SmartMoney

BONDS by J.R. Brandstrader

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In Bonds They Trust

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AMERICAN BEACON ADVISORS' bond mavens, Kirk Brown and Patrick Sporl, have done an admirable job of flying their respective fixed-income funds, AB Treasury Inflation Protected and AB Intermediate Bond, through the credit-market turbulence of the past two years. By mandate, they've stuck to plain-vanilla stuff — in Brown's case, mostly inflation-indexed Treasury securities, and in Sporl's, Treasuries and corporate bonds. They also have hewed closely to their benchmarks, taking only modest-duration risks. Best of all, perhaps, they've done it on the cheap, keeping a lid on fees.

The **AB Treasury Inflation Protected Fund** (*ATPIX*[1]) returned 4.34% this year through July 16, slightly trailing the Barclays Capital Treasury Inflation Protected Securities (TIPS) Bond index's 5.39%. That put the TIPS fund in the top quintile of its category, according to fund-tracker Morningstar. The fund's negative 1.77% return over the last 12 months beat the index's negative 2.81%. And over three and five years, the TIPS fund posted average annual returns of a positive 4.62% and 3.71%, respectively. Its three-year record earns four stars from Morningstar.

AB Intermediate Bond (AABDX) also gets four stars for its thee-year showing, and five stars — Morningstar's highest rating — for its five-year performance. In addition, it gets the highest ratings for total return, consistent return, preservation and fees from Lipper, the fund-tracking arm of Reuters. Like Treasury Inflation Protected, its performance is nearly even with its benchmark, the Barclays Capital U.S. Aggregate Bond Index. Year-to-date (again, through July 16), Intermediate Bond is up 3.23%. It returned 6.89% over the last 12 months, landing in the top quintile in its category; it rose 6.80% over three years, besting 91% of its peers, and 5.12% over five years, outperforming 92% of similar funds.

The two funds carry no loads, 12b-1 or administrative fees. Treasury Inflation Protected has an expense ratio of 0.29% of assets, while AB Intermediate Bond's is 0.68%, also well below the average bond-fund expense ratio of 1.07%, as reported by the Investment Company Institute.

American Beacon Advisors was created in 1986. The Fort Worth, Texas-based firm manages the pensions of American Airlines' parent, **AMR** (*AMR*[2]), and 401(k)s and other health and welfare plans for AMR, plus non-AMR money. Last September, American Beacon was sold to Lighthouse Holdings, owned by investment funds tied to Pharos Capital Group and TPG Capital, two private-equity concerns.

Brown, 46, and Sporl, 39, are both AMR veterans; Brown, a Jamestown, N.Y., native and graduate of the State University of New York at Brockport, went to work for AMR in 1988, after earning an MBA from Vanderbilt. He serves as senior portfolio manager of asset management for American Beacon. Sporl, the son of a bond manager, was born in Los Angeles and has an accounting background. He earned a bachelor's degree from the University of the Pacific and a graduate degree from the University of Texas at Arlington, and worked at Deloitte before joining AMR in 1994.

As bond-fund managers, Brown and Sporl pay close attention to macroeconomic issues, including leading economic indicators, the shape of the Treasury yield curve, the business cycle and monetary policy. Brown concedes that TIPS investors might have been burned if they piled into this market at the first sign of "green shoots," in the expectation an economic recovery would blossom. Instead, TIPS declined in value when the recovery began to look slow and halting, posing no inflation threat.

In the first quarter, the Barclays TIPS index was up 5.5%, while Treasuries and corporate bonds rose by 0.12%, on average. In the second quarter, things reversed: the TIPS index edged up 0.66%, while Treasuries and corporates came in at 1.78%.

First issued in 1997, TIPS are government-guaranteed bonds whose face values fluctuate with the consumer-price index. If prices go up, the bond's principal rises. If the CPI falls, the principal falls to the level of the original investment. The amount of interest TIPS pay every six months is determined by how much the principal has been adjusted. It is lower than the interest on comparable Treasuries, however, because of the inflation-protection feature.

The difference between the Treasury and TIPS yield is known as the break-even rate of inflation. In the market-wide flight to quality last fall, the gap disappeared because of intense demand for Treasuries. Says Brown: "Currently, [the break-even rate] suggests that the market expects CPI-Urban [the benchmark measure of inflation in urban areas used by the U.S. Department of Labor] to average about 1% per year for the next five years, and about 1.5% per year for the next ten years."

Given the extraordinary amount of stimulus injected into the U.S. economy, inflation could become a much greater problem down the road. "History suggests inflation is a tough problem for policy makers to solve quickly," says Brown.

He thinks that stagflation — the dreaded combination of a stagnant economy and inflation — is more of a possibility now than at any time since the 1970s. "TIPS are attractively valued, particularly when compared with analogous-maturity nominal Treasury issues, which are offering meager yields," he says.

AB Intermediate Bond, meanwhile, is underweight mortgage-backed securities and overweight corporates. It is invested in agency paper such as Federal Deposit Insurance Corp.-backed **Citigroup** (*C*[3]) and **Morgan Stanley** (*MS*[4]) bonds. Sporl also buys the unsecured debt of these issuers.

In corporate bonds, he sticks to large issuers within a sector, and recently bought investment-grade paper from **Pfizer** (*PFE*[5]), **ConocoPhillips** (*COP*[6]) and Anheuser-Busch Inbev (ITK.Belgium). Sporl's fund also owns bonds issued by **AT&T** (*T*[7]), **Verizon Communications** (*VZ*[8]) and **Comcast** (*CMCSA*[9]), because "they were incredibly cheap in late 2008 and early '09," and these companies aren't consumer cyclicals.

A lot of bonds owned by the fund at the end of last year are up 20% or so. No matter what follows for the economy and the markets, that's a lovely start.

[1]http://www.smartmoney.com/quote/ATPIX/
[2]http://www.smartmoney.com/quote/AMR/
[3]http://www.smartmoney.com/quote/C/
[4]http://www.smartmoney.com/quote/MS/
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