

# AQUILA THREE PEAKS OPPORTUNITY GROWTH FUND PORTFOLIO MANAGER COMMENTARY

March 31, 2012

The first quarter of 2012 produced strong returns from the equity markets. Improving employment trends coupled with improved consumer confidence sparked a shift in investor risk appetites during the quarter. In addition, and important to our universe of high yield companies with public equities, the high yield asset class performed exceedingly well for the first quarter. Record quarterly new issuance and mutual fund inflows helped propel the Barclay's High Yield Index to a total return of 5.34% for the quarter. Key metrics that define the health of the high yield market, including bond yield spreads, default rates, and distressed debt remained positive throughout the quarter. When combined with a low rate environment and slowly improving economic data points, the equity market was able to produce its best first quarter since 1998. However, many issues remain prevalent that could dampen the domestic U.S. growth rate going forward, including rising gas prices, inflation, rising interest rates and European sovereign debt concerns. These concerns are at the forefront of our modeling process and selection of securities, as significant upward movements in energy prices and other goods and services could potentially take a toll on consumer confidence, thereby hindering discretionary spending and slowing economic activity. While the equity markets are off to a good start in 2012, there is still a strong debate as to whether U.S. GDP can increase faster than 2.0% this year and whether corporate earnings can continue to outperform expectations. We continue to rely on our internal research checks, management team visits and constant "kicking of the tires" by visiting our companies' properties, plants and other assets, all in an effort to help us construct what we believe to be a unique strategy in the equity world due to our credit-oriented stock selection process. With this backdrop, we continue to look for fiscally responsible management teams that are improving their credit metrics and paving the way for potential equity appreciation as a result of balance sheet improvements.

## **Performance Overview – First Quarter 2012**

The Russell 3000 Index returned 12.86% in the first quarter. The gains were relatively consistent throughout the quarter with January +5.04%, February +4.23% and March +3.08%. The Aquila Three Peaks Opportunity Growth Fund Class Y shares (ATGYX) posted a positive 12.60% return for the first quarter. The Fund is primarily composed of the equities of high yield credits that are either currently owned or were previously owned in the Aquila Three Peaks High Income Fund. Thus, the objective of finding cash flowing companies that are engaged in improving their leverage profile is our principle thesis. We generally avoid the same industries in the Opportunity Growth Fund as the High Income Fund avoids, including financials, autos, airlines and other highly-cyclical sectors. To give further perspective on levered equities, the Credit Suisse Levered Equity Index produced a positive 14.86% return for the first quarter. While we don't compare directly to this index, it does encompass all high yield credits with public equity.

## **Market Commentary – March 2012**

In our last several commentaries, we have been highlighting how a potential rise in interest rates could drive mutual fund flows away from interest rate-sensitive fixed income funds and into equity funds, thereby driving stock prices higher. We feel that the Treasury yield curve can be helpful in anticipating a shift in fund flows. The most telling movement in interest rates occurred during a two week period in March when the yield of the 10-year Treasury widened nearly 45 bps to 2.38%. While this 2.38% 10-year yield was still considerably lower than the 3.73% yield seen at its peak in 2011, we believe this movement was indicative of a shift in risk appetites. In our opinion, the potential for sustained economic growth and inflation could ultimately lead to higher interest rates going forward, which could drive a shift of fund flows into equity funds. We will be watching the yield curve closely to gauge the likelihood of shifting flows out of Treasuries and duration-sensitive securities and into the equity asset class. If the U.S. economy does in fact generate stronger than expected GDP growth rates for 2012, we would not be surprised to see a fairly swift rise in interest rates, regardless of Fed policy. We believe a moderate amount of growth would benefit both our high yield and equity portfolios.

To change gears slightly, another important metric this quarter was the effect that Apple Inc.'s stock had on the quarterly return of the S&P 500 and other equity indices. According to Barclays Capital, Apple contributed 13% of the total return of the S&P 500 during the first quarter. Barclays notes that this was the first time since 1991 that a single stock has had such a large contribution on the S&P 500's return. We highlight this because the Opportunity Growth Fund does not typically own any of the very large names that are commonly held across most growth equity portfolios, such as Apple. Despite the significant contribution that Apple had to the S&P 500's 12.6% return for the first quarter, the Opportunity Growth Fund matched the performance of the S&P 500 due to our credit-oriented focus on finding companies that are improving their balance sheets. If Apple were to have a period of sustained downside due to company-specific issues, we would expect to correlate negatively to this driver of index performance.

Overall, we have seen a remarkable period for high yield issuance which can have positive ripple effects in a portfolio like Opportunity Growth because our companies are refinancing higher coupon debt with lower coupon debt while extending maturities significantly. This reduces interest expense and drastically reduces default probabilities and firm-specific risk. In certain instances, high-quality high yield issuers have been able to issue debt with coupons in the 5% area. As well, the overall high yield market has seen leverage move lower, which is important to shareholders as it allows companies with lower leverage to more fully utilize their balance sheets to increase shareholder value. In our opinion, our focus on the credit perspective of these companies should provide us with earlier signals as to when these shareholder-friendly actions could occur.

### **Important High Yield Metrics**

Since we derive our equity ideas primarily from our high yield expertise, we believe monitoring the health of the high yield market is of paramount importance. Thus, we will be highlighting important aspects of the high yield market on a quarterly basis, as we believe it helps clarify the backdrop for the equities we own. The stocks we generally focus on have high yield balance sheets or at least some component of leverage.

**Spreads** – High yield bond yield spreads declined during the first quarter by 110 bps to end at 644 bps. The combination of a move higher in interest rates, as a result of some better-than-expected economic data, and continued credit strength from high yield companies helped to compress bond yield spreads. Should economic data remain positive with U.S. GDP growth continuing to indicate a 2.0-2.5% increase for the year, we would expect yield spreads within high yield to remain steady, if not decline further. At 644 bps, bond yield spreads compare favorably to the 25-year average of 585 bps and the 2005-2007 timeframe when spreads trended in the 300-400 bps range.

**Default Rate** – The default rate remains historically low at 1.9%. In March, only one company defaulted for \$143 million. The strength of the new issue calendar and the strong inflows into the asset class are helping to keep the default rate below its historical average. This also is a very popular metric to gauge the risk premium demanded by the asset class. When defaults rise to higher levels, the risk premium also rises in high yield. Today's 1.9% default rate signals a healthy environment.

**New Issue Review** – The first quarter set a new quarterly record for issuance with \$107 billion. This was the highest quarter on record and highlights several points. 1) High yield is one of the most active areas within all capital markets. 2) High yield equities (our companies) are seeing continued balance sheet improvement. 3) The low rate environment has created a windfall of inflows for high yield. We will be watching intently to gauge any deterioration of the new issue calendar or if issuers are using proceeds for overly aggressive purposes. More aggressive high yield new issuance may benefit the equity of high yield companies as it may indicate more shareholder-friendly activity is occurring either from increased share repurchases and dividends or acquisitions and leveraged buyouts.

### **Balance Sheet Improvement**

We continue to search for companies which have fiscally prudent management teams who recognize that they can improve their equity valuations by focusing on credit specific measures. These improvements include reducing the company's leverage ratio (reducing debt relative to cash flows) and increasing the

company's coverage ratios (increasing cash flows relative to interest expense). As these metrics improve, it can lead to better credit ratings which may lead to a lower cost of capital. In addition, credit improvement can also take the form of using high yield bonds to refinance existing debt in order to extend maturities, secure lower coupons or possibly to remove restrictive covenants. While these factors are not always the primary focus of many equity analysts, we believe our high yield process for finding improving high yield bond stories leads us to these types of improving equity stories. A high percentage of the companies owned in the Fund have undergone fundamental balance sheet improvement and laid the groundwork for what we believe is a migration to higher stock values. Several of our companies have been so successful at balance sheet improvement that their debt has been upgraded to investment grade.

Covenant analysis brings a very distinct advantage to our research in stock selection. Frequently, high yield issuers have maximum leverage ratios, minimum coverage ratios and restrictions on the amounts of stock they can repurchase or dividends they can pay out. These covenants can change as companies' financial strength and credit ratings improve which may impact corporate decisions that could lead to higher stock values. We will continue to emphasize in our research the covenants within our high yield equity stories, as we believe this analysis is unique and sets our strategy apart from other equity managers.

We believe bond yields can also be an important piece of the equity valuation puzzle. From a company-specific point-of-view, it is our belief that declining bond yields can signal good opportunities to buy a company's equity, and conversely, rising bond yields can indicate credit concerns and therefore serve as a good signal to sell a company's equity. We monitor the bond yields of all names in the portfolio, which adds another layer of depth to our differentiated stock selection process.

As previously mentioned, we will be taking cues from the high yield market and other fixed income markets, including spreads, defaults, the Treasury curve and the new issue calendar, to help us decipher the equity landscape. Our rigorous high yield research process, which includes company visits, frequent communication with management teams and detailed models, helps our investment team uncover new equity ideas. We believe that our credit-focused research process, in addition to the positive economic indicators that we are seeing, provides the Aquila Three Peaks Opportunity Growth Fund with a positive backdrop as we continue through 2012.

#### Performance as of March 31, 2012

	Cumulative Return		Average Annual Return					Inception Date	Max Sales Charge	Max CDSC	Total Operating Expense	Net Expense Ratio
	1st Qtr 2012	YTD	1 year	3 year	5 year	10 year	Since Inception					
A Shares NAV	12.52%	12.52%	0.11%	22.87%	-1.03%	3.96%	6.57%	7/25/94	--	--	7.25%	1.50%
A Shares MOP	7.72%	7.72%	-4.16%	21.10%	-1.89%	3.51%	6.28%	7/25/94	4.25%	--	7.25%	1.50%
C Shares w/o CDSC	12.33%	12.33%	-0.68%	21.94%	-1.78%	3.19%	4.90%	5/1/96	--	--	7.95%	2.25%
C Shares w/ CDSC	11.33%	11.33%	-1.67%	--	--	--	--	5/1/96	--	1.00%	7.95%	2.25%
Y Shares	12.60%	12.60%	0.39%	23.20%	-0.76%	4.24%	5.89%	4/30/96	--	--	6.95%	1.25%
Russell 3000	12.87%	12.87%	7.19%	24.26%	2.18%	4.67%	--					

*For Internal/Broker Dealer Use Only*

*April 2012*

*Before investing in the 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, and when you call 800-437-1020 or visit [www.aquilafunds.com](http://www.aquilafunds.com).*

*Performance data is based on past performance and does not guarantee future results. Current performance may be*

*higher or lower. Data current to the most recent month end is available at 800-437-1020 or [www.aquilafunds.com](http://www.aquilafunds.com). The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Total return calculations include changes in share price and reinvestment of dividends and capital gain distributions in a hypothetical investment for the period shown. Class A shares have a maximum sales charge of 4.25%; Class C shares have no initial sales charge, but a 1.00% contingent deferred sales charge applies to Class C shares redeemed within 12 months of purchase. Class I and Y shares have no initial and no contingent deferred sales charge and are available only through certain financial institutions. An explanation of the share classes appears in the Fund prospectus. Management has contractually undertaken to waive fees and/or reimburse Fund Expenses through April 30, 2013. Returns would have been less if full management fees and expenses were applied.*

*Information contained herein has been obtained from sources we consider reliable, but its accuracy is not guaranteed. Any opinions expressed are based on the interpretation of data available to Three Peaks Capital Management, LLC and are subject to change at any time without notice. This report is for informational purposes only and is not intended as an offer or solicitation for the purchase or sale of a security. The Russell 3000 Index measures the performance of the largest 3000 U.S. companies representing approximately 98% of the investable U.S. equity market. 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. The Members, Officers and Employees of Three Peaks Capital Management, as a policy of the firm, are required to disclose and report investments in reportable securities as defined in Rule 204A-1(e)(10) of the Investment Advisers Act of 1940. Three Peaks Capital Management, LLC may from time to time buy or sell securities of companies mentioned in this report for its advisory clients. Aquila Investment Management, LLC, as well as certain of its Investment Companies or Investment Advisory accounts, may own the Securities being reviewed or recommended in this report. Aquila Investment Management, LLC and others associated with it may from time to time have long or short positions and effect transactions in the securities of companies mentioned in this report.*