Fund focuses on the lowest rung of investment-grade-quality corporates with the view that that area offers the most attractive opportunities over the long term.

A Top-Down Approach to Investing in the Corporate Bond Market

An interview with Jeffrey Koch, portfolio manager, Strong Corporate Bond Fund

Given last year's record performance of the stock market, it isn't surprising that stock funds tended to overshadow bond funds. However, 1995 ranked high for bond returns as well, with corporate bonds leading the pack. The Lehman Brothers corporate bond index was up 22.2% for the year.

One of the best-performing corporate bond funds last year was the Strong Corporate Bond Fund. In 1995, the fund was among the top five performers, up 25.3% compared to 17.7% for the average corporate bond fund. The fund also has a good long-term performance record. Over the last five years it is ranked number 2, with an average annual return of 12.6% compared to 10.6% for the average fund in its category; over the last 10 years it is also ranked number 2, with an average annual return of 10.0% compared to 9.6% for the category average. The fund currently has about $267 million in total assets.

In early March, portfolio manager Jeffrey Koch discussed the fund's investment approach with Maria Crawford Scott.

Could you give an overall description of the fund and its investment objectives?

It's an intermediate-term corporate bond fund. We tend to concentrate in the BBB part of the market, which is the lowest rung of investment-grade-rated bonds. The central tendency for the fund over the market cycle is to have a duration of about six years. [Duration measures the amount of time it takes to receive half of the present value stream of payments—both coupon and return of principal—from a bond.] It is a gauge of volatility; longer duration portfolios are more sensitive to interest rate changes.

The AAII's "Individual Investor's Guide to Low-Load Mutual Funds" puts your average maturity at about 10 years—does that roughly correspond to a duration of six years for a fund that concentrates on BBB bonds?

That's roughly the right range. The duration of BBBs will be lower than governments of the same maturity because of the higher coupons.

Why do you focus on the BBB part of the bond market?

We think that is the most attractive place over the long-haul with respect to the investment-grade bond market—it tends to provide greater return per unit of risk and, historically, it's been the best-performing part of the market.

What drives your investment decisions in the corporate bond fund?

We follow the same philosophy as our other funds. We follow a top-down process where we develop with a macroeconomic view of the world that helps us develop a forecast. We then build portfolios in a four-step process that is consistent with this macro view of the world. The four-step process is based on duration, yield curve, sector, and issue selection.

Now, what we do that might be a little different from other people is that we limit the degree to which we will make bets. For instance, in terms of duration we will make only modest deviations from our benchmark, which for the corporate bond fund is the Salomon Brothers BBB bond index. That index has an average duration right now of six years, which would be considered neutral for us. If we like the market outlook, we will go out to as much as 125% of that index and if we don't like the market outlook, we would shorten up to 80% of that index.

The same thing is true with the yield curves. We split the yield curve up into four baskets by effective duration and we make modest overweights or underweights in those four baskets based on our anticipation for changes in the shape of the yield curve.

What do you mean by four baskets?

Zero to three years, three to five, five to seven, and seven-plus, by effective duration. We compare how the index is composed in each of those baskets with our portfolio composition and we will adjust the relative weightings in our portfolios in those baskets depending on how we feel the shape of the yield curve is going to change over the near term. That's the second step of building our portfolio.

Sector decisions are the third step, although with the corpo-

The Strong Corporate Bond Fund is part of the Strong family of funds, P.O. Box 2936, Milwaukee, Wisconsin 53201; 800/368-1030.

rate bond fund it's less of a concern because we're committed to corporate bonds. We will necessarily always be weighted in the corporate bond market. And then the final thing is issue selection.

Is issue selection more important for the corporate bond fund than, say, for a government bond fund?

Yes and no. We place a great degree of emphasis in all of our products on trying to derive equal increments of value from each one of those levels of decision making. In the corporate bond fund issue selection is important in the sense that it's tied into credit work and credit quality.

We take a very offense-oriented approach to credit, which I would contrast with the traditional, more defensive approach in which a fleet of analysts try to produce an approved list of corporate bonds for the portfolio managers. In that approach, they're simply trying to avoid the down side. But they're missing a lot of the up side that you can get in the corporate bond market by positioning yourself in securities of companies whose credit is going to improve over time. What we try to do is to buy only those companies where we can identify a positive trend in credit quality, and I think if you do that, you take care of the down side. That way, you can really add some value at the issue selection level where you're looking for relative price appreciation rather than just being comfortable that you're getting paid a decent income for running the corporate bond.

Once you've spotted a candidate, how do you decide if you want to actually purchase it?

We try to determine relative value in the market, which I think doesn't get enough attention. It's not enough to know that you have a credit that's improving, you also have to know if you're paying too much for it, because if it is well-recognized that the credit quality is going in a positive direction, that may already be incorporated into the price. And you only know that by being involved in the market on a day-to-day basis. You have to marry the two disciplines—trading and understanding the fundamentals.

What indicates 'value'?

You need to compare and contrast trading levels in individual securities with individual credits. You can't just look at a credit and say, "I like this credit, let's buy it," without going into the marketplace and seeing where similar issues are trading.

And you have to be trading in it because, unlike the stock market, there's no central marketplace?

It's an over-the-counter market, while stocks are traded on the exchange. Also, stocks are the same—a stock's a stock, it's just a different company, and you trade them all the same way. Bonds are individual unique animals, each issue is different. They all have their own cash flow characteristics. Some of them trade quite often, some of them hardly ever trade.

Your portfolio turnover is very high relative to other funds. Why such heavy trading?

Two reasons really. The first, and most important, is that we're trying to add as much value at the issue selection level as we do from our duration decisions. We'll make interest rate bets in our portfolios, but it's not the only thing we do. In practice, what that means is that I really don't change the major parameters of the portfolio as much as I change the issue selection that we have, positioning us in bonds that we believe will appreciate relative to the bonds that they've replaced.

The second reason for the turnover is that we think that it's harder to sell than it is to buy, and we therefore maintain a disciplined approach to the sell decision. If a bond hits a sell target we'll pull the trigger on it and sell.

What kind of targets do you set?

It's really a spread target, based on the spread relative to Treasuries. In other words, where are XYZ bonds trading relative to Treasuries of comparable maturity? If a bond is, say, 100 basis points off [its yield is 100 basis points—1%—over the yield of a comparable Treasury] when we buy the bond, we may feel we can make five to 10 basis points, so if it tightens to where it is only 90 basis points off, we'll sell it, assuming that the change isn't due to overall market conditions. If it has tightened 10 basis points and the whole market has tightened 10 basis points, we'll re-evaluate it and say, "Okay, it's performed in line with the corporate bond market, do we still expect it to outperform the corporate bond market?" If so, we have to readjust our price targets.

What about selling on the down side?

That's even harder, because the tendency is to sit and root for your losers and hope they come back. The key for us is that we objectively try to determine whether we still want to hang on to that security.

How do you maintain diversification?

We generally limit ourselves to positions that represent 5% or less of our total portfolio. We want to have a meaningful position, though—we want to have at least a 1% position if we can do it because we don't want to spread ourselves too thin in the portfolio where we're buying bonds just to meet a diversification target. After all, we're making the decisions based on the belief that we think that the securities are attractive. So we generally maintain between 1% and 5%. The 5% positions are positions where we're very comfortable over the near term.

What about diversification in terms of the types of companies that you're buying at any one point in time?

Well, to some extent it is part of our sector decisions, although we really don't make a lot of sector decisions with the corporate bond fund itself because it always has to be in corporates. But part of our decision-making process with respect to the corporate bond fund is, "What industry should we be in?" And we will make bets on industries versus the market. If we like cable and media versus what the market's weighting in cable and media is, we'll overweight that sector. Those are very explicit and intentional bets, and they represent certain parts of the market that we think are cheap relative to other parts of the market.

Do you go into foreign bonds ?

If we do, it is typically Yankee bonds—dollar-denominated bonds of foreign issuers—usually investment-grade. However, at times we'll have a small position, by small I mean generally less than 5% of the portfolio, in bonds that are not investment-grade foreign companies or foreign government bonds.

Last year your performance was very good, and you did much better than many of your peers. What accounted for that?

Well, first of all, the bond market had a very good year last year, so we did well. Secondly, we had anticipated at the end of 1994 that the bear bond market had pretty much run its course. Evaluations were attractive and we extended our duration at the end of 1994 and the beginning of 1995 out to about 110% of our benchmark duration, and we left it there the whole year.

There was also our emphasis on issue selection, and we were right in identifying those opportunities where we could add value within the corporate bond market. We had a decent-sized position in airlines, cable and media, which are very large sectors in the BBB bond market and also very volatile, but they performed very well last year. At the end of the year we moved into some of the financial areas, insurance and the like.

Did the second half of the year surprise you, given the strong performance in the first half? Did you expect that to continue?

The size of the move in rates did surprise us and left the market at a level where it was at pretty full valuation levels. But we think it's hard enough to determine the direction of rates, much less the magnitude. So I can't say that I'm ever really surprised by the magnitude of a move, because basically anything can happen. If we get the direction right more times than we're wrong, we're already ahead of the game. Recognition of this is very important.

What about 1994—a down year in which you managed nonetheless to better your peers?

At the end of 1993 the market had reached levels where it was easy to be complacent, but it was pretty overvalued. In fact, we haven't been back there yet. We anticipated that the economy was strengthening, and that the Fed would have to start tightening rates after a 17-month period of doing nothing. And we knew that that first tightening would be followed by other tightenings, and that it would be "the shout heard 'round the world." As a result, once the Fed tightened on February 4, 1994, we shortened up to 80% of our duration, and we stayed there all year until the end of the year. At that point, we felt that the bear market was overdone and there was some value in the market again.

But 80% of your duration would be as defensive as you would get—you would not move to a heavy cash position?

No, but you know, within that, you also have the yield curve, and we had positioned ourselves for a flat yield curve, because we didn't feel spreads would remain as wide as they were. And there was in fact a dramatic flattening of the yield curve over that time period. So, not only were we short relative to our benchmark, but we were flatter.

What's your outlook for 1996?

Well, we've had a pretty interesting market so far. We like the market at these levels. As I said earlier, bull markets breed complacency and I think that the market had gotten pretty complacent. There was a lot of leverage in the market and that leverage tends to all go in the same direction at the same time, so we've had pretty significant corrections over the last three or four weeks that brought us back to a better level.

We think that the economy is really in a slow-growth mode and that slow growth means that at times it's going to look very weak, and at times it's going to look like it's accelerating. For instance, there were some numbers in the last week that led the market to believe that the economy was accelerating [lower than expected unemployment figures]. It will be volatile, but at the end of the day, we think we'll end up with an economy that will grow 1% to 2% with inflation that is very much under control. And now you've got some value back in the market. We do not think that the Fed's about to embark on a tightening cycle. I think that represents an opportunity for us. It leaves us at a level that we like, so we're at 110% of our duration.

So the new numbers didn't change your opinion of the overall direction?

Well, obviously it makes you reconsider because it was a real outlier. But since it was an outlier, you have to think long and hard about it. And when you do that, you may find, as we did, that the number isn't as strong as it appeared on the surface and that there are a number of factors that could have led to an overstatement of job growth in February.

The market is very confusing at this level. It's easier to see when you are actually heading into a recession, with negative growth. It's a lot harder to determine where the trends are going when you are bouncing around at 1% to 2% growth. It's sort of an ugly process, and creates the tendency for the markets to really get whip-sawed. You have to be very careful about how you position your portfolio in that type of market. And one series of numbers, in our opinion, is not enough to make us believe that we're wrong on this economy.