



Municipal Bond Fund Market Update

PODCAST TRANSCRIPT

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Interviewer:

Hello, and welcome to an Aquila Group of Funds podcast. We're going to have on Tony Tanner, a Lead and Co-Portfolio Manager on three of our in-house state-specific municipal bond funds. Today's a special podcast. We're going to tackle the recent events within the muni market. It's been through a rather unique opening to the year. We'll discuss why and where we go from here. But first, I do want to welcome our guest today. Tony, we really appreciate you being on for this discussion.

Tony Tanner:

Thank you for having me on board today, Phil.

Interviewer:

So, I want to start off by asking a question based on something that was mentioned to me by a financial advisor and it's this: Is it true this January experienced one of the largest monthly increases in tax-free yields in the muni market?

Tony Tanner:

Phil, that's a great question. And with it, I'd like to welcome value back to the municipal bond asset class. And I have to say, it couldn't have appeared at a better time for investors seeking tax-free income. You're indeed correct, 10-year benchmark AAA yields in January rose by 57 basis points. That's the second largest increase we've seen on a monthly basis since the June 2013 "taper tantrum"—the largest being November of 2016, when those yields went up 72 basis points before the election. The surprising thing is that's a larger increase than we saw in March of 2020 at the outset of the pandemic. I want to provide some context on where that leaves the muni market now. Over the last 14 months, since the end of 2020, the average yield on 10-year AAA munis has increased a full percentage point, from 0.7% to 1.7%. And while that might sound like it would have been damaging to muni bond portfolios, the truth is that if you look at high quality intermediate and municipal indices for the last two years, their total returns are relatively flat, even though 30% of those months were negative. And what we've seen is that bond prices, and most bond fund net asset values, have returned to roughly the same level they were about three years ago. And in one of my analysis, it shows that for most bond funds and bond portfolios, only about 30 to 50 basis points of the return for those last three years has come from price change. The majority return comes from income. One of the lessons from that is, you have to give the income time to do its job when it comes to investing in bonds and a bond fund. And now, we're situated with much better income with which to do that.

Interviewer:

Interesting environment for sure. So, I guess the natural next question is the why. How did we get here? What do you believe was behind this recent increase?

Tony Tanner:

Well, for me, the seeds for this increase were sown in the "Build Back Better" story that dominated 2021. Most people would find it surprising that in the middle of this 14-month increase in tax-free yields, that from March 1st to December 31st of last year, bond yields actually declined over those 10 months. And for me, the question around that has been "why?" And to me, one of the main reasons was that the prospects for meaningful changes in individual income tax rates from the new Administration, a topic that dominated much of 2021, created somewhat of a demand mirage in the muni market. It attracted the prospect of permanent increases in the value of munis. Because of higher tax rates, attracted excess demand from a lot of nontraditional buyers. I kind of refer to these people as "crossover mercenaries," and they came in and they crowded out a lot of individual investors. And these were buyers that were not in it for the income and for the long run. They were in it to take advantage of the prospect that we're going to see this permanent increase in the value of munis. This drove muni valuations to substantial premiums. As an example, a little over a year ago, a typical five-year muni yielded only about 16 basis points, which was only 36% of the yield on the U.S. Treasury. Even going out to 20 years, the 1.15% yield on the average AAA muni was only 68% of the U.S. Treasury. Today, those ratios have improved to 74% and 81%, respectively. Put another way, you're getting last year's 30-year yields at this year's five-year maturities. And this is something I identified at a discussion that I had the opportunity to have with J.R. Rieger in December. And that this inaction on individual tax rates was probably the most impactful outcome because it drove out these crossover mercenaries as the yield ratios went up and the values diminished, and allowed value to return now in the form of attractive yield ratios. And so, the tailwind of that tax policy driven price and performance gain has seemed to have run its course.

Interviewer:

Interesting. And I guess my next question is a tougher question. Are there any positive opportunities that some of the recent municipal bond market performance may present?

Tony Tanner:

They do. And the yield ratios I pointed out. I can provide some kind of concrete examples that exemplify how the current level of interest rates offer an attractive entry point. This week, a year ago, when I noticed how expensive munis had gotten in the short-end, I sold a couple positions with 40-month durations at a yield of 31 basis points, which was only about 40% of that particular Treasury yield at the time. Today, there's the opportunity to buy 55-month duration bonds at one and a half percent or 83% of the comparable Treasury. So, what this has done is given a very attractive entry point for those that have been seeking tax-free income, but were worried about the generational lows and rates. The other thing that's done for existing investors is an opportunity to rebalance—take some tax losses and mitigate some risks now that there have been some shifts in the yield curve.

Interviewer:

It sounds like current conditions would create a positive backdrop for Aquila Group of Funds' local approach to managing single-state muni bond funds. And I do want to ask you about that, and we usually talk about that, but I wanted to ask, perhaps, a bigger question. There are a number of ways to invest in the municipal bond markets. So, why mutual funds?

Tony Tanner:

That's a great question, Phil. And the best example I can give is the active management benefit of an open-end mutual fund. One thing that open-end municipal bond fund managers have the advantage of, is using what I consider the complete kitchen of ingredients in order to enhance the main basket ingredients of a portfolio, which are average maturity and credit quality. For example, it's much easier for an active portfolio manager of mutual fund to consider the whole maturity spectrum of the yield curve from one to 30 years. We have the opportunity to look at and incorporate small and frequent issuers into our portfolios and really the opportunity to mine the secondary market for values, which is an area where only 2% to 4% of the muni market ever trades on a daily basis. Municipal bonds are definitely a challenging do-it-yourself asset class, and mutual funds have the capacity to afford investors very broad, genuine diversification and the opportunity to respond to changing market conditions.

Interviewer:

That's great. And now, I'd like to go back to "why local management?" Which I think, in a way, we could say "why Aquila?"

Tony Tanner:

One of the benefits of Aquila Group of Funds' approach to single-state bond management and having the portfolio managers embedded in those states is that, we're really well-situated to exploit the uniqueness of each economy. Here in Arizona, we're seeing not only tremendous population growth, but a real evolution of the local economy. It's transforming to a smart manufacturing hub. And so, there are a lot of strengths to the economy. And the reason I give that perspective is that, when the pandemic came about in March of 2020, we saw the economy shut down, we saw college campuses empty and go remote, we saw the airport locally here become dormant and, at the same time, our hospitals began to get very full. But understanding the nature of the economy enabled us to find some very good values during that sort of March-May period in the immediate aftermath of COVID. Rather than avoiding risk, we thoughtfully engaged risk by buying some select issues in high-quality hospitals, higher education bonds from Northern Arizona University, and even student housing apartments in Downtown Phoenix. And so, our knowledge of the economy and its shift enabled us to take advantage of some very attractive dislocations. And since then, these holdings, which we acquired at around an average yield of 4% and an average maturity of 15 years, have been significant contributors to the income that our portfolio has provided, as well as stabilizing the value of the Fund.

Interviewer:

So, at the end of the day, how does all this leave the municipal bond asset class positioned for investors and their advisors? And what I think I'm asking, in a more point-blank manner is, does this really make sense to buy a bond fund after individual bond yields have increased and prices have declined?

Tony Tanner:

That's sort of the issue that's top of mind for a lot of advisors and investors in a period like now where we've seen a meaningful uptick in yields. And one of the things to consider is, that's a great opportunity to lean in because the risk/return proposition has really improved a great deal. Yes, there might be some further downside, but it's now compensated by much higher after-tax income. It also affords the opportunity to engage in some tax-efficient, after the allocation rebalancing. And so, oftentimes, the tendency and first response is to remain on the sidelines. A good example for us here in Arizona is in the second half of 2018, right in the teeth of the Fed tightening campaign, we took the opportunity to capitalize on some really elevated yields and extend the maturity of our Fund. And this allowed us to mitigate a great deal of reinvestment risk. And I would counsel people that now is a good time to look at the value proposition even though the headlines might be saying otherwise.

Interviewer:

That makes sense. And the last question is, why look at the intermediate range now?

Tony Tanner:

Well, the intermediate range of the yield curve is beginning to emerge as one of the sweet spots within fixed income investing. The yield curve beyond 7- 10 years now is much flatter compared to the last time in June of 2016, which is the last time we really saw steady high-quality benchmark bond yields around 1% in the five-year maturity range. And going back and looking at the

yield curve over that time, today, the difference between 10 and 20-year bonds is only around 24 basis points versus 73 basis points back in June of 2016. The difference between 7 and 30-year maturities is only about 52 basis points compared to 105 basis points in June of 2016. This tells me that an intermediate portfolio position may mitigate some of the interest rate risk ahead without a substantial opportunity cost in the form of lower income. The other thing that this yield curve tells me is that the inflation outlook is still very muddy. And if you look at the history of Federal Reserve interest rate tightening cycles, one of the things that I've discovered is that over four distinct tightening periods, beginning all the way back to 1994, the average increase in the Fed Funds rate was about 250 basis points. Whereas, at the end of that period, 10-year muni bond yields had only increased about 87 basis points to about a third of that. Well, we've already had a 100 basis point increase in 10-year AAA bond yields. And that would suggest the Fed Funds rate going to 3%. And while we've seen a lot of forecasts for higher interest rates, I don't think we've seen anything that dramatic. What I'm really observing in the muni market is this tendency—unlike the stock market to buy the rumor and sell the fact—is to sell the rumor, which is “don't fight the Fed.” But now the market may have sold the rumor enough that it might be time to consider the facts about yields being a little higher and a little more attractive.

Interviewer:

We really appreciate it, Tony. There was a lot of information there; a lot was covered. What is your wrap-up? Or, if you have two or three key takeaways you'd like our clients to walk away with.

Tony Tanner:

First and foremost, value has returned. For how long? That's what's uncertain. But I can say that Aquila portfolio managers are really uniquely situated to exploit the double tax-free income opportunities that are in their state. And more importantly, consider how an intermediate maturity position may present a very compelling risk/return solution for those who have an asset allocation requirement that needs some component of return from tax free income.

Interviewer:

Tony, as always, thank you for taking time out. I found this incredibly insightful, and I hope our clients feel the same way. Thank you and have a great rest of your day.

Tony Tanner:

Thank you too, Phil.

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

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