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Our Favorite Short-Term Muni-Bond Funds

by Scott Berry | 11-19-2002

This category should prove to be a relatively safe haven if interest rates tick higher.

Muni-short funds are a step up from tax-free money market funds. They don't offer the fixed-dollar share price of a money market, but they do offer more potential return without a lot of added volatility. For the year to date through Oct. 31, 2002, for example, the average muni-short fund gained 4.2%, while the average tax-free money market gained just 0.7%. That pattern holds over longer periods as well, as the average muni-short fund has outperformed the average tax-free money market by considerable amounts over the trailing three-, five-, and 10-year periods.

Of course, the added interest-rate sensitivity of muni-short funds relative to money market funds can cause losses during periods of rising rates. In 1994 and 1999, for example, the average muni-short fund posted capital losses of 4.9% and 3.4%, respectively. Those losses compare favorably with the losses posted by intermediate- and long-term municipal-bond funds in each of those years, but they are losses nonetheless.

Our favorite muni-short funds include Vanguard Limited-Term Tax-Exempt VMLTX and T. Rowe Price Tax-Free Short-Intermediate PRFSX. Both funds boast solid long-term records, and both have continued to perform well in 2002. Vanguard Limited-Term continues to benefit from its ultralow expense ratio, while T. Rowe Price Short-Intermediate has profited from its exposure to the health-care sector.

Rising interest rates could make for rough sledding, but we think our muni-short Analyst Picks will continue to serve conservative muni investors well.

Analyst Picks: Muni Short Category

	YTD Return (%)	3-Year Return (%)	5-Year Return (%)	Expense Ratio (%)
Evergreen High Income Municipal Bd A VMPAX	4.08	5.55	4.32	0.83
Strong Short-Term Municipal Bond Inv STSMX	4.17	4.76	4.47	0.60
T. Rowe Price Tax-Free Short-Interm PRFSX	4.77	5.70	4.83	0.52
USAA Tax-Exempt Short-Term USSTX	4.06	5.06	4.59	0.46
Vanguard Ltd-Term Tax-Ex VMLTX	4.85	5.53	4.85	0.19
Muni Short Average	4.31	5.00	4.31	0.81

Evergreen High Income Municipal Bond VMPAX

This fund is not nearly as conservative as the Vanguard pick, but it has a solid long-term record (largely as Davis Tax-Free High Income). Manager Clark Stamper is known for his ability to scour the market for underpriced bonds. And though the fund stumbled a bit in 1999, it bounced back strongly in 2000 and earned topnotch returns in 2001.

Strong Short-Term Municipal Bond STSMX

This fund also takes on more credit risk than many rivals, as manager Lyle Fitterer typically holds a large stash of BB and BBB rated issues. He does, however, keep the fund's duration in a tight two- to three- year range, which has helped moderate the fund's volatility. The portfolio will likely lag its peers if there is a flight to quality -- as it did in 2000. However, it remains a good choice for those who don't mind taking on additional credit risk to capture more income.

T. Rowe Price Tax-Free Short-Intermediate PRFSX

This fund is a solid all-around offering. It boasts a below-average expense ratio, sticks mainly with high-quality bonds, and has delivered strong long-term returns. The fund's risk/reward profile is impressive, and it has consistently delivered a better-than-average income payout.

USAA Tax-Exempt Short-Term USSTX

This fund also takes advantage of its low expense ratio. Manager Clifford Gladson is keen on low- to mid-quality credits, and keeps duration short and fairly steady, which moderates volatility.

Vanguard Limited-Term Tax-Exempt VMLTX

Ultralow expenses are the key here. This category's winners and losers are often separated by less than 1%, so the importance of this fund's expense advantage can not be stressed enough. And because of that advantage, the fund doesn't need to take on lots of extra credit risk to keep up with the group's more-aggressive members. Quite simply, it is a terrific choice.

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