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Muni Index Funds Are Moving Closer to Their Benchmarks.

- **'Tracking error' on funds has narrowed to 0.35%: Morningstar**
- **Muni-bond ETFs attracted a record $10 billion in 2019**

Municipal-bond exchange-traded funds, which attracted $10 billion in investor cash last year, are getting better at tracking their benchmarks.

The average gap between municipal-bond index fund returns and their targets fell to 0.35 percentage point for the three years ended Dec. 2019, compared with 0.57 percentage point for the 36-month period ended in November 2013, according to Morningstar Inc. Expanded electronic trading and improved sampling of bonds by large asset managers like The Vanguard Group Inc, BlackRock Inc. and State Street Corp. have lowered costs and made tracking more precise, said Neal Kosciulek, a Morningstar analyst.

"Managers themselves have gotten better and more experienced," Kosciulek said in a telephone interview. "A lot of that has to do with sampling, considering the size and diversity of the municipal-bond market. Picking the right bonds is very important."

A narrowing tracking error means investors are getting closer to what they paid for and could make muni ETFs and a small number of muni open-end index funds more appealing. At about $50 billion, muni ETFs comprise just more than 1% of the state and local government debt market, but the segment is growing quickly. Last year, muni ETF inflows grew 48% after increasing 26% the previous year, according to UBS Global Wealth Management's Chief Investment Office. Actively managed open-end municipal-bond funds include more than $800 billion in assets, according to Morningstar.

Index funds were slow to arrive to the fragmented and relatively illiquid $3.8 trillion muni market, which is comprised of almost a million securities issued by an estimated 50,000 municipalities. The first muni open-end index fund was created in 2000, according to Morningstar. The first municipal-bond ETF, iShares National Muni Bond ETF (MUB), was formed in September 2007, 14 years after the first ETF, the SPDR S&P 500 Trust was created by State Street.

"Liquidity and fragmented issuance were challenges that had to be overcome," said David Perlman, ETF strategist at UBS Global Wealth Management.

Sampling Process

Muni-bond indexes include thousands or tens of thousands of individual bond issues, and muni ETFS can't fully replicate them. Instead, portfolio managers use a sampling process, buying enough bonds from the index to match its key characteristics like sector, credit risk and duration.

Technology improvements have enabled fund managers to more effectively sample indexes by simplifying monitoring of changes to the funds' benchmarks and helping to identify bonds on the market, according to Kosciulek. And when a manager finds the bond, the expansion of electronic trading has made it less costly to buy and sell securities.

The average spread between what a seller receives and a buyer pays for a security with dealers acting as an intermediary dropped by more than half between 2005 and 2018, according to the Municipal Securities Rulemaking Board. Institutional investors who buy blocks of $1,000,000 or more are paying less than 20 basis points to trade on average, according to the MSRB.

More than 60% of institutional investors reported using electronic trading platforms in 2018, up from half only two years before, according to a survey last year by Greenwich Associates.

Both MUB and Vanguard's Tax-Exempt Bond ETF, (VTEB), the biggest muni ETFs, aim to mirror the S&P National AMT-Free Municipal Bond Index, which contains more than 12,000 bonds. MUB, which holds about 4,200 bonds, returned 7.28% last year on a net asset value basis, compared to 7.42% for the index. MUB's management fee is 7 basis points.

VTEB, with 4,350 bonds and a management fee of 8 basis points, returned 7.5% last year on a net asset value basis. VTEB had a slightly higher average coupon, stated maturity and duration than its benchmark.

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By Martin Z Braun

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