THE BOND BUYER

Managing Munis From a Corporate Credits Perspective

By Sharon R. King | 09-21-1994

There can be advantages to managing both tax-exempt and taxable mutual funds, says B. Clark Stamper, a senior vice president at Selected/Venture Advisers Inc.

Since 1990, Stamper has managed the $187 million Venture Muni (+) Plus Inc. fund, an eight-year-old high-yield municipal fund. He also manages a high-yield corporate bond fund, a retirement fund, and a government bond fund for the Santa Fe, N.M.-based Venture.

Keeping an eye on trends in the taxable fixed-income market, where rates began peaking last year ahead of municipals, led Stamper to become more defensive last fall and has helped make his funds top performers.

Recently, several companies ranked three of the funds that Stamper manages among the top 10 best performers in their categories. CKA/Wiesenberger ranked the high-yield municipal fund number one for the seven months ended July 31. The funds, which Morningstar Inc. gives five stars, also is ranked as the top high-yield municipal fund by Lipper Analytical Services Inc. for the year ended Aug 31.

In addition, Lipper ranked the retirement fund and the government bond fund third and 10th respectively among all general U.S. government bond funds for the year ended Aug. 31.

In an interview with staff reporter Sharon R. King, Stamper discussed his defensive portfolio strategy and his outlook for many high-yield municipal credits.

Q: Give me a quick breakdown of the Venture Muni Fund's portfolio.
A: The cash level is about 2% right now (Aug 31). Triple A is about 18%; double-A is about 11%; single-A, 21%; triple-B, 13%; double-B, 5%; single-B about 0.3%. No triple C's. Non-rated is 29%. The average rating of the rated securities is still A-Plus. The average maturity is about 16 years. The average coupon is about 8.25%.

Q: No triple C's?
A: Yes. On of the things I'm worried about is a liquidity problem. I saw a little bit in March this year, when the bond market was bottoming. I was one of the only bidders on some double A munis, about 10 different issues. These issues had come at par maybe a month or two before, and I was bidding them in the mid-80's. I was high bid and I picked

up about three of them. The rest didn't trade. That was double A quality. My worry is that if that type of this happens again, if you had to sell, say, a non-rated bond or a lower-rated bond, you would hardly even get a bid.

Q: So the liquidity problem wasn't based on the quality of the bond?
A: Well, there are two things. One is a liquidity problem and one is that the credit quality spreads had tightened dramatically. Back in 1990, the spread from a triple B to a triple A was about 150 basis points. It tightened all the way up in late 1993 to about 35 basis points. So you weren't really paid a lot to take the extra risk.

Q: Your largest holdings are healthcare, housing, and industrial revenue bonds. What attracted you to those particular sectors?
A: I came out of the high-yield taxable area. And a lot of those health care bonds that's a corporate credit and the industrial revenue bonds are corporate credits. Some of them are the same as the credits I have in my (taxable) junk bond fund. What I found was that I was probably one of the most knowledgeable people on corporate credits in the muni area.

And not only that, there used to be huge values in that sector. In fact, on an after-tax basis, a lot of the munis were trading maybe 100 to 200 basis points cheap to the taxable market. That was back in 1990. Since then it's really tightened up and they're probably about even. So I've lightened up. I had been about 40% in that category. Now I'm about 25.5%.

Q: That's on the industrial revenue bonds?
A: Right. Housing would be the next largest, at 21%. There are a lot of opportunities in that sector, too, versus some of the other muni sectors. There are a lot of higher-coupon housing bonds. Prepayments in the muni housing bond market have been a lot less than the prepayments in the mortgage-backed area. So those seem to offer a lot more value.

Q: I noticed some Kmart and Kroger bonds in the municipal fund. Are those tax-exempt?
A: Those would be industrial revenue bonds. I've followed Kroger for 10 years on the junk bond side and have owned a lot of Kroger, although I used to be at my maximum at 5% in Kroger, in my muni fund. Now I'm about 3%.

Q: In addition to the Venture Muni Fund, you manage three other taxable funds. Do you find it difficult to manage both tax-exempt and taxable funds?
A: Not really. Every once in a while it'll get a little hectic. Last year, you had record muni issuance. You also had near-record junk bond issuance. In the junk market, the taxable market, a lot of times they were issuing bonds to take out old bonds, so I knew the credits, though the capital structure would change a little bit. Last year, there also were a lot of new issuers in the market so that created some problems. And some of the same bonds, or companies, are in the muni market and in the junk market.

Q: Can you explain your investment philosophy?
A: I use bottom-up credit analysis because we're looking at riskier credits where credit is important. I focus on the upside potential versus downside protection of each individual

investment for the credit-sensitive bonds. I also look at the upside potential versus downside protection on an interest rate prepayment or call risk basis. And I do that in all the different markets.

Q: As spreads continue to tighten, are you finding it more difficult to find high-yield bonds for the portfolio?
A: I was, late in 1993. The higher the market went, the tighter the spreads got, the more defensive I became. That's when I was selling off what were higher-yielding bonds with less credit quality spread and buying the higher-quality bonds with less-yield. It turned out to be the right thing. Now I'm seeing a bit of the opposite, or some credit quality spread widening, especially in health care and also in the industrial revenue bond sector.

Q: What's the reason for that?
A: I think part of it is that people might be concerned that the economy isn't as strong as they thought it was. Part of it is that instead of having big inflows into the market, where portfolio managers are just buying everything they can because there's kind of a shortage of bonds, now you have the money flowing out slowly. In order to make someone want to buy something, you've got to offer an extra bit of yield.

Q: Has insurance also taken away bonds from the high-yield market as insurers reach to lower-rated securities to offer to investors?
A: I haven't really noticed that. My insured percentage is pretty high; it's about 20%.

Q: Is 20% in insured investments considered a high percentage for a high-yield portfolio?
A: I would think so, definitely. But it has to do with keeping the credit quality higher and the liquidity higher. In fact, I'm still able to achieve a high-yield payout because of the bonds I have had real high coupon even though they're insured. Of course, yields are subject to change.

Q: How are you positioned to take advantage of the current market environment?
A: Well, it looks pretty good for a countertrend correction to about 7% on the long bond. So I bought a lot of higher-rated discount bonds, like a double A with coupon of 5.5% at an $87 price, or something like that. So that it could rally with the market. I'm not positive we're going to get a rally, but those (discount) bonds have better upside downside characteristics because of the low dollar price.

Q: What kind of coupon levels do the new cushion bonds have?
A: The oldest coupon is 8.25% probably up around that level, and, say 8%.

Q: What kind of coupons were you selling?
A: About 7.25%. Back then, I think the double A's were trading at a 5.25% or something like that. Now they're up around a 6.40%, something like that. Those bonds that I sold, because they were currently callable, they have almost no upside and they had a lot of downside because the coupons weren't that large relative to the market.

Q: Why don't you own any Denver airport bonds?

A: I bought it as a new issue probably three years ago and I sold it at a profit. There've been a lot of questions about whether they really need the airport. I just didn't think the return was worth the risk. That kind of risk is hard to quantify. There are a lot of other areas where I have much more expertise, where I think I can get better upside-downside characteristics. I had owned quite a few different airports.

Q: Have you sold all of your airport bonds?
A: I don't think I own many airport bonds. I'm staying away from cyclical credits.

Q: Do you own any derivatives?
A: There are no derivatives in the muni fund. It just didn't look appropriate at all.

Q: What's your interest rate forecast?
A: I think we're going to see rates go to 7% in the short run, but in the long run I expect them to go higher, say, above 8%, like an 8.20%, somewhere around there.

Q: Over what time frame?
A: It could be at 7% within the month. I would say it would take probably about a year from that level to reach 8.20%. I think until the economy really slows down, rates won't go down for any extended time. My biggest fear is that the economy goes into a recession.

Q: Are you forecasting that?
A: Yes. The long bond is off about 20%. The stock market is only down about 3% from the top. So I'd much rather own bonds than stocks, but I think these rate increases, increased taxes and regulation pushed the economy into recession. If the stock market does fall by 500 points or more, I would expect that to impact credit-quality spreads negatively and make them widen out. And that's another reason why I don't own that many of the lower-quality bonds right now.

Q: Are there any other sectors that you would expect to perform well, that would aid the high-yield muni fund?
A: I think the housing bonds will do fine. A lot of those are backed by Ginnie Mae or Fannie Mae or (the Federal Housing Administration), where you don't have much credit risk and a lot of them have higher coupons.

Q: There's no risk of prepayment on those bonds?
A: The prepayment risk should be lessening if rates go up. So you'd want to own the higher-coupon ones.

Q: What's the availability of those securities?
A: There are not many new issues. Most of the action is in the secondary, old issues. That's where most of my trades take place.

Q: You mentioned that last year you become more defensive. Was that because you anticipated that rates would go up?

A: Well, this was one area where I got a play from being in the three different markets or the four different markets. I owned a bunch of utility bonds. So I watched the utility market and index very closely and the utility index peaked in September and started going down. I had been getting more and more defensive because the aggressive investments were less compelling and the defensive investments were getting better risk characteristics, upside-downside. And then the government market peaked in October, so I started building cash in my two government mortgage-backed funds. Then the junk bond market peaked, say, in December, so I was building cash or going defensive in all the funds. Then the muni market didn't really peak until January, so there was a pretty big lag and because I was in all the four markets, I could see what was going on.

Q: When did you start raising cash in the tax-exempt market?
A: In the tax-exempt market, there were enough alternatives that I didn't really have to build a cash balance. I could hide out in these cushion bonds.

Q: The cash position that you have now in the muni fund, is that relatively low to what it has been in the past?
A: No, that's actually it's cash and accrued interest. I would say probably half of that is accrued interest. I would say my average cash balance is under 3% for the whole year.

Q: With your defensive stance, do you end up giving up any returns?
A: You give us some upside potential. So if the market rallies, you lag. If the market stays flat or goes down, then you outperform.

Q: So you'll continue your defensive stance?
A: Yes, Overall, I'm defensive with some aggressive investments that I'd hope to sell on a rally.

Q: In a flat to rising rate environment, what type of securities do you think will do well for you?
A: The shorter-term, higher-coupon bonds, some that are trading to a call. If they don't get called, then you get that coupon for a longer period of time.

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