FINDING VALUE IN CORPORATES: A FOCUS ON MEDIUM-QUALITY CREDITS

FUND FACTS

STRONG CORPORATE BOND (STCBX)

CATEGORY:
Corporate Bond

PERFORMANCE: (thru 12/31/98)

Compound Annual Return (%)	Fund	Category
1 Year	7.2	6.0
3 Years	8.1	6.5
5 Years	9.3	6.5

RISK: (relative to category)
High

TOTAL ASSETS: (as of 3/1/99)
$860 million

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Stock mutual funds have received most of the investor glory in recent years, much of this due to the outstanding performance of the overall stock market. But most individuals don't invest solely in stock funds. What about other asset classes?

While corporate bond funds haven't turned in the stellar returns of equities, neither have they fared badly over recent years. One corporate bond fund that has performed consistently well relative to its peers has been the Strong Corporate Bond fund. The fund has been among the top 25% of all funds in its category for the last year, three years, and five years (through year-end 1998), and it has bettered the category average for each of the last five years, although at a higher risk level than average.

In early March, co-portfolio manager John Bender discussed the management of the fund with Maria Crawford Scott.

What is the investment philosophy of the fund?

We run the fund with a couple of very basic tenets. Our goal is to outperform the market by about a 100 basis points a year, but we also want the fund to move in a very consistent manner with respect to the underlying benchmark, which in this case is the Lehman Brothers corporate BAA bond index. We want the overall risk profile of the portfolio to be consistent over time with the benchmark so that our investors have a pretty good idea of the fund's risk with regard to both interest rate risk and credit risk. [Interest rate risk is volatility in the price of the bond caused by changes in interest rates; when interest rates fall, existing bond prices rise, and when interest rates rise, existing bond prices fall.]

And, as the benchmark implies, the fund invests primarily in the medium-quality credit area of the corporate bond market.

Why do you concentrate on that particular area of the corporate bond market?

We started managing the fund this way in about 1991. At that time, we studied the different sectors of both the corporate market and other areas of the fixed-income market and found that the BBB sector of the corporate bond market was a very attractive sector. In other words, given the risk that you are taking, which is both a combination of interest rate risk and credit risk, the returns that you are getting in exchange for the extra risk in the BBB market are very attractive relative to the government market or the higher-quality part of the corporate market or even the mortgage market.

Throughout the 1990s—it was true back then and it is still true today—Wall Street devotes a lot more resources to researching equity stories than they do researching bond stories. By hiring good credit analysts and doing credit research ourselves as portfolio managers, we can find unique situations by focusing on BBB- and BB-rated companies that are improving in their credit profile in the very near future.

What is the process you use to select bonds?

We start with an overview of the macro-economic environment, which gives us a good idea of which industries in the market we should overweight and underweight.

In managing the portfolio, there are four decisions we have to make when we come in every day—we have to think about how we are positioned relative to the benchmark in each of four areas.

The first decision concerns duration, which is how much exposure to interest rate movements you have in the portfolio. [Duration takes into consideration both the maturity and coupon size of a particular bond, both of which affect a bond's sensitivity to interest rate changes.] Right now our average duration is a little bit more than the benchmark, which is about six and a quarter years, while we are running at about six and half years, which is roughly a 10-year maturity level. We are running a little bit longer because we think that the market at these levels has good value. The U.S. economy is running above trend, and there may even be a modest chance that the Federal Reserve raises interest rates by 25 basis points between here and the end of the year.

The second decision we have to make is which maturities we want to own. Although our fund has an overall portfolio average duration of six and a half years, not every one of those bonds is a 10-year bond. The benchmark index and our portfolio are divided up into baskets of four yield curve 'buckets,' consisting of bond maturities of zero to three years, three to five years, five to seven years, and seven years and longer in duration. [A yield curve plots the yields of similar quality bonds over different maturities; the steeper the curve, the greater the difference between the yields of the longer maturities compared to the yields of the shorter maturity bonds.] We are currently slightly overweighted in the long end of the market, so we have more 20- and 30-year securities in the portfolio than we do five- and seven-year securities, but again it is a modest bet. The reason is that we thought the long end of the curve had steepened somewhat in last year's sell-off. We think that right now, 30-year rates are relatively attractive and the yield curve could flatten out again, particularly if the Fed does raise rates by 25 basis points. Generally when the Fed is easing, the curve will steepen out somewhat and when they are tightening, the curve will flatten a little bit.

So, in other words by having different mixes within those four baskets, you could still get the same duration?

You could get the same duration but different movements relative to the market. Last year when everybody was afraid that many emerging market countries were going to default and there were huge credit concerns in the market, the front end of the yield curve [short-term maturities] moved much further than the back end of the yield curve [longer-term maturities]. Basically we think we are making a small bet that that will reverse itself somewhat, and it already has to some extent.

That said, over the last two years we've been very close to the index in terms of our interest rate risk and our yield curve risk. Really where we've been making a lot of our money is in the industry selection and the issue selection.

And are those the other two decisions you must make with respect to the portfolios?

Yes. The industry selection decision is similar to the decision stock portfolio managers have to make if they are managing against the S&P 500—they have to decide whether they want to own technology stocks or capital goods stocks or services companies or food manufacturing companies.

There are a total of 50 industries represented in the Lehman index, so it is a very broad cross section of the economy. Some of the biggest industries in the index are the electric utility sector, entertainment industry, cable companies, telephone companies, and railroads. So you can build a very well-diversified portfolio within the index, and we do diversify, but we'll make active decisions with respect to our outlook for different industries and different companies, and we will overweight and underweight certain industries at different times.

When we are making the industry decision, there are two parts. The first is what we call the top-down part. We take a look at how the industry is structured, whether it is a fiercely competitive industry or whether the companies that we are looking at have a healthy competitive structure, where they have some pricing power and good market share. We look at the regulatory environment to see how that's changing.

Then we use a bottom-up approach that is very much like equity research. We spend an awful lot of time getting to know the managements of the different companies that we lend money to. We think it is very important to understand the strategic direction that the companies are taking with respect to how they want to grow their business and how they want to run their capital structure, because what is good for stockholders isn't always good for bondholders. Sometimes companies will leverage themselves, adding extra debt to their capital structure in order to buy back stock or buy back other companies. That could be a great thing strategically, but if they choose to do that, then their bond ratings might go down.

What we want to find are companies that can grow and are good operators, but we also want to find companies in which, from a strategic perspective, it makes sense for them to lower their financial risk. We want to identify companies that by lowering their financial risk and by paying down their debt create a good situation for both them and their shareholders.

Over the last year or two we found good examples of that in the electric utility area. The whole regulatory environment of the electric utility business is changing very rapidly, going from a regulated monopoly-type industry to open competition and a totally deregulated environment. Utilities used to be able to look at themselves and say, 'We have very little business risk because we are a regulated monopoly, we get stable price increases, our cash flow profile is very stable, so we can run with more financial leverage.' Now, the utilities that ran with higher financial leverage and were BB- or BBB-rated realize that they are going to have to be much more competitive in terms of price as they go to open competition. And so, in order for them to keep their total risk profile down, they are going to want to have less financial risk and less leverage. A couple of the issuers that we've invested in over the last year or so that have improved their credit profiles and have been upgraded include Niagara Mohawk, Cleveland Electric, and Calenergy.

On the other hand, we don't spend a lot of time trying to bottom fish and look for companies whose credit profile is deteriorating and where people think it won't deteriorate any more in the near future. For example, take a company like Rite Aid. Just last week, the drug store chain, which is a BBB-rated company, reported very disappointing earnings. The bonds widened, but many people think that the worst-case scenario is that they will get downgraded a small amount, and therefore they think the bonds are too cheap. But a lot of times when a company disappoints like that, they tend to take shareholder-oriented actions. We stay away from those kinds of companies, and instead look for companies that have started to turn the corner, or that have articulated a good plan where we think we can see a catalyst for something that will improve their credit profile.

The strongest stories that we find for the portfolio are where the industry fundamentals, the macro-economic fundamentals, and the management strategy are all lined up to where bondholders can benefit. In other words you want an industry where there are good margins, good cash flow, where those cash flows are improving and operations are sound, and also where management strategy is bondholder friendly.

How do you find the bonds you purchase? Do you survey a list of BBB-rated stocks?

We have four dedicated credit analysts who follow their industries across the ratings spectrum and around the globe, so that they have the most exposure to the largest number of names they possibly can. We're also very careful to know who the large issuers in the marketplace are, where we can invest a significant amount of money in not just one type of company. We work very hard to keep on top of the market—we have two traders who follow the prices daily. The corporate bond market is a negotiated market, so we have to work on the telephones with our brokers and Wall Street to maintain a good sense for what types of credits are worth what price.

Which areas are you currently overweighting and underweighting?

We're very overweight in the utility industry. We are also overweight in cable, retail, lodging, airlines, banking, and we are starting to get overweighted in energy. Our biggest underweights are sectors of the market that trade relatively rich compared to what we think the fundamentals are worth, and that would include the entertainment industry right now. We are a little bit underweighted in telecom sector, paper, defense, and rails.

What would prompt you to sell a bond?

Two things. A company may do great things for us, but if the price gets ahead of the fundamentals, we would consider selling.

The other thing would be if the fundamentals and operating environment in the industry, or for that company, changed dramatically. When we invest in a company and we are investing in medium-quality corporate bonds, we have to be very cognizant of what the downside is at all times because with any bond investment, your downside is almost always greater than your upside. Companies can disappoint a lot faster than they can improve. So we always try to be very careful as to what we think a bond is worth and to cut our losses. It is a big part of our philosophy that if a company starts to change the strategic direction that they articulated when we first invested with them or if they start to disappoint from a performance standpoint—whether it be poor earnings, an acquisition that we don't agree with, or an aggressively financed acquisition—then we are fairly quick to sell and cut our losses.

The portfolio turnover of the fund is very high. What is the cause of that?

Remember there are four decisions we have to make with respect to the portfolio: There is how much interest rate risk we want to take, there is maturity risk where we have to decide what part of the yield curve to buy, there is an industry decision, and then there is the particular bond—which company, which issue. A company like Time Warner has 15 different bonds outstanding. Most of our turnover comes at that last decision-making spot. Because the corporate bond market is fairly inefficient and it is a negotiated market, there are a lot of arbitrage opportunities between different maturities. There are also arbitrage opportunities in different companies within the same industry, for instance Time Warner versus Comcast in the cable market, or in the airline market you can trade United Airlines versus Delta Airlines. These trades don't really change the portfolio risk by a meaningful amount. When we think about how much interest rate risk we should have or our yield curve and maturity portfolio positioning, we really look out 12 to 18 months for those kinds of decisions. It is unusual for us to make more than one or two changes to our interest rate policy a year. But the relative price movements from one bond to another can change by a little bit each day, and each of those little bits can add up to a nice amount of extra return each year.✦