
Mutual Fund Holdings Set Record as Households Wane: Muni Credit

(Bloomberg) — U.S. mutual funds' holdings of municipal debt grew to a record $658 billion in 2014 as individuals shunned direct purchases in favor of managed money amid Puerto Rico's woes and the loss of top-rated bond insurance.

The funds increased their stake by almost 40 percent in the past five years, solidifying their position as the second-biggest category of muni buyers, according to Federal Reserve data released Thursday.

Even as regulators seek to promote transparency in the market for state and city debt, the shift underscores the diminishing role of individuals who buy bonds for their own account. Households, while still the largest muni holders, reduced ownership to the lowest in almost a decade as Detroit's historic bankruptcy and junk-rated Puerto Rico's struggle to repay $73 billion of debt steer them toward more diversified investments.

"Credit concerns, especially Detroit and Puerto Rico, have caused a lot of individuals to want professional credit advice," said Phil Fischer, head of muni research at Bank of America Merrill Lynch in New York.

Growing Influence

Mutual funds are expanding their influence as the supply of munis is shrinking. The tax-exempt market, which localities use to finance roads, bridges, public schools and water systems, dwindled for the fourth straight year, to $3.65 trillion as of Dec. 31 as officials hesitate to take on borrowing for new projects.

It's the longest stretch of declines in data going back to 1945, and the market is still contracting: Local-government obligations tallied $3.5 trillion as of Wednesday, data compiled by Bloomberg show.

The declining amount of debt and buying by funds helped munis advance 9.8 percent in 2014, the most since 2011, according to Bank of America Merrill Lynch data.

With the top federal income-tax rate the highest since 2000, the appetite for munis' tax-free interest isn't waning. Investors are just reconsidering how they buy the securities.

Holdings of households have dropped every quarter since March 2013, to $1.54 trillion at the end of 2014, the least since March 2005, Fed data show. Their ownership has dropped to 42 percent of the market, from 50 percent at the end of 2010.

Insurance Crutch

The transition gained momentum after the companies that insure munis lost their top credit ratings in the wake of the financial crisis. Unable to rely on the guarantee, buyers had to take a closer look at the creditworthiness of specific holdings, said Alan Schankel, a managing director of fixed-income strategy at Janney Capital Markets in Philadelphia.

"It's tough for individual investors," he said. "If they have 20 different positions in their portfolio, it may be difficult for them to keep on top of all of them."

The concerns of individual buyers have grown as Puerto Rico's fiscal challenges mount. The debt load of the island and its agencies is greater than all states but California and New York, even though it has about 3.5 million people. Because the territory's bonds are tax-exempt nationwide, they're widely held by both individuals and mutual funds.

Puerto Rico lost its investment grades last year as officials struggle to revive the commonwealth's economy. Its Electric Power Authority is negotiating with creditors to potentially reduce $8.6 billion of obligations, in what may become the largest muni restructuring.

Stress Push

Reports of financial stress and failures "have pushed a growing amount of investors towards some kind of managed solution," Schankel said.

Professional money managers can also help investors deal with a potential increase in interest rates, which can reduce prices on muni holdings, said Fischer at Bank of America. The consensus on Wall Street is that the Federal Reserve will raise its target interest rate from near zero this year as the economy strengthens.
Benchmark 10-year munis yield about 2.2 percent, close to the highest since November.

"They're willing to buy more assistance when they're anxious," Fischer said. "They can have a variety of anxieties, and certainly one of them is credit and another one of them deals with interest rates."

Bloomberg Muni Credit

by Michelle Kaske

March 12, 2015

To contact the reporter on this story: Michelle Kaske in New York at mkaske@bloomberg.net

To contact the editors responsible for this story: Stephen Merelman at smerelman@bloomberg.net Mark Tannenbaum, William Selway