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The Most Dangerous Four-Letter Word Many bond investors still ignore r-i-s-k

By Randall W. Forsyth | 12-04-1995

Risk is a four-letter word for bond-fund investors, or it ought to be. But it's not something they always consider or understand. Only after the fact, perhaps, do the risks in bond funds become apparent. By then, of course, it's too late; the money has been lost and the investor has fled, probably at the worst time.

And it isn't just bond funds whose risks should be so obvious that there ought to be a skull-and-crossbones on the prospectus. Anyone who buys a fund that invests in junk corporates or emerging-market bonds (which might better be labeled 'junk government bonds') and is surprised when there are the inevitable losses most likely is an innocent who has been fleeced by an unscrupulous salesman. Or, he's stupid and greedy enough to think he's guaranteed a fat, double-digit yield without any prospect of ever taking a hit. Which is one reason why a fool and his money are soon parted.

But last year proved that even "risk-free" government bond funds can be subject to substantial downsides. When the Federal Reserve began to hike rates in February 1994, the bond market embarked on what became it's worst year in nearly six decades, until it began to recover in the final two months. Hard hit were some mortgage-backed-securities funds managed by Piper Capital, notable Piper Institutional Government Income and Managers Intermediate Mortgage, which professed to pay high yields with only negligible volatility:

In the wake of 1994's bond-market fiascoes, the Securities and Exchange Commission has sought comments for proposed disclosure of fund risk. The SEC wants funds to provide investors with a simple, easy-to-use yardstick - but that's easier said than done.

While the commission mulls the question, bond-fund investors are focusing more on the returns in the current bull market than on the risks. Consider a recent advertisement headlined "Bullish on Bonds?" from the Benham Group for its Target Maturities Trust. These funds invest in zero-coupon U.S. Treasury securities maturing in the years 2000, 2005, 2010, 2015 and 2020. Benham trumpeted that its 2020 Target fund returned 47.05% in the 12 months ended Sept. 30.

That was about twice the total return from the widely watched Treasury long bond, whose yield fell from nearly 8% to around 6.50% over that span. It figures that a 25-year

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zero-coupon bond had double the return since it has almost twice the duration of a 30-year coupon-paying bond. (Duration is a measure of the sensitivity of a bond's price to changes in interest rates.)

The ad also pointed out that rising rates also significantly reduced that value of zeros. However, the stress on short-term performance from long-term zero-coupon bonds is something new. The pitch previously had been that zeros (and only zeros) could promise a precise payoff at a predetermined date, making them ideal for retirement savings or college costs.

Be that as it may, zeros are optimal if, and only if, you think that today's rates are the best you'll see over the life of the security. That's because zeros do protect against one danger: reinvestment risk.

Zeros lock in a reinvestment rate, something that's impossible to get with coupon-paying bonds. The yield-to-maturity calculation on a typical bond assumes each semiannual coupon payment is reinvested at that yield. That may not be realistic, however. Investors who bought bonds in the 'eighties', when yields were north of 10%, aren't realizing that yield if the coupons are being reinvested at 6%. Reinvestment risk works both ways. When yields soared in the late 'seventies and early eighties', investors who suffered principal losses could at least reinvest their coupons at much higher returns.

Bond-fund managers are supposed to minimize the risk and maximize the returns for their shareholders, but the evidence suggests they fall short of that ideal. Few actually even match the returns of the bond market. According to Morningstar, some 85% of Treasury, mortgage-backed and government (typically an amalgam of mortgage and U.S. issues) debt lagged the Lehman Government Index. Not only are few managers able to guess the direction of interest rates, but their funds also have to clear the hurdle of average annual expense ratios of 1.05%, Morningstar points out.

Similarly, the Vanguard Bond Index Total fund, designed to track the entire U.S. taxable bond market, consistently ranks in the top quartile of bond funds. Over the 12 months ended Oct. 31, it returned 15.57%, which placed it 478th among the 3,568 fixed-income funds tracked by Lipper Analytical Services (excluding money-market funds).

Among the few government funds Morningstar sees as worthwhile are the low-cost offerings from Vanguard plus two that go a bit afield: the Strong Government Securities Fund, which will add "exotic" mortgage and some corporate securities; and SIT U.S. Government Securities, which emphasizes high-yielding, relatively stable, mobile-home loans.

Corporate-bond funds carry their weight better, owing to managers' ability to cherry-pick credits and reduce risk through diversification, according to Morningstar. Its favorites: FPA New Income (Mutual Bonds, Aug. 15, 1994), Loomis Sayles Bond (Mutual Bonds, Feb. 23, 1993); Dodge & Cox Income and Harbor Bond. On the junk side, it

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recommends Seligman High-Yield (Mutual Bonds, May 22, 1995) and Fidelity Capital and Income, which recently was nicked by a Chapter 11 filing by Harrah's Jazz.

While managers of these funds have admirably earned their keep by beating indexes, they've done so by taking on more risk and making it pay. Peter Van Dyke of T. Rowe Price suggests a means of obtaining a higher return than an index fund without added risk: diversification.

Diversification goes beyond the hoary maxim of not placing all your eggs in one basket. Van Dyke found that mixing six Price bond funds produced returns about 50-60 basis points higher than that generated by the Lehman Aggregate Index, with no more risk. Making the mix work were Price International Bond and Price High Yield Bond, two risky funds that move almost entirely independently of one another. As one zigs, the other zags, and the entire portfolio's volatility is dampened.

Volatility typically is the way financial risk is defined, although few investors are distressed by the volatility on the upside. Standard deviation appears to be the statistic the SEC is likely to settle on, Van Dyke says. "It's the Bob Dole measure of risk," he quips. "It's been around forever, everybody knows it and nobody can come up with anything better."

Clark Stamper, who manages the Davis High Income and Davis Tax-Free High Income funds, thinks the Sharpe Ratio does the best job of telling fund investors that they need to know. Developed by Nobel laureate William Sharpe (interviewed in this week's Fund of Information), the ratio measures the "excess" return of a security or portfolio over a risk-free T-bill versus the volatility of those excess returns. In other words, the payoff compared to the risk; which means the higher, the better.

The Davis funds rank high based on their Sharpe Ratios. Stamper achieves this by ferreting out obscure securities that tend to be inefficiently priced and by spreading their risk among a larger than normal number of credits: 200 in the muni fund, 140 in junk corporate funds, nearly twice the average.

Stamper's risk aversion paid off in the 1994 debacle, when he was among the few to eke out positive returns, but he admits he turned too defensive too soon this year. The High Income A shares returned 9.28% for the first 10 months of 1994, while Tax-Free High Income A shares returned 7.14%, according to Lipper. Still, given how far the market has rallied, Stamper prefers to give up some upside in exchange for downside protection.

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Returns - Figures quoted are total returns calculated for the share class and time periods shown. Performance includes the reinvestment of income dividends and capital gains distributions. Performance does not reflect the deduction of taxes that a shareholder would pay on a fund distribution or the redemption of fund shares. Please go to Morningstar's and/or Lipper's websites for more information.

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