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Vanguard Steps Into Muni-Bond Indexing.

Long associated with index funds, Vanguard Group didn't launch its first municipal-bond index fund until this past August.

At an annual cost of 0.12%, Vanguard Tax-Exempt Bond ETF (VTEB) tracks the S&P National AMT-Free Municipal Bond Index, the same one tracked by iShares National AMT-Free Muni Bond ETF (MUB), which has a 0.25% expense ratio .

Vanguard, which already had active mutual funds for the sector, hasn't set off fireworks with the ETF so far. The iShares fund dwarfs the Vanguard ETF in assets (\$5.6 billion to \$60 million) and average daily volume, where differences in expense ratio can be made up in trading spreads.

Yet, Vanguard's launch is sure to bring added focus to muni-bond indexing and passive-investing strategies. Through Sept. 30, actively managed municipal-debt funds held \$573 billion, compared with just \$20 billion for index funds, the largest active/passive discrepancy for eight distinct fund types tracked by Morningstar Inc. And 85% of those passive funds were in ETFs.

Muni bonds (and funds) are typically held by investors in higher marginal tax brackets, those who benefit the most from the state, federal and local tax-exempt status of interest income from munis. Moreover, the muni market isn't nearly as large or as liquid as those for federal or corporate debt—so trading individual bonds can be a challenge.

"In a more fragmented market, the sampling approach a manager uses to align with an index is extremely important," says Peyton Studebaker, managing director of Caprin Asset Management in Richmond, Va. His clients are invested in the \$1.2 billion Market Vectors Intermediate Municipal ETF (ITM). The fund, which costs 0.24%, has an effective duration of 7.1 years compared with 4.7 years for the more broadly based MUB.

"Intermediate muni ETFs offer a more-reasonable risk/reward in today's interest-rate environment," adds Mr. Studebaker. ITM yields 2.1%, or 3.52% tax equivalent at the 39.6% marginal federal rate. MUB yields 1.63%, or 2.89% tax equivalent as of Nov. 2, according to each company.

It remains to be seen whether Vanguard's entry into the market will win over customers from existing funds, including the \$1.5 billion SPDR Nuveen Barclays Municipal Bond ETF (TFI), or expand interest in muni-bond indexing generally.

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By ARI I. WEINBERG

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Mr. Weinberg is a writer in New York. He can be reached at reports@wsj.com.

