

BETTER INVESTING

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Mutual Fund Trends

By Amy E. Buttell



Bruised by a brutal bear market in 2008-09, more mutual fund investors are turning to packaged fund solutions, such as target-date life-cycle funds, to help manage fund investing. Although stocks were up in 2010, it wasn't easy for investors to forget the financial crisis or the volatile ride stocks have experienced during the past three years.

Between 2005 and 2010, fund sponsors launched 273 target-date funds, which raked in \$89.6 billion worth of assets, according to fund data-tracker Morningstar. Target-date funds weren't the only beneficiary of investor interest: 2010 capped off several years of strong interest in bond funds, also born of investor uncertainty and the bull market in bonds.

Alternative funds gained assets, as investors sought to diversify their portfolios and protect themselves against market volatility. Emerging markets were also a popular destination for investor funds in 2010, both for bond and stock funds, as high-growth economies such as China, Brazil and India tempted investors away from the anemic growth and more troubled economies of the developed world.

While doomsayers predicted the end of stock investing for individual investors, the data didn't bear them out, as investors continue to plough dollars into stock funds, according to the Investment Company Institute, a Washington, D.C., based trade association for fund companies. What's changing, to a degree, is the types of funds that investors are choosing: more target date and less individual fund selection. "In terms of where the money is actually flowing to, investors are reacting to the past decade," says Karen Dolan, director of fund analysis at Morningstar. "We've had a decade of subpar, if not just bad, stock performance.

"We've had a decade where bonds looked good," she continues. "I think the fear, bear market, and ups and downs of the past decade have really driven investors towards solutions-oriented offerings like target-date funds, where funds put together the portfolio for investors. If you go back to the late 1990s where everyone thought they could pick stocks, it's a big change. Investors may be losing confidence in their ability to pick stocks after the bear markets."

Target-Date Funds

Target-date funds are especially popular in company-sponsored retirement plans, such as 401(k) and 403(b) plans, and in Individual Retirement Accounts. These funds, a type of fund-of-funds, package a number of different mutual funds from the same family together and periodically rebalance that fund portfolio. Most target-date funds are designed to coincide with

a particular retirement date. If you are 60 now, and plan to retire in five years, you could buy shares in a Target-Date 2015 fund.

While all target-date funds are composed of a number of different mutual funds, they can be very different. Some are made up of index funds and others, actively managed funds. Fund sponsors have very different ideas about asset allocations, with some funds heavier in bonds and others in stocks even when the target date is achieved. If you're considering investing in a target-date fund, look under the hood to see what the fund is currently invested in and how the asset allocation will change over time to make sure it lines up with your risk tolerances.

Dolan says she believes the move towards target-date funds and other packaged solutions will continue and sees it as an overall positive move for individual investors. "I think these types of solutions help tone down the volatility of any one individual asset class and are a good thing for investors," she says. "We've seen a very heavy prevalence of these funds in the retirement space. That's the No. 1 trend we've seen this year and I don't see that letting up."

Bond Market Nears a Peak

Behind the success of bond funds are the recent bull market in bonds, record low interest rates, investor risk-aversion, aging baby boomers and poor stock returns, says Brian Reid, chief economist with the ICI. While that demand has been slackening a bit, bond funds still benefit from strong investor interest, he adds.

"I think there are two factors that are going to persist and drive investor interest in bond funds," he says. "The first is demographics, as investors age and approach retirement, they tend to allocate a larger portion of their portfolio into fixed-income securities. Also, the overall risk tolerance of investors is at a really low level for the past two years, according to our studies. Individuals seem to have less tolerance for investment risk than they did five years ago and certainly less than in the 1990s."

However, ICI data does show a slight cooling of investor interest in bond funds towards the end of 2010, as interest rates rose a bit despite the Federal Reserve Board's attempts to keep long-term rates down via a policy of quantitative easing. "Of those factors that drove the inflows into bond funds, the interest rate story is changing with rates starting to rise, and that is starting to reduce demand somewhat," Reid says. "We've seen some outflows among tax-exempt and taxable bonds, which is moderated by the demographic factors, but the overall return on funds is really the key driver for investor demand."

Target Date Funds Inception, 2009-10	
Year	# of Funds
2005	27
2006	44
2007	62
2008	58
2009	60
2010	22
Total # of New Target-Date Funds:	273
Total Assets:	\$89,613,559,715.00

Source: © 2010 Morningstar, Inc.

New Fund Inception 2005-2010		
Fund Category	# of Funds	Assets
Diversified Emerging Markets	20	\$ 2,557,825,926.00
Foreign Large Blend	13	2,832,274,724.00
World Stock	45	3,040,167,490.00
Multi Sector Bond	15	3,141,271,495.00
World Allocation	39	3,946,456,606.00
World Bond	10	4,381,061,572.00
Long-Short	53	4,489,531,146.00
Large Growth	25	5,996,929,473.00
Large Blend	41	9,550,812,953.00
Intermediate Term Bond	25	51,087,654,933.00
Total New Funds:	570	\$143,789,674,108.00

Source: © 2010 Morningstar, Inc.

Bond Funds		
Year	Total Net Assets (in billions)	
2007	\$1.46	
2008	1.38	
2009	1.98	
2010	2.40	

Source: © 2010 Morningstar, Inc.

Assets of Funds and ETFs		
	Nov. 2009	Nov. 2010
Mutual Funds	\$11,120.20	\$11,486.70
ETFs	\$737.90	\$927.60

Source: Investment Company Institute

Marilyn Plum, CFP, of Ballou Plum Wealth Advisors in Lafayette, Calif., agrees. "As people think about the potential of interest rates going up, there's a shift away from fixed income," she says. "Also, with the stock market going up, that's another reason for the net outflows in fixed income. We don't think investors will be abandoning fixed income, although there are some areas that we believe will be better than others, one of which is high yield and another is preferred securities." Plum also likes municipal bonds, particularly California munis for California residents.

Of the 570 new funds created in 2009-10, 121 were bond funds and 75 were blend funds that include both stocks and bonds, according to Morningstar. This data also reveals that total assets invested in bond funds grew from \$1.46 trillion in 2007 to \$2.37 trillion in 2010.

Most economists believe interest rates will begin to rise during the long term, although the Fed has stated its intent to keep the interest rates under its control, such as the Federal Funds rate, low for an extended period of time. When interest rates rise, bond prices fall, making existing bonds less valuable.

However, investors who buy individual bonds can hold onto those bonds and redeem them at maturity, even if interest rates rise and the value of that bond decreases on the open market.

Bond fund investors, on the other hand, are more impacted by rising interest rates because the market value of bonds in a bond mutual fund falls when interest rates rise. That leads to a decline in bond fund net asset value.

Stock Funds Still Popular

Although pundits like to regularly declare that individual investors aren't investing in stocks and stock funds any more, that's far from true. "Clearly, there are tens of billions of dollars going into stock funds every month," says Reid. "And while there are about the same amount of redemptions of stock funds where money is going into other types of funds, there are many investors who continue to buy stock funds."

This is especially true for investors in company-sponsored retirement plans, where 60 percent of assets in stocks either in the form of stock funds, the stock portion of balanced funds and company stock, according to the ICI. In addition, 55 percent of all assets invested in Individual Retirement Accounts (IRAs) are invested in foreign or domestic stock funds.

Emerging Markets, Alternative Funds Gain

It's no surprise that investors are finding rewards in emerging markets; both stock and bond funds are attractive, with higher potential returns than in many developed markets. Developed

markets, particularly Europe and the U.S., have struggled in the wake of the financial crisis. Uncertainty lingers in Europe, where the weaker members of the Euro Zone will likely need more financial support next year.

"We think there's good potential in foreign bonds and emerging market debt even if it's counter intuitive," says Plum. "We think many of those countries are actually in better financial shape than we are; their GDP growth rates are in better shape compared to their level of debt."

According to Morningstar, fund sponsors launched 20 diversified emerging markets funds in 2009-10, which gathered \$2.6 billion in assets. Dolan notes that more fund companies that have a history of investing overseas are launching funds specifically aimed at investing in emerging markets.

More fund companies are also launching alternative and commodity funds to take advantage of investor's desire to diversify following the financial crisis. "Commodities are not correlated with stocks and bonds and can bring diversification to a portfolio," says Dolan. "This is a trend that's been happening for a while, but commodities haven't necessarily been a really profitable investment during the past three to five years.

"It sounds good, but commodities are really more of a bet," she continues. "The reality is, unless you really think

the prices of commodities are going to go up, the reality is, they haven't. If you look at commodities over a very, very long period of time, in real terms, inflation adjusted, they have remained pretty flat."

Hedge fund like mutual funds, such as long-short funds, are also gaining more assets. During 2009-10, fund companies launched 53 long-short funds that gained \$4.4 billion in assets. Long-short funds can both buy stocks and sell stocks short in an effort to profit from company stock price declines.

Another hedge fund strategy that more mutual funds are employing is absolute returns, which can include short selling, futures, derivatives, options, leverage and arbitrage. "I get nervous when I see funds that promise absolute returns," says Dolan. "That's promising a positive return. Short of an insurance guarantee, there are no guarantees of making money. I worry that people's expectations may be a little out of whack with what these funds can actually deliver."

ETFs Get More Attention

While mutual fund assets dwarf those of exchange-traded funds, ETFs continue to gather assets. However, it's hard to tell if individual investors are investing more with ETFs or not, says Reid. "We don't know whether the flows into ETFs are retail or institutional," he says. "It does seem, though, because of the fact that mutual fund flows tend to be retail and the fact that ETF flows tend to be mirroring those of mutual funds would suggest that the individual investors are in the ETF space."

Reid notes that more financial advisers are investing client funds in ETFs, so that some of the institutional money invested in ETFs comes from individual investors via financial advisers. Dolan sees more individual investors using ETFs to make targeted investing bets. "During the past three to four years, there has been a real questioning of buy-and-hold and the sense that if you can do some of your own analysis and understand the

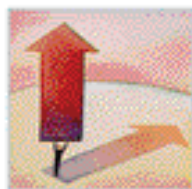
macroeconomic landscape, then you can try a tactical investing strategy using ETFs."

Dolan also sees more commodities investing in the ETF space, where individual investors can buy ETFs specializing in specific commodities or a broad-based commodity ETF. Tactical investing proponents find ETFs easier to use than funds, because they can be traded during the investing day, unlike mutual funds.

A final word

As the investing world gets more complex, more investors are turning to packaged fund solutions, such as target date funds, for investing simplicity. On the other end of the spectrum, more investors are interested in alternative, hedge-fund type strategies. However you invest, before you buy shares in a fund or ETF, do your due diligence and make sure the fund fits into your investing objectives and strategies. **B**

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BetterInvesting's Screen of U.S. Funds

By Amy E. Buttell

After 10 years of presenting the *BetterInvesting* Top 10 Funds survey, there's not a lot more to say. Our readers are a discerning, disciplined group of investors: Year in, year out, they stick with mostly the same bunch of top-quality funds.

In the interest of presenting readers with some new options, this year the editors elected to do something different: Run some screens of funds listed by Morningstar and Lipper. By using the BetterInvesting criteria emphasized over the years in the pages of this magazine in those screens — along with some discretion in some circumstances — a list of three worthy funds in 15 different domestic stock, bond and balanced funds was compiled. While not all of these funds meet every BetterInvesting criteria — very stringent criteria, in some cases — they come as close as possible.

The factors taken into consideration in the screens include:

- **Reasonable minimum investment:** You don't stand a chance to invest in a fund if the minimum is too high; these funds have minimums of \$10,000 or less.
- **Open to new investors:** There's nothing more frustrating than finding what looks like a perfect fund and then realizing that it's closed to new investors. All of these funds were open to new investors at the beginning of 2011.
- **Sales and earnings growth rates:** With stock funds, we looked for those with earnings and sales growth rates higher than the category averages.
- **Management tenure:** A manager is only responsible for a fund's performance during the time period he or she is in charge. We searched for managers with at least five years of experience with a specific fund.
- **Five-year average annual returns:** Long-term performance is the only kind that matters. We screened for funds with a five-year average annual return rate higher than category averages.
- **Portfolio turnover rate:** For stock funds, high turnover hurts performance and increases costs. We screened for as low a turnover as possible; 20 percent on an average annual basis is ideal.
- **Costs:** Expenses are one of the few variables you can control when you invest in a fund. We screened for funds with expenses as low as possible. In most cases, this was at 0.50 percent or less; in some cases, such as for specialized and foreign funds, we set the criteria at 1 percent or even 1.5 percent at the highest. All funds are no-load: If you're investing on your own, there's no need to pay a broker's commission for investment advice.

Both index and actively managed funds were included. Most funds don't meet every criterion, but all met at least three of the criteria, and more, in most cases. Here are the results, with a brief description of the type of fund for each category and key facts about the funds. The fact that returns for some categories look much better than others doesn't say anything about a specific fund's management. Fund categories tend to rotate in and out of favor, and strong recent performance can skew performance numbers upward, just as recent poor performance can skew performance numbers the other way.

Large-Cap Growth Stock Funds

Large-cap growth stock funds invest in growth-oriented large U.S. companies. Funds in this category didn't perform particularly well in 2010, as the market favored small-cap stocks. There's a lot to choose from in this category; Morningstar lists 586 funds, excluding different share classes of the same funds. Of those, 23 are index funds. In this screen, one index fund, **Vanguard Growth Index** (ticker: VIGRX), made the cut. **Fidelity Contrafund** (FCNTX), one of the two actively managed funds, has been a favorite in the Top 10 survey.

Large-Cap Blend Stock Funds

The large-cap blend funds category includes some of the most popular funds in the country, including the first retail index fund, the **Vanguard 500 Index Fund** (VFINX). This category performed better in 2010 than its large-growth cousin. There are slightly fewer funds in this category — 568 — but more, 82, are index funds. Besides index funds based on the S&P 500 Index, index funds that track the entire stock market fall into this category. **Sequoia Fund** (SEQUX), one of the actively managed selected funds, reopened several years ago after being closed to new investors for a quarter century.

Large-Cap Value Stock Funds

Large-cap value stock funds occupy the opposite end of the style box from large-growth funds. Managers of these funds tend to look for large-cap companies that are undervalued and underappreciated by the markets. Morningstar lists 356 funds, excluding different share classes of the same funds. Of these funds, only 11 are index funds. Both **T. Rowe Price Equity Income** (PRFDX) and **Fairholme Fund** (FAIRX) have been *BetterInvesting* Fund in Focus picks in the past several years.

Mid-Cap Growth Funds

Mid-cap growth funds occupy a sweet spot between large- and small-cap growth funds. They don't have quite the appeal of their faster-growing small cousins, but sport

more growth opportunity than large-cap growth funds. Mid-cap growth funds ranked top in performance among domestic stock funds during the past five years. Morningstar finds 275 mid-cap growth funds; eight of those are index funds. **Meridian Growth Fund (MERDX)** has been featured as a *BetterInvesting* Fund in Focus pick.

Mid-Cap Blend Funds

Mid-cap blend funds sit squarely in the middle of the domestic fund style box. These funds performed pretty

recently as a group during 2010. Of the 215 funds listed by Morningstar, 19 are index funds, the rest actively managed. **Vanguard Extended Market Index Fund (VEXMX)** is one of those funds; it includes all of the companies in the stock market with the exception of those in the S&P 500. **Fidelity Low-Priced Stock (FLPSX)** was a fund that frequently ranked in the Top 10 survey in past years.

Mid-Cap Value Funds

Investors in mid-cap value funds have had reason to

BetterInvesting's Screen of Stock and Bond Funds

STOCK FUNDS	Ticker	5-year Return %	Turn-over %	Expense Ratio %	Mgmt Tenure
Large-Cap Growth Funds					
Fidelity ContraFund	FCNTX	4.09%	60%	0.95%	20 yrs
Jensen	JENSX	1.97	9	0.96	9 yrs
Vanguard Growth Index	VIGRX	1.42	23	0.28	10 yrs
Large-Cap Blend Funds					
Schwab Total Stock Market	SWTSX	1.12	2	0.12	11 yrs
Mairs & Power Growth	MPGFX	1.91	3	0.71	11 yrs
Sequoia	SEQUX	2.82	8	1.05	7 yrs
Large-Cap Value Funds					
Yacktman	YACKX	7.05	9	0.93	18 yrs
T. Rowe Price Equity Income	PRFDX	0.90	21	0.73	25 yrs
Fairholme	FAIRX	8.40	37	1.01	11 yrs
Mid-Cap Growth Funds					
Meridian Growth Fund	MERDX	5.20	32	0.86	27 yrs
Prudential Jennison Mid-Cap Growth Z	PEGZX	7.12	136	0.91	5 yrs
T. Rowe Price Mid-Cap Growth	RPMGX	5.91	29	0.83	18 yrs
Mid-Cap Blend Funds					
Fidelity Low Priced Stock	FLPSX	3.93	24	0.99	21 yrs
Vanguard Extended Market Index	VEXMX	3.43	27	0.33	13 yrs
Ariel	ARGFX	-0.67	19	1.14	24 yrs
Mid-Cap Value Funds					
Delafield Fund	DEFIX	7.14	71	1.26	17 yrs
Heartland Select Value	HRSVX	5.29	42	1.27	7 yrs
T. Rowe Price Mid-Cap Value	TRMCX	5.39	46	0.84	10 yrs
Small-Cap Growth Funds					
Vanguard Small-Cap Growth Index	VISGX	4.37	39	0.28	6 yrs
Wasatch Small Cap Growth	WAAEX	1.48	36	1.31	13 yrs
LKCM Small Cap Equity Institutional	LKSCX	2.77	56	1.01	16 yrs
Small-Cap Blend Funds					
Royce Pennsylvania Mutual	PENNX	4.52	26.00	0.92	38 yrs
Vanguard Tax-Managed Small-Cap	VTMSX	3.03	20.00	0.19	11 yrs
T. Rowe Price Small-Cap Value	PRSVX	4.62	12.00	0.97	19 yrs

STOCK FUNDS (cont.)	Ticker	5-year Return %	Turn-over %	Expense Ratio %	Mgmt Tenure
Small-Cap Value Funds					
Heartland Value	HRTVX	3.82%	36.00%	1.18%	26 yrs
Aegis Value	AVALX	2.85	29.00	1.53	12 yrs
American Beacon Small Cap Value Investors	AVPAX	2.48	47.00	1.16	3 yrs
Balanced Funds					
Permanent Portfolio	PRPFX	9.18	6.00	0.84	7 yrs
Dodge & Cox Balanced	DODBX	0.83	18.00	0.53	11 yrs
Manning & Napier Pro-Blend Conservative Term	EXDAX	4.91	60.00	0.94	9 yrs

BOND FUNDS	Ticker	5-year Return %	Yield %	Expense Ratio %	Mgmt Tenure
Short-Term Bond Funds					
T. Rowe Price Short-Term Bond	PRWBX	4.51	2.69	0.60	15 yrs
Vanguard Short-Term Federal Inv	VSEBX	4.85	1.46	0.22	5 yrs
Vanguard Short-Term Treasury	VFSX	4.45	1.05	0.22	7 yrs
Intermediate-Term Bond Funds					
Fidelity Government Income	FGOVX	5.72	2.20	0.45	3 yrs
Dodge & Cox Income	DODIX	5.78	4.88	0.43	14 yrs
Vanguard Total Bond Index	VBMFX		3.13		
Long-Term Bond Funds					
Vanguard Long-Term Treasury	VUSTX	5.33	3.74	0.25	7 yrs
Vanguard Long-Term Investment Grade	VWESX	5.63	5.13	0.26	2 yrs
Fidelity Spartan Long-Term Treasury	FLBIX	5.50	3.89	0.26	1 yr
Municipal Bond Funds					
Vanguard Intermediate-Term Tax Exempt	VWITX	3.96	3.39	0.20	2 yrs
Vanguard Limited-Term Tax Exempt	VMLTX	3.61	2.14	0.20	2 yrs
T. Rowe Price Tax-Free Short-Intermediate	PRFSX	3.89	2.45	0.15	13 yrs
High-Yield Bond Funds					
Vanguard High-Yield Tax-Exempt	VWAHX	5.42	4.54	0.20	1 yr
Fidelity High Income	SPHIX	7.98	6.87	0.65	10 yrs
T. Rowe Price High-Yield	PRHYX	7.31	7.66	0.76	4 yrs

Sources: Morningstar, Lipper

rejoice during the past five years, as these funds have performed very well, close to the performance of their mid-cap growth cousins, according to Morningstar. In consequence, many of the funds with the best track records are closed as managers seek to insulate themselves against hot money flows. Morningstar identifies 215 funds in this category; five of those are index funds.

Small-Cap Growth Funds

Small-cap growth companies tend to be the fastest growers in the market so small-cap growth funds usually have some of the highest average earnings and sales growth of all domestic funds. Because information on small companies isn't as readily available as their larger peers, expense ratios for funds focusing on small companies tend to be higher, except for index funds. Morningstar lists 234 funds in this category with four index funds.

Small-Cap Blend Funds

One way to participate in the growth potential of small-cap blend funds without the high expenses and potential for large capital gains distributions is by selecting one of the funds in this screen: **Vanguard Tax-Managed Small Cap (VTMSX)**. Since it was launched more than 10 years ago, this fund has avoided paying any capital gain distributions by managing trades in a tax-efficient manner. Morningstar identifies 206 funds in this category; 27 of them are index funds.

Small-Cap Value Funds

Small-cap value funds bounced back from the bear market better than just about any fund category, according to Morningstar. Like many mid-cap value funds, some of the best funds in this category are also closed to new investors. During the five years between 2006-2010, this category returned 5.89 percent overall. Morningstar identifies 96 funds in this category; four are index funds.

Balanced Funds

Balanced funds combine stocks and bonds in varying proportions depending on whether they're aggressive or conservative. **Dodge and Cox Balanced (DODBX)** has been chosen several times by our readers as a Top 10 fund, while both **Manning & Napier Pro-Blend Conservative Term (EXDAX)** and **Permanent Portfolio Fund (PRPFX)** were selected for the Fund in Focus column. Permanent Portfolio is different than the vast majority of these funds in that it also invests in commodities and currencies in an effort to preserve invested capital. A Morningstar screen finds 1,003 balanced funds; 14 are index funds.

Short-Term Bond Funds

Many investors upset with the low yields of money market funds have moved into short-term bond funds. During the long bull market for bonds, these funds have fared well: Morningstar's Short-Term Core Bond Index is up 4.8 percent during the past five years. Because rates are so

low, yields aren't that terrific, although this will change once short-term interest rates start to climb. Morningstar identifies 109 funds in this category; three are index funds.

Intermediate-Term Bond Funds

Yields for intermediate-term bond funds are better than for short-term bond funds, but if interest rates increase, yields will go up as well. However, the prices of existing bonds will fall, meaning that bond fund net asset values are also likely to decline, leading to uncertainty in the bond market and the minds of fund managers. Morningstar's Intermediate-Term Core Index rose 6.38 percent during the past five years. The fund data-tracker lists 319 intermediate-term bond funds; of those, 19 are index funds. **Vanguard Total Bond Index (VBMFX)** is one way to get exposure to the entire bond market at a low price.

Long-Term Bond Funds

Long-term bond funds are one of the least popular categories for fund sponsors. Morningstar lists only 22 long-term bond funds; two of those are index funds. The Long-Term Core Bond Index returned 6.60 percent during the past five years, slightly more return for more risk than the Core Intermediate Term Bond Index. Long-term bond funds are the riskiest type of bond funds — outside of junk bond funds — because the prices of long-term bonds will fall the most once interest rates begin to rise.

Municipal Bond Funds

Municipal bonds turned in a decent performance in 2010, although the fourth quarter was difficult with the mid-term elections, as well as more cities and states experiencing financial problems. The Barclays Capital Municipal Total Return U.S. Index posted a 4.08 percent average annual return during the past five years. Muni bond yields have been favorable compared to taxable fund yields, so investors in higher tax brackets may want to consider adding a muni bond fund to their portfolio. Morningstar lists 584 muni bond funds; no index funds are listed.

High Yield Bond Funds

Plump returns lured many investors into high yield bond funds, especially as yields declined on investment-grade funds. The Bank of America-Merrill Lynch U.S. High Yield Index returned 8.81 percent during the past five years, the best return for that time period for any bond category. However, these funds are quite risky because managers in this category invest in the bonds of companies that have poor credit risk and may actually default on their obligations. Morningstar lists 584 funds that fall into this category; no index funds are listed.

A Final Word

These screens are presented for informational purposes only; no investment recommendation is intended. Use them as a starting point for investigating a fund or funds that lines up with your investing philosophy and objectives. **B**