

# **Bond Case Briefs**

*Municipal Finance Law Since 1971*

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## **Can You Index Municipal Bonds?**

Indexing has limitations. Some markets or market segments are easier to index than others. The degree of difficulty is largely a factor of the breadth, depth, standardization, and liquidity of the pool of assets in question. Nonstandard assets that are difficult to trade, like municipal bonds, can be difficult to index. Indeed, running an index-tracking municipal bond fund is a tricky proposition. The managers of an indexed municipal bond portfolio have to strike a balance between tracking their index and the costs involved in doing so. Based on the performance records of many of the municipal bond index funds available to investors, these funds' managers appear to be capable of managing this balancing act.

Let's say you're a portfolio manager running a bond index fund. When your fund's target index rebalances, you'll likely need to do some trading so the fund's holdings match those in the index. This is a necessary maintenance activity that keeps your fund's portfolio and performance in line with its benchmark.

Now suppose the target index requires that you buy bond A following a rebalance. You go to the market, but there is only one willing seller of bond A. You make an offer to buy. But that lone seller knows he's the only show in town and attempts to take advantage of his status by counter-offering at a higher price. You're in a predicament. You can buy the bond, but it's going to cost you. And that cost is absorbed by the fund's shareholders.

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**Morningstar**

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22 Feb 2019

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