# Bond Case Briefs

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## Vanguard to Make It Easier to Invest in Munis.

The municipal-bond market isn't always the easiest to navigate. But the simple, cheap choice of investing in muni bonds through ETFs is about to get a boost.

Already, exchange-traded funds that focus on tax-exempt municipals make it possible to get a diversified holding of such bonds with a single trade, at low cost. That is a lot less labor-intensive than creating a portfolio with individual securities.

Still, until now, few people seem to have noticed. Muni ETFs hold only about $15 billion, remaining a niche in the $2 trillion ETF universe.

One possible reason: Unlike stock investments, it doesn't cost that much more to own an active muni bond fund, whose manager can monitor the creditworthiness of issuers, says wealth adviser Vern Sumnicht, in Appleton, Wis.

That may change soon.

**A first for Vanguard**

This spring, index-fund giant Vanguard Group aims to launch its first tax-exempt muni index fund with an ETF share class. Vanguard says it will charge annual expenses as low as 0.12 percentage point of assets for the funds. That compares with 0.20 to 0.35 point for existing muni ETFs and around 0.50 to 0.90 point for actively managed muni funds.

With yields still near historic lows, a bond ETF with significantly lower expenses could be a strong draw, says Thomas Boccellari, a passive-strategies analyst at Morningstar Inc. "It would put more money in investors' pockets," he says.

Bonds of state and local governments have some attractive features, although their greatest appeal is to investors in higher tax brackets. The interest such bonds pay generally is exempt from federal taxation, and sometimes also from state and local taxes.

And despite some high-profile fiscal meltdowns, such as Detroit's 2013 bankruptcy filing, defaults are significantly lower for munis than for debt of corporations.

**Design challenge**

Designing muni ETFs was more of a challenge than creating ETFs in other markets, though.

Unlike stocks, many munis don't trade very often. The dilemma for fund companies was how to accurately value a basket of munis underlying an ETF throughout each trading day, says James Colby, senior municipal strategist for Van Eck Global's Market Vectors ETFs unit.

Eventually, ETF sponsors, regulators and firms that track muni prices agreed that the baskets would be valued with the help of algorithms—rules-based mathematical analyses based on historic data and the prices of bonds that have traded. The resulting ETFs deliver tax-exempt income at “a very reasonable price with transparency and liquidity that investors don’t get in the underlying muni market,” says Mr. Colby.

For people who already own individual munis, an index-based, passively managed approach might provide further diversification, says David Mazza, head of research for SPDR ETFs at State Street Global Advisors.

Experts caution that anyone considering a muni ETF should understand the risks inherent in bond investing generally, as well as the differences between passive and active muni funds.

One ever-present concern is that inflation fears could push up yields. Bond prices move in the opposite direction of yields, so both index and active bond funds can lose value when yields rise.

Moreover, although credit risk is low in municipal bonds, a credit-ratings downgrade or a default can cause individual bonds to lose value—or in the worst case, cause the whole market to sell off.

**Spreading the risk**

ETF managers don’t do credit analysis or sell in anticipation of downgrades, says Matt Tucker, head of Americas Fixed Income Strategy for BlackRock Inc. ’s iShares unit.

The trade-off, he says, is that ETF holders get wide diversification, so problems affecting one bond likely would have modest impact. The iShares National AMT-Free Muni Bond (MUB) fund, the largest muni ETF, with more than $4.4 billion in assets, holds around 2,400 individual bonds.

Owning a larger muni ETF could have other benefits, too, says Michael Iachini, managing director of Mutual Fund & ETF Research at Charles Schwab Investment Advisory Inc. The bigger ones trade at significantly narrower bid-ask spreads, or the margins between the price at which market makers are willing to buy and sell. When spreads are wider, that raises costs if an investor periodically trades an ETF, he says.

Vanguard says its new muni funds will invest in investment-grade securities in various maturities. A Vanguard spokesman declined to comment beyond the firm’s announcement of the funds, citing restrictions while they are under review by regulators.

Executives at other fund firms wouldn’t speculate on the impact of Vanguard’s entrance to the sector. But some said it wouldn’t hurt if more investors notice that ETFs offer another route to owning munis.

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By MICHAEL A. POLLOCK

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