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MORNINGSTAR

Our Favorite Short-Term Muni-Bond Funds

by Scott Berry | 08-01-2002

Morningstar's Fund Analyst Picks are excellent starting points for investors. Each week, our analysts highlight their favorite funds in one of Morningstar's 44 categories based on superior track records, compelling strategies, and impressive managers. We avoid closed funds, institutional offerings, and others that aren't readily available to individual investors.

The Fund Analyst Picks article that you're about to read is available for free to all Morningstar.com readers. Our picks for all 44 categories are available to Premium Members. If you're not a Premium Member, sign up for a free trial.

Remember, each pick may not be appropriate for all portfolios. For some investors, the selections themselves may be unsuitable, while for others the category may be inappropriate.

Analyst Picks: Muni Short Category

	YTD Return (%)	3-Year Return (%)	5-Year Return (%)	Expense Ratio (%)
Evergreen High Income Municipal Bd A VMPAX	3.52	5.41	4.55	0.9
Strong Short-Term Municipal Bond Inv STSMX	3.86	4.85	4.55	0.60
T. Rowe Price Tax-Free Short-Interm PRFSX	4.13	5.81	4.71	0.52
USAA Tax-Exempt Short-Term USSTX	3.56	5.25	4.98	0.46
Vanguard Ltd-Term Tax-Ex VMLTX	4.46	5.72	5.02	0.19
Muni Short Average	3.84	5.08	4.48	0.83

*Risk scores through 07-31-2002. Returns through 08-23-2002.

Investors turned off by rock-bottom money-market yields may find short-term municipal-bond funds to their liking.

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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 June 30, 2002, for example, the average muni-short fund gained 2.8%, while the average tax-free money market gained just 0.4%. That pattern holds over longer periods as well, as the average muni-short fund has outperformed the average tax-free money market by a considerable amount 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 capital 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. The added dividend income provided by the funds offset most of the losses, but the category as a whole underperformed the average tax-free money market in both years.

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

The muni-short category could lose some ground if interest rates move higher, but we think conservative municipal-bond investors will find it to be a relatively safe haven.

Evergreen High Income Municipal Bd 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 In 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-Interm 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

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This fund also takes advantage of its low expense ratio. Manager Clifford Gladson is keen on low- to mid-quality credits, which have rallied strongly for much of the past few years, bolstering the fund's long-term returns. At the same time, he keeps duration short and fairly steady, which moderates volatility.

Vanguard Ltd-Term Tax-Ex 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.

Scott Berry is an analyst with Morningstar.com.

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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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