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SEC Investor Advocate Worried About Narrowing of Muni Market.

WASHINGTON - Financial regulators and others should work to reverse the increased narrowing of the municipal market caused by fewer retail investors and more munis concentrated among wealthier bondholders, the Securities and Exchange Commission's Investor Advocate told regulators.

"Personally, I hope we can reverse this trend toward concentration of assets among fewer investors," Rick Fleming said in a speech at the Municipal Securities Rulemaking Board's Securities Regulator Summit on Aug. 25.

Fleming said that, as of December 2015, individuals owned approximately 70% of munis either directly or indirectly through mutual funds or other pooled investment vehicles with the average age of a muni investor at 62.

"However, if you drill beneath those statistics, some interesting - and some might say troubling - patterns emerge," he said.

Fleming noted that "a mere 2.4% of households hold any municipal debt," about half of what the percentage was in 1998.

Further, the wealthiest one-half percent of U.S. households now own 42% of all municipal bonds, compared to ownership of only 24% in 1989. Additionally, the bottom 90% of households, as measured by net wealth, hold less than 5% of munis, falling from 15% in 1989, Fleming said.

"How did muni bond ownership become a lifestyle of only the rich and famous, as opposed to an investment option for the middle and upper-middle classes?" Fleming asked.

The investor advocate traced the narrowing of holdings to munis' tax exemption. While the tax-exempt status is attractive when compared to other investments, the interest rate on munis is often lower than the interest rate on other taxable fixed-income securities like corporate bonds, he said.

Households in higher tax brackets have always had more incentive to invest in muni bonds, he said, adding "this is not news." In addition, the shift from defined benefit pension plans, where the plan sponsor promises payments based on a pre-defined formula rather than individual investment returns, to defined contribution pension plans, where the employer and employee both make regular contributions to an account, "seems to have significantly deteriorated the incentive for less wealthy persons to invest in munis," he said.

Fleming said that the lower-yield for lower-tax tradeoff that munis promise to investors tends to be less attractive to individuals that have tax-advantaged retirement accounts where all holdings are tax-deferred.

"It usually makes little sense to hold tax-exempt munis within an IRA, 401(k), or 403(b), and, as we

might expect, research suggests that people who direct their savings into tax-advantaged retirement accounts are unlikely to hold munis,” Fleming said. That means that muni investors are likely to be individuals who are wealthy enough to have fully funded their retirement accounts, he added.

While Fleming said more study is probably needed, he added it is “worth asking whether the tax benefits of municipal bonds, which were presumably intended ... to incentivize investment in munis, are actually accomplishing that objective.”

“Competing tax policies that favor retirement savings may actually drive most investors away from muni bonds, given their traditionally lower yields,” Fleming said.

“Regardless of our views on income or wealth inequality, I think we can generally agree that the projects funded by municipal securities improve the quality of life for all Americans, so we all have an interest in making sure the marketplace is attractive to investors of all stripes,” Fleming said.

He further warned that “if the current trends continue and we see fewer investors holding an ever-larger proportion of muni bonds, the traditional retail-oriented muni market will change dramatically in the not-too-distant future.”

The Bond Buyer

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August 29, 2016