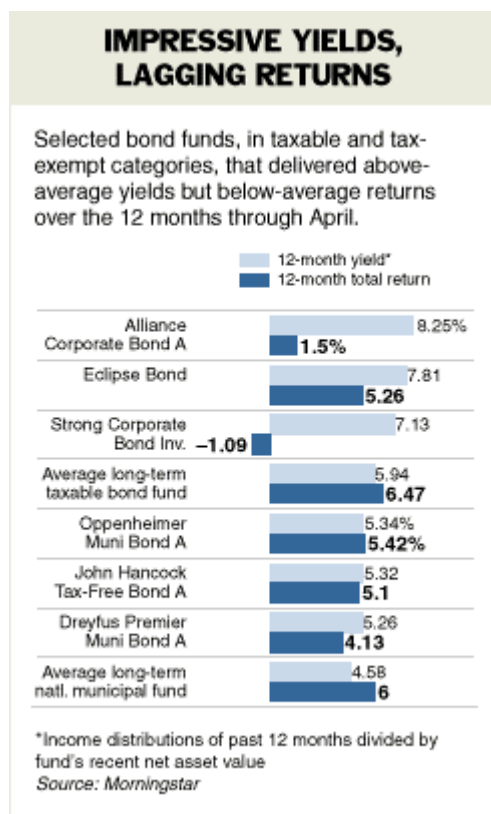


## Real Bottom Line for Investors In Bond Funds Is Total Return

By Karen Damato  
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What's the yield? That's the first question many investors ask in selecting bond funds, and sometimes it's the only one. Unfortunately, the answer can be less informative than investors realize.

"There can be a perception on the part of the public that yield equals your return. It is absolutely not the case," says Mark McCray, executive vice president and head of municipal-bond management at Pacific Investment Management Co., Newport Beach, Calif.

The real bottom line for bond-fund investors is total return. That figure includes both the yield -- that is, the bond interest distributed to investors -- and any change in the price of those bonds and thus the bond-fund shares.

Selecting a fund with an impressive yield doesn't guarantee a high total return. Just consider funds such as Strong Corporate Bond Fund and Dreyfus Premier Municipal Bond Fund. Over the past year, those are two of numerous funds that paid out more income than their average peers but simultaneously delivered significantly lower total returns.

The Strong fund actually posted a 1.09% loss for the year through April. Its income distributions to investors over that period were equal to 7.13% of the fund's recent share price. But the fund's bond holdings declined in price by a greater amount, producing a net loss when the two parts of the total return are combined. The fund has been stung by losses in bonds issued by Enron, Global Crossing and AT&T Canada, according to a recent report by researchers Morningstar Inc.

Investors have \$1 trillion tucked away in various types of bond funds, well under the \$3.5 trillion invested in stock funds, but still a huge chunk of assets sitting in an investment category whose mechanics are often misunderstood. While many bond investors understand that bond prices move in the opposite direction of interest rates, the confusion over returns and yields persists.

One reason may be the differences between holding bond funds and individual bonds. With an individual bond, the investor can expect to collect a fixed interest rate until maturity and then receive the face value, giving the yield some utility in estimating total return to maturity. By contrast, because bond funds have no maturity date and their portfolios are constantly changing, today's yield figure provides less indication of future return that shareholders will receive.

Information on bond-fund returns and yields is available from fund companies by telephone or on their Web sites. Third-party Web sites such as Morningstar.com also have such data. Most daily newspaper fund listings include total-return figures but don't list fund yields.

It may seem illogical that funds can deliver both high yield and low total return over some time periods, but it really isn't surprising. After all, it's not just chance that leads some bonds to have higher yields than others. "Yield is compensation for taking risk," explains Dan Shackelford, a senior portfolio manager of bond funds at T. Rowe Price Associates in Baltimore.

Taking added risk sometimes pays off, but in other instances it doesn't. For that reason, it's important for bond-fund investors to understand the types and magnitude of risk they are taking.

One type of bond risk that has been prominent lately is credit risk. Yields are higher on lower-rated bonds because there is a greater chance of the bond issuers defaulting on paying back what they borrowed from investors.

Over the past year, with the economy weak, there have indeed been numerous bond defaults and worries about additional companies encountering financial trouble. As a result, funds that hold lower-rated bonds, including "junk" bonds that are rated below investment grade, have delivered lower returns than high-quality bond funds.

To be sure, lower-rated and junk-bond funds sometimes outperform higher-quality ones. Indeed, some bond specialists believe lower-rated bonds, on average, will be strong performers over the next year as the economy improves. If defaults and default-related worries subside, lower-rated bonds could rally in price as well as delivering their substantial level of interest.

Another source of bond risk relates to bond maturity -- and that risk may be the more significant one for investors over the coming months. Yields typically increase with the length of time until maturity, because longer-term bonds are more volatile in price. If interest rates rise, which is likely to happen one of these days, longer-term bonds will tumble more in price than short-term ones for any given change in rates.

"Oftentimes people buy long-term bond funds not knowing the risks that are involved," says Bob Auwaerter, a principal and senior fixed-income portfolio manager at Vanguard Group. "When rates are low [as they are now] that's about the wrong time to buy a long-term bond fund," he says. He suggests that investors generally steer clear of long-term bond funds at the moment and emphasize short or intermediate maturities instead.

So if yield isn't the right way to select bond funds, what is? The first step is to decide on the maturity and credit quality of the bond fund you want, based on how long you plan to invest and your desire to take risk. Then, in selecting among similar funds, Mr. Auwaerter suggests looking for those that have done well relative to peers over the past three to five years. Investors can identify such funds on numerous Web sites, including Morningstar.com and WSJ.com.

Among intermediate-term taxable bond funds, two large funds with top three-year performance are Calvert Income Fund and Dodge & Cox Income Fund. Among intermediate-term municipal bond funds, two large funds with top three-year results are Vanguard Intermediate-Term Tax-Exempt Fund and Fidelity Spartan Intermediate Municipal Income Fund.

Also look directly at a bond fund's expense ratio, since low expenses can be a big contributor to strong total returns. In selecting tax-free bond funds, for instance, identifying those with low expenses is "a significant predictor" of future above-average performance, according to a recent study by Financial Research Corp., Boston. Low expenses are "an exceptional predictor" of above-average performance among government bond funds, the research firm said, since there is typically less variation in the raw investment results of government-only bond funds.

Expenses also play a role in determining fund yields, because expenses are subtracted from bond interest before the remaining income is distributed to investors. In any bond category, the lowest-yielding funds typically include some funds with unusually high expenses. Meanwhile, low-expense funds can deliver above-average yields without taking on extra risk.