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### **MORNINGSTAR**

#### ***Our Favorite Muni Short Funds***

by Scott Berry | 02-20-2002

Short-term municipal-bond funds may not pack a big punch, but they have proven to be quite reliable.

As 2001 drew to a close, rising interest rates and a lack of demand pushed long-term municipal-bond prices lower. Short-term municipal bonds, however, weathered the storm quite well, as evidenced by the category's break-even fourth-quarter performance. As bond prices have rebounded in early 2002, most short-term muni funds have fallen off the pace of their longer-term rivals. Still, the group averaged a very respectable 4.4% gain for the trailing 12 months ended Feb. 13, 2002.

T. Rowe Price Tax-Free Short-Intermediate, Strong Short-Term Municipal Bond, and Fidelity Spartan Short-Intermediate Muni Income FSTFX--which is not one of our picks--have all been among the category leaders in recent months. Fidelity and T. Rowe Price have benefited from their high-quality focus. That helped limit their exposure to airline bonds, which struggled following last September's terrorist attacks. Strong, on the other hand, typically takes on more credit risk than its average peer. However, it has received a big lift from the strong performance of its mid-quality health-care holdings, which have rallied over the last year.

Looking forward to the remainder of 2002, the municipal-bond market has a number of question marks. The terrorist attacks have obviously clouded the outlook for New York City bonds, though the city expects to get a significant amount of federal assistance. In California, the utility crisis could continue to cause problems. And finally, as the economy gets back on track, interest rates could tick higher, putting added pressure on bond prices.

However, short-term muni funds have proven quite resilient over time and should continue to balance the risks for portfolios heavy in long-term bonds.

Vanguard Ltd-Term Tax-Ex VMLTX

Ultralow expenses--that's 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 with its expense advantage, the fund doesn't need to take on lots of

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extra credit risk to keep up with the group's more-aggressive members. Quite simply, it is a terrific choice.

#### Evergreen High Income Municipal Bd VMPAX

This fund is not nearly as conservative as the Vanguard pick, but it has an excellent 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 delivers 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, which at just 0.38% is quite reasonable. Manager Clifford Gladson is keen on low- to mid-quality rated credits, which have rallied strongly for much of the past few years, so the fund's long-term returns are strong. At the same time, he keeps duration short and fairly steady, which moderates volatility.

Scott Berry, CFA, is an analyst with Morningstar.com.

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