

Steady Returns in High Yields

Investing in high yield bonds can be a rewarding experience if one takes the right approach. Aquila Three Peaks High Income Fund manager Sandy Rufenacht and his team believe that, if one does thorough research of every credit and limits the volatility, then the high yield asset class can generate superior total return in the longer term.

Q: What is your investment philosophy?

A: We believe that the high yield category is one of the best total return asset classes in the longer term. Whatever the duration of the bonds, this asset class displays less volatility than stocks, and offers higher income compared to the ten-year treasury or investment-grade bonds.

Our philosophy is to thoroughly research and understand every credit that we consider for investment, because we believe it is far easier to make money if we don't lose it. Therefore, our objective is to protect principal and generate returns with less volatility.

Q: What is your investment strategy?

A: The overriding theme is to limit volatility. Consequently, we steer away from convertible bonds, emerging markets bonds, preferred stocks, pick bonds which are pay-in-kind bonds which pay in incremental debt rather than cash interest, zero coupon bonds and even common stocks, that historically have shown a great deal of volatility. We thus try to reduce volatility relative to equity markets while managing a high-yield bond portfolio.

Therefore, our strategy differs from that of many managers in the high yield space that add a lot of beta to their portfolio, thereby making them as volatile as equity portfolios.

Within the high yield sector itself we will limit investments in businesses that are cyclical in nature like steel, paper, chemicals, and oil. In cyclical companies, we cannot predict earnings and cash flow streams on any reasonable basis. Whereas, we are looking for companies having reasonably predictable earnings streams so that they can take those cash flows and amortize the debt on the balance sheet. We also avoid airlines, automobiles, homebuilders and restaurants, and are very limited in our selection of companies in the retail sector.

Another focus we have is to look for companies that have an exceptionally fiscally responsible, management team that can articulate a roadmap to deleveraging the balance sheet. We thus look for management teams that are in a debt pay-down mode. We look at only those industries that we can understand and analyze from a logical perspective, such as supermarkets, healthcare, energy companies, and gaming companies, and avoid technologically driven companies as they are far more complicated to comprehend.

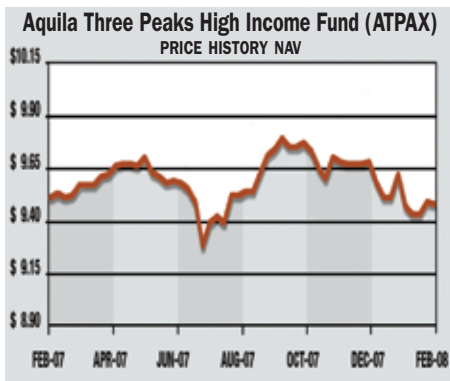
Consequently, when we combine the fact that we eliminate the equity types of securities dressed up to look like debt securities, along with avoiding the cyclical stocks and focus on debt pay-down type stories, we end up having a unique strategy within the high yield asset class.



SANDY RUFENACHT is the Chief Investment Officer, Portfolio Manager and principal owner of Three Peaks Capital Management, LLC. He also serves as the Portfolio Manager for the Aquila Three Peaks High Income Fund. Prior to founding Three Peaks in 2003, Rufenacht managed or co-managed multiple fixed-income products at Denver-based Janus Capital for more than a decade. From 1990-1991, Rufenacht was a Senior Fund Accountant for the Janus Flexible Income Fund and the Janus Twenty Fund.

Rufenacht launched and managed the Janus World High Yield and Short Term Bond Funds in January 1998. He received numerous international accolades during his tenure at Janus while managing the Janus High Yield Bond Fund and the Janus World High Yield Bond Fund. Prior to joining Janus Capital, Rufenacht spent two years at Colonial Investments in Boston, as Fund Accounting Supervisor.

Rufenacht graduated from the University of Northern Colorado with a degree in business administration. He also serves on the University of Colorado's School of Medicine Council of Advisors and on the University of Northern Colorado's Monfort School of Business Deans Leadership Council.



Q: Can you walk us through your research process?

A: We look for companies that are in debt repayment mode. For example, suppose that a company has a term loan with JP Morgan, which requires that a certain percentage of that debt be paid back on an annual basis. Our model companies would be those that have the free cash flow to service the amortizing debt schedule on that term loan. Such companies would then cause rating agencies like Moody's and S&P to seriously consider upgrading them. We are basically looking for balance sheets that are improving and situations in which the management team is being rewarded with an rating upgrade.

Furthermore, we rely mainly on our own research to generate ideas. We are totally independent of the sell-side and build all of our models internally. It is important for us to go and visit not just the top management on their own campus, but dig deep into the infrastructure and get to lower level employees who will be less guarded with company information. We keep in constant touch with management teams.

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We model our companies on three potential scenarios, namely, the base case, best case and a worst case scenario. The worst case would involve an assumption that a company takes on any incremental debt they might be able to use, at a future date. After we lever up the balance sheet, we test lower EBITDA levels, or earnings before interest tax depreciation and amortization, whereby the company will either bust the bank or high yield bond covenants or may force the firm into bankruptcy.

This however, is just a way to stress test each and every credit. We approach every year with the mindset that we want to build a portfolio whereby the yield that we display at the beginning of the year, based on the current yield, can actually be earned.

Ours is also a hands-on type of research. If we see a company in which the physical property (the collateral for bondholders) doesn't look well maintained we will photograph or video tape it and send it to the management team, or visit them to show our findings. We give suggestions for improvement. For instance, we might own the bonds of a restaurant chain; if we walk into one of the restaurants and find that the restrooms are not spotless, we videotape or photograph it, ship it to management and demand that things be fixed.

Our research process is therefore very aggressive and pro-active. As bondholders, our approach is that we own the property and expect management teams to maintain the value of the bondholders' collateral. If the management team does not share that perspective, their bonds have no place in our portfolio.

Q: Can you give some historical examples that illustrate your research process?

A: The Venetian in Las Vegas, better known as the Las Vegas Sands, which at the time of construction was one of the largest of such projects in the world. We were the lead buyer of that

particular deal and oversaw every stage of the construction process to make sure that the property was on time and on budget. Furthermore, based on our expected cash flow generation we knew they would eventually be in a position to de-lever the balance sheet.

Our intense research was fruitful. The company issued bonds originally at a 12¼ rate, then 11 some years later, and recently a 6¾ coupon so the market now has rewarded the company. The project is now one of the better cash flowing properties in all of Las Vegas.

Another example is the popular computer game retailer, Game Stop where we own some shorter dated bonds. We believe one of the other ways to reduce volatility is to focus on shorter dated bonds, so we've historically had a shorter maturity portfolio, to limit the downside. In the case of Game Stop, the very short bonds that we own have been paying off debt at a record clip and yet their quarterly earnings are reaching new records. Game Stop was easy to analyze because their facilities are in strip malls across the United States and our analysts could just walk up and talk to the guy behind the counter and find out about sales.

Another example illustrating the hands-on type of research is a company called Valmont Industries that manufactures street light poles; the kind one sees around airports that light up a wide space. We met the management in Omaha and when we returned to Denver, we discovered that the airport's light poles had fractures. On further probing, we found those to be Valmont poles. We photographed them and called the management to verify that they really were Valmont's. They confirmed our findings but said that the poles were put in an area that had a very high wind velocity and they weren't recommended for those conditions, yet Denver International Airport elected to put them up anyway.

Q: How is your portfolio constructed?

A: We may hold between 100 and 115 credits and we seek to limit the volatility. Our research process should help us identify issues that are not default candidates and we should earn at least the yield to worst at which we purchased the bonds.

Consequently, if the markets get volatile the portfolio performs exceptionally well relative to its peers. We have historically benchmarked ourselves relative to the Lehman High Yield Bond Index. Year-to-date our fund would be in and around the 5th or 6th percentile according to Lipper, and again, it is largely because the market has become volatile.

Q: What is your buy and sell discipline?

A: We describe our sell discipline before the buy discipline because we are far more sensitive to an indication to sell a bond than to buy one. For instance, the moment we see excessive volatility, it is a trigger for a sell.

Again, a breakdown in communications with a management team would be a very strong sell signal. If they fail to call us back in an appropriate amount of time or do not allow us to make a company visit, their bonds will be sold.

We also look at upside versus downside. Many times news releases will trigger bonds to trade up. If we feel there is only a limited amount of upside relative to the downside, the bonds will be sold, or at least some percentage of them.

We also closely monitor trading. If a bond trades lower we will react to sell the bond so that we don't erode the value of the coupon. We have a formula whereby if we lose two years' worth of coupons and, for instance, we have a 10% coupon, then 10 times 2 is 20. This means if the bond was priced at 100 and it drops to 80, it will be sold. This is again a way to limit volatility and since it is formula driven, bonds


that are accruing income are not jeopardized by a minor drop in principal.

The telecom industry aptly illustrates our market perspective. In the '90s telecom was a big industry but we do not think the buy side understood it. Furthermore, we felt one thing that was going to be common with all these telecom companies is their insatiable need for debt. That factor alone steered us well away from telecom. We did not understand the sector, saw it as a far too volatile sector that did not have enough capital or hard cash invested in the companies and yet, it was mostly debt financed.

Q: What is your view on risk? How do you mitigate risk in your portfolio?

A: We approach every company as though it's a potential default candidate until proven otherwise. It is the management team's job to convince us of their honesty, solvency, ability to support the leverage and more importantly, their desire to rid themselves of leverage and willingness to use free cash flow to pay down debt. Only then we would commit capital to that security.

We try to limit very aggressive securities so that we limit the beta of the portfolio. We do allow for a basket of more aggressive high yield securities but all within our frame work, namely, debt pay down, good collateral, predictable earnings, transparent and cooperative management team etc.

We also try to limit volatility by focusing on a shorter dated portfolio. Other risk control measures include avoiding deals that are being made to finance an acquisition, a stock buyback, or to pay a dividend to an equity holder. We look for very stringent covenants in such bond deals and want them to be exceptionally debt-holder friendly and anti-stock holder. Ultimately, we think ours is a very balanced approach between credit risk and duration or interest rate risk, thereby leaving us with a good total return product. 

Aquila Three Peaks High Income Fund

| | |
|-----------|---|
| Symbol | ATPAX |
| Website | www.aquilafunds.com |
| Address | Aquila Group of Funds 380 Madison Avenue Suite 2300 New York, NY 10017 |
| Tel. No. | 800-437-1020 |
| Inception | 06/01/2006 |

PORTFOLIO

| | |
|------------------------|--------|
| Total Net Assets* | \$31.0 |
| Avg Coupon Percent | N/A |
| Avg Duration (years) | 3.77 |
| Effective Avg Maturity | 4.84 |
| Maturity Method | F |

INVESTMENT INFORMATION

| | |
|----------------------------|---------|
| New Investment | Open |
| Min Initial Investment | \$1,000 |
| Min Subsequent Investment | \$0.00 |
| Min Initial IRA Investment | N/A |

RETURNS VS. LB US HIGH YIELD CORPORATE BOND INDEX

| | ATPAX | Index |
|---------------|-----------|--------|
| 1 Year (Cum.) | -0.51% ** | -3.30% |

FEES AND EXPENSES

| | |
|-----------------------------|-------|
| Max Sales Charge - Front | 4.00% |
| Max Sales Charge - Deferred | 0.00% |
| Max Redemption Fee*** | 2.00% |
| Total Expense Ratio | 1.00% |

PORTFOLIO MANAGER

| | |
|-----------------|------|
| Sandy Rufenacht | 2006 |
|-----------------|------|

*millions **based on the NAV

***within 1 month after purchase

Data through: 02/29/2008

Source: Company Documents; Lipper

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