COMPELLING AFTER-TAX RETURNS IN THE HIGH-GRADE MUNICIPAL MARKET

FUND FACTS

T. ROWE PRICE TAX-FREE INCOME (PRTAX)

CATEGORY:
Tax-Exempt Bond

PERFORMANCE: (thru 6/30/01)

	Fund	Category
Compound Annual Return (%)		
1 year	10.2	8.8
3 years	4.6	4.2
5 years	6.1	5.5

RISK:
Above Average

TOTAL ASSETS: (as of 9/1/01)
$1.45 billion

CONTACT:
800/225-5132
www.troweprice.com

Few investors are turning away from the stock market entirely. But the stock market downturn and the realization that long-term stock returns may not be as rosy as many had once assumed has prompted many to shift part of their focus to other asset classes, including bonds.

Investors re-evaluating their bond investments should not overlook the municipal bond market. For investors with memories of higher-yielding environments, the low rates currently offered by municipal bonds at first glance may appear distasteful. Yet on an aftertax basis, municipals currently yield rates that are very attractive relative to similar-maturity taxable bonds.

One municipal bond fund that has performed very well over the long term is the T. Rowe Price Tax-Free Income Fund. The fund has outperformed the average tax-free fund over the last year, three years and five years (through June 30), and it has been in the top 25% over the last year. Currently, the fund has $1.45 billion in total assets.

In mid-September, portfolio manager Mary Miller discussed the management of the fund with Maria Crawford Scott.

What is the investment objective of the fund and the overall approach you use in managing the fund?

The Tax-Free Income Fund is a long-term, investment-grade municipal bond fund. Our goal is to achieve returns that are above our benchmarks, and to do that with less volatility than the market. Our benchmarks include the Lipper peer group, which is over 200 similar funds, and the Lehman Brothers municipal bond index, which is a broad universe of municipal bonds.

We have an active management approach. There are other parts of the bond market that are easier to index and to manage close to a benchmark. But we think the municipal market is still inefficient enough that you can add some value through active decisions in portfolio management and through good credit research.

People talk a lot about volatility, but I don't think investors mind volatility to the upside. However, they don't like volatility to the downside. We are pretty quick to move to protect the portfolio in a rising rate environment. We don't just match our benchmark and weather it out, but instead we'll shorten up, raise cash levels, sell more aggressive bonds, and buy more defensive bonds.

We also try to be careful about our credit moves and to be on the right side of credit events, to move away from things we think are going to do poorly and into things we think will do well.

What is the maturity structure?

The structure of the municipal market is such that, as an example, the Lehman Brothers municipal bond index has an average maturity of 13 years. However, that includes a lot of very short-term bonds. In this fund, we expect our average maturity to be longer than 15 years because we are trying to achieve maximum income within the credit quality constraints of the portfolio. And in fact, today, our average maturity is between 16 and 17 years.

Of course, while the average maturity is one indication of interest rate risk, a better measure is duration. Right now the duration of the fund is seven years.

Is a duration of seven years typical of a fund with an average maturity of around 15 years? Could you explain the difference between these two measures?

Let me talk for a minute about what the portfolio looks like, and that may help to explain this a bit further.

When we determine the weighted-average maturity, we take the stated maturity of everything in the fund, from a cash investment that provides liquidity for the portfolio all the way out to the longest bond, and we weight that by the dollar value of each holding.

Duration looks at all of the cash flows over the life of the bonds in the portfolio. If a bond is paying a 5½% coupon each year, duration looks at all of those cash flows, as well as the final payment at maturity, and it takes the present value of all of the payments to figure out an average life for a bond. If you have a high coupon bond that pays 7% a year, the present value of those income payments will be greater relative to the final payment at maturity than the present value of the income payments of a low coupon bond paying 3% a year. So a bond with a higher coupon has a shorter duration than a bond with the same maturity, but a lower coupon.

There are many other factors that go into the calculation of duration, including, for instance, call features. If you own a 30-year bond with a 5½% coupon and interest rates fall below 5½%, as they are today, the call becomes the effective maturity for the bond. Therefore, if a 30-year bond is callable in 10 years, you now have a bond that the market is pricing to that 10-year call date.

A duration measure isn't encompassing the true maturity of the bond, but instead it focuses on what is the expected maturity of the bond by the market. Weighted-average maturity must use the stated maturity.

The concept of duration is a good measure of interest rate risk in a portfolio. For the Tax-Free Income Fund, generally the duration falls between seven and eight years, so at seven years [the current duration] we're at the shorter end of that range. And that's largely because many of the calls in our holdings are operative in a low interest rate environment.

In this fund, we manage the duration carefully. If we like the direction of interest rates and we think they're heading lower, we will move our duration longer; if we don't like the direction of interest rates, we will move shorter.

Do most of the bonds in the portfolio have call provisions?

In the Tax-Free Income Fund, most bonds out to 10 years of maturity are non-callable—that's kind of a given in the market. Bonds longer than 10 years usually have calls.

We have about 47% of the portfolio that is non-callable, although 20% of that is bonds under 10 years that typically won't be called anyway. We try to overweight non-callability in the portfolio because we think those bonds trade better and have better characteristics than bonds with calls. It is a theme in the portfolio because when you're in a falling interest rate environment, having bonds that are non-callable helps you—they tend to perform well because they don't jump from a 30-year maturity to an effective 10-year maturity if a call comes into play.

The fund appears to be highly diversified. How much do you manage the various sectors of the municipal bond market?

In the portfolio today, we have just over 300 bond holdings spread over about 170 bond issuers, because we have more than one holding from some issuers. I would say it's highly diversified.

I think if we were going to describe our style, it's that we take lots of small bets.

The municipal bond market has quite a wide array of sectors, from general obligation debt issued by state and local governments backed by general tax revenues, to the many sectors of revenue bonds and project financings that are secured by a particular stream of revenue—for instance, water and sewer bonds that are backed by water and sewer payments by users. We have, generally, broad exposure to all the sectors. But at different times we're going to like certain things and not like other things, and we'll try to overweight or underweight according to that. Several times a year we'll revise our list of sector recommendations of what we really like or don't like. Then within those sectors we identify credits that we like or don't like. If we don't like a sector, we probably have more sale recommendations or avoid recommendations.

In the municipal market, particularly in a portfolio like the Tax-Free Income Fund, I don't spend a lot of time worrying about actual defaults. We are mainly buying higher-quality bonds; our investments in lower-rated securities are pretty low. What I do worry about are credit rating downgrades—moving from a AA to A, or an A to a BBB—because that can impact the market price of the bond. So we try to move away from those situations and conversely to look for opportunities where we think things are improving and where we can make some money by a credit upgrade.

Also, one thing we don't invest in are municipal bonds subject to the alternative minimum tax (AMT). That's an important issue because many people think that over the next few years, far more investors will become subject to the alternative minimum tax unless the tax laws change, and it wasn't addressed in the tax bill this year.

Some of your holdings are insured bonds. Is the insurance something that is important to you?

It's something that's difficult to not have in a portfolio. Between 40% and 50% of new issuance in our market has been insured for the last few years. I've watched that grow dramatically from the early 1980s.

From our perspective, we have a strong credit research staff, and we would like to use them to select bonds. And if we buy bonds that are already rated AAA there's very little room for upside improvement. But given the presence of the insurers in the market, it would be very hard to run a portfolio without insured exposure.

It looks like roughly 10% of the portfolio, perhaps a little bit less, is in bonds that were rated BBB or below. Would those be considered your more opportunistic bonds?

Yes, that's an area we've actually increased a little bit this year. Last year we saw a great deal of "spread widening" in the lower-rated market, which means that the difference in yield on a BBB-rated bond versus a AAA increased last year. We had a lower exposure to BBB-rated bonds, so this year we have increased our exposure because we think we'll get paid for it.

Typically, what kinds of issues would those be?

Some of them are healthcare. We felt hospitals had gotten really beaten down over the last few years. We felt some of them would be long-term survivors and were likely to be good performers.

We've added utility sector muni bonds that we think will do well, and we have some retirement home bonds in the portfolio because we think that is an industry which has good demographics and good potential over the long term.

How often do you make changes to the fund?

We don't change course every day, but we have strategy meetings where we meet every two weeks to review the course of the markets and our portfolios, and we'll make some mid-course corrections there. But you can't take a fund of our size and turn it around day-to-day. Our strategy is to make good longer-term decisions in terms of direction, and then to make good shorter-term, tactical moves where we see relative value and we can jump on something.

However, we also try to keep our turnover relatively low, for a couple of reasons. One, we want to minimize transaction costs to the portfolio. Two, we're very interested in limiting capital gains recognition.

Trading can be somewhat market directional—when you're in a period when rates are falling, the bonds we hold are probably appreciating in value. So at this time if we were to sell a lot of bonds, we would book a lot of capital gains and we would give up some embedded tax-free yield that we purchased at higher rates. So at these times our transaction volume tends to go down.

If rates are rising, the opposite is true—we have bonds that are at losses in the portfolio that we bought at lower interest rates. Then we have an opportunity to sell them, reinvest the proceeds in new bonds with higher coupons, and importantly, capture a realized loss that we can carry forward for eight years. That's very helpful in terms of managing the portfolio. If you have a loss carried forward, then you can realize gains at other times when you want to realize gains without pushing through a gain to the investor.

The tax-free issues have been yielding very attractive rates—better than taxable bonds on an aftertax basis, even at some lower tax brackets. Why is that the case, and do you see that continuing?

We are today at relatively low absolute rates on a historical basis, looking back 20 years in the municipal market. Having said that, they are very attractive versus Treasuries and even to other taxable markets. To give you an example: The 30-year municipal high-grade index today was set at a 4.95%. If you were in a 35% tax bracket, that is equivalent to a 7.6% taxable yield. In contrast, the Treasury market is at 5.4% for a 30-year maturity.

Part of this, I think, is a little bit of rate shock. Investors tend to focus on stated yield, and they don't often stop to calculate what that would be on an aftertax basis. People look at these absolute levels and say, 'I'm buying a 30-year investment with a 4.95% yield?'

In the short term, meaning within the last week [the week following the September 11 terrorist attack], we've also seen a big flight to quality and to Treasuries, which have pulled, in particular, short-term Treasuries down dramatically. Municipals have been slow to follow, which is not unusual.

What is your outlook?

In the short term, right now, I don't have many concerns about the municipal market. I think it's a less volatile market, and a high-quality market. There are certainly sectors and issues to worry about, but I'm less worried about it than I am the stock market.

I'd say generally that the pressure on interest rates is probably downward for a couple of reasons. I think the Fed is determined to provide liquidity to the market and to lower rates enough to keep things moving well. I think that there's definitely going to be some economic fallout to the whole disaster, which will effect the economy in the sense of slowing it down further, and that will tend to move interest rates lower.

Having said that, we're starting from some pretty low levels and we got a pretty good injection when the Federal Reserve lowered interest rates this morning. When you begin to see signs of light at the end of the tunnel, such as spending on recovery efforts and more physical stimulus from the federal government with disaster recovery and military responses, that may put some pressure on rates in the other direction.

But right now, in the short term, I would say the direction of rates is probably lower. ❖