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Opportunity Growth Fund

Aquila Three Peaks Opportunity Growth Fund
Podcast Transcript March 7, 2019

Interviewer:
Today we're speaking to Zach Miller, Co-Portfolio Manager of Aquila Three Peaks Opportunity Growth Fund. The high yield corporate bond market has been viewed as a leading indicator for the equity market. Do you see any clear indications from the high yield market that might be signaling an equity market trend as we head into 2019?

Zach Miller:
We've seen that the credit markets historically, and the high yield market in particular, have been a very good leading indicator for the stock market. Our team at Three Peaks is regularly talking with analysts and strategists from credit trading desks, as well as analyzing overall trends in the debt markets, and we believe that having an eye on the credit markets gives us a much more well-rounded approach to equity investing, rather than just looking at the stock market on its own.

From a micro perspective, how this looks is that we track the credit spreads of all of our individual stock holdings in the Opportunity Growth Fund. If a credit spread is widening for an individual company where we own the equity, this could be a red flag for the stock and could be a sell signal. And on the other hand, might see credit spreads tightening for an individual company which could signal a lower risk profile and could present an opportunity to buy the stock.

From a macro perspective, Three Peaks is also taking cues from the credit markets to adjust the risk profile of our equity portfolio. And historically we've seen that credit markets will sell-off in advance of equities, leading into a major market sell-off, as spreads widen in order to incorporate a view of increasing risks. And we think that one of the reasons that credit market sell-offs precede stock market selloffs is because bonds inherently have limited upside potential, and credit investors are therefore more concerned about downside protection, while equity investors are perfectly willing to maintain risk during the late stages of a bull market rally. We saw this spread widening precede the large equity market sell-offs in 2008, as well as the market peak of '99 to 2000.

And most recently we noticed that investment grade spreads in the first half of 2018 were widening despite the equity markets continuing to rally in this period. And we took the signal as an opportunity to reduce risk in our equity portfolio during the second half of 2018, which we believe helped the Opportunity Growth Fund outperform our peers during the second half of last year. So far in 2019 we've seen credit spreads tighten in tandem with the rally in the equity markets. And we viewed this as a positive indicator. High yield spreads today are around 450 basis points, which compared to the December highs of nearly 600 basis points off of their respective Treasuries. So this is a positive indicator, but we're also looking at the 10-year Treasury as another indicator within the debt markets. And usually when you see risk assets are rallying, you'll also see a selloff in the Treasury market, which pushes up Treasury yields.

In 2019 we've actually seen the 10-year yield stay relatively flat in a 260 to 270 range, compared to last November when the 10-year yield was at a high of three and a quarter percent. So on the one hand, some people will say that this low yield is because the Fed has put a pause on future rate hikes. But we also think that the Fed wouldn't be pausing these hikes and the 10-year wouldn't be so stubbornly low if the Fed was seeing very robust economic growth. So we've taken all of these things into consideration as we think about the risk profile of the Opportunity Growth Fund at the beginning of 2019. And we're still taking a more defensive approach to the overall portfolio from a risk perspective, while still looking for opportunities for capital appreciation on an individual stock basis. We think the markets will favor this defensive-over-cyclical strategy in this environment. But we also think that if companies are using their balance sheets and their free cash flow for positive shareholder actions, these companies will be able to create value for shareholders, even in a volatile environment. So we're constantly reassessing these views on a regular basis, but we feel really good about where we're positioned today.

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Interviewer:

The Opportunity Growth Fund strategy focuses on free cash flow. What characteristics lead you to the types of companies that you would view as investment opportunities?

Zach Miller:

Yeah, I would say there's three main characteristics that we're looking for in the stocks that we invest in and cash flow is at the center of each of these. First, we're looking for companies that have stable and predictable cash flow generation. We like to see this predictable cash flow because it allows a company to control their own destiny and not be at the whim of the economy or the business cycle. Companies that have predictable cash flow often have high revenue visibility and stable cost structures. And these are the types of companies that we would like to invest in. On the flip side, we typically avoid companies in very cyclical industries, such as paper, chemicals, airlines, autos and retailers. And cash flow from these companies is often dependent on the economic cycle and many of these companies might have negative free cash flow during an industry slowdown or economic recession.

So we want to have this stable and predictable cash flow, and then the second characteristic that we look for is companies that are deploying their cash flow in a prudent and favorable manner for shareholders. This might include reinvesting back into the business, making accretive acquisitions, paying down debt, buying back stock or even paying dividends. And these uses of cash flow can help grow the business over time, while also appropriately stewarding shareholders' capital in an efficient balance sheet.

And this leads to the last characteristic that we look for, which is that companies are utilizing their balance sheet in a prudent manner. If a company is generating predictable free cash flow and appropriately deploying that cash flow, we think that shareholders could benefit from having an optimal amount of debt on the balance sheet. And when we say optimal amount of debt, what we mean is looking for companies who can use their balance sheet to maximize return on equity while minimizing financial risk and also, optimizing their flexibility for future investment opportunities. We think companies can do this by targeting what we consider an optimal leverage ratio. That's going to be different for every company, but companies can use this leverage in a way that flexes over time to the appropriate level and one example of this might be to use the balance sheet to make an acquisition, but then quickly pay down debt to get back to that optimal range. Now if companies take on too much debt, they increase the financial risk and reduce their balance sheet flexibility and that's something we don't like to see. And so, for each stock that we own, we have an out-of-bounds leverage ratio that if leverage gets above a certain level it's a sell signal for the stock.

So we believe that companies that are doing these three things with having predictable free cash flow, deploying that capital – that cash flow, along with utilizing the optimal balance sheet, these are going to be positives for long-term stock appreciation.

Interviewer:

What aspects of the research process for this Fund do you feel are most distinctive?

Zach Miller:

Research is a very central part of the investment process at Three Peaks. We believe we take a distinctive approach to research that allows us to find attractive opportunities that match up with the characteristics that I just described earlier. And one of the ways that Three Peaks differentiates our research is what we call the 'Three Peaks extra mile'. This is research that goes above and beyond what we believe other firms are doing.

An example of this is, one of our analysts regularly visits a large auction site for construction equipment and has conversations during the auction with buyers, and sellers and listens to their views on the economy and the business cycle. And then after these auctions, he goes back and compares the prices that some of this large equipment was selling for. Some of these pieces of equipment can sell for $1 million and so, he's comparing these prices to how that equipment has sold in previous auctions. And then this research, marrying that qualitative and quantitative approach, can give us a lot of views on the economy, including seeing the strength of new construction or the state of the agriculture industry or even the willingness of banks to lend for large capital projects.

Another example of the 'Three Peaks extra mile' is our coverage of a company called Ryman Hospitality. Ryman owns some of the largest convention hotels in the U.S. and recently opened its latest property in the Denver area. During the construction process of this hotel, Three Peaks was constantly monitoring every step. We attended meetings with the Aurora City Council, where Ryman received the sales tax incentives to begin this project and during the construction phase of the projects, we were meeting with project managers and sales managers to ensure that the hotel would be completed on time and on budget. Then even after the hotel opened in December, our team has gone out to visit the hotel and stay at the property multiple times, and make sure that the opening has gone smoothly by talking to employees and other people who are staying at the hotel. And it was actually right around the time that the hotel opened that we noticed that there were other investor groups that were going to this property, but they were being part of a group that was sponsored by a large investment bank.

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And so, it really speaks to the fact that we were doing this research before other investors were doing it, and we were doing it on our own as opposed to utilizing banks and other resources like that. So these are just a couple examples of some of the lengths that Three Peaks will go in order to gain an edge in our research.

Interviewer:

Recent economic reports have been positive with high employment, stable inflation, good corporate earnings reports and positive consumer sentiment. Are these factors sustainable through 2019?

Zach Miller:

There have been a lot of positive economic indicators recently and we pay attention to all of this incoming economic data. And since the end of last year, we think the market has really been focused on three big things; that's the Fed, China and earnings. And with regards to the Fed, in December, we saw the Fed pivot pretty dramatically from their data dependent course of rate hikes towards a now more patient Fed that might not hike rates again in this cycle. And many blame the Fed's aggressive tone in September and October of last year on the volatility that was experienced in the markets during the fourth-quarter. And then late in December, when they pivoted towards a more dovish stance towards monetary policy, the market really liked to see this and that really helped spark the rally that we experienced.

China has also been a major focal point as a trade war between the U.S. and China would have very major consequences. In 2019, there seems to be more signs that President Trump will come to an amicable agreement with the Chinese that will remove the threat of tariffs that the U.S. has partially implemented. However, this is still an uncertainty. But the market is also rallying in advance of a deal because we think investors believe that this will eventually happen.

Lastly, investors have been focused on earnings in 2019, even slowing growth around the world and the impact that the Fed and China have also played in this as there's been concern that companies might give cautious guidance, taking in additional interest rate hikes or tariffs on Chinese goods in 2019. And so, with some of those risks less likely this year, the markets have been pretty positive for the earnings reports that have come out. And so, investors have been cheering these reports and typically, the stocks, when they report earnings, have been trading well. And so, we see these as signs that perhaps the Fed, China and earnings are less of a concern right now in investors' minds. Going forward, the question is, will these elements be sustainable and while I don't have a view of any material changes from what the market is expecting, relative to the Fed, China and earnings, I think there is still a good amount of debate as to where we head from here.

And on the one hand, I think credit markets have signaled positive things with the rally in credit spreads and we're also watching all of these economic data points and potential uncertainty out of Europe and other places in the world, and just having a balanced approach to how we view risk. We believe that what we're doing though is prudent, to focus on more defensive companies now, that are deploying their free cash flow for shareholder-friendly things, while also utilizing their balance sheets in an optimal manner. And we think that this approach that we bring to investing will allow us to find great ideas. It can perform well, even with volatility in the markets.

Interviewer:

Thank you very much. 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.