Fund seeks higher yields and total returns by looking for the value among lower-rated investment quality municipals as well as some below-investment grade paper.

A Search for Value and Higher Yields In the Municipal Bond Market

An interview with Philip G. Condon, portfolio manager, Scudder High Yield Tax Free Fund

Municipal bond funds, the subject of this issue's Mutual Funds Workshop, are long-time favorites of investors seeking shelter from taxes. And among those funds that offer the highest levels of tax-free income are high-yield municipal bond funds.

One fund in this category that has done particularly well over the long term is the Scudder High Yield Tax Free Fund. The fund has produced returns ranking it as one of the top five high-yield bond funds for the five years ending June 30. [For more performance data and comparisons with other high-yield municipal bond funds, see table on page 15]. Currently, the fund has about $300 million in total assets.

In early July, portfolio manager Philip G. Condon discussed the management of the fund with Maria Crawford Scott.

What is the investment objective of the fund?

The investment objective is tax-free income but we also have a second objective, which is to provide an after-tax total return that's competitive with the Lehman Brothers municipal bond index.

And you try to meet your objectives by investing in high-yield munis?

Our portfolio can invest up to 35% in bonds rated below investment-grade, in what would be the BB and B categories.

That's not a large portion of the portfolio.

Lipper expects funds in the high-yield universe to be 50% invested in high-yield paper, but I don't think all of the funds in the Lipper high-yield universe meet those requirements. We consider ourselves a high-yield fund, but you'll find some general municipal bond funds that have as much high-yield paper as we do.

We're similar to a Fidelity High Yield fund or a Vanguard High Yield fund. We use the term to differentiate the High Yield Tax Free Fund from our other long-term municipal bond fund, which is all investment grade.

Within your investment-grade holdings, do you tend to be invested in lower-rated bonds than your investment-grade fund?

Yes, we've found more value in the BAA sector than we have in the below-investment-grade sector. In fact, we have a high percentage of the portfolio in investment-grade bonds rated below A, and that's where we get most of our high yields.

How do you decide which areas of the market have the highest value?

It's a question of what deals we're seeing and what experience we've had. We've had a lot of success with bonds in the hospital sector, and they tend to be in the BAA range, so we continue to play that part of the market.

Three years ago, we changed the prospectus in this fund to allow us to add below-investment-grade paper, and so we've been making this transition. In that sense we might differ from a fund that started up initially to be a junk fund. We're adjusting to this, trying to find opportunities in the below-investment-grade sector. But it's been slow because we haven't seen a lot of great opportunities.

If you compare the yields, a hospital bond might give us 60 or 70 basis points [a basis point is 0.01%] more than an A-rated revenue bond. Then, if you drop down from a BAA to a BB, you might pick up another 60 or 70 basis points. Depending on the risks we see in these investments, we're willing to take that extra 60 or 70 basis points. But we've found that a lot of B and BB bonds tend to not pay as much as we think they should.

What about non-rated bonds?

We've done a lot of non-rated bonds. In the muni market, very few issues come rated below investment grade, instead they tend to be non-rated. So, if a bond is non-rated, it means it's probably a junk bond. There are a number of situations where we've seen non-rated deals that are investment-grade quality and for various reasons the issuer

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Scudder High Yield Tax Free Fund is part of the Scudder family of funds, 2 International Place, Boston, MA. 02110; 800/225-2470.

doesn't want to spend the money to get rated. But typically in our market, it means that you are below investment grade. So then we do our own in-house analysis to decide what it's worth to us.

Would you get insurance on those?

No. Almost everything bond issuers insure is investment grade or better. If we're looking at a non-rated piece of paper that isn't good enough to be BBB, it's not good enough to be insured. Also, insurance takes away the additional yield that we would rather have for our shareholders.

I can see insured bonds are a good product for individuals because they don't have the expertise to analyze a credit. But if you're putting money into a bond fund, we have the expertise and we would just as soon make the money for our investors.

In terms of the overall structure of the portfolio, do you first do top-down analysis?

We come to our conclusions both ways—our traders are always looking for the best values in the market, and then our research group does a top-down analysis, by which we look at the yield curve and decide where the best value is. For instance, if we don't see a lot of value out past 20 years, our portfolio would tend to have maturities in the 10- to 20-year range, and we would be heavily in the 10- to 15-year range. If the yield curve shifts, we make adjustments in the portfolio based on where we see value.

Right now, if you go past 20 years, you might pick up five to 10 basis points—not much of a pick-up. And that's been the case historically. So, what we like to do is buy bonds in the 15-year range. Then as we go down the yield curve, three years from now that bond is a 12-year bond, and even if market yields haven't changed, the yield on the bond has dropped, which means the price has gone up. In contrast, if I bought a 30-year bond, three years later I would have a bond that's trading at pretty much the same level in an unchanged market and I don't really get any price appreciation. So, we're looking for that combination—we want income, but we also want to have a total return that looks attractive, and that's either by adding to the price or minimizing the loss on the value of the bond.

In terms of diversification, the prospectus talks both about sector diversification and geographical diversification. Which is more important?

I would say geographical is not as important most of the time. I say most of the time because you do get situations where you can have a state that has a problem—Massachusetts had a problem in the early '90s and many Massachusetts bonds suffered because of that. For the most part, what we try to do is buy California when it's cheap because there's a recession going on, and then as that regional recession ends, we benefit from that. So, I don't think geographical diversification is that important, and for defensive purposes, overconcentrating in one state to take advantage of some opportunity in the market is more important.

Municipal sectors aren't quite as clear-cut as in the taxable bond markets. Just to back up and explain a bit, the two biggest specifications in municipal bonds are general obligation bonds and revenue bonds. General obligation bonds give you the full faith and credit of the municipalities to raise taxes if there is a problem, and so are thought of as the most secure of the two major classifications. They also tend to have lower yields than revenue bonds and therefore are not held heavily by high-yield bond funds. For instance, we have 2% of the portfolio in general obligation bonds and 98% in revenue bonds. But general obligation bonds make up about a third of the market and revenue bonds make up two-thirds.

Revenue bonds are backed by the revenue stream from a particular project, which will be in a particular sector. For example, an airport is a revenue bond payable from the revenues of the airport. If the airport has difficulty, it's like any other business that has difficulty.

But we don't feel two bonds in the same sector will necessarily perform similarly. Utilities may be weaker now than they have been in the past, but it isn't clear-cut that we would want to sell all our electric utilities. We try to justify individual stories that we like, which is more of a bottom-up approach than a top-down one. The one exception is that we think hospitals have historically been attractive, so we tend to keep 20% of our holdings in hospitals.

What features do you look for in terms of individual security selection?

We may find a particular bond that is trading much cheaper because of its perceived credit risk. For instance, one is the Washington Public Power Supply System (WPPSS), which had a lot of problems in the early '80s that has been resolved, but the bonds still trade cheap, so our portfolio is overweighted in WPPSS bonds. Now, that's not a sector that's standing out as being cheap, but it's one name we've found. Denver Airport bonds had problems as well, and we bought those when they were under a lot of distress. The problems have been resolved, and the credit's much better now, but we still hold the bonds because of the capital gains. Again, airports weren't particularly cheap, but that credit was.

Another reason we may purchase a bond would be if it offered fair value relative to others with similar characteristics, but is uncallable. We stress call protection a lot in our portfolio.

You have a number of zero-coupon bonds in your portfolio. Do you use those as a form of call protection?

It is call protection. It is also a question of value. Two credit stories that are important parts of the portfolio are from two turnpikes being built out in California, and those are showing up as zeroes. Actually they convert to coupons in a few years—I think one's in seven years and one's in nine years. But that does allow us to lock in call protection. It also

allows us to buy credits that are very cheap.

What would cause you to sell a bond?

Quite often when the cash flow's quiet, it's a question of whether we see something that's a better alternative. So, if a new deal is priced that I think is attractive, I'll find something in the portfolio that has outlived most of its usefulness.

What if a bond is not performing up to your expectations?

Well, quite often if a bond is underperforming, it's when you don't want to sell. In other words, unlike stocks where you may have a stock that will continue to underperform because its management or product isn't quite the best, with bonds what usually happens is the structure was the wrong structure in that particular market. Let's say I had both a high-premium bond and a 20-year discount bond at a time when market yields went up and prices dropped. In that market environment, the bond that would go down the most would have been the discount bond, and it may have gone down twice as fast as the premium. That's the bond I'm not going to sell because that's the bond that will come back the fastest when the market comes back.

What about when there's a credit problem?

Well, that's a question of deciding whether, given our outlook for the credit, it is going to get worse. We're always reassessing our credit versus the price of the security.

Your portfolio turnover is very low.

We know that investors want as much tax-free earnings as possible. Heavy turnover can sometimes hurt that. So if we like the situation, and we have sizable gains in those bonds, it would take a lot for me to sell those because I don't want to pay a capital gain on them. My style has been to find long-term value and stick with it.

Do you hold those to maturity?

Not necessarily maturity, but to a point where they've shortened [in terms of maturity] quite a bit more. We could hold to maturity, but if the market collapsed again and much of the gain is lost, that's the time to adjust the portfolio. Or, if I can find other losses in the portfolio to offset those gains, there would be turnover.

Is the possibility of significant tax changes, such as the flat tax, affecting the municipal bond market?

I think that was very much over-rated as having an affect on our market. There were probably a couple of weeks in April of 1995 when several publications—Barron's, Fortune—had articles on the flat tax, but other than that, it really flattened out. I think that if you look at what happened to all bond funds' cash flow, the biggest effect in 1995 was not the flat tax, but the fact that the bond market did so poorly in 1994 and many conservative investors who were in bond funds were startled to see how much the bond market could be affected. That's why now we're competing with the stock market. It's obviously one more negative thing to a potential tax-exempt bond investor. But hopefully, things have settled down and we hope to see renewed interest in bonds in general.

What risk does an individual investor face in a high-yield fund?

Unfortunately, risk now only means price volatility to many people. I guess we can thank Morningstar for that, and it gives investors this perverse notion that because the price hasn't changed much, it isn't risky. Now, funds that are, let's say, 50% invested in high-yield paper will have volatility that's much lower than the average, which for some investors means less risk. Investors should recognize that if you buy more low-rated securities, you have increased your risk regardless of what the day-to-day price change is and that over time, if you have defaults in the portfolio, you're going to see it.

And the price change is less in a high-yield fund because of the higher coupon?

No, it's mostly because of the illiquidity in the high-yield market. For instance, last Friday the Treasury market moved down 2 points, and most high-grade municipal bonds followed that market. But if you owned a non-rated life care center, that probably didn't change in price. Those bonds may be bought by three or four investors when they are issued, and they may never trade again. It's difficult for pricing agents to decide what that security's really worth, so quite often it doesn't get repriced.

I don't know what the solution is, no one's at fault. But the fact is, in a year like 1994 when rates went much higher, you find that the high-yield funds had much less price change, and vice versa. In 1995 when rates came down and bond prices went up, high-yield funds didn't come up as much. If you look at that two-year period, and looked only for low volatility, it doesn't necessarily mean that you had less risk, it only means the bonds in the portfolio didn't get priced as accurately.

I think volatility is probably the easiest way to determine risk for large classes of funds, but investors should recognize that some of that lower volatility in high-yield funds is coming at the price of higher credit risk.

At the end of the day, it's going to be that fund's ability to manage the credit risk that will determine how the fund really fares.