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Stamper Takes Low-Risk Path to Returns
His High-Yield Davis Portfolios Invest in Specialized Bonds

By Doug Rogers | 05-28-1997

Sure, the stock market looks good now: But how about just seven weeks ago, before the 15% jump to new highs on the Dow? And even now, some look askance at all the volatility.
Clark Stamper, who manages Davis High Income and Davis Tax-Free High Income funds, sees reasons to continue being wary of stocks, even amid the strong rally. The stock market's above-average returns for the past three years aren't likely to be repeated indefinitely, for one, he says.

And his funds offer an attractive alternative. "Why own stocks when you can get equity-size yields at a fraction of the risk from specialized bond funds?" said Stamper, 41.

Davis Tax-Free High Income, which has $160 million in assets, offers an SEC yield of about 6.89% now. Investors in the highest tax bracket - say 40% - would have to get a return of 11.48% on taxable investments to match the 6.89%.

And that taxable equivalent is a tad higher than the long-term total return of the broad stock market, Stamper notes.

The average credit rating of the 280-security portfolio is rated A+ by the credit rating agencies. Stamper uses tactics to reach for those yields while limiting downside risk.

That shows in the fund's performance when the market is falling. In the first quarter, when 72% of the 525 municipal bond funds tracked by Morningstar had negative returns, Davis Tax-Free High Income returned 1.27%. The general equity fund tracked by Lipper Analytical Services Inc. fell 1.98%.

Davis High Income, which has $60 million in assets, has similar traits, Stamper says. It's yielding 9.53%, while its holdings have an average credit rating of BB+, substantially higher than the average junk-bond fund, Stamper notes.

Both funds have estimated durations of about four years. Duration measures a security's sensitivity to interest-rate changes. Four years suggests moderate rate sensitivity.

So far this year, Tax-Free High Income is up 3%, while High Income is up 4%.

That's not impressive unless you consider how the funds are positioned now. Remember their holdings will be paying out interest that will be reinvested and compound the investment.

How does Stamper get such yields? By holding securities that have few "natural buyers," he says.

While some of his holdings don't trade as frequently as others, diversification helps limit the risk of holding them, Stamper says.

In the muni fund, Stamper holds a lot of so-called cushion bonds. These are large-coupon bonds trading near a call date. Many issuers of debt put in provisions to call in - or return - principal early to protect themselves against declining interest rates.

For example, a bond with no call provision might trade at 110, while another with a call in six months at 102 might trade at 102.5. The difference in prices - 7.5 - is the cushion.

"The bond market in general could drop about 7.5 points before that bond would be under any pressure," Stamper said. "The bonus is if the bond doesn't get called and it goes past the call. Then your total return starts stepping up dramatically."

There are many reasons some munis don't get called. Stamper owns Clifton Park 11.25. They were originally guaranteed by Caldor, which entered bankruptcy proceedings. The facility is being used and paid for by May Co., which carries a high rating.

"Those bonds have been passing their call for several years," Stamper notes.

Sometimes, a municipality issues debt for the same facility twice and therefore is restricted from further tax-free funding. "They have to go to taxable bonds, so it doesn't make economic sense," he said.

"Or maybe the guy who controls the call isn't incentivized to do anything. Or it might be that it's a small issue from a large corporation. They aren't willing to waste their time with a little $2 million tax-free bond when they're worried about $1 billion of taxable debt."

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