Municipal Bonds Increasingly Held by Funds Instead of Individuals.

Share of munis held by individuals falls to 40% in the first three months of the year from 46% in 2020, study finds

One factor aggravating volatility in munis this year: Asset managers' increasing share of a $4 trillion market once dominated by buy-and-hold individual investors.

The share of outstanding municipal bonds held by U.S. households fell to 40% in the first three months of the year from 46% in 2020, according to a Municipal Securities Rulemaking Board report scheduled for release Wednesday. The board, a self-regulatory body overseeing the muni market, analyzed Federal Reserve data and determined that the market is shifting from direct ownership of bonds to investment through funds.

The true amount held outright by buy-and-hold retail investors through individual brokerage accounts is likely closer to 20%, because the Fed includes some Wall Street-managed accounts in its household category. So-called separately managed accounts are run by an asset manager on behalf of a single investor. Those hold about 18% of munis, according to Citigroup.

Mutual and exchange-traded funds controlled 24% of munis in the first quarter of 2022, up from 20% in 2020, according to Federal Reserve data.

Wealthier investors are attracted to debt issued by state and local governments because the interest is typically exempt from federal, and often state, taxes. Prices have slid for muni debt and across bond markets this year following aggressive moves by the Fed to curb inflation. The Bloomberg municipal bond index returned minus 9.31% through Friday, counting price changes and interest payments, its worst year-to-date performance on record.

Asset managers' increasing control over the market is part of a dynamic aggravating that price drop, analysts said. Investors in mutual and exchange-traded funds can watch their prices fall in real time and cash out easily. Buy-and-hold investors, in contrast, tend to own bonds until maturity, clipping coupons for income.

"I think they probably trade less frequently than financial professionals, whether they be [separately managed accounts] or mutual funds," said John Bagley, the Municipal Securities Rulemaking Board's chief market structure officer and an author on the report.

Investors have pulled more than $80 billion from muni mutual and exchange-traded funds this year though mid-June, more than in any full calendar year going back to 1992, the 30 years tracked by Refinitiv Lipper. That can force fund managers to sell bonds at unappealing prices to drum up cash for investors.

Mutual funds, exchange-traded funds and separately managed accounts appeal to investors because the oversight of a professional manager makes them more comfortable holding riskier bonds. Those bonds have relatively higher yields, which held particular appeal in the low-yield environment of the past decade.

Some investors also prefer to hold a small share of debt from a diverse pool of borrowers to guard against defaults. Some like the flexibility with which they can get in and out of mutual and exchange-traded funds.

Vanguard Group, Nuveen LLC, Franklin Templeton and BlackRock Inc. were the managers with the largest dollar amount of municipal bonds under management in 2021, according to Refinitiv Lipper.

The market continues to be dominated by individual investors, even if more of them are investing through accounts controlled by Wall Street money managers. In contrast, only 3% of Treasurys and 1% of corporate bonds are held by U.S. households, the Municipal Securities Rulemaking Board found.

“Even though individual investors are going down, it is still an individual investor market unlike any other market,” Mr. Bagley said. “They have a lot of ways to access it: mutual funds, ETFs, SMAs, individual brokerage accounts. The components that make it up have changed but the overall number has been pretty consistent.”

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