Bond Case Briefs

Municipal Finance Law Since 1971

Muni-Bond Investors Stick With Active Fund Managers Even as They Fall Short.

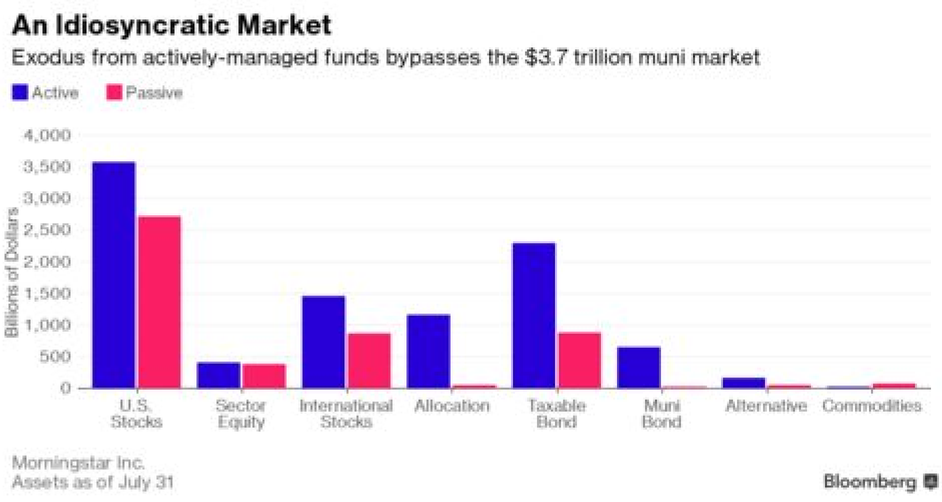
Municipal-bond buyers are sticking by their mutual-fund managers, even though the chance that many of them will beat the market is no better than a coin toss.

The broad shift into low-cost index funds, which have drawn cash away from those that buy and sell stocks and bonds in a quest for outsize returns, has largely stopped at the U.S. state and local securities market, a bastion of buy-and-hold investors looking for steady, tax-exempt income. And they're not necessarily being rewarded for their loyalty: About 50 percent of the actively-managed funds lagged a Bloomberg benchmark over the past five years, according to Morningstar Inc. data on those holding debt maturing from 5 to 12 years.

"You have some entrenched ways of investing here," said Chris Alwine, who oversees more than $167 billion in municipal-bond assets at Vanguard Group Inc., one of the biggest providers of index funds. "You had the belief that you couldn't index it. That's been thrown out."

The traditional way of investing hasn't gone with it. As cash flooded into municipals amid turmoil in global financial markets, actively run funds took in $48.7 billion in the 12 months through July — eight times more than those built to mimic the performance of an index, according to Morningstar. As a result, the managed investment vehicles had $653 billion of assets, compared with $27 billion held by their passive competitors.

That stands in contrast to other markets over the same time period. Souring on underperforming stock and taxable-bond managers, investors withdrew almost $380 billion and put $367 billion into index funds.



While passive municipal funds are growing at a faster rate than active ones — if only because they are relatively new and had far fewer assets to begin with — there are several reasons for their slow inroad to the $3.7 trillion market, said Karen Schenone, a San Francisco-based fixed-income strategist at BlackRock Inc.'s iShares unit, a provider of exchange-traded funds, or ETFs.

Some investors prefer buying bonds issued by their local governments or, if they live in high-tax states like New York and California, state-specific funds, instead of the nationally oriented ETFs. Investors also tend to focus on the indicated yield without considering total return, Schenone and Alwine said. Active funds generally yield more than ETFs.

"Most people think, 'I want a manager who's doing credit research, adjusting for duration, looking for blowups," Schenone said.

That also leads to bigger fees, though not necessarily better returns. The average expense for actively-managed open-end municipal funds is 0.91 percent, compared with 0.3 percent for ETFs, according to Morningstar. Yet over the past five years, only about half of the intermediate active funds tracked by Morningstar returned more than the Bloomberg Barclays Intermediate Index as of June 30. The index returned 6.48 percent for the 1-year period, 4.7 percent over three-years return and 4.47 percent over five.

Awaiting Opportunity

JPMorgan Chase & Co.'s $4.5 billion Intermediate Tax Free Bond Fund was among the laggards. Chloe Etsekson, a spokeswoman for JPMorgan, said more than 90 percent of the fund's holdings were in lower-yielding AAA and AA rated bonds, a higher percentage than the index.

"VSITX is a low volatility fund for asset allocators looking to use the municipal portion of their overall fixed income allocation as the anchor and source of cash when fixed income volatility spikes," she said in an e-mail. "It is structured to provide liquidity when other opportunities arise."

BlackRock's $7.6 billion, iShares National Muni Bond ETF, the biggest municipal ETF, outperformed 77 percent and 72 percent of national intermediate active managers, over 1 and 3 years, according to data compiled by Bloomberg.

The rise of "robo advisers," that use software programs to build portfolios could give a boost to ETFs, said Schenone. Web-based financial advisers Wealthfront Inc. and Betterment are using BlackRock's as its only municipal holding, she said.

Vanguard, a pioneer in mutual fund indexing, has been a later entrant than BlackRock to passive municipal management. The world's largest mutual fund manager started its first fund last year. Vanguard's $460 million index fund pales in comparison to its actively managed $52 billion intermediate fund.

This year, the passive fund's ETF shares returned 4.13 percent, beating the 3.92 percent posted by Vanguard's actively managed intermediate fund.

"We believe fully in low-cost active but we also believe in indexing," Alwine said. "Ultimately, it comes down to investor preferences."

Bloomberg Business

by Martin Z Braun

August 29, 2016 — 2:00 AM PDT