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SOUTH FLORIDA SUN-SENTINEL

Manager's Savvy Helps Bond Fund Combine Good Yields With Low Risk

By Humberto Cruz | 10-12-1997

You wouldn't think of a municipal bond fund as a substitute for stocks, but that's exactly what the Davis Tax-Free High Income Fund marketing material suggests.

"Here's an opportunity you won't find every day - the opportunity to earn equity-type returns with low risk," says the fund sales literature.

For investors in high tax brackets, the numbers back up the promise.

With a recent yield of 6.43 percent, the fund is throwing off the equivalent of 10.64 percent in taxable income for taxpayers in the top 39.6 percent bracket.

That's about the historic average annual rate of return for the stocks in the Standard & Poor's 500 Index.

For middle-income taxpayers in the 29 percent tax bracket, the fund's tax- yield is the equivalent of a taxable 8.93 percent.

That's quite a respectable yield for a fund with low volatility and not a single losing year since it began in 1985.

"I think it is a great fund, one of the best managed municipal bond funds there is," said Mark Wright, an analyst with Morningstar, a fund research firm in Chicago that has awarded the Davis fund the highest five-star rating for risk-adjusted return.

The fund has earned the Five stars despite a sky-high 2.13 percent expense ratio for the "B" shares, highest of any fund in its category, "I normally would not recommend a fund with such high expenses," Wright said, "but in this case the fund's returns have more than compensated for the high costs."

And, he added, "there are compelling reasons to believe its strong performance will continue."

Those reasons center around the bond-picking skills of 41-year-old B. Clark Stamper, who since June 1990 has been the lead portfolio manager of the Davis Tax-Free High Income and the Davis High Income Fund, which invests in corporate bonds.

His dual role has benefited investors.

"Most municipal buyers aren't comfortable analyzing corporate credits but I am," said Stamper, a 13-year veteran of the bond market.

The tax-free portfolio, while highly diversified with about 300 bonds from 48 states favors industrial revenue bonds, which are municipal bonds guaranteed by a private company, and bonds backed by a hospital or nursing home.

Stamper has chalked up strong returns with them and with so-called "cushion" bonds. These are bonds that pay above average interest rates but can be bought at relatively low prices because they are expected to be "called" or redeemed by the issuer before maturity.

By buying these bonds at low prices, the fund enjoys a protection or "cushion" if the overall bond market drops, Stamper said.

And if the bond is not called as expected, the fund will continue to collect the high interest payments.

Bonds tend to be called when interest rates have dropped and the bond issuer is better off issuing new bonds at the lower rate.

But that doesn't always happen. A bond issuer, for example, may be running into temporary financial problems and be unable to issue new bonds even if the current bonds are insured and carry a high credit rating.

"If you know how to pick them, and I have been doing this for many years, you can have a pretty high probability of picking bonds that won't get called," Stamper said. "I can play the call risk game because I am spreading it over a large portfolio. You wouldn't want to do it with just 10 bonds."

That statement is in line with the investment philosophy of the fund, spelled out in the prospectus.

It is based on the premise that, over the long term, "a diversified portfolio of high-yield fixed income securities should, even taking into account possible losses, provide a higher net return than can be achieved with a portfolio of higher rated securities,"

Although the fund is allowed to invest all its assets in lower rated, higher yielding "junk bonds," Stamper maintains an average "investment grade" rating of A+ plus among those bonds in the portfolio that are rated.

His goal is to get "the best yield per credit quality," that is, the best combination of risk and reward.

As a rule, lower quality bonds must pay higher interest rates to compensate investors for the extra risk that payments won't be made on time or at all. Stamper said the spread, or the extra yield offered by lower rated funds, is the smallest he has ever seen.

So he is erring on the side of buying higher quality bonds and refusing to overpay for a bond just to get a little more yield.

"I am willing to giveaway some upside potential to pick up more than a proportionate amount on the downside," he said. "If the bond market rallies this fund will not rally that much. However, when the market goes down, it won't go down that much."

So far Stamper has shown he can weather bond market downturns.

Davis Tax-Free High Income, with a return of 2.3 percent, was the top performing municipal bond fund and only one of two to make money in 1994, one of the worst years ever in the bond market.

In the first quarter this year, when 72 percent of 525 municipal bond funds tracked by Morningstar lost money, the fund was up 1.27 percent.

And in the good times for bonds, for example in the three years from February 1991 through January 1994, the fund returned an average of 9.55 percent a year, most of it in the form of tax-free income.

"If you are in at least the 28 percent tax bracket and are getting scared of stocks," Stamper said, "this fund is a good diversification vehicle for someone in a high tax bracket who is looking for similar returns with a lot less risk."

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Stamper Capital & Investments, Inc. has been the sub-adviser to this Fund since October 1995 and B. Clark Stamper, our President, has been its Portfolio Manager since June 1990.

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