Bond Case Briefs

Municipal Finance Law Since 1971

Don’t Blame ETFs For Poor Muni Liquidity.

Most municipal market investors and their advisors would agree that liquidity in the municipal bond market has declined in the last several years.

Even as liquidity has declined, however, the municipal bond market has continued to grow and attract investors. According to data from the Federal Reserve, in the first three quarters of 2015, total market size increased by $57 billion (to $3.7 trillion) and direct household ownership of municipal bonds increased by $8.8 billion. Indirect ownership through mutual funds increased by $29.8 billion. According to FactSet Research Systems, over the same time period, total assets in muni bond ETFs grew by $3.6 billion, to an estimated $22.0 billion.

Some participants in the traditional over-the-counter municipal bond market have been wondering if the growing popularity of municipal bond ETFs has been draining liquidity from the market for individual bonds.

An analysis of municipal bond ETF flows suggests that rather than draining liquidity from the municipal bond market, muni ETFs (the first of which came to market in 2007), have in fact attracted new liquidity to the marketplace.

Historical Demand

Because of the lower interests rates earned when compared with comparably rated taxable bonds, municipal bonds have historically been most appealing to individual investors in the upper Federal income tax brackets. (The higher the tax rate, the greater the benefit of the tax exemption on the income earned.) Because of this, ownership of municipal bonds has been dominated by households.

Direct ownership (via portfolios of individual bonds) accounts for more than 40% of the market. When combined with indirect ownership through mutual funds, closed-end funds and ETFs (presumed to be primarily from individual investors), household ownership represents almost two-thirds of the market.

Trading Activity

At $3.7 trillion, the market is large, but it is also very complex. With more than 60,000 issuers and well over 1 million CUSIPs, it is the complexity of the municipal bond market that has made it difficult to attract significant participation by hedgers, traders and active (tactical) asset allocators.

Additionally, even though the municipal market includes several electronic trading platforms, the overall market is not centralized on an exchange, so trading liquidity is supported by the more than 1,500 registered dealers located around the country. (The number of dealers has declined 22% since 2009.)

Municipal bond trading activity has long been dominated by customer-related transactions. Through October of last year, 45% of municipal bond market trading activity was customer buying (which includes household purchases as well as investing by institutions such as insurance companies and

funds); customer selling was an additional 23% of total volume. (The balance consisted of trading between dealers.)

In contrast, the consolidation of all ETF trading onto a centralized exchange brings together all interested participants. The centralized trading and the popularization of the ETF “wrapper” has attracted broader participation to this part of the municipal bond market.

The fact that net investor buying in muni bond ETFs represented less than 20% of total trading volume suggests that—unlike the underlying municipal bond market—a much greater percentage of market liquidity is being provided by other participants such as traders, hedgers and asset allocators. (See the table below for select details on the market’s trading flows.)

The Decline In Muni Market Liquidity

Using the amount of financial assets reported by broker-dealers as a proxy for their market-making activities, and therefore the depth of markets, reveals why liquidity in some markets has declined. Since the end of 2006, the estimated amount of broker-dealer assets devoted to supporting the municipal bond market has declined by almost 70%.

Over that time span, corporate and foreign bond market support declined 73%, while overall market support was down only 26%.

The disproportionate reduction of broker-dealer support of the municipal bond market is not surprising, as the trend reinforces the anecdotal observations about the changing nature of secondary market liquidity. (This chart is not intended to imply complete precision in the amount of capital deployed by the broker-dealer community to the markets, but rather to be indicative of the trend of their level of activity in the markets.)

The changing nature of municipal bond market liquidity is more the result of industry forces than the growth of the muni bond ETF product class. However, it is worth keeping in mind that the ETF sponsor firms and other fixed-income asset managers have vested interests in fostering a healthy and viable municipal bond market.

It seems unlikely that municipal bond market liquidity could return to historical norms. Even with an expected increase in interest rates, the ability of the existing network of dealers to finance an increased commitment to the market would require greater profitability from a widening of the bid/ask spread—also unlikely, due to improved transparency and competitive pressures from the much tighter bid/ask spread available with muni bond ETFs.

Further consolidation of the number of municipal bond dealers would have an unknown effect on liquidity, but could be positive if it means that the remaining market-makers are that much more able to be fully committed to the market.

Conclusions

As with investment portfolios, securities markets are most resilient when they are well-diversified. The strongest and deepest markets benefit from the active involvement of participants with a wide range of needs and objectives.

Municipal bond market buying and trading has long been dominated by a single category of participant: the long-term investor. The recent reduction of support of the market by broker-dealers has created a tangible reduction in the ability of investors to easily sell or buy on a consistent basis.

While this does not mean that investors should reduce or avoid municipal bond investments solely for this reason, it does raise the importance of considering potential secondary market liquidity prior to making any investment decisions. Self-directed investors must be comfortable with the implications for their own portfolios, or consider if they would prefer delegating portfolio decisions to a professional manager.

While the size of the muni ETF market is still only a small percentage of the overall municipal bond market, investors may wish to consider if the muni bond ETF merits consideration as a potentially more liquid means of accessing the investment class—particularly for tactical (short-term) portfolio needs, but also for long-term holdings as a replacement or addition to individual bonds.

ETF.com

By Patrick Luby

January 07, 2016

Patrick Luby is the author of Income Investor Perspectives. This article is provided for informational purposes and is not to be construed as offering investment advice. Additional information is available upon request.

Copyright © 2026 Bond Case Briefs | bondcasebriefs.com