INVESTING

Coupon Clipping, the Old-Fashioned Way

By KEN BELSON

MOST bonds these days are never touched by human hands. They are typically bought online and plunked into brokerage accounts, where they are registered and tracked digitally. Interest is automatically calculated, paid and reported to the tax authorities.

Then there are bearer bonds, the old-fashioned kind that my 92-year-old cousin Lou owns. Like silver dollars made with real silver and stock tickers that spit out prices on strips of paper, these bonds are relics of an earlier age. They are impressive-looking documents, printed on fancy, perforated colored paper.

In some ways, bearer bonds are like cash: the holder is the owner and the bonds need not be registered, a feature that makes them highly appealing to tax evaders and to criminals looking to steal them from their holders. Worry about theft explains why Lou did not want his last name or photograph used for this article. (Bearer bonds even worked their way into a Hollywood script. In the first "Die Hard" movie, the villains tried to steal hundreds of millions of dollars worth of them.)

Many holders leave their bearer bonds for safekeeping with their brokers, who every six months clip the coupons that are attached to the certificates and collect the interest payments. They also keep track of bonds that are called or retired.

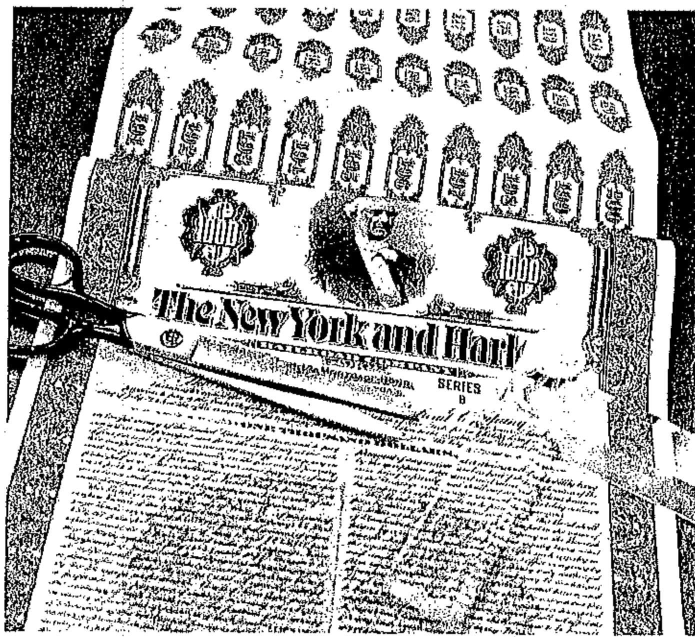
Lou, though, keeps his bonds locked in a safe at a bank and clips the coupons himself. A feisty native New Yorker, he ran a small business in Manhattan, and he still likes to handle his own finances. "I had a broker, but I got so many phone calls, letters and distractions that I was happy to pay $50 to transfer the account," he said.

But as Lou has discovered, bearer bonds aren't long for this world.

The bonds are the victim of tighter tax laws and the growing digitalization of the financial industry, which increasingly shuns paper pushing. Since 1982, when lawmakers passed the Tax Equity and Fiscal Responsibility Act partly to foil tax evaders, few bearer bonds have been issued in the United States. (They remain popular overseas, however.)

As a result, American bearer bonds will all but disappear when the remaining 30- and 50-year issues come due. "By 2013, most bearer bonds will go the way of the dinosaur," said John Colangelo, a managing director at the Depository Trust & Clearing Corporation, a settlement company that holds bonds on behalf of many financial institutions.

The D.T.C. has a dozen or so employees working full time to clip coupons, redeem them and transfer the proceeds to the brokers, who credit their customers' accounts. That's a far cry from the situation in 1991, when the company handled 21 million bearer bonds, or 42 million coupons a year, and employed 600 people to get the work done.



Ruby Washington/The New York Times

Bearer bonds, like this one from the New York and Harlem Railroad Company, have coupons attached. Holders submit the coupons to collect interest payments.

Since no new bonds are being issued, the number of bonds in the D.T.C. vault has fallen to about 700,000. (Most bonds have a face value of $5,000, so that is about $3.5 billion worth of securities, not including interest.)

While the company has a well-honed system for dealing with bearer bonds, investors like Lou are having a harder and harder time handling them on their own. He has several bearer bonds issued decades ago by New York City agencies, including the New York City Housing Authority and the Battery Park City Authority.

In the mid-1980's, he bought a bunch of them at a discount — about 50 to 60 cents on the dollar, because their coupon rates of 5 to 9 percent were considered low at the time. The bonds turned out to be a smart buy. Interest rates have generally fallen over the last 20 years, and because he lives in New York, he has not had to pay federal, state and local taxes on the municipal bonds.

"I wish I had bought more of these bonds, because when interest rates dropped, I was doing better," Lou said.

Over the years, the agencies have called many of Lou's bonds, in order to avoid paying relatively high interest rates. He has held onto as many of the securities as he can, but there are fewer and fewer places to redeem their coupons. Until late in the 1980's, Lou took them to his local bank and deposited them, along with his checks and cash. Nowadays, there are not enough bearer bonds around for banks to justify the expense of handling them.

A pensioner, Lou does not want to spend the money to send the coupons by registered mail to a paying agent — typically the bank or broker that handled the original issue — in order to collect his interest. Besides, like many other people of his generation, he prefers to do things the old fashioned way: face to face. Or, as Mr. Colangelo put it, taking care of your own bearer bonds is "a throwback: you feel like you're engaged in handling your own assets."

Lou is still in good shape, so he takes the subway to the financial district twice a year to find a teller who will take his coupons.

That has become something of a quest. Many banks that handled the bonds have merged out of business. Some of the acquiring banks continue to accept coupons in person, but others have shut their windows and forced customers to send their coupons to a processing center.

In December, I accompanied Lou on one of his bearer-bond jaunts. To redeem the coupons from his Battery Park City Authority bonds, we found the "J. P. Morgan Chase Bank Investor Services Receiving Window," which was behind an out-of-the-way door on the ground floor of 4 New York Plaza.

Lou put his coupons, which look like raffle tickets, into a special see-through envelope and wrote his name and Social Security number on the outside. The teller spent five minutes checking a computer before handing him a receipt for a check that would be sent to him in about 10 days.

That interest payment didn't arrive. He later received a note saying the bond had been called six months earlier. Lou had missed the advertisement in The Wall Street Journal announcing it, so, while he got his $5,000 principal back, he missed the chance to collect the last $215 interest payment.

WE didn't have much more luck around the corner, at Deutsche Bank. There, a teller told us that Lou must now send his five coupons — worth $125 each — to its processing center in Tennessee. I called Nashville to find out more. An operator said that Lou could send the coupons in an ordinary envelope with a signed W-9 tax form.

A lot of people are angry about the change. "We've been getting a lot of calls on this where people have gone to the old window and found it's not there anymore," she said of the New York location. It was small comfort to Lou, who ended up paying $10.32 in postage. On the ride uptown, we pondered technology, efficiency and how bonds issued by New York City agencies could no longer be redeemed in person in New York City.

"It seems to me," Lou said, "that the coupons and the bonds are a contract, and if they are going to void part of the contract and make you send them in, they should reimburse you for the expense."

It may be the way of the world, but that doesn't mean he has to like it. "It doesn't seem right," he said, "that I'm paying more and getting less service." □

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New York Times 2/12/06

Don't Judge Bond Mutual Funds' Yield Alone

By Karen Damato

A JUICY YIELD is hard to resist, often enticing mutual-fund investors to select one bond fund over another.

But bond-fund investors tempted by high current yields often end up with a lot of sizzle but little steak down the road. Yield isn't a reliable predictor of future fund returns, or even of how much income a fund will deliver, new research by Morningstar Inc. shows.

"Investors shopping for funds based on their yields are likely to be disappointed if they think the highest yielding funds [in a category] will return the most income over the next 12 months," says Morningstar analyst Bradley Sweeney, after studying six years of results for two categories of conservative, short-term bond funds.

FUND TRACK

"There were very few years when yield said much about the total return or the income return that investors would experience," according to Mr. Sweeney.

That said, quoted yields still can provide a useful service to bond-fund investors in raising red flags about funds they might want to avoid, according to the Morningstar analyst. That is because a higher-than-average yield can suggest that a fund is taking on more risk than peers.

The Morningstar findings just confirm what bond professionals have known for years: Investors coming upon a bond fund with a noticeably higher yield than its peers should respond by scrutinizing—and not salivating over—the situation.

"For some investors, [the yield] is primarily what they look at. But...they need to look at how a bond-fund manager gets that yield," says Dave MacEwen, chief investment officer for fixed-income investments at American Century Investments.

"If you've got a higher yield, it is because the manager is following a strategy that produces that yield," Mr. MacEwen adds. "Invariably that means higher risk."

Of course, the fact that current yield is a poor guide to future returns doesn't stop some funds from spotlighting those numbers in advertising and other materials. Consider **Oppenheimer Rochester National Municipals**, which boasted in a shareholder report last July that its yield was 1.34 percentage points higher than the average for Lipper Inc.'s high-yield, that is below-investment-grade, municipal-bond fund category.

So far this year, the Oppenheimer fund has posted a negative 10% total return, far worse than its peers, largely because of tumbling prices for municipal bonds backed by struggling airlines. An **OppenheimerFunds** spokesman declined to comment.

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For his study, Mr. Sweeney looked at performance data for two relatively low-risk categories of bond portfolios: short-term bond funds and short-term government-bond funds. He compared the funds' yield at the beginning of each of the past six years with the total income distributions they paid over the course of the year. He also compared the initial yields with the funds' annual total return—the performance measure that includes both income and the change in share price.

The conclusion: Investors can't consistently rely on yield to identify the funds in a category that will be standouts measured either by income or by total return.

Stable Year Helps

In some years, the bond funds that start the year with the highest yields in each category do indeed end up as the top performers in income and total return. That was the case in 1997, a calm period of stable short-term interest rates, for instance. But results in other years, with 2002 being the latest case in point, highlight the limitations of yield as a tool for selecting bond funds.

At the start of last year, an investor shopping for a fund in Morningstar's short-term bond category would have seen widely divergent yields. The top quarter of funds based on yield had an average yield of 6.29%, while the bottom 25% had an average yield of 3.87%. By the time the year was over, however, the actual income thrown off by the four quartile groupings was quite tightly clustered—and the 25% of funds that had the highest initial yields ranked third on the basis of the year's income payments.

There was further bad news for investors who picked a short-term bond fund last year on the basis of yield: The 25% of funds that had the highest initial yields ended up with the *lowest* total returns for the full year. That is probably because those funds bought more lower-rated bonds than their competitors; last year, lower-rated bonds dropped in price amid escalating corporate defaults.

Default risk, also called credit risk, is only one of several categories of uncertainty that await investors when they invest in most types of bond funds. Another is interest-rate risk, which reflects the fact that bond prices fall whenever interest rates rise. That interest-rate risk looms largest for long-term bond funds, because long-maturity bonds will drop in price more than short-maturity bonds for any given increase in rates.

In any given time period, investors may be rewarded or penalized for taking a particular risk. To make an informed choice among the many types of bond funds available, investors should consider the risks and potential returns of each category, with yield as just one indication. "That is why you have money-market funds with a yield of 0.75% and high-yield funds up around 8%, Mr. MacEwen says.

Many investors buy bond funds just for the income, the stream of monthly or quarterly distributions from the interest payments on the underlying bonds. But Daniel Wiener, editor of the Independent Adviser for Vanguard Investors newsletter, questions the whole notion of income investing.

Paying for Groceries

"You don't need 'income' to pay for groceries, rent or even a ticket to the opera. You need cash," he writes in the current newsletter issue. He points out that cash can be generated as easily by selling some fund shares as by cashing those periodic distribution checks. As a result, his recommended portfolio for income-oriented investors emphasizes bond funds but also mixes in stock funds that are investing for capital gains.

Mr. Sweeney of Morningstar agrees that income-oriented investors "should be indifferent between receiving income [distributions] and creating their own income" by selling some fund shares. And so, besides looking at a bond fund's yield, he says bond-fund shoppers should put a lot of emphasis on a fund's total return, which reflects both income and changes in share price. Investors can see how a fund's total return compared with similar funds over a period of five or 10 years, for example.

Bob Auwaerter, head of fixed-income portfolio management at **Vanguard Group**, says there is another reason for bond-fund investors to be thinking about the share-price part of total return these days: Yields are currently at four-decade lows and are sure to begin rising again eventually. Bond-fund investors need to be cognizant of how much their bond-fund shares might suffer in a rising interest-rate environment.

To understand how a fund might be affected by rising rates, investors can look back to prior periods when rates rose. Within the past decade, 1994 provides "a fairly dramatic example" of how rising rates can produce negative returns for many bond funds, notes Bill Gillen, national sales director for the distribution unit of fund company **Eaton Vance Corp.**

FRIDAY, APRIL 4, 2003

THE WALL STREET JOURNAL.