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<u>Skittish Muni-Bond Investors Are the Worst at Timing the</u> <u>Market.</u>

- Individual returns on funds lag more than any other sector
- Morningstar study reinforces susceptibility to 'headline risk'

The municipal-bond market is dominated by individual investors, and it turns out they're not nearly as good as the pros.

Over the past decade, individuals earned an average of about 1.26 percentage point less annually on their investments in open-end state and local government bond funds than the funds themselves, according to a study released by Morningstar Inc., which took account of what investors make after shifting their money in and out of the market. That gap was the biggest among the eight asset classes the research company examined.

Even though state and local government debt is one of the world's safest investments, buyers are still prone to so-called headline risk, or bad news stories that undermine the market's perception as a haven and cause investors to sell when they should stay put.

That happened in 2010, when banking analyst Meredith Whitney triggered a selloff by predicting that recession-battered governments would default on "hundreds of billions of dollars" of bonds. That forecast proved widely off the mark, and in 2011 municipals returned 11 percent. They haven't had a better year since.

Puerto Rico's debt crisis — which was unique to the Caribbean territory — also drove investors away from municipal securities at the wrong time, according to Russel Kinnel, Morningstar's director of manager research.

"You had the Meredith Whitney '60 Minutes' interview, predicting mass bankruptcies in Muniland or mass defaults, and that scared the hell out of people even though it was a ridiculous prediction," said Kinnel. "Then you had Puerto Rico, which was real. It's just that in the case of Puerto Rico, from a fund perspective, it was not a big deal because most of the good funds had very little or nothing in it to begin with."

The study estimates what individuals earned after shifting money in and out of their funds and then compares it with the performance of the funds overall. It found that the asset weighted return for individuals in open-ended funds was 2.23 percent annually for the 10-year period ending March 31, compared with a 3.49 percent average return for muni bond funds.

Since municipal bonds don't trade heavily, spikes in inflows or outflows can have a larger impact on prices than in other markets and trigger a self-reinforcing cycle: A wave of selling driven by bad news can cause a second exodus when investors see their subsequent returns, Kinnel said.

"For skittish investors, it doesn't take much," he said, adding that fund companies and planners need to a do a better job reassuring investors. Municipal bonds are heavily weighted toward longer maturities, making them more sensitive to changes in interest rates. While investors have been putting money into the funds recently despite the Federal Reserve's rate increases, they yanked \$65 billion from the vehicles between June 2013 and January 2014 after then-Fed Chair Ben Bernanke jarred bond buyers with plans to scale back asset purchases, an event known as the "Taper Tantrum."

In addition, municipal-bond funds are typically sold based on their yields. Higher-yielding funds that buy riskier bonds may get hit harder in an economic downturn, Kinnel said.

Morningstar's annual study, titled "Mind the Gap," measures the performance of the average dollar invested in a fund and estimates the impact investor behavior had on investment outcomes.

To calculate fund investor returns, Morningstar adjusts official returns by using monthly flows in and out of a fund and asset-weights the returns to get an average for an asset group. In all asset classes overall, the average open-end investor lagged behind the average fund by 0.26 percent.

"The basic idea is we know people aren't necessarily there for the whole five or 10 year period," Kinnel said. "They move in and out and want to take a look at how that timing works."

To be sure, the goal for investors is to get a good return in absolute terms. They likely don't look at the gap between their own returns and those of the funds in which they invest.

"I could have a small gap on a really bad fund," Kinnel said.

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By Martin Z Braun

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