Beware the Pitfalls of Muni-Bond Funds.

Individual investors’ focus on higher yield and propensity to follow trends stoke volatility; for some clients, try separately managed accounts

Although retail municipal-bond mutual funds continue to be widely used by registered investment advisers as cost-effective investment vehicles for their clients, many advisers may not be aware that those funds are susceptible to hidden risks.

These funds may be significantly more costly than they first appear as they cater to retail, or individual, investors, are often focused on maximizing yield at the cost of credit quality and diversification, are subject to ill-timed flows of assets in and out of the fund, and are often susceptible to thin liquidity in the market.

A key problem with the municipal-fund market stems from the fact that the funds are typically owned by untrained individual investors. Many of those investors focus on yield rather than the riskiness of the underlying bonds in the fund, resulting in funds that are overconcentrated in risky securities.

Further, individual investors’ decisions to purchase or redeem shares largely dictate fund managers’ decisions. Managers are continuously buying and selling securities in order to provide returns or liquidity for investors, a process that makes it difficult for those managers to put their knowledge of the market to work for their clients.

Research shows that retail fund flows have historically followed past performance in the muni market, with the inflow of cash into funds typically following periods of high returns and outflows often coming in the wake of falling or negative returns. In other words, individual investors time the market poorly by buying high and selling low. As a result, as bond prices fall as interest rates rise, investment managers often find themselves forced to sell their municipal-bond holdings.

Although mutual-fund shares can be immediately liquidated, the actual liquidity of the underlying assets can vary. Often this means mutual funds sell the highest quality, most liquid securities to raise the cash for the individual investors redeeming their fund shares. For those fund investors who have a long-term buy-and-hold approach, that kind of activity lowers the overall quality of the securities in the fund and actually increases the riskiness of their investment.

For advisers of clients who are long-term investors, it is wise to explore alternatives to standard municipal-bond mutual funds. There are options that enable investors to avoid individual co-investors altogether or carefully choose co-investors whose investment behaviors more closely mirror the patience of institutional investors.

One strategy to consider is separately managed accounts with low fees and minimums that are on par with low-cost mutual funds. These accounts provide access to the muni market, but unlike a mutual fund, investors have ownership of the individual securities and control over the transactions of those securities—an important feature during times of rising rates.

Rather than selling shares of a muni-bond fund, which must be done at the net asset value of that fund, managers of separately managed accounts have the ability to sell individual securities. That allows the manager to potentially select and sell shorter duration bonds within the account, which will be less negatively affected by rising rates.

For clients with less in assets, there are also options to purchase mutual funds that are limited to approved investors only. In this case, the fund manager limits investment exclusively to institutionally minded investors and investors working with investment advisers. Without being subject to the whims of individual investors, the fund's management can avoid frequent flows in and out of the funds.

While rates are low and markets are still liquid, it's a good time to begin having conversations with clients about the hidden risks of municipal-bond mutual funds, and make any adjustments necessary to position them well for the future.

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