Bond Case Briefs

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Vanguard, Once Thwarted, Launches a Muni-Bond Rival to BlackRock's iShares.

The Vanguard Group Inc. was playing catch up when it was getting ready to launch its first municipal bond index fund in 2010.

Its competitors had already successfully brought similar products to the market, including State Street Global Advisors and BlackRock's iShares. Those issuers, who at the time had substantially larger ETF businesses than Vanguard, offered a suite of muni-bond products with more than $2 billion in assets apiece.

But Vanguard was forced to call off its launch. The December 2010 prediction by the analyst Meredith Whitney on "60 Minutes" — that bonds issued by U.S. cities and states would see billions in defaults — worsened the mood of investors shell-shocked by the financial crisis. A fund launch then could have been catastrophic, according to Christopher W. Alwine, the head of Vanguard's municipal bond group.

"People thought munis were the next shoe to drop," Mr. Alwine said. "There were heavy outflows in the muni market at the time. It wouldn't get any interest or it'd get redemptions, and it would make it difficult to produce tight 'tracking' in the product," capable of successfully matching the returns of its benchmark.

Five years later, Vanguard, now the top mutual fund company and No. 2 ETF shop behind iShares, is hoping that this time is different.

The Vanguard Tax-Exempt Bond Index Fund (VTEBX), launched Monday, is the mutual fund industry's first passive municipal bond fund, according to Nadine Youssef, a spokeswoman for fund researcher Morningstar Inc. But its ETF counterpart, which Vanguard now runs under the ticker VTEB, will be going head to head with deeply entrenched competitors.

The top product, managed by BlackRock Inc., is a colossus: The iShares National AMT-Free Muni Bond ETF (MUB) manages more than $5.2 billion.

The Vanguard product is the cheapest fund of its kind, with annual expenses of 0.12% for both the ETF and the lowest-cost mutual-fund share class.

Mr. Alwine said that expense ratio will allow the funds to top the performance of its competitors, including the comparable iShares product. A BlackRock spokeswoman declined to comment.

They're launching the fund into a much healthier market, analysts said, with many cities and states displaying stronger financial conditions and refinancing their debts at lower rates in the past several years. But it's also potentially an environment of rising interest rates, which to some degree will erode the value of bonds.

The S&P National AMT-Free Municipal Bond Index, tracked by the Vanguard and iShares products, focuses on investment-grade bonds exempt from U.S. federal taxes and excludes the troubled U.S. territory Puerto Rico, which has been purchased by a number of municipal bond mutual funds. The index has averaged a 2.4% return over each of the last three years, or 3.7% each of the last five.

Over five years, 45% of active fund managers have topped the return of that index, according to Todd Rosenbluth, director of ETF and mutual fund research at S&P Capital IQ.

Like many bond index funds, this product looks to match the returns of its index not through buying every underlying bond but by “sampling,” using the assets they have to buy a representative group that matches the characteristics of the bonds in the index.

“While investors should expect that this product should be performing closely in line with the S&P index and should perform close from an ETF perspective to MUB, which tracks the same index, there will be some slight deviation in performance and how well it tracks the benchmark,” particularly before the fund reaches a critical mass of assets, Mr. Rosenbluth said.

“Especially in a world of soon-to-be-rising interest rates, that should make it harder for bond funds to perform as well as they have historically,” he added. “By shaving off the expense ratio, that increases the likelihood of stronger performance.”

Investment News

By Trevor Hunnicutt

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