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[Fast-Growing Force in Muni Market Is Upending Mutual Funds' Grip.]

- **Investors flocked to separately-managed accounts in 2023**
- **The products could deter interest in muni mutual funds**

A booming corner of the municipal-bond market is poised to topple the long-standing dominance of mutual funds.

Affluent investors wanting to get in on surging yields have been increasingly turning to so-called separately managed accounts instead of mutual fund portfolios posting losses.

Estimates of the hard-to-track products — which allow investors to build customized portfolios with the help of a professional — suggest accounts hold anywhere from $600 billion to nearly $1 trillion of US state and local government bonds.

Citigroup Inc. estimated the market has grown more than 40% over the past decade to about $750 billion of munis as of the third quarter. Mutual funds, meanwhile, have shed more than a quarter of muni assets from their 2021 peak, with Federal Reserve data showing the funds held about $727 billion of the securities in the third quarter.

With yields at multi-year highs, individual investors have opted to snap up muni bonds using separately managed accounts as well as exchanged-traded funds rather than the traditional mutual funds.

Allspring Global Investments, for one, has seen significant inflows into its offerings. SMAs own about 23% of muni bonds, while mutual funds now hold about 20%, according to Manju Boraiah, Allspring's head of custom SMA investments. Households account for another 19% while banks, insurance companies and others own the rest, he said.

"The SMA growth has been fairly persistent and growing double digits over the past few years," he said.

Buying Force

Separately managed accounts began to make inroads in the early 2000s as advances in technology improved the ability of firms to oversee more accounts.

The interest in the products has been a major bright spot for demand given that municipal-bond mutual funds — one of the major buying forces in the market — recorded another year of outflows in 2023.

Kara South, municipal portfolio manager for GW&K Investment Management, said her firm tends to favor the products for its clients because they are so customizable. "SMAs will continue to be a driver of demand," she said.

Fee War

In addition to their individualized nature, competitive costs are a draw.

Fees on the products are often cheaper than mutual funds, and have been falling, according to Eric Kazatsky, municipal strategist for Bloomberg Intelligence. “Ten years ago, SMAs were basically 0% of the market, now they’re 25%,” he said.

Allspring’s Boraiah estimates passively-run SMA portfolios fees range from 10 to 18 basis points, while actively managed ones are north of 20 basis points — still much less than what mutual funds charge.

While it can be harder to withdraw money from these accounts, it also protects them from the “herd mentality” that can spur mutual fund outflows as investors dump assets during a market selloff, Cumberland Advisors, an investment firm, said in a report in November.

Unlike mutual funds, SMAs often have high investment minimums, usually around $250,000. Those minimums have been dropping over the years, which has made the products more accessible to a wider swath of investors.

Exchange-traded funds, meanwhile, have also made inroads, but still only have a market share of about 3%. The funds saw inflows of about $14.7 billion in 2023, data compiled by Bloomberg show. The overall muni ETF universe is over $120 billion.

Year Ahead

Of course, if interest rates fall mom and pop investors sitting on the sidelines in cash could return to municipal-bond mutual funds to goose returns.

Vikram Rai, head of municipal markets strategy at Wells Fargo & Co., said investment firms would benefit from including open-end funds, SMAs and ETFs in their product offerings. “In fact, most large complexes are doing so,” he said.

Allspring’s Boraiah doesn’t see mutual funds going away, but noted that the products are less popular among the financial advisory community. That will dampen growth.

“There is definitely a threat, but it’s kind of like a slow moving iceberg,” he said.

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