A STEADY, DIVERSIFIED APPROACH TO INVESTING IN THE MUNICIPAL BOND MARKET

FUND FACTS

USAA TAX-EXEMPT SHORT-TERM (USSTX)
USAA TAX-EXEMPT INTERMEDIATE-TERM (USATX)

CATEGORY:
Muni: National Short-Term Bond
Muni: National Intermediate-Term Bond

PERFORMANCE: (thru 3/31/02)

Short-Term Fund

	Fund	Category
Compound Annual Return (%)		
1 year	3.6	3.4
3 years	4.2	3.8
5 years	4.6	4.3

Intermediate-Term Fund

	Fund	Category
Compound Annual Return (%)		
1 year	3.9	3.1
3 years	4.2	4.1
5 years	5.7	5.1

CATEGORY RISK:
Short-Term: Above Average
Intermediate-Term: Average

TOTAL ASSETS: (as of 2/28/02)
Short-Term, $1.145 billion
Intermediate-Term, $2.4 billion

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Tax-filing season may be over, but taxes shouldn't be out of your mind for long. Taxes obviously cut into your bottom-line return, and the effects can be substantial when compounded over time.

Taxable investors who want to shelter their income can turn to tax-free bond funds, and today's tax-free rates are particularly attractive relative to taxable bond yields. One key, however, is making sure that most of the return you receive is really tax-free. Municipal bond funds that trade frequently and generate gains may have distributions that include taxable capital gains.

Two funds that have had very strong long-term track records both in terms of total return and return in the form of tax-free income are the USAA Tax-Exempt Short-Term and Intermediate-Term Bond Funds. Both funds have beat the average for the category for the one-, three- and five-year periods ending March 31. In addition, the intermediate-term fund has been among the top 25% in its category for the one- and five-year periods ending March 31.

Currently, the short-term fund has $1,145 million in total assets, and the intermediate-term fund has $2,427 million in total assets.

In early April, portfolio manager Clifford A. Gladson discussed the management of both funds with Maria Crawford Scott.

What is the investment objective of the short-term and intermediate-term tax-free funds?

For both funds, the investment objective is to provide a high level of tax-exempt income to our investors. However, the short-term fund has an implied lower volatility.

We buy only investment-grade municipal bonds, and we try to use qualitative analysis to add value. When we look for value, we're not just talking about credit quality, but we're talking about where we invest in terms of maturities based on our interest rate outlook. We want to make sure that our funds are going to provide the kind of income streams that we think our investors are looking for.

Another important objective is that we run efficient funds, so that we have relatively attractive, low expense ratios.

And, of course, our investors are very tax conscious—they want income that is tax exempt. So we try to manage the tax efficiency of the funds quite closely. We minimize capital gains, and we do not buy bonds that are subject to the alternative minimum tax (AMT).

Are the portfolios structured based on a forecast of interest rates?

We normally stay fully invested, but I do tilt the portfolios based on my interest rate outlook. We're not market timers—we don't take wild and radical bets.

The way I control the interest rate risk in the short-term fund is to use variable rate demand notes. These are bonds that have a demand feature that lets me put them back at any day for either the same day or seven-day settlement. This demand feature is usually backed by a high quality bank. These bonds will always be at par because of the short reset dates on them. As rates rise, the interest that's earned by them goes up. Of course, as rates fell, they went down a little bit, but it does keep the share price very stable. They are, of course, tax exempt, and typically, between 20% and 25% of the short-term fund has these types of instruments in it. They really do help to

stabilize the fund—we think of this section of the short-term fund as a money market with steroids.

Would that allow you to do a little bit more with the other part of that short-term fund?

Yes, it does. We feel that, with these variable rate demand notes, we can produce cash flow streams and predict where things are going more easily in the short term, so that allows us to go out and look for BBB and A– rated credits in that fund. We typically hold more than our competitors, but in the municipal markets, we think that the credits are much more stable than in the corporate markets.

Does that mean credit research isn't quite as critical?

Let's say there's a lot more transparency in the municipal market. If you think about it, it makes sense. The budgeting and debt decisions for a municipal entity are open to the public, they usually have another political party looking over their shoulder, they have the press looking over their shoulder. So there is more accountability, and there are fewer shenanigans that go on in the accounting and the actual issuance of debt.

In terms of market sectors, is there a difference between the short-term fund and the intermediate-term fund?

A little bit. A lot of municipal electric utility bonds have been issued on the short end of the spectrum; these are one- and two-year bonds. In fact, that was a very attractive sector to buy when California was having all of their problems, once we could figure out what was going on with deregulation.

We always were very good analysts of electric utilities, but quite frankly, when deregulation came into place, I wasn't sure who the winners and losers were going to be. So we went from having about 15% or 20% of the portfolio in electric utilities, literally down to less than 5%. Once we saw what was happening in California, we could read the tea leaves across the nation. So we brought those ratios back up to about 20%.

That was an opportunity in the short-term fund, but it wasn't there in the intermediate-term fund because in some of the areas, looking out past three or four years is very difficult. You don't know if they're going to deregulate or not. So in the intermediate-term fund, we are underweighted in the electric utility industry.

On the other hand, in the intermediate-term fund I have been able to find multi-family housing revenue bonds that have a good solid guarantor, and that are attractively priced. There is also a lot of general obligation issuance, more than you'll usually see in the short-term range. They're slightly different markets.

How do you make sure that you are diversified in the municipal markets? For instance, is it in terms of the type of bond issued, or the geographic location of the issuers?

We're diversified not only by state, but we're also diversified by industry and by issuer. In other words, we have limits on everything.

The intermediate-term fund holds 250 individual credits, although it actually holds more issues than that because it holds serials. We have a 5% limit on one issuer. The largest we hold right now is about 4%, and that's in a AAA security. But most of the time we're buying less than 2% positions.

Within the intermediate-term fund, are you spread across the maturity spectrum in that three- to 10-year range?

Typically the fund runs a little toward the longer end of the maturity range because the municipal yield curve is normally positively sloped, so as the maturity becomes greater you are paid more. The weighted-average maturity of the fund is somewhere around 8.5 years now. I have had the fund into the 9.25 range on occasion, depending on how attractive the yields were, so we're flexible on where we wind up. But normally we try to get the best amount of yield for the least amount of risk.

How do you go about finding particular issues?

Because I run diversified funds, I actually look for what appears to be the best value of the week. I'll consider all of the new issues and all of the secondary offerings that are out there. I have traders that help me screen these things also. If we see a new issue that looks attractive, we'll do a review on it. If I see issues that look attractive in the secondary market, and many of the names we know already, we'll consider making a bid in that market. We're very flexible, we don't try to be really dogmatic about what we buy. We really are looking for that elusive value. And if I don't have any cash flows, I'll sell something and replace it. We can do that as fund managers because the bid/ask spreads in our markets are low.

What percentage of the holdings are in insured issues? Do you prefer issues that are insured?

In the intermediate-term fund it's about 18%. I do have other bonds that have letters of credits, but I'm talking traditional bond insurance here.

There are times when insurance represents a good value and times when I'd really rather do the underwriting myself. If there's an event risk in the credit, many times I want to have it insured. I can do the credit analysis, but if there's some sort of a political event risk that might be facing the credit, then I'd prefer to see it insured.

What do you mean by event risk?

Let's say there's a school funding court case that's outstanding. Trying to predict what's going to happen in the courts is very difficult, but it could well affect the state's finances—between schools and Medicaid or Medicare, those are the things that cost the states the most money. So, it could cause some credit distress. If we're having a problem I might like to see insurance on

the state or the localities. That's the kind of event risk that I'm talking about.

Another example would be an established turnpike. If I think that the growth patterns are changing in the area, I might like to see insurance. It's a risk that I can't really mitigate away for that particular credit. That's when we use insurance.

Now, there is one whole class of security that I avoid entirely because of event risk. Those are the so-called 'tobacco bonds' that are secured, not by taxes, but by the anticipated revenue stream of the out-of-court settlements between the tobacco companies and the participating state governments.

I feel that there's a lot of event risk that's being transferred to the investor concerning whether there are going to be other judgments against the companies, or whether there are going to be superior liens if the companies go bankrupt. To me, it's not an acceptable amount of risk: The event risk is so great that, no matter what they're rated—and they could be rated AAA for all I care—I don't think they're investment grade.

Unfortunately, I think these bonds are going to be pushed more and more to individual investors as there are more and more issued. And to me, these are 'investors beware' issues.

Are any of those insured?

No, they're not. And I'm not going to speak for the insurance companies, but that in itself does say something, doesn't it?

It appears that tax-free rates today are very favorable compared to taxable bonds. Why accounts for that?

I have to agree. The advantage of municipals is very appreciable for anybody in the 28% bracket and higher. As to why, that's a question that a lot of people have been asking. I think that there's a lot of issuance, which has outstripped the demand a little bit. Also, they're a little less liquid. I can buy and sell them quite easily, because we deal in large lots, but for individuals they're less liquid.

Typically, how long is a security held in the fund?

Our turnover is very low—around 7% in the intermediate fund and 9% in the short-term fund, and the short-term fund turnover is higher only because I have shorter maturities.

We want to keep costs down, and so our idea is to make the right decision the first time.

I will have higher turnover if rates rise. What I'll typically do—because I can carry losses forward for seven years—I'll take losses and try to find higher-yielding bonds. That gives me a tax shield against times when I do sell and we make a profit. And in that way, I'm able to put capital gains into the share price as unrealized capital gains rather than distributing them. That lets the shareholders make up their mind as to when they want to pay taxes.

Do municipal interest rates follow the taxable rates closely, and what is your interest rate outlook?

The municipal yields normally follow Treasury yields, except for the fact that in the very short-term issues, you can sometimes in the municipal markets see an inverted yield curve [shorter-term securities yield slightly more than longer-term maturities].

As for my interest rate outlook, right now I think the economy is going to enter into recovery. How fast that will happen and how fast the short-term rates are going to go back up is debatable. But short-term rates are going to drift up.

Now, the intermediate-term rates are pretty interesting, because the 10-year rates are actually higher than they were before the Federal Reserve started cutting rates. It looks like the credit markets in general looked right beyond the recession, and it looks like they were right. The recession wasn't very deep and it wasn't very long. It seems they had confidence that the Federal Reserve actions would take effect eventually, and they did.

I don't see inflation as being a big factor. I won't try to predict oil prices because that's always the wild card, but there doesn't seem to be wage push inflation or anything like that at the moment.

So, my outlook is for more stable longer rates, and rising short-term rates as the year goes on. How quickly they rise is the $64,000 question.

That's why, in the short-term fund right now, the average rated maturity is 2.3 years—that's very short for that fund. It normally runs closer to three. And I've done that by placing about 27% of the fund in those variable rate demand notes I talked about. They're very defensive type issuances. I hope that, as rates rise, we'll benefit from the rising variable rates on those. And when I think that the rates are stable again, I'll be able to lock in some good interest rates for our investors and give them that stable income stream that they've come to enjoy.

What about the outlook for municipalities?

My guess is that the revenues for most states are going to be higher than they're estimating now. As the economy recovers, tax receipts will pick up, so it won't be a worst-case scenario and they'll be able to weather the storm.

The other wonderful thing is that municipalities have had 10 good years to build up rainy day funds and reserves. Most of the states really took it to heart and did that. In fact, the last 10 years has seen very good government management throughout all of the state governments. I can't name one that I think has done a poor job of going off and spending like a drunken sailor when times are good. With all the budgetary problems, you hardly hear any state talking about tax increases. They've been able to make the cuts and use the reserves they've built up in the good times to help weather the storm. ✥