David Lindsay, portfolio manager, Galaxy II U.S. Treasury Index fund

Tracking the Government: A Low-Cost Approach to Investing in Treasuries

In this month's Mutual Funds Workshop (on page 3), John Markese focuses on Treasury bond funds. These funds are viewed as relatively low-risk by investors seeking a safe harbor from volatile stock markets, along with the credit safety of the U.S. government. These funds are not totally risk-free, however as Prof. Markese points out in his article. Returns on this type of fund are affected by the average maturity and average size of the coupons of its bond holdings—and by its expense ratio. Volatility can be reduced by seeking funds with shorter average maturities and avoiding zero-coupon funds. And, since expense ratios are a drag on returns and yields, performance can be enhanced by selecting a low-expense mutual fund.

One way for a fund to keep expenses low is to simply follow an index, rather than make active management decisions. That is the approach taken by the Galaxy II U.S. Treasury Index fund, which seeks to match the price performance of U.S. Treasury notes and bonds, as represented by the Salomon Brothers U.S. Treasury index. The fund's expense ratio of 0.40% compares to 0.64% for the average Treasury fund; it is the fourth lowest after the three Vanguard Treasury funds, with expense ratios of 0.25%. [For more investment characteristics of U.S. Treasury funds, see the table on page 4.]

Currently, the fund has about $113 million in total assets.

In early December, portfolio manager David Lindsay discussed the management of the fund with Maria Crawford Scott.

What is the investment objective of the fund?

The objective is to provide a return identical to what the overall U.S. Treasury market provides, minus our modest expense ratio. Basically, we track the U.S. Treasury component of the Salomon Brothers broad investment grade bond index.

What is included in the index?

Because of the homogeneity of Treasury securities, there are only about 175 different Treasury issues in the index, and we're able to profile them using between 25 and 30 issues.

The Galaxy II U.S. Treasury Index fund is part of the Galaxy family of funds, 4400 Computer Drive, P.O. Box 5108, Westboro, MA 01581-5108; 800/628-0414; www.galaxyfunds.com.

Why set up a Treasury index fund, as opposed to actively managing a Treasury bond portfolio?

There are some people who want the absolute safety of U.S. Treasury securities, and who feel that sometimes when people try to outguess interest rates by betting heavily very long or very short, they mess it up and do not get such a good return.

In addition, the fees on an index fund are lower than the average by quite a bit, and some people may feel that the benefit from the lower fees is likely to outweigh any benefit from the portfolio manager trying to outguess which way interest rates are going to move.

What is the maturity range?

The Salomon Brothers index drops out all Treasuries once they go under one year. So, we follow the same policy of selling them before or right after they go under one year. On the long side, they go out as far as 30 years.

Is it weighted toward one particular range of maturities?

Currently 56% of it is in the one- to five-year range, and that reflects the fact that the Treasury does an awful lot of two- and five-year note issuances. About 17% is in the five- to 10-year range, and beyond 10 years, makes up about 27%. So it's primarily an intermediate index, with 73% between one and 10 years.

Do those weightings change much over time?

No, and to the extent it does, it's very gradual. What would change it over time is if the Treasury starts doing more financing using longer-term bonds or shorter-term bonds, but it's a very long process because the amount of new debt is relatively small compared to all the outstanding debt.

It can get a little confusing, though, because sometimes when the Treasury wants to do more financing in the short end, they'll do it with Treasury bills (Treasuries with less than one year maturity), which are not part of this index. And the fact that they are doing more financing shorter could actually lengthen the index because that may slightly lengthen their issues that are over one year.

Would you ever take any actions to change the composition of the fund if you saw adverse market conditions?

No. It would purely reflect the U.S. Treasury market at all times. If we felt something huge had changed, we would go back to the holders of the fund, and there would have to be a vote from them to change the nature of the fund.

What's the average maturity of the fund?

The average maturity is 8¾ years.

Is that a very accurate indicator of the way that the Treasury index would respond to interest rate changes, since it is composed of many different maturities? In other words, would it behave differently than a fund that really was invested in 8¾-year bonds?

It would be somewhat less volatile because bond price volatility is not proportional to maturity. In other words, if you add a unit of maturity, you add less than a unit of volatility, so it really behaves roughly like a 6- to a 6½-year bond. That's the kind of volatility it has even though its average maturity is 8¾ years.

What about in terms of its yield?

At the end of the last month, its yield was a little under 6%—5.94%, actually.

Does that correspond roughly to an eight-year bond?

Yields are so flat now that they run only from about 5.66% on a two-year note to maybe 6.05% on a 30-year.

What are the risks that an investor in the fund would face? Obviously they don't have a credit risk.

Interest rate risk. If interest rates were to rise, the price of the fund would decline in price. On the other hand, if one is bullish on the bond market and believes interest rates are likely to decline, then the fund will not only provide a good rate of interest, but some capital appreciation as well.

What would they be giving up by going with Treasuries as opposed to corporate bonds?

Theoretically, you would be giving up some yield because the interest rates on corporates are higher. In point of fact, relative to an investment-grade corporate fund, you probably wouldn't be giving up much of anything because the extra yield would probably be eaten up by extra fees. So, only if you were comparing this fund to a junk fund where the yields are a whole lot higher, would you see a substantial increase in yield. And then, of course, in a junk fund you have both interest rate risk and credit risk.

The Treasury index is essentially a laddered portfolio of Treasuries. What would be the advantage of having that laddered index as opposed to simply a target maturity?

Our fund will be perpetually duplicating the Treasury market, whereas the target fund eventually reaches its target date. So early in its existence, it will be quite volatile in terms of price movement, and late in its existence, it will be almost like a money market fund, and at that point you would be giving up a fair amount of yield. Since we're constantly moving the maturity out just a little bit every month, we prevent that yield decline aspect. So we're always offering a yield consistent with what the overall Treasury market is offering.

Obviously, you don't do a lot of bond management, but you have to do some buying and selling—probably more so than a stock index fund because Treasuries are constantly maturing. How do you do that?

Well, that's exactly right. Each month, the issues that have moved under a year go out of the index. And the Treasury is almost always doing some financing, so there are new issues coming into the index. As a result, on a monthly basis we have to readjust the fund to take account of how the Treasury index has changed. We also have cash flows in and out of the fund, so we have to keep readjusting for that, spreading them across all the different Treasury issues.

What happens is that each month we get a computer program through, ironically, Lehman, which is identical to the Salomon Brothers index. We use that because of the automation, and we are able to match our fund up through a computer program with the index and make sure that we are profiling the index very, very closely. Now, we don't necessarily transact in all 25 to 30 issues each month. Typically, in fact, we're probably only taking action in five. You don't need to fine-tune things that tightly to exactly match the performance of the index, and we like to work in minimum lots of $100,000 to keep costs down, so that can lead to some very slight over- or underweighting, which has very little impact on the performance. So each month, we would just buy the ones where we were marginally underweighted with new cash in lows, and if we had cash outflows, we would sell the ones where we were marginally overweighted.

You mentioned that you are able to do that with only 25 issues, rather than purchasing all 175 different issues. How do you accomplish that?

Let's say that the Treasury has a 5⅞ issue of May 31, 2002, and a 6% issue of June 30, 2002. Those two are going to perform virtually identically, and so we just own one of them. So, in a sense, by picking every seventh Treasury, we really come close enough to profiling the whole index.

Do you use futures to help out in the process?

No, we don't. One could, but futures are impacted to some extent by a "cheapest-to-deliver" phenomenon, and that can sometimes make the futures move a little bit differently than the Treasury securities themselves.

If you are not buying and selling, then investors are essentially receiving most of their distributions in the form of income?

Yes, pretty much. Now there is a little buying and selling, as we've discussed, in terms of responding to cash flows and the constant need to adjust the portfolio to be like the index. In a bull market, that will generate a moderate amount of gains, and in a declining market, a small amount of losses. But those are not a very substantial part of the return.

Is a Treasury index fund the only fixed-income fund that an investor would really need, or would it be better for someone to go into other areas of fixed income?

I think it depends on the size of the investor's portfolio. I think this is probably the first step, because I think you want to be as safe as possible in your initial bond investments. So, it could serve as a core. Probably, the next step would be an investment-grade corporate bond fund, and then a high-yield or a so-called junk bond fund, although, I think that would be a smaller weighting for most investors. And then, some kind of international or global bond fund.