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TICKER

Finding Refuge at City Hall: Muni-Bond Funds
They have tax advantages and juicy yields

By Harvey Shapiro | March 1998

It's that time again. Spring is in the air, and clients are thinking about taxes. And even though it's too late to do anything about last year's taxes, March is always a good time to remind investors-especially those of the higher income variety-about tax-free, municipal-bond funds.

Municipal bonds are extremely safe, and, for people in the top tax brackets, they usually provide higher after-tax income than Treasuries do. Investment grade long munis currently yield more than 5%. To someone in the 31 % tax bracket, that's the equivalent of a taxable bond paying more than 7.2%, a fat reward at a time when long Treasuries yield about 5.8%.

These relatively juicy muni bond yields result from unusual market conditions. Demand for Treasuries has been particularly strong lately as foreign investors seek a stable income source. Although they might find any fixed-income issue attractive, overseas buyers-with little use for bonds that escape state and federal taxes-have ignored munis. So to attract buyers, munis have been forced to fork over relatively high payouts.

What's more, the long-term outlook for munis remains solid. The strong economy has boosted tax revenue, bolstering state and city creditworthiness.

To find attractive tax-free bond funds, Ticker conducted a search using Morningstar's Principia software, which tracks 180 tax-free load funds. We instructed the system to find funds that have produced above-average returns while recording relatively little volatility, as indicated by standard deviation (a measure of how much a fund moves above and below its mean results). Our findings include two riskier long-term funds, two tamer intermediate- term offerings, and a very safe short-term fund. We've listed them in order of risk:

Davis Tax-Free High Income
This short-term fund manages to produce above-average returns while recording a miniscule standard deviation. And good news for pessimists:

The fund particularly shines in down markets. In 1994, when bonds tanked, Davis stayed firmly in the black.

Manager B. Clark Stamper holds a broadly diversified portfolio with an average credit quality of A. He gets top returns by scouring the corners of the market for bargains.

All in all, these scraps add up: The $370 million fund "Probably has over 400 positions," Stamper says. Why? "We generally seem to get more value in smaller positions," he says. "In many cases, I buy 50 or a 100 bonds here or there and build the position up."

What kind of bonds? Generally, unusual issues-or "story bonds"-that require a little understanding. Other investors might avoid such issues. "Many of the bonds we own have a special quality to them," says Stamper. "Each one has an individual story."

And he has a few other tricks: "Sometimes regional brokers will bring stuff to market cheaper," Stamper says, and adds that "if one state trades cheaper, we'll buy it, and, when it rallies, we'll sell it."

Another trick is to find premium-coupon bonds that are trading near their call dates, but which Stamper thinks won't be called, enabling the fund to collect above-market income if he's right.

Moreover, many weaker bond issues are underpriced in relation to their risk. Besides providing fatter yields, out-of-favor issues hold up better in down markets.

When rates rise, hefty yields help prop up prices of weaker bonds, so they drop less than high-quality issues with lower yields. And Stamper's holdings are higher in quality than one might expect at a high-yield fund-an average rating around AA. Says Stamper, "It's a lot higher than junk level, because we're not paid to take that much credit risk right now."

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