



AQUILA
GROUP OF FUNDS®

RELEVANT FACTS REGARDING THE MUNICIPAL BOND MARKET

August 9, 2011

On August 9th, S&P announced that it had lowered to AA+ from AAA the ratings of certain public finance debt issues linked to the federal government, matching the downgrade it applied to US government debt on August 5th. At the same time, the rating agency announced that some state and local governments will maintain AAA ratings.

The issues affected by the downgrades (11,000 as of 8/9/11) represent less than 1% of the estimated 1.2 million outstanding debt issues in the \$2.9 trillion municipal bond market.

S&P had announced on August 8th that, following its decision to downgrade the credit rating of the US, it would downgrade municipal bonds “directly linked” to the federal government, including pre-refunded bonds escrowed with US treasuries, public housing agency bonds backed by federal agencies, and limited transportation and other special revenue bonds secured by payments from the federal government.

There are a number of relevant facts to bear in mind in connection with these announcements:

- S&P is one of 3 major rating agencies, the others being Moody’s and Fitch. Although S&P has announced its downgrade decisions, the other two rating agencies have, at this point, maintained their AAA ratings for US credit and “directly linked” municipal bonds. Moody’s has indicated that they will review individual states and, in particular, those with a significant financial reliance on revenue from the Federal government.
- States must balance their budgets, they have seen growing revenues over the past 5 consecutive quarters, and they have taken steps to improve their finances and deal with pension issues. Based on their balance sheets, there are some states in better financial condition than the US government.
- Municipal bonds are structured with serial and term maturities, so that the \$2.9 trillion municipal bond market contains roughly 1.2 million individual CUSIPs, compared to approximately 75,000 in the US corporate bond market.
- Pre-refunded bonds and housing revenue bonds represent a relatively small portion of the total municipal bond market: pre-refunded bonds are 4.3% and housing revenue bonds are 1.7% of the Barclay’s Municipal Bond Index.
- Given the large number of individual issues in the municipal bond market, even the small percentages represented by pre-refunded and housing revenue bonds, and potentially subject to a downgrade by S&P, result in absolute numbers that, out of context, seem very large.
- The media emphasizes attention-grabbing headlines.

Those investors who have allocated assets to high-quality municipal bonds, seeking double tax-exempt income, have very valid reasons to “stay the course”. There are certainly difficult budgetary issues that state and local governments have had to address through the recession, and will have to address going forward. At the same time, there are many high-quality issuers in the municipal bond market providing investors with double tax-exempt income.

As investors in the municipal bond market, we monitor the financial condition of individual issuers looking for those that meet our quality criteria. We construct portfolios of over 200 issues of various types and maturities in order to provide fund investors with broad diversification. Within the Aquila Group of Funds, the investment strategy pursued by our single-state municipal bond funds 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. We plan to continue investing prudently in pursuit of these objectives, and appreciate the opportunity to serve the investment needs of fund shareholders.