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[Coronavirus Pandemic Hastens the Demise of at-Risk Municipal Money Funds.]

Vanguard, Federated Hermes and Bank of New York Mellon's Dreyfus shutter state-focused funds

The pandemic is putting a nail in the coffin of the most vulnerable municipal money funds, taking away tax-free investment options from some mom-and-pop investors.

In September, Vanguard Group told investors it would shutter New Jersey and Pennsylvania-focused funds. Bank of New York Mellon's Dreyfus liquidated one state-specific fund last month and in August, Federated Hermes said it would wind four down in February.

These muni money funds invest in the ultrasafe, short-term debt of states and local governments.

In the past six months, assets in tax-exempt money funds shrank nearly 10% to about $130 billion across about 180 funds in August, according to Crane Data. At their height 12 years ago, they held almost four times the amount they do now—and there were more than twice as many.

"The Covid storm revealed these evolutionary changes that had been taking place," said Patrick Luby, a municipal strategist at research firm CreditSights. "You don't know your roof has a hole in it until it rains."

The pandemic accelerated a decline in yields after the Fed pledged to keep rates near zero. The drop in yields is squeezing money fund manager profits, shrinking investor returns and dissuading debt-issuing governments from short-term securities.

"In the current low yield environment, the demand from clients for state-specific municipal funds has decreased significantly," said Stephanie Pierce, CEO of BNY Mellon Investment Management Cash Investment Strategies.

With fewer state money-market funds, individual investors are left with fewer tax-free ways to invest their cash. A New Jersey resident who uses a Vanguard money fund to avoid state taxes on her short-term investment income, for instance, could opt for a different money manager but her overall pool of choices is shrinking.

From individuals to corporations, many investors use different types of money funds as a safe place to hold cash while earning some income. Money funds that hold municipal debt are a small corner of the industry, offering a way for investors to earn interest exempt from federal income taxes. If the debt comes from municipalities within a specific state, local investors can usually also avoid income taxes there.

When tax rates fell for corporations as part of the 2017 tax law overhaul, many companies' interest in muni investments waned. However, individual investors piled into the muni market after seeing their tax bills rise from a separate tax law provision that capped state and local tax deductions. As a result, there were fewer other types of investors waiting to pick up the slack when the March upheaval prompted some individuals to dump their holdings.

In March, BNY injected money to prop up its New Jersey money fund after the value of its assets plunged during the liquidity crunch. The firm told investors this summer it was liquidating the fund.

The pandemic also sent shock waves across the more than $4 trillion money fund industry prompting a Federal Reserve rescue in March. It was the second since 2008, sparking questions from regulators last week about whether rules made after the last crisis have fallen short.

Money managers are now struggling to find enough municipal securities in some markets for their funds to invest in. With interest rates near zero, municipal governments are taking advantage of cheap long-term financing, shifting away from short-term debt and floating-rate bonds that reset at short-term rates. Some municipalities are refinancing floating-rate debt at fixed rates to avoid a repeat of March when short-term rates shot up, costing them dearly, said people familiar with the matter.

“People saw what transpired and started to ask themselves whether this was the right type of debt for them to be in,” said Hazim Taib, chief financial officer of the Connecticut Housing Finance Authority. The authority briefly paid between 5% and 7.5% for AAA-rated short-term debt.

Last year, Vanguard monitored how tighter supplies in Pennsylvania and New Jersey affected its money funds. The firm debated steering the two funds beyond their specific state focus, but decided against wiping out local investors’ tax benefits at the time, said a person familiar with the matter. After its latest fund review this year, Vanguard decided that there weren’t enough municipal securities to warrant stand-alone funds. The firm already had to shoulder some expenses borne by investors in its Pennsylvania muni money fund to prevent yields from falling below zero. Dreyfus also cited limited availability of securities in its decision to liquidate a New Jersey fund.

Deteriorating government finances could further shrink debt supplies that meet money funds’ high thresholds for creditworthiness if cash-strapped governments get downgraded or issue less debt.

Federated Hermes plans to close funds focused on Massachusetts, Pennsylvania, Georgia and Virginia around February 2021, saying the moves were in investors’ best interest. The firm doesn’t see supply across muni money funds as a problem and expects states to issue more debt, according to an October note.

Supply is stronger for funds focused on large states like New York and California, where there are many governments issuing many types of debt, as well as for multistate funds aimed at avoiding federal taxes. Closures of smaller state-specific funds could steer investor dollars into remaining funds, helping the strongest.

“It’s not a stampede,” said Pete Crane, president of Crane Data. ”If anyone does exit, it leaves more of the pie.”

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