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Muni Bond Managers Beaten by Index Funds Eye a 2021 Comeback.

- **70% of active muni fund managers lagged benchmarks in 2020**
- **Strategy 'reflects a winning position in the long run'**

This may be the year that money managers in the municipal-bond market show up the index funds that have been raking in record amounts of cash.

The bond pickers, who pride themselves on deep research and skill at profiting from pricing inefficiencies and swings in a market with 50,000 issuers, largely lost out during the chaos that erupted early in the pandemic, when prices lurched from an unprecedented freefall to a record-setting rally. The returns of more than 70% of national municipal funds lagged their benchmarks — the third time in five years a majority have underperformed, according to data compiled by Bloomberg.

Yet there are signs they may be bouncing back. With the freedom to hold more lower-rated bonds, they have been more insulated from the recent surge in yields and stand to gain as the nation's rebound reduces the economic pressure on public transit systems, hospitals, nursing homes and others that have struggled during the slowdown.

"Given the outlook for credit with fiscal stimulus being supportive and the vaccine being given to more and more people, there is a good chance that the outperformance of lower quality will hold up with the economy improving," said Dan Solender, head of municipal debt at Lord, Abbett & Co. "With rates rising a little, many portfolios are more defensive than the benchmarks, with higher average coupons."

The stakes are high for money managers who have seen low-cost ETFs steadily lure in customers. Such funds, including the dominant ones run by Vanguard Group and BlackRock Inc., had record inflows of $13.6 billion in 2020, a 37% increase over the prior year, according to UBS Global Wealth Management. At the same time, the pace of investment flows into mutual funds — which hold 14 times as much in assets — slowed: they took in $39.1 billion, a 60% decline from a year before, according to Investment Company Institute data.

This year, the ETFs winning streak has snapped. BlackRock's iShares National Muni Bond ETF and Vanguard's Tax-Exempt Bond ETF, which hold about half of the $62 billion in muni ETF assets, have lost 1.05% and 1.06%, respectively. The median intermediate muni mutual fund has lost 0.67%, according to data compiled by Bloomberg. And about six in 10 active managers are beating their benchmarks.

Last year, less than a third of active municipal-bond managers beat their benchmarks. All nine of Fidelity's national mutual funds missed their bogeys. Adam Banker, a spokesperson for Fidelity, declined to comment.

This year bets on riskier bonds are paying off, a shift from 2020, when they were pummeled during a panic-driven crash at the onset of the pandemic.

Active managers were particularly hard hit in that rout because a larger share of their holdings were in A, BBB and lower quality bonds than their respective benchmarks, said Beth Foos, senior analyst at Morningstar. Those with more transportation or hospital bonds relative to the benchmark also suffered.

“The riskier, low-quality bonds that drove solid returns in the strong muni markets of 2019 underperformed in early 2020 and funds that loaded up on some of the market’s riskier names and leveraged structures followed in that bumpy ride,” she said.

Vanguard, the low-cost fund behemoth, was able to capitalize on the pandemic dislocation because its funds were more heavily weighted to higher-rated bonds at the beginning of 2020, said Paul Malloy, head of municipals. All six of of Vanguard’s actively managed national muni funds beat their benchmark last year. Over the five-year period, three funds outperformed and three others missed their benchmark by 0.04% or less.

“We came in light on credit risk with dry powder to deploy,” Malloy said in an interview.

Amid the selloff, Vanguard, which oversees about $230 billion in municipal assets, swooped in to buy the safest tax-exempt bonds at unusually low prices then added lower-rated bonds from issuers like Illinois and the Metropolitan Transportation Authority that would benefit from stimulus.

Baird Advisors also had a good year. Three of its four national funds outperformed, including its new Strategic Municipal Bond fund, which returned 8.4%, beating its Bloomberg Barclays 1-10 Year Municipal Blend Index by 4.4 percentage points.

Baird’s managers knew all the investors in the fund, which opened in November 2019, and felt they’d stick with their bets. That gave bond pickers the confidence to be more aggressive amid the selloff. The small size of the funds also made it easier to find cheap bonds when smaller retail investors were selling, said Lyle Fitterer, co-head of municipal investments at Baird.

Only one of T. Rowe Price Group’s six national muni funds beat its benchmark last year, while all six fell short during the three and five year periods.

Hugh McGuirk, managing director of municipal investments at T. Rowe, said the firm is more focused on beating its peers than fund benchmarks. T. Rowe’s muni funds tended to have lower rated bonds than their index, he said. Some positions, particularly senior living were particularly hard hit and haven’t recovered as much as other sectors.

McGuirk said T. Rowe’s under-performance in 2020 dragged down returns over the three and five year period. The firm’s tax-free short fund has performed better than the Morningstar average over the 1, 3 and 5 year period, he said.

“We are active managers and we are taking greater positions in credit and typically running them a little bit longer against the benchmark,” McGuirk said. “The way we are positioned reflects a winning position in the long run. It didn’t pay off in 2020. But we expect over a long run period of time it will.”

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— With assistance by Bert Louis

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