

“Our Clients’ Past Successes are Not Necessarily Indicative of Future Successes.”

Stamper Capital & Investments, Inc.

“Focusing on Upside Potential with Downside Protection Since 1995.”

TAX ANGLES MONTHLY NEWSLETTER

Low-Risk, High-Yield Muni Fund

By Author Unknown | March 1997

A recent Morningstar summary commends Davis Tax-Free High Income Fund for two features that are usually mutually exclusive: its "almost imperceptible volatility" and a rate of return that in 1996 put its A shares ahead of all those of its 508 peers. Clark Stamper, the portfolio manager, will not speculate on the outlook for this balancing act, but he does say he has built "huge" downside protection into the portfolio and that, although it has an A+ credit rating, the fund's pretax equivalent yield is higher than many junk bonds.

That this is not just a flash in the pan is confirmed by Morningstar's five-star rating. The fund's performance in the last three years puts it among the six least risky in the group, yet its return in the same three years is among the highest. For someone in the 39.6% tax bracket, the current yield of around 6.4% is equivalent to a taxable 10.6%.

The most unusual feature of the portfolio is the almost 60% invested in cushion bonds (these are callable bonds with higher interest rates selling for a premium). Most of these can be called in during the next few years or even months. Because these bonds have to be surrendered whenever the issuer decides, they cannot rise much so the fund would almost certainly under-perform if interest rates fell sharply. But the bonds are equally unlikely to fall if rates rise. "The market could drop 7 or 8% and the principal on most of these bonds wouldn't be eroded at all," Stamper estimates. Meanwhile, they are providing unusually high yields.

He advises caution in current conditions: "The yield difference between high- and low-quality bonds is closer than it has been in 10 years. You are getting almost as much on an A bond as a BB. Looking ahead, you'd expect spreads to widen rather than narrow. If that happens, the lower qualities would under-perform. You're looking at poorer prospects for a riskier bond, which doesn't seem to be much of a deal."

Now that fear of a flat tax, which spooked the market for a while, has been shelved, Stamper says investors need to start thinking about another problem: As the federal government puts more financial responsibility on local governments, many states, cities, and counties are more vulnerable than they have been to some kind of setback. A recession could bring widespread problems.

Observation: The fund's approach is to buy municipal bonds issued on behalf of corporations, which are backed by salable assets, housing bonds guaranteed by federal

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agencies, and insured bonds. The portfolio's average duration is a low four years and includes no fewer than 250 broadly diversified issues.

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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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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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