A Natural Born Bond Picker

When Dan Fuss says the Loomis Sayles Bond Fund takes a multi-sector approach, he means it. Anything in fixed income is fair game-as long as it's cheap and makes sense to own for a few years. That approach through 40 years of fixed-income management has provided shareholders with equity-like returns since inception.

Loomis Sayles Bond Retail

Fund Facts	
Symbol	LSBRX
Website	www.loomissayles.com
Address	Loomis Sayles Funds, One Financial Center, Boston, MA 02111
Tel. No.	800-633-3330
Inception	01/02/97

Portfolio	
Total Net Assets *	$106.70
Avg Mkt Cap ($ Weighted) *	---
Average Price/Earnings Ratio	---
Average Price/Book Ratio	---
Turnover Ratio	22%

Investment Information	
New Investment	Open
Min Initial Investment	$2,500
Min Subsequent Investment	$50
Min Initial IRA Investment	$2,500

Risk (Against Lehman Aggr Bd Tr - 3 Years)	
Alpha	0.2269
Beta	0.6891
R-Squared	0.0974

Returns vs. Lipper BBB Rated Fund Index	LSBRX	Index
1 Year (Cum.)	21.50%	10.77%
3 Year (Ann.)	9.88%	8.89%
5 Year (Ann.)	7.06%	5.91%

Returns vs. Lehman Aggregate Bond Tr	LSBRX	Index
1 Year (Cum.)	21.50%	10.47%
3 Year (Ann.)	9.88%	10.21%
5 Year (Ann.)	7.06%	7.58%

Fees and Expenses	
Max Sales Charge - Front	0.00%
Max Sales Charge - Deferred	0.00%
Max Redemption Fee	0.00%
Total Expense Ratio	1.00%

Portfolio Manager	
Daniel Fuss / Kathleen Gaffney	Jan-97 / Nov-97

* millions
Data through: 04/30/03
Source: Company Documents; Lipper

Q: In examining the fund's data, I learned that aside from the institutional class, Loomis Sayles offers what it calls a retirement class.

A: That's the R class. In relation to the total size of the fund, it's relatively small. The institutional class picks up the Schwabs and Fidelitys of the world.

Q: I've learned that in terms of style, you're viewed as something of a contrarian.

A: That's one way to put it. We're obviously very aware of the bond market itself, but for a lack of a better word we're more inclined to be item pickers. The quantitative people say we're specific risk oriented. In other words, we like to find things that are happening over and above what is going on with the market. Bond picker is perhaps the best term for us. But there is much more to it than that. And, I don't really have a really great way to express because it's what I've done now for nearly 45 years.

Q: Is this is a situation where a style becomes second nature to you?

A: It's not really a style. All we're really doing is based on our view of the world in looking for cheap bonds. We like to buy them reasonably cheap and hold them until they're not cheap anymore - that process, depending on the market environment, can take anywhere from two-and-a-half to four or five years. We're not bond swappers, per se. We're not high turnover people. Turnover will rise a bit when the interest rate spreads get really narrow, but that implies a four-year holding period. The shortest tends to be two-and-a-half and the longest might run out to five, which would be even less turnover.

Q: That is apparent in the data you faxed.

A: Again, we like to buy them cheap. The other thing that is different, in order to buy things cheap, you have to look reasonably far ahead. This is true in all types of investing, but there is quite a difference between how you approach it on the stock side with a similar style than on the bond side, because stocks by and large are an auction market. Unless you are Fidelity Magellan's size, you can wait reasonably long to establish your positions until you're pretty sure it's going to go your way. On the bond side that is not so, unless you're dealing with government bonds. On the bond side, you have to say, "Well, I think this is going to get better in two to three years. It doesn't look that way to people right now. Although it's not the same thing, this is analogous to turn around types of investing. That may be because of credit; it may be because of market conditions; it may be because of the absolute level of interest rates, although that is certainly tricky; or the actual shape of the yield curve. So, if you say, "This bond is selling cheap now, but given a deeper perception, it's substantially undervalued and it's for sale."

Q: What about the underlying liquidity problems facing such securities?

A: It's a dealer market. You don't need to trade at the price. It becomes a liquidity func-

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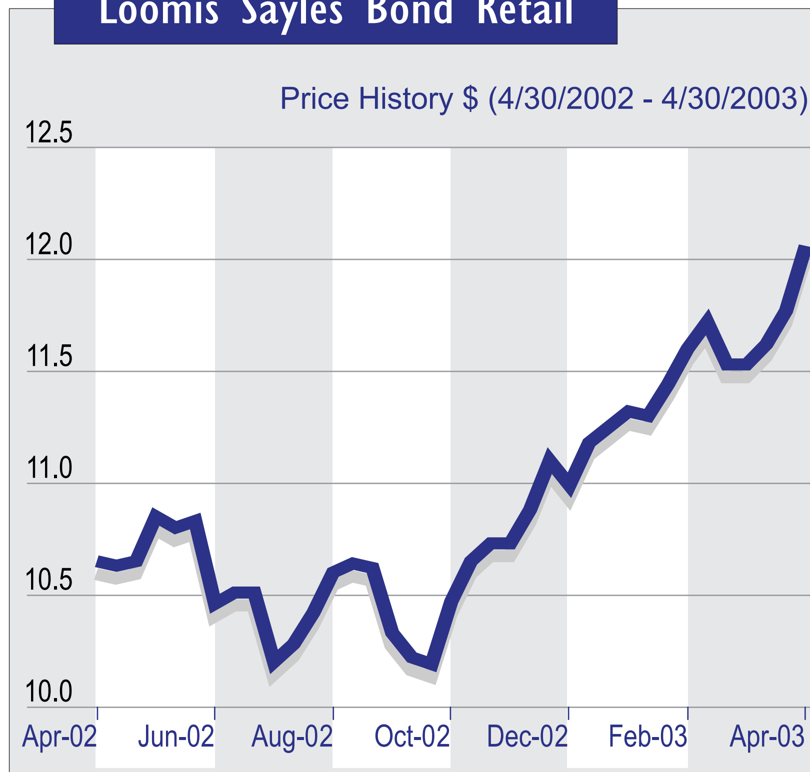

tion in the market. This may be for a very small amount, like a treasury, where you're talking 33 seconds. We don't do much of that. Even in the accounts where it might be appropriate we just don't do that because one mistake kills everything we ever made. But, if you.say, "I think this bond is 10 price points cheap." And not only the price differential but the absolute yield differential that comes with that then you say, "All right, that sounds good. Let's be sure we're checking everything." Next is, can we buy it there? With bonds, what happens is they get quoted. The newspaper will say they went up, down, sideways. The reality is they didn't trade. It may not have for a while. So, it becomes much the real market. The point I'd like to make with people is that, number one, I think it's a very good way to run money; number two, you need a very strong stomach, because you're essentially providing a bid in an illiquid market and getting paid accordingly. It's not the same thing as running a pure high-yield account or a pure distressed or a pure global or a pure emerging market or a convertible bond fund.

Q: Do you invest in all the types of situations that you've mentioned?

A: We have all of it in there. We also like to rebalance a bit where the bonds are cheapest. In order to be able to buy something, you have to find something that is priced pretty rich. If you can't, then you just don't do a thing. That way you wind up selling things. The analogy on the stock side of things - again, it's a poor analogy - I can't buy a stock until I sell a stock. With bonds and the poor liquidity it doesn't work quite that way. But, it's the same thought process.

Q: That view of bonds explains the low turnover relative not only to peers in the multi-bond sector but also the bond fund management complex as a whole.

A: It first costs money. There is a good article on the front page of section C of the Wall Street Journal on mutual funds turnover. It doesn't cover a long enough period of time, but it makes a good point - the higher the turnover the lower the return. That's true in spades in the bond market. In the bond market, the dealers are not charitable institutions. It may look like it at times, but they don't do it on purpose. There is a spread between bid and ask. We have an excellent trading department. These folks are really good, but nonetheless, there is a spread.

Q: How do you structure the portfolio to keep the portfolio turnover low and still account for good long-term returns?

A: Getting down to business, the bond fund construction will look different over time, to a degree. It's not remarkable. We don't go from long to short to long to short. But we do vary as we find what is offered and bid for in the market. One thing I like to do for starters is I like to see what sort of yield advantage we have versus the market, but still getting a reasonable proxy for the market - not the treasury market or the aggregate index. The numbers you see on the side was the yield on the Merrill Lynch Government Corporate Bond Index and the Merrill Lynch High Yield Index. We took it out of the Wall Street Journal.

Q: That is quite an interest rate spread.

A: Well, high-yield is a funny index. There is actually a conservative yield. I weighted two-thirds to the government and corporate bonds. That is a reasonable proxy for what the mutual fund with the guidelines we have might show for a yield. Then I look at the yield to maturity for the fund, not the SEC yield, which is 6.95%. That contrasts with 5.67%. It's higher to the tune of 128 basis points. Another way to look at that is percent of percent; it's maybe 22% higher. Now, we have a yield advantage. There are all sorts of ways to get a yield advantage. A lot of them aren't very good. The one thing we do protect against very, very hard, is the risk of what happens if interest rates go down a lot. People tend to be focused on the idea of bonds are risky because interest rates may go up. That's true. But you are far more at risk if interest rates go down a lot because your reinvestment return goes out the window. That's the killer for bond funds. The best living example of that today is in Japan. They thought it was wonderful for a while. Bond prices went up. Do you realize that you're not getting any cash flow? The best way to protect against that is to have some discount from par in the bonds. You want to be sure they're going to pay you back, but you really don't want them calling the bonds away from you.

Q: Limiting the amount of callable securities provides a great deal of protection against a drop in total return.

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A: That is a particular fear of mine. If you look across the rest of the portfolio, obviously you're not going to have a yield advantage versus an index in your short-term holdings. But, if you look at the other three categories: 1 to 5, 5 to10 and over 10, yes, they have reasonable yield advantages. That 1 to 5 might look a little suspicious. You might ask, how are you getting a 5.90% yield with a Double-A3 average quality in a market where that clearly isn't the case. Well, that is the case, depending upon which market. Obviously a few of the corporates will give that. The rest of it is when you're in someone else's currency. For example, you're in a Norwegian government bond or a World Bank bond payable in New Zealand dollars. What we are doing here is unlike other phases of the market, we shifted some of the long bonds into what we call a yield curve posture where the passage of time ought to help the bond as long as interest rates stay more or less as they are today. We actually think - all you can do is guess - is that we're probably in a period of time where rates may hang around this level for a while. But, probably in a few years they're going to be a bit higher.

***Q:** Does that mean you smell inflation?*

A: Not now, but it is building. It's in the system. The commodity indices are in a period of economic history where we don't have strong capital spending push. An analogy would be the late 50s, early 60s. The economy in North America isn't going to look hyper strong for quite a while but we have a succession of inventory cycles within that so I wouldn't lean too much on the CRB Index for the inflation. Eventually that is where it is going to show. But we are building the base for a tremendous monetary expansion as a way to boost our economy. This has been going on for some time. It actually started with Y2K. The same thing is happening in Europe and has been happening for some time in Japan.

***Q:** The central banks are printing money like crazy.*

A: You got it. They're doing other things to make future money growth more likely. They'll be the first to say this. "Wait a minute. We've got a very soft economy, so don't worry about it." Well, that is true. Over in Asia, they've got a very strong economy. There is demand over there. If you look at it on a worldwide basis, you say, "Oh, what happens if North America and Western Europe pick up? Of course, the Chinese currency will revalue up". No, it's not true. It's tied to the U.S. dollar. You have the potential. Is it going to happen? I don't know. Is it likely to happen? Yes. The odds are like 95 out of 100. That's pretty strong odds. We're getting ready for this. We're not betting the ranch on it. What we want to do is if interest rates do not jump; that's essentially good news once you get there. The trick is to get there with your capital intact. At the other end of it, you say, "I'm getting a couple percent higher yields on the portfolio. That's wonderful." But you'd like the portfolio value to be the same. That's the trick with bonds. It's very difficult to do unless you do some things that are not fully related to the bond market itself, what we call non-market related. Credits are one of those. Yield advantage in a different country of issue is another. A different yield curve for different currencies is another. Busted converts, sinking funds - all those things that really come up out of the item picking. That's how we're postured.

***Q:** A bond portfolio denominated in foreign currencies as well as directly invested in foreign bonds requires extensive research. How deep is the research department at Loomis Sayles?*

A: We continually interact with our analysts and actually have the analysts incorporated into various portfolio functions to be sure we are up-to-date on their thinking. The corporate analysts are broken into groups depending on industries. Country analysts obviously focus on a region. Our economic team supports each group. Loomis Sayles pioneered the industry's second-oldest proprietary credit rating system, which we still use today. Analysts supplement this system with Wall Street research, analysis from the major ratings agencies, and other resources. Fixed income analysts also work in conjunction with their equity analyst counterparts, particularly in the development of earnings and cash flow forecasts. The analysts aren't restricted to a style-driven focus, but instead concentrate on the fundamentals of each security when making credit recommendations. ▮

Dave Jennings

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Dan Fuss

With more than 40 years in the investment industry, Daniel J. Fuss has been with Loomis, Sayles & Co., L.P. since 1976. Fuss manages several proprietary and firm sub-advised mutual funds including the flagship Loomis Sayles Bond Fund and Managers Bond Fund as well as institutional accounts. In addition, he serves as chairman of the firm's Global Investment Committee and Bond Policy Committee. In 2000, he was named to the Fixed Income Analyst Society's Hall of Fame. In 1995, Fuss earned Morningstar's coveted Fixed Income Manager of the Year distinction. Currently serving as President of the Boston Security Analysts Society, Fuss earned a B.S. degree and Master of Business Administration from Marquette University.

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