Ultra Short Tax-Free Income Fund Commentary

How did the municipal bond market perform?
The employment situation remained a strength in the U.S. economy, as nonfarm payrolls gained an average of 184,000 in the quarter and the unemployment rate ended 2019 at 3.5%. While growth hasn’t been robust, it has been steady and is expected to stay in the 2% range in the near future. U.S. consumers continue to be resilient as evidenced by a strong holiday shopping season. The Federal Reserve Board (the Fed) lowered the overnight lending rate at the October Federal Open Market Committee meeting, but then left rates unchanged at the December meeting and indicated that they may be on hold in the coming months.
The short end of the municipal market was relatively quiet in the fourth quarter, as rates in the 1-year fixed-rate market traded in a fairly tight range during the period. However, there was some volatility for yields on variable rate demand notes (VRDNs). Yields dropped in October in conjunction with the Fed move, held steady in November, but then rose rapidly in December in response to year-end pressure, as the SIFMA Index1 closed 2019 at 1.61%, rising from 1.06% in the fourth quarter, as rates in the 1-year fixed-rate market traded in a fairly tight range during the period. However, there was some volatility for yields on variable rate demand notes (VRDNs). Yields dropped in October in conjunction with the Fed move, held steady in November, but then rose rapidly in December in response to year-end pressure, as the SIFMA Index1 closed 2019 at 1.61%, rising from 1.06% at the beginning of the month.
The fixed-rate portion of short end of the muni market didn’t provide many buying opportunities during the quarter, but the spike in VRDN rates at the end of the year made those an attractive option for investors. As has been previously mentioned, the supply/demand dynamic is a big driver in the muni market. Lipper has been tracking muni bond fund flows since 1992 and 2019 was a record year for inflows, so demand was quite strong. Supply was robust in the quarter, but one trend that bears watching is the amount of taxable muni bond issuance. The tax reform act took away the ability for muni issuers to advance refund their deals, but the low-rate environment enabled them to issue taxable muni deals. If this trend continues, it will provide a challenge to investors who are seeking tax-exempt bonds.

What were your primary investment strategies during the quarter?
The Fund continued to hold a mix of fixed-rate bonds and VRDNs throughout the quarter, which proved to be effective at times during the period, but underperformed the benchmark for the quarter on the whole.**

How do you expect to position the Fund in the coming months?
Given the current economic situation—steady growth, strong labor market, benign inflation—it appears that the Fed will be on the sidelines in the coming months, leaving short-term muni rates fairly range-bound. Market participants will be closely monitoring the supply/demand dynamic. If the taxable muni issuance continues to reduce the tax-exempt supply, investors could face a challenging environment for deploying cash. Aside from the market fundamentals, the first half of 2020 could see some volatility due to the Trump impeachment trial, the Democratic primary season heating up, and the trade deal (or tension) with China.

If short-term muni bond rates are relatively range-bound, the Fund will look to take advantage of buying opportunities as they arise in the coming months. Tax time has historically

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† Each Lipper Mutual Funds average is an equally weighted average of the mutual funds within their respective investment objectives, adjusted for reinvestment of capital gain distributions and income dividends.

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Investment Risks
Fixed income securities are subject to interest rate risks. The principal value of a bond falls when interest rates rise and rise when interest rates fall. During periods of rising interest rates, the value of a bond investment is at greater risk than during periods of stable or falling rates. Intermediate- and short-term investment-grade bonds offer less risk and generally a lower rate of return than longer-term higher yielding bonds. Bond funds will tend to experience smaller fluctuations in value than stock funds. However, investors in any bond fund should anticipate fluctuations in price, especially for longer-term issues and in environments of changing interest rates. The Fund’s income may be subject to certain state and local taxes and, depending on one’s tax status, to the federal alternative minimum tax.

been a window to lock in fixed-rate purchases, so the Fund will extend duration if that occurs.**

Market participants will also be watching the Democratic primaries. If a more progressive candidate emerges as the frontrunner, muni spreads could be affected, with a rise in income tax rates priced into the market.

** Portfolio composition is subject to change.

The Lipper Mutual Funds Average is an equally weighted average of the mutual funds within their respective Lipper classification, adjusted for reinvestment of capital gains distributions and income dividends. Lipper ratings are not intended to predict future results, and Lipper does not guarantee the accuracy of this information. More information is available at www.lipperweb.com. Thomson Reuters Copyright 2020. All Rights Reserved.

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1 Definitions

Bloomberg Barclays 1-Year Municipal Bond Index includes bonds with a minimum credit rating of BAA3, are issued as part of a deal of at least $50 million, have an amount outstanding of at least $5 million, and have maturities of 1 to 2 years. Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Index produced by Municipal Market Data (MMD), is a 7-day high-grade market index comprised of tax-exempt variable rate demand obligations (VRDO’s) from MMD’s extensive database. SIFMA is a leading securities industry trade group representing securities firms, banks, and asset management companies in the U.S. and Hong Kong. The index is unmanaged and does not reflect the fees and expenses associated with a mutual fund. An investor cannot invest directly in an index.

2 Since December 31, 2017.

An investor should consider a fund’s investment objectives, risk and charges and expenses carefully before investing or sending money. This and other important information about an investment company can be found in the fund’s prospectus. To obtain a Cavanal Hill Funds prospectus or summary prospectus, please call 800-762-7085 or visit us at www.cavanalhillfunds.com. Please read it carefully before investing.