A TOTAL RETURN FOCUS IN THE TAX-EXEMPT BOND MARKET

FUND FACTS

SAFECO MUNICIPAL BOND FUND (SFCOX)

CATEGORY:
Tax-Exempt Bonds

PERFORMANCE: (thru 6/30/98)

Compound Annual Return (%)	Fund	Category
1 Year	1.3	2.0
3 Years	6.7	5.6
5 Years	7.1	5.9

RISK: (relative to category)
High

TOTAL ASSETS: (as of 6/30/98)
$521 million

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Sheltering income from taxes is always appealing, and municipal bond funds offer just that. But different funds use different strategies to achieve similar goals: a high aftertax rate of return. This month's Mutual Funds column, starting on page 8, takes a look at the characteristics of municipal bond funds and the different approaches used.

One non-state-specific fund that has done quite well relative to its peers over the long term is the SAFECO Municipal Bond Fund. It has performed among the top 20% of all municipal bond funds over the last three years and five years (through June 30), although it underperformed the average muni fund over the last year. The fund invests primarily in investment-grade tax-exempt bonds, but has a longer-term average maturity than most muni funds. That has benefited the fund with higher long-term returns, but at greater levels of risk due to higher volatility. [For more comparison characteristics, see the table on pages 9–10]. Currently the fund has about $521 million in total assets.

In early July, portfolio manager Stephen Bauer discussed the management of the fund with Maria Crawford Scott.

What is the investment objective and philosophy of the fund?

The fund seeks to provide a high level of tax-exempt income by investing primarily in investment-grade municipals.

The way I manage the fund is based primarily on a total return idea, rather than a focus on current yield. We have a very long-term orientation both in terms of maturity of the fund as well as the outlook and our planning process. That is probably the single thing that gives us an advantage over some other bond funds.

What are your criteria for buying an issue?

To start with, we eliminate almost anything that's not rated. Very few non-rated issuers are really appropriate for a bond fund. Over half of the rest of the market is insured, unfortunately, so we buy a lot of insured bonds. We would prefer to have fewer insured bonds and get more yield, but that's really not available right now.

Insurance really has taken a lot of the extra yield out of the market—the spread between AAA bonds and insured A-rated bonds is virtually nothing—maybe 10 basis points. Other than that, we try to take advantage of whatever disparities might happen in the marketplace—for instance, a large issue may need to come at a discount to the market to be absorbed easily. Or maybe a given state has a number of issues that come all at one time.

And how do you normally find those?

Well, that's what I do all day long. I talk to salesmen on the phone who tell me about new issues they are planning to bring or secondary offerings that they have purchased or that are available from other customers. I make comparisons every hour of the day in my own head, trying to keep track of where levels are and how they compare historically.

Do discrepancies typically occur among types of issues—for instance, will electric revenue bonds be particularly cheap for some reason that you can take advantage of?

For many years that was true because there were so many issues, and funds would have restrictions, like mine, in that they couldn't own more than 25% of one category. So if bond funds were a dominant factor in the particular market and all the funds had reached their limit on electric revenue bonds, the issuers had to attract a different audience, which meant probably having more yield. There were also some investors who were reluctant to own electric revenue bonds after several electric issuers got into trouble. Those kinds of things can change the quality image of a type of issue, and that will affect their value in the marketplace.

If an investor disagrees with the general consensus, you might take a position in a bond that is struggling and hope that it rebounds and does better—that happens all the time. But with the advent of insurance, there is less of that that goes on.

Does the fund focus on any specific category of tax-exempt issues, or is it broadly diversified?

It's a diversified fund. We have a number of different parameters by which we have to be diversified, many required by the SEC. For instance, I'm not allowed to buy more than 5% from any one issuer. In addition, we do not have more than 25% of the fund in any one category, such as water revenue bonds or hospital revenue bonds. And geographically, we aren't allowed to have more than 25% in any one state.

Traditionally over the years our largest single category of holdings is the electric revenue bonds, but that has been declining because there isn't anybody building new plants around the country anymore; currently it is around 18% of the fund. The second largest category, surprisingly, is escrowed bonds—bonds that have been advance refunded or escrowed to maturity, and which are now backed up by U.S. Treasuries. That category is around 14% and is a result of the fact that interest rates have declined over the years and lots of bonds that we bought in previous years have been advance refunded.

Can you explain that?

Well, it's just like refinancing the mortgage on your house. When you bought your house, it had an 8% mortgage and now you can do it at 6%, so you go out and borrow 6% and pay off the old 8% mortgage.

In the case of the mortgage, you pay it off at the time you borrow the new money, but that isn't always possible for municipalities because traditionally when they come to the market, they promise not to call in the bonds for at least 10 years. So, if rates drop before those 10 years are up, what they typically do is advance-refund those bonds rather than wait and actually refund them on the call date. They do that by issuing the new bonds at lower interest rates, then taking the proceeds and buying U.S. Treasury securities that mature at the date of the call on the original bond—they basically set up an escrow account with the proceeds of the new issue held in trust in the form of government securities that will mature at the time that the old bonds are callable. At that point, the new bonds become the ones outstanding.

For instance, say that the city of Seattle sold bonds back in 1994 that paid 7% for a 30-year bond, and I bought some of those bonds. Seattle promised they wouldn't retire [call] those bonds at least until 2004, but now interest rates have come down and the city realizes it can save a lot of money if it can refinance at these lower rates. So they issue new bonds that come to market at 5¼%, and take the proceeds from the issue and buy government bonds that are going to mature in 2004. So, I still own the sevens [the bonds yielding 7%], but now they are backed up by U.S. Treasury bonds.

Was security selection a factor in the fund's large holdings of escrowed bonds?

Not really. If you bought any bonds in 1994, they're probably going to be advance refunded, because rates have come down and everybody likes to save money when rates come down.

However, what I did pick were the bonds that had the best call protection, so that when the bonds were called, I got the best total return. If, instead, I had bought bonds with only a five-year call protection and they refunded those, those bonds would be gone by now in 1999—they would just take them away from me and instead of continuing to yield 7% for another five years, which they will until 2004, I'd have to reinvest now at 5¼%.

That's why call protection is very important. It is one thing that I've always stressed.

How do you get call protection?

There is really only one way to get call protection unless you can find bonds that are just plain non-callable, and there aren't very many of those because the issuers don't want to be locked into any given interest rate scenario. Other than that, the way to get call protection is to buy deeper discount bonds—basically low-coupon bonds that are selling at a discount to par [face value]. Those bonds aren't as likely to be called because what issuer wants to call a 4¾% bond? Rates aren't that low, so the issuer can't save any money by calling it in. And yet, people don't seem to put them in the same category as non-callable bonds, so they don't trade with the kind of premium, although for all intents and purposes, they are nearly non-callable. Why that happens is a mystery to me. Nevertheless, I buy a lot of deep discount bonds for the call protection, and I can do it without giving up any yield.

Don't you give up some yield that is tax-exempt?

Not really. If a discount is modest, maybe only 10 points, you're talking about a capital gains tax on 10 points of yield 30 years from now. It makes a difference of three or four basis points at the very most.

How much of a discount do you seek for call protection?

I try to get as much as I can. It is difficult at times when there are not the bonds out there with the proper coupons on them. For instance, right now if you buy a 4¾% coupon, which are quite prevalent since a lot were issued in the last couple years, the dollar price on those bonds at current yield levels will be around 87 or 88, which means prices have to rise by 12 or 13 points [due to a decrease in interest rates] before they reach par. At that point they might become callable, although it would probably require an even larger price rise before it made sense to call those bonds. So, that level of discount seems sufficient to me. I'm not going to say that rates won't drop to 3%—they might, although it doesn't seem likely, but it does seem sufficient protection to me.

The average maturity of your fund is quite a bit longer than the average municipal bond fund. Why do you go out that far?

Because there is more yield out there. The yield curve in the municipal bond market is always positively sloped. The longer the bond you buy, the more yield you get and yield is what we all want, of course. Now many people say that if you do that, you're exposing yourself to more volatility. But I say that when yields are declining, I want all the volatility I can get. And since I don't know which way rates are going to go, why is volatility a bad thing? It may be good, it may be bad. But I do know that I get more yield if I go longer, and I can put that in the bank everyday.

Do you do any interest rate projections?

No we don't—none at all. We can't do it and I haven't yet met the person who can. People claim they can all the time and you look at their record and they obviously can't.

Do you restructure your portfolio when interest rates are changing?

No, other than trying to take advantage of dislocations that occur when markets change. I am much happier in the kind of market that we've seen over the last quarter than I was during all of last year. There is very little to do in a market that doesn't ever change from day to day, and it was very frustrating. I did very few transactions because there were very few things that could be done. But in a market like we've had lately, when prices do decline a bit and yields rise, people start to do things based on short-term considerations, and that opens the door to some longer-term values.

What would prompt you to sell a bond?

Sometimes, I just hear of a good bid. For instance, I had some specialty Idaho bonds that I bought three or four months ago when they came to market. Well, their prices went high relative to the market because there was no more Idaho paper around and there was some retail demand in Idaho from some local brokers who were willing to pay very high prices. So I sold off some pieces of it over the course of a few days. Sometimes, that kind of action will do it.

Sometimes when my bonds are advance refunded, I may sell them depending on the overall tax effect to the shareholders. I try to spread out those capital gains taxes as best I can and generally when a bond is advance refunded it trades at a fairly significant gain. I don't want to sell them all at once, and that is why I have as much as I have right now. I'd prefer to have fewer advance-refunded bonds and more longer-term, higher-yielding securities, but I want to spread that capital gain over a few years if I can't offset it with losses.

Sometimes I'll do a swap to improve call protection, or to pick up some yield on a new issue that's attractive, so I will sell a bond that is yielding less in order to add some yield to the fund.

Those are generally the reasons I will sell things.

How closely do interest rates in the municipal market follow interest rates in the taxable market?

During this last quarter, they have followed very closely almost tick for tick, but that is the first time in a couple years that has happened. The reason is the Treasury market, at least the Treasury market that is quoted in the newspaper, has been a phony market for some time in that it was dominated by a lot of international investors and hedge fund people who didn't really have the same goals as you and me when it comes to buying bonds. They were buying Treasury bonds because they were a safe haven to place money rather than foreign currencies they were afraid of. They weren't concerned with the yield, particularly. So last year and particularly during the Asian crisis when things went sort of wacko, the Treasury market in terms of yield dropped to all-time lows, and for awhile tax-exempt bonds yielded more than Treasury bonds. That doesn't make a lot of sense, does it? It made munis look really cheap, but that wasn't necessarily true, it was just that Treasuries were really rich. It also meant munis were somewhat less volatile.

That market is pretty much stabilized now. However, tax-exempts are still pretty darn cheap. If you look at the relationship of long-term muni bonds to Treasury bonds right now, munis are yielding over 90% of the yield on Treasury bonds. That's traditionally on the high side. Over the last several years the average has been more in the mid-eighties. Considering the maximum tax brackets, it is still a gift. If you are going to buy bonds and you're a taxpayer, you ought to be buying munis and not Treasuries. ✦