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What's Missing from Passive Muni ETFs?

Some of the largest municipal bond ETFs are passively managed, but did you know that these index-tracking funds exclude a significant portion of the muni bond market?

Notably, the two largest ETFs in this category are passively managed and account for nearly 75% of overall municipal bond ETF assets.¹ While passive ETFs, including these giants, are attractive due to their low fees, these funds miss out on some compelling areas of the municipal bond market due to the rules that define their construction.

What sectors are often excluded from passive muni ETFs?

By design, a passive ETF's portfolio is tied to its underlying benchmark. Examining the rules governing these benchmarks can shed light on which segments of the municipal bond market aren't represented within their associated ETFs.

Commonly excluded areas of the market include housing bonds, tobacco bonds, and bonds that are subject to the alternative minimum tax. Conduit bonds, which are a specific type of municipal bond issued by a governmental entity but primarily for the benefit of for-profit institutions like hospitals and universities, can also be excluded from the index. Due to these exclusions, it's estimated that the largest passive municipal bond ETFs lack exposure to around one-fifth of the municipal bond market.

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