

Times good for veteran bond manager



By Dalia Fahmy

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Dan Fuss is having a good time. Never mind the crashing markets, sinking economy or recent losses in his \$48bn fixed income portfolio. For the vice-chairman of Loomis Sayles, a Boston-based money manager, it is a rare opportunity to load up on cheap bonds.

"This is our kind of market," says Mr Fuss, who has been investing in fixed income for half a century and these days buys everything from beaten-up municipal bonds to peso-denominated Mexican government paper. "We're basically discount bond buyers, and for a number of years it was very difficult to find those."

Mr Fuss, 74, soft-spoken and grandfatherly in thick glasses, learned to invest in another era. He frowns on the latest derivatives, and prefers his slide rule to a computer.

Yet he has made more money for his clients than most of his competitors. His flagship \$17bn Loomis Sayles Bond Fund has gained an average 9 per cent a year in the past decade, according to Morningstar. That puts it in the top 2 per cent and ahead of the Lehman Brothers Aggregate Bond Index by almost 3 percentage points.

"Dan is perhaps the only bond manager who is more obsessive than I am," says Bill Gross, founder of investment house Pimco, who runs the world's largest bond fund. "He and his firm are perhaps Pimco's fiercest competitor."

Mr Fuss attributes his success to the simple strategy of buying bonds when they're down and selling them when they're up. His favourites are "discount bonds", which are issued below face value and which he says are responsible for most of the return that corporate bonds offer over US Treasuries.

Aside from that strategy, he sets few limitations. Loomis Sayles dubs his fund a "go-anywhere" portfolio, with low correlation to other equity and bond funds. He puts a good portion in exotic currency issues – a staple is **General Electric** debt issued in New Zealand dollars.

Mr Fuss's predictions – or guesses, as he calls them

Economy Expect slow growth at least until autumn, even early next year. Look for signs: housing and autos to recover first.

Interest rates Federal Reserve will bring its Fed Funds rate to a low of 1 per cent to 2 per cent next year, but the rate will increase after the economy looks to be in a real recovery, probably not until late 2009 or 2010. Expect about 5.50 per cent in five to six years.

Markets By summer, 10-year Treasuries will probably have bottomed to about 3.30 per cent, perhaps even at the 2003 low of 3.11 per cent. Expect little movement until spring

But he is best known for spotting potential in credits abandoned by others. In the past few months he has bought bonds of the finance companies **CIT Group**, which has had trouble funding itself, and **GMAC**, which bled billions of dollars last year. Mr Fuss is betting on future ratings upgrades. He expects CIT to sell itself to a highly rated bank, and GMAC's management to turn the company round.

In March he ventured outside his taxable bond territory to scoop up tax-free municipal bonds that had hit a record low. Munis had become oversold, and he expects them to benefit from tax hikes.

Occasionally the strategy of buying battered bonds hurts performance. The fund lagged its peers during the downturn of 2001, and has lost 2 per cent in the year to date, underperforming the benchmark index by 3 percentage points. "I don't mean to sound flippant, but we always underperform this time of the market cycle, because we load up on corporates while they're still going down," he says.

Colleagues and clients say Mr Fuss is known to take risks when others waver. David Rolley, co-head of Loomis's global fixed income group, says Mr Fuss is not afraid to act on hunches. That willingness to move early often protects clients from bearish markets.

2009, when rising inflation and bigger budget deficit will push rates higher.

Buy the following:

Municipal bonds Taxes likely to rise after elections; tax-free munis to benefit.

High yield closed-end funds Selling at substantial discount to net asset value.

Multi-sector open-ended funds Have most flexibility to deal with current turmoil.

Agencies Fannie Mae and Freddie Mac are ultimately supported by the government.

Preferred stock of the financial companies They are cheap, and the worst will soon be over.

Avoid:

US Treasuries They are overbought; too much supply ahead.

Last year, as US junk bond prices hit record highs, Mr Fuss resisted the buying frenzy, slashed his corporate bond allocation and positioned himself defensively in long-dated US Treasuries and foreign bonds. When the credit squeeze hit, investors followed his lead. Since then he has reversed course and sold most of his Treasuries, buying corporates instead.

Mr Fuss's willingness to go against the grain stems from long experience. A former naval officer, he began his financial career as a janitor at a small bank in Wauwatosa, Wisconsin, 50 years ago. His experience comes in handy as market pundits fret about how much worse the credit crisis will get and how long it will last.

Mr Fuss rejects the term "crisis", but offers a damning assessment. "This is the most worrisome financial situation I've seen in my working lifetime," he says. The current credit crunch is unique in its severity because it has sapped liquidity in bond markets and is threatening the banking system, he says. "We're asking ourselves: is this thing going to hold together?"

He blames hedge funds and other leveraged players, and argues that today's problems date back to the early 1980s, when financial technology made it possible to add layers of unreported, unregulated leverage.

Some of the financial instruments created with new technology in the past decade were not transparent enough, he says, citing collateralised debt obligations cubed – far-removed derivatives of mortgage bonds.

Irresponsible borrowing was fuelled by the "two and 20" system, by which hedge fund managers are paid a 2 per cent flat fee of assets under management in addition to a 20 per cent cut of profits. The system encouraged fund managers to maximise returns regardless of risks, he says. Demand from wealthy individuals clamouring to make a quick buck exacerbated the problem.

He also blames large banks that hid leverage from regulators by setting up structured investment vehicles, which operated like hedge funds and took risks off balance sheet. The result, he says, was a murky auxiliary banking system whose recklessness bled into the economy and is threatening the financial sector.

Some have called this overreach greed. Mr Fuss prefers to call it human nature. "It's very understandable," he says, and recommends that hedge funds be regulated and banks prevented from taking vehicles off their balance sheets.

Mr Fuss approves of Washington's response to the credit crunch so far. The Federal Reserve has cut interest rates sharply and taken other steps to boost cash on banks' balance sheets. He does not deny the risk that these moves are laying the groundwork for the next bubble, but regulators have no choice but to deal with the "here and now", he says.

"The Fed and the Treasury have been acting appropriately. I applaud them," he says. "If you didn't have liquidity pretty soon you'll have insolvency."

He disputes one widespread concern that the recent rate cuts will fuel inflation later, although he sees risks of inflation in coming years from the growing budget deficit.

He expects the unwinding of leverage to take several more quarters. "We're not even a third of the way through yet with the unwind," he says.

Mr Fuss makes his predictions – he prefers to call them guesses – with concern in his voice. He knows that for most investors, more unwinding spells bad news. For Mr Fuss, however, more unwinding spells profits. It is an excellent time to load up on cheap bonds.

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