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Do Municipal Bond Exchange-Traded Funds Improve Market Quality?

In this paper, Justin Marlowe of the Harris School of Public Policy at the University of Chicago examines the relationship between exchange-traded funds (ETFs) and the liquidity profiles of municipal bonds. Like mutual funds, ETFs own the underlying bonds and can create and redeem shares in the fund every day. Unlike mutual funds, investors in ETFs can trade in and out of positions throughout the day because ETFs trade like a stock on an exchange. This makes them attractive to investors who want a degree of liquidity not typically available in fixed income over-th--counter markets. ETFs are, in many ways, an ideal innovation for the municipal bond (i.e. "muni") market. The muni market is fragmented and comparatively illiquid. Unlike publicly-traded corporations, state and local government financial disclosure is largely unregulated, so price-relevant information can be costly to obtain. This lack of liquidity and high search costs are reflected in mark-ups on muni trades that are often orders of magnitude larger than similar trades in corporates or equities. The muni market has high barriers to entry, but ETFs are a comparatively low-cost, well-diversified, and richly-informed vehicle for investors to access it.

But despite these benefits, ETFs also raise concerns for regulators and policymakers. Many of those concerns surround liquidity dynamics. Like with many fixed income ETFs, the bonds held by muni ETFs can be considerably less liquid than the ETF itself. That can create a substantial liquidity mismatch where ETF issuers might need to buy (sell) a particular bond at a considerable price premium (discount) when liquidity is scarce. This mismatch can distort the relationship between the ETF's net asset value and its share price. It can also uncouple the ETF from the market index it is designed to track.

This paper is the first to examine the implications of ETF ownership for individual municipal bonds. Using data on the bond-level holdings of ETFs from 2010-2020, Marlowe finds that bonds held by ETFs tend to trade more often than bonds held by mutual funds, but with little or no impact on price dispersion, returns, or systematic risk. However, these effects vary considerably by the type of bond. Lower credit quality bonds held by ETFs tend to trade much more frequently than those with higher credit quality. Market conditions also matter. During the COVID-19 market dislocation of March 2020, bonds held by ETFs traded far less often. These results have implications for regulators' stated concerns about the liquidity differential between ETFs and their underlying holdings, especially during market downturns. Marlowe's findings suggest that at best ETFs bolster municipal bond liquidity overall, and at worst, bonds held by ETFs are no less liquid than bonds held in mutual funds.

Read the full paper here»

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December 14, 2020