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The Munificence of Bond Funds

By Cheryl Peress | 07-07-2000

No one likes taxes, especially those who pay a lot of them. For those who think they pay a lot, an effective way of keeping Uncle Sam's greedy hands to himself and out of your wallet is via municipal bonds.

Municipal bonds, or munis, are debt obligations issued by states, cities, and other government entities to raise money to build schools, highways and hospitals, among other things. In most cases, the income generated by munis is exempt from both federal and state taxes, and hence, offer the biggest benefit to those whose taxes are high.

"A person in a high tax bracket should definitely own munis," says B. Clark Stamper, manager of Evergreen Tax-Free High Income B (VMPIX), a $352 million diversified portfolio of 300 high-yield munis.

The long-term return of equities is roughly 11% while the pre-tax equivalent dividend yield (interest income) on this fund is 10% (assuming a 40% tax rate).

"But this [fund] is significantly less risky than the stock market," notes Stamper.

He says studies show that a 20% stock and 80% municipal bond combination offers the best risk/return combination for individuals in a 20% bracket or higher. That means those fortunate enough to have struck it rich in the recent tech boom should own munis.

"Many of the newly wealthy should be worried about protecting [their earnings] rather than maximizing return," explains Stamper. "This is a fund where you can take some money off the table and get a better return for a much lower amount of risk."

Out of the Junk Yard

Stamper is a fixed-income veteran, learning his craft during the junk-bond heyday in the 1980s. He managed a junk fund for eight years as well as two mortgage funds, before managing this muni fund beginning in 1990.

"This is the only one I manage now," he says. "The market is so inefficient and it offers so much value for shareholders." The average muni size is $10 million to $20 million with 7,000 different issues, explains Stamper.

"A lot of the big guys won't bother with some of these little bonds," he says. Because many of these forgotten issues don't get priced accurately, he can get better risk/reward characteristics.

"On the muni side, high yield doesn't necessarily mean high risk," he says.

Sensitivity Training

The fund has lower interest-rate risk than other high-yield funds because its duration is only four years. Duration is the weighted maturity of a bond's cash flows, and is used to determine the price sensitivity with respect to interest-rate movements.

A shorter duration means the bond is less sensitive to changes in rates and vice versa. In a rising interest-rate environment, as we are in now, shorter-duration bonds like munis are better able to weather the storm (when rates rise, the yield demanded on a bond also rises, but prices decline).

"Under most scenarios, munis do better than most bond categories," says Stamper.

So far this year, the fund's 4.28% total return -- interest and principal -- places it in the fourth percentile of the muni short category, according to Morningstar. More impressive is its 5.59% ten-year annualized return, which puts it in the sixth percentile. Assuming a 40% tax rate, the pre-tax equivalent 10-year return is 9.32%.

However, in 1998 and 1999 the fund ranked among the worst. Both outperformance and underperformance have much to do with the fact that this fund falls in the longer duration end of its category. This means that in lousy bond years -- as in the prior two -- this fund will perform worse than its shorter-term peers.

Stamper points out that 1999 was one of the worst bond markets in history, and especially hard hit were bonds other than US Treasurys.

Cheap Relatives

High-yield munis generally have higher ratings than junk taxable bonds, which means there is less risk of default by the issuer, or less credit risk. The weighted average rating of the bonds in this fund is AA -- higher than the average high-yield muni fund and certainly more so than a high-yield junk bond fund.

Moreover, most of the portfolio (74%) is comprised of bonds that are secured by the likes of US Treasurys, GNMA, FNMA, or corporations and 48% of the portfolio is insured.

However, the credit quality of the fund has not always been this high. Stamper explains that five years ago, the average rating of the fund was BB+ with 45% of the portfolio in non-rated bonds. That's because investors were compensated by a much higher yield to take on the higher risk. But since that time, spreads have tightened up dramatically, meaning yields have come down, approaching those of US Treasurys.

Still, the muni market is cheap relative to US Treasurys, says Stamper. According to Bloomberg, 30-year AAA-rated munis trade at a 5.57% yield -- a pre-tax equivalent of 9.28%. This compares with the 30-year US Treasury, which trades at 5.79%.

"[Munis] are a little bit riskier credit wise, but not that much," he says.

Minimum initial investment is $1,000. While Evergreen Tax-Free has a relatively high expense ratio at 1.82%, as well as varying level loads, the management company expects to reduce expenses by about 0.1%.

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