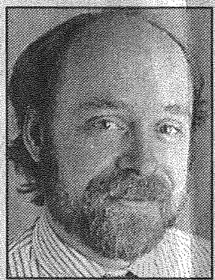
How good bond funds sound: Zzzzzzzzzzzzzz



JOHN WAGGONER

If a snail marathon is your idea of a good time, you'll like the bond market this year. Interest rates should stay in a narrow range — exactly the right climate for bond mutual funds. But not any bond fund will do. You'll need a fund that raises blandness to an art form.

You have to watch a bond fund's yield and its price. Funds pass on to investors the interest payments they receive from bonds they own. That's the yield. And, because a bond fund's portfolio varies in price every day, its share price varies, too. Put together a fund's yield and price change, and you have total return.

Bond prices soar when interest rates fall, and fizzle when rates rise. In 1994, rates rocketed, handing losses to all but the most astute managers. But this year has been terrific for bonds. The yield on 30-year Treasury bonds has fallen from 7.87% Dec. 30 to 6.60%. And the average government securities fund is up 11.3% through Aug. 31, Lipper Analytical Services says.

The rest of the year should be, well, boring, says Theresa Havell, head of Neuberger & Berman's bond funds. Blame low inflation. Bond traders look at inflation the way Superman looks at kryptonite. Inflation destroys the value of a bond's fixed interest payment. For example, a $1,000, 30-year Treasury bond issued last August will pay $68.75 interest a year until 2025. If inflation is 3% a year, $68.75 will be worth $51.16 in 10 years. At 6% inflation, $68.75 will be worth $38.39.

Inflation is a byproduct of an overheated economy. No danger of that any time soon, says Eugene Sit, head of Sit Government Securities. The economy should crawl ahead at a 2% annual growth rate the rest of the year.

Increased foreign buying, especially by Japanese investors, could push bond yields a bit lower, Sit says. "U.S. interest rates are a lot more attractive than the 3% they could get in Japan," he says. But he doesn't expect a huge run-up.

So how do you invest for a boring bond market? First, remove any possibility that the manager can do something interesting. For example, a fund manager can spice up his returns by buying long-term bonds, which typically yield more than short-term bonds.

Normally, that would be a good move. But it doesn't help much now. A five-year T-bond yields 6.03%, vs. 6.60% for a 30-year bond. And 30-year bonds are much riskier than five-year bonds: If long-term interest rates rise 1 percentage point, a 30-year T-bond's price will fall 10.4%, vs. 4% for a five-year note.

You also don't want a bond manager to make wacky bets on low-quality bonds. Bonds are interest-bearing IOUs. And when the economy is sluggish, companies that issue low-quality bonds can default.

So the best type of bond fund to buy now? Funds that buy high-quality intermediate-term bonds — those that mature in three to seven years. If you're in the 31% tax bracket or higher, consider an intermediate-term municipal bond fund. Interest from muni funds are free from federal taxes. Two top-performing intermediate muni funds:

▶ **Vanguard Intermediate-term Municipal Bond Fund**, up 53% the past five years. Yield: 4.75%. Phone: 1-800-662-7447.

▶ **Prairie Intermediate-term Muni Bond Fund**, up 48% the past five years. Yield: 3.8%. 1-800-370-9446.

You might also consider a fund that invests in government securities that mature in three to seven years. These funds offer an average yield of 5.6% now, exempt from state tax. In the box, left, are intermediate-term government funds with the best five-year records.

Bond funds: Steady performers

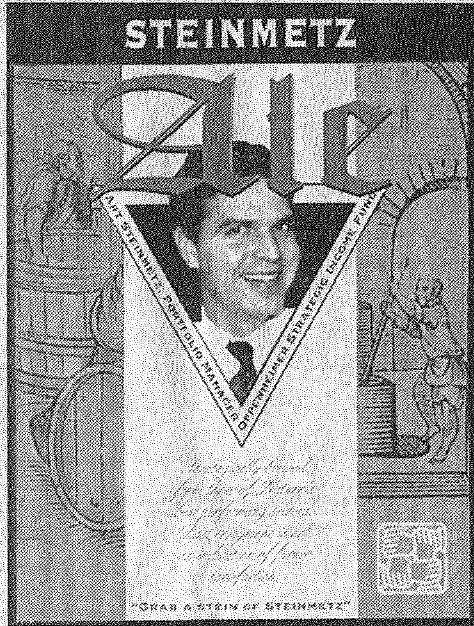
These intermediate-term bond funds have produced solid, unspectacular returns the past five years — just what you want from a bond fund.

Fund, phone 1-800	Total Return[1] 12 mos.	5 yrs.	Yield
Rushmore US Govt Int-term, 343-3355	12.1%	59%	5.85%
Vanguard Bnd Indx Total Ret, 662-7447	11.1%	57%	6.57%
Paragon Int-Term, 777-5143	10.5%	53%	5.86%
Winthrop Fixed Income, 225-8011	8.9%	52%	5.57%
Principal Preservation Govt, 826-4600	8.8%	52%	4.77%
Warburg Pincus Int Govt, 257-5614	9.1%	51%	5.80%
Glenmede Int Govt, 441-7379	9.0%	50%	6.60%
Invesco Int Govt, 525-8085	10.4%	50%	4.96%
Midwest Int Govt, 543-8721	10.3%	50%	5.46%
Eaton Vance Trad Govt, 225-6265	8.9%	49%	5.11%
Average int-term govt fund	**9.1%**	**47%**	**5.57%**

1 – interest, gains reinvested through Aug. 31

Source: Lipper Analytical Services

Fund pursuits: Fund managers have a nerdy image. In most cases, they deserve it. But a few actually have a life after work. Three examples:



STEINMETZ: Fund manager brews up dividends for clients and wheat beer on the side.

▶ Art Steinmetz, manager of Oppenheimer Strategic Income fund, is a serious beer brewer. Steinmetz's wheat beer took second place in the American Home-brewers Association national wheat beer competition last year.

His grandfather got him interested in home brewing. "There's an old family recipe, but it stinks," Steinmetz says. His beer — presumably better — is available only to friends.

▶ Peter Van Dyke, manager of T. Rowe Price Spectrum Income, keeps several hives of bees at his Baltimore home. He harvests about a hundred pounds of honey a year and gives it away under the Poplar Hill Hives label.

▶ Barry Gordon and Marc Klee, fund managers at John Hancock, are co-owners of two minor-league baseball teams — the Norwich, Conn., Navigators and the New Jersey Cardinals.

John Waggoner's column appears most Fridays.