



AQUILA
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Churchill Tax-Free Fund of Kentucky

Investment Commentary



CHURCHILL
TAX-FREE FUND
OF KENTUCKY

January, 2012

Fund Facts

Co-Portfolio Managers (PM)

Royden Durham (since 9/2011)
Todd Curtis (since 4/2009)

Inception Date

5/21/1987

Assets Under Management

\$247.6M (as of 12/31/11)

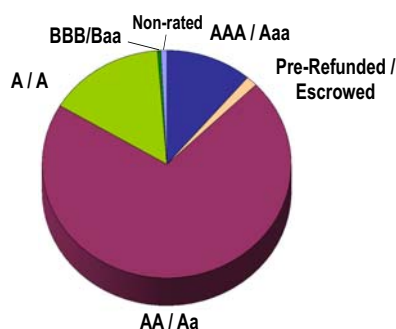
Number of Holdings

181 (as of 12/31/11)

Maturity Allocation (as of 12/31/11)



Credit Ratings ¹ (as of 12/31/11)



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," has taken a toll on the municipal marketplace. 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 Kentucky 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.

¹ 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

Kentucky's fiscal situation has been improving steadily over the past year. From a revenue perspective, personal and corporate income tax revenues were both up for FY 2011, while sales tax revenue was below estimate. Other than a gap in Medicaid funding that was resolved in the spring legislative session, the budget was in good shape. The state finished FY 2011 with a \$120 million surplus that was deposited into the Budget Reserve Trust Fund, which had previously been depleted. So far FY 2012 appears to be on track. The state revised up the estimates for personal income tax and corporate income tax and both appear to be on target. General sales tax was revised down slightly for FY 2012 and also appears to be on target. No budget gaps exist at this time, and the projected return to peak revenue collections for the state is FY 2012.

Although revenue is growing, it is not increasing at a pace that will offset the loss of federal stimulus funds that were available in the current budget, which leaves future funding issues that need to be resolved. Governor Steve Beshear proposed a budget earlier this month that includes cutting budgets for most state agencies by 8.4% in the next fiscal year, which will likely mean reduced or delayed services and potential layoffs for some state workers. The plan also reduces funding for state universities by 6.4%. To increase revenue, the Governor proposed expanded gambling in the state, which is meeting conservative opposition.

Job growth was good in 2011. At the end of the summer, the state had added close to fifty thousand jobs from the bottom of the recession, but still had over seventy thousand to add before returning to prerecession employment. The unemployment rate for the state was 9.4% in November, higher than the national rate of 8.7%.

Tax-free municipal bond issuance for Kentucky was \$3.2 billion in 2011, down 41% year-over-year. Overall, issuance is expected to remain lower through 2012. We do expect bond deals that were pulled due to elevated financing costs in 2011 will return to the market to capture lower rates. Kentucky may also see bond issuance associated with several bridge projects that are expected to start in the near future.

Portfolio Review

The Churchill Tax-Free Fund of Kentucky experienced relatively strong performance in last year's municipal bond environment, and the Fund's portfolio quality remains strong. The Fund's assets under management have recovered well from a decline amidst speculation around the health of the municipal bond market in early 2011. The duration of the portfolio has been extended to find yield in the current market, but is still considered intermediate. We expect duration will begin to decline as issuers take advantage of low rates and begin to refund outstanding bonds. In the current market, we remain comfortable with Kentucky issuers. The investment strategy of Churchill Tax-Free Fund of Kentucky is focused on high-quality issues and an intermediate portfolio maturity. In our view, this strategy facilitates our pursuit of the objectives of providing as high a level of current income exempt from state and Federal income taxes, as is consistent with capital preservation.

Symbols and CUSIPs

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|---------|-------|-----------|---------|-------|-----------|---------|-------|-----------|
| Class A | CHTFX | 171562101 | Class C | CHKCX | 171562309 | Class Y | CHKYX | 171562408 |
|---------|-------|-----------|---------|-------|-----------|---------|-------|-----------|

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.

**- 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

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