



AQUILA  
GROUP OF FUNDS®

# Hawaiian Tax-Free Trust

## Investment Commentary

January, 2012



### Fund Facts

#### Portfolio Management Team

Stephen Rodgers, CFA®  
Janet Katakura  
Denis Massey

#### Inception Date

2/20/1985

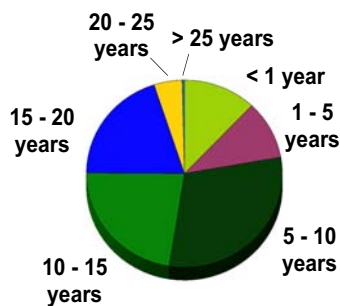
#### Assets Under Management

\$850.7M (as of 12/31/11)

#### Number of Holdings

233 (as of 12/31/11)

### Maturity Allocation (as of 12/31/11)



### Credit Ratings <sup>1</sup> (as of 12/31/11)

|             |        |
|-------------|--------|
| VMIG1       | 4.47%  |
| AAA/Aaa     | 2.43%  |
| Pre-Ref/Esc | 9.63%  |
| AA/ Aa      | 71.08% |
| A/A         | 8.95%  |
| BBB/Baa     | 2.33%  |
| Non Rated   | 0.37%  |
| Cash        | 0.72%  |

### 2011 Market Review

Last year brought many financial stories that were fodder for a media circus. The United States government came within hours of defaulting, certain municipal governments now have higher credit ratings than the Federal government and the Federal Open Market Committee reintroduced monetary policy from the 1960's in an attempt to spark economic growth. However, the most exaggerated story was a statement made by a banking analyst in 2010 claiming "hundreds of billions" of municipal bonds may default in 2011. Investors were unduly frightened by the unusual market volatility of a normally staid asset class, but the municipal credit based defaults proved significantly milder than suggested by the financial media's initial headlines. This "Headline Risk," took a toll on the municipal marketplace early in the 2011. Although distinct from credit risk, Headline Risk increased investor concerns, causing investors to exit the municipal market at an inopportune time as bond prices decreased and yields rose. Rising state revenues, meaningful expenditure reductions and attractive relative yields have overcome most fears and investors have returned to the municipal bond market.

Ironically, the impending default risk of the Federal government proved less troublesome to the municipal market than the aforementioned Headline Risk. A last minute deal avoided a default, but the spectacle raised the eyebrows of citizens and investors questioning the ability of our Federal government to make decisions about national debt and budgeting issues. The resulting effect on the municipal bond market is difficult to quantify since the event was spread over a long period of time and largely priced into the market by the time it ultimately unfolded. The resulting damage inflicted on the credit side was felt primarily by certain state and local governments dependent upon Federal appropriations.

On August 5, 2011 Standard & Poor's downgraded the long-term sovereign credit rating of the United States for the first time. The rating was lowered one notch from AAA to AA+ and was largely attributed to the instability of American policymaking, specifically the partisan fight over raising the nation's debt ceiling. The market, in general, still views the nation in a triple-A light with Moody's Investors Service affirming its Aaa rating and Fitch Ratings maintained the Nation's sovereign debt at AAA. S&P analyzes state and local government credit quality independent of the Federal government, placing certain state and local governments in higher ratings categories than the Nation for the first time in history. The negligible reaction of the municipal bond market to S&P's downgrade demonstrates the resiliency of the municipal bond asset class. Furthermore, the effect on Hawaii municipal bonds has been minor; the primary result being increased scrutiny of credits relying upon Federal appropriations. Nevertheless, the downgrade of our Nation's credit rating reinforces the value of deep credit research and a disciplined approach to portfolio management.

The Federal Open Market Committee continues its efforts to reinvigorate the economy, this time with Operation Twist designed to lower yields on long-term bonds through the purchase of \$400 billion of longer-term Treasuries, and sale of \$400 billion of Treasuries that mature in three months to three years. The "twist" term refers to early 1960s-era operations wherein the central bank sold shorter-dated securities and bought longer-dated securities in an effort to drive down long-term rates and stimulate economic growth. The policy goal is to make home and business loans more attractive to encourage home purchases and business expansion. At the very least, we believe this policy will keep long-term rates on Treasuries low and have a corresponding effect on highly rated municipal bonds forcing investors who are seeking higher yields to look further out on the yield curve.

<sup>1</sup> 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 the underlying bonds in the portfolio. Where the independent rating services differ in the rating they assign 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/Escrowed bonds are issued for the purpose of retiring or redeeming an outstanding bond issue at a specified call date. Until the call date, the proceeds from the bond issuance are typically placed in a trust and invested in US Treasury bonds or state and local government securities. Non-rated bonds are holdings that have not been rated by a nationally recognized statistical rating organization.



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### Municipal Overview

Hawaii's economy continues to move slowly toward recovery. FY 2011 closed in June with a positive year-end balance for the state's general fund. The unemployment rate has held steady for the past several months and continues to fall well below the national average. In November, the Hawaii unemployment rate was 6.5%, while the national rate was 8.7%, and the Honolulu rate was 5.7%. Tourism was expected to struggle after the tragic Japanese earthquake and resulting tsunami in March, since roughly 18% of tourists in 2010 were from Japan. As expected, there have been fewer Japanese tourists, but the loss has been somewhat offset by a growing number of visitors from China and Korea. An additional 89,000 airline seats are expected to be added to Hawaii bound flights in the first quarter of 2012; the largest quarter-over-quarter increase in over a year. Honolulu is attracting prestigious international events. The Asia-Pacific Clean Energy Summit was held at the end of August, and the city hosted the Asia-Pacific Economic Cooperation Leaders Week in early November, which brought in approximately 20,000 attendees and provided global media coverage. The Pro Bowl and several professional golf tournaments are expected to contribute to keeping tourism steady in 2012.

Hawaiian municipalities appear to be managing their finances well. The state has been lagging on revenue expectations, but reported year-over-year revenue growth for FY 2011 as well as an increase in general fund spending. For FY 2012, the state expects revenue to grow by 11.2% and general fund spending by 10.3%.

After an expected lull in issuance this calendar year, the State of Hawaii issued a tax-exempt municipal bond deal in mid-November. The issuance was large for the state totaling \$1.3 billion. New funding comprised sixty-two percent of the deal, or \$800 million. The remaining \$500 million provided refunding for existing issues. Total new issuance in Hawaii for 2011 was \$2.3 billion, down from \$2.9 billion in 2010. New issuance is likely to be lower for 2012.

Hawaii is expected to continue on the recovery path going forward, though there may be a few bumps in the road. Although healthier than many other states, Hawaii faces some of the same problems including a stagnant labor market, slow income growth, limited construction and potential increases in travel costs. The state's economy will likely be affected by global events more than other states since it relies heavily on tourism and imports. For example, oil price fluctuations are translated into the end cost of almost all goods and services in the state. As the global economies strengthen and move toward a path of sustained recovery, tourism should continue to rise, lifting sales and income tax revenues for the state. Projections by the state legislature suggest revenue collections will return to the 2008 peak in FY 2012.

### Portfolio Review

Hawaii saw a significant amount of bonds maturing over the summer months which consequently left Hawaiian Tax-Free Trust with a larger than normal cash position in a low issuance environment. A portion of the cash position from maturing issues was redeployed into the recent large Hawaii State GO deal, as well as a deal from the Hawaii Department of Transportation Airports Division in September, a deal from the Honolulu City and County Wastewater System in October and a Hawaii Housing Finance and Development Corporation deal that was issued in November. Hawaiian Tax-Free Trust also invested a portion of its cash balance in a Hawaii Department of Transportation Highways Division deal that was issued at the end of November.

The Trust's duration was extended over the first few quarters of 2011 to capture yield. We expect duration to remain slightly longer than the benchmark as cash is utilized to purchase longer bonds and take advantage of slightly higher yields in the existing low rate environment. In the current market, we remain comfortable with Hawaiian issuers and look to maintain a relatively high level of tax-exempt income, together with reasonable principal preservation.

### Symbols and CUSIPs

|         |       |           |         |       |           |         |       |           |
|---------|-------|-----------|---------|-------|-----------|---------|-------|-----------|
| Class A | HULAX | 420016107 | Class C | HULCX | 420016206 | Class Y | HULYX | 420016305 |
|---------|-------|-----------|---------|-------|-----------|---------|-------|-----------|

*Before investing in the Trust, carefully read about and consider the investment objectives, risks, charges, expenses and other information found in the Trust 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).*

**- NOT FDIC INSURED - NO BANK GUARANTEE - MAY LOSE VALUE -  
NOT NCUA INSURED**

For more information on this fund and the entire Aquila Group of Funds, please visit [www.aquilafunds.com](http://www.aquilafunds.com)  
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