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Bond Funds That Defy Gravity

By Stan Luxenberg, Senior Editor | 02-24-1997

Every so often, bond funds get clobbered. When interest rates rise, prices of previously issued bonds drop as investors flee to new, higher yielding ones. That happened during the first quarter of 1996 and throughout much of 1994.

Do any bond funds manage to avoid periodic bouts of red ink? To find out, we conducted a computerized search using Morningstar OnDisc, a program that tracks more than 3,500 fixed-income funds. Our tough criteria: The contenders had to have made money during the first quarter of 1996, a period when most bond funds lost more than 1 percentage point. Then the survivors had to report average annualized returns of more than 5 percent for the past three years, out performing the average bond fund by more than half a percentage point. And finally, the winners had to be more stable than average, according to a measurement called standard deviation.

The computer popped out 73 names, most specializing in high-yield corporate bonds. We eliminated the high-yielders because they might not be appropriate for cautious investors. We also weeded out funds aimed at big institutions. Only 22 choices remained. To make sure the portfolio managers had survived the cut because of their skill, not luck, we checked how the funds had done during three other periods when many bond funds lost money-the first and second quarters of 1994 and the fourth quarter of 1993. We settled on seven funds that seemed suitable for cautious investors and had profited in at least three of the four difficult quarters in our study.

It turns out that the winners focus on short or medium-term securities. When rates rise, these don't fall nearly as hard as long-term holdings. Though short-term securities produce relatively skimpy yields, our winning funds all found ways to turbocharge their portfolios, as you'll see below.…

In the first half of 1996, Davis Tax-Free High Income Fund-Class B outperformed more than 99 percent of the municipal-bond funds tracked by Morningstar. That was a complete turnaround from 1995, when the fund neared the bottom of the heap.

Neither result was surprising. Davis is designed to excel in rough markets. During good periods-such as 1995-the fund lags. By avoiding big losses in bad years, Davis generates winning long-term results. The fund returned 5.2 percent annually over the past three years. If you're in the 36 percent bracket, that's equivalent to a taxable bond yielding more than 7.5 percent. Portfolio manager B. Clark Stamper earns his top results by employing strategies middle-of-the-road investors shun. For example, most tax-free investors look for solid issues, such as general-obligation bonds backed by a municipality's taxing power. But Stamper sometimes goes out on the edge. He'll buy bonds backed by revenues from nursing homes and hospitals, sectors where bankruptcy is a distinct possibility. Stamper also has some holdings in lower rated industrial-revenue bonds, which are backed by companies. "People overpay for high-quality issues," Stamper says. "Weaker issues tend to be under-priced in relation to credit quality and default risk."

One typical holding Stamper considers under-priced is an industrial-revenue bond from San Diego Port Facilities. Morrison Knudsen, a company with shaky finances, and National Steel and Shipbuilding, a little known operation, back the issue.

Besides providing high yield, unloved issues tend to hold up during rough periods. When rates rise, the generous yields prop up the iffy bonds, so they drop less in value than lower-yielding quality bonds.

To limit default risk, Stamper holds a diversified portfolio of more than 200 issues. So if one or two collapse, the fund won't suffer much.

Stamper's portfolio includes many stable securities known as cushion bonds. These can be called by issuers before their maturity date. When they are redeemed, an investor gets back the principal and usually must reinvest it at lower rates. For instance, Stamper might buy a 20-year bond that could be called after 10 years. Say the bond is 12 years old and could be called shortly at a price of 101. No matter what interest rates do, the bond will trade around that figure because that's what the investor could receive from the issuer soon. Meanwhile, comparable non-callable bonds with more than 10 years till maturity could trade all over the map. In a bad bear market, cushion bonds may hold their ground, while regular issues paying the same yields might drop 6 or 7 percent. In 1994 and 1996, the fund's cushion bonds barely budged.

Why don't more bond managers grab these solid issues? The reason is that while they provide downside protection, they don't rise much in a good market. Aggressive investors hate that kind of showing. But it's fine with Stamper. Because they're so unloved, he grabs cushion bonds at bargain prices.

....Some bond funds try to attract investors by boasting sky-high yields or big returns in bull markets. But the funds we've highlighted share a duller yet perhaps more laudable philosophy: They seek to produce decent results while protecting shareholders' money.

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