate of the state's technology employment of 40% was one of the highest in the country. At a recent ASU economic outlook luncheon, they cited some very interesting facts that also reflect this shift in the composition of the economy, and that is that Phoenix now ranks as the fourth most desirable city for Millennials to relocate, the other three being in Texas and the other being Orlando, and, not surprisingly, ASU's economic team reported that 25% of all new mortgage originations that occurred in the state last year were by Millennials aged 25 to 34, which is by far the largest age category taking out loans, and so it certainly appears that Millennials are moving into the home-and-house stage of their lives, and given Arizona's attractive business climate, reasonable costs, I expect to see a continued diversification and strong trends in the state's economy.

Matthew DiMaggio:
Thank you for the clarity on that topic. As we wrap up, can you give us an overview of how the Fund is positioned as we enter the new year?

Tony Tanner:
We believe that the Fund is really well-positioned for this current backdrop of an easier Fed that is going to take a long pause and inflation and economic growth that remain relatively subdued. Over the last year, we have actually reduced our average maturity by about a year and our average duration by about the same, and so we're in a position where, as an intermediate fund, the shareholders are compensated enough to not be on the sidelines and are able to earn an attractive rate of income after state and Federal taxes that more than compensates for the rate of inflation, but at the same time, being an intermediate portfolio, is defensive enough that it mitigates a larger degree of the interest rate risk that would be associated with going into a long-term fund, and so we really like the positioning for the current backdrop and for some of the prospective changes that we might see at year end when we get beyond the election.

Matthew DiMaggio:
Thank you for your time today, Tony.

Tony Tanner:
Thanks for having me, Matt.

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.

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.