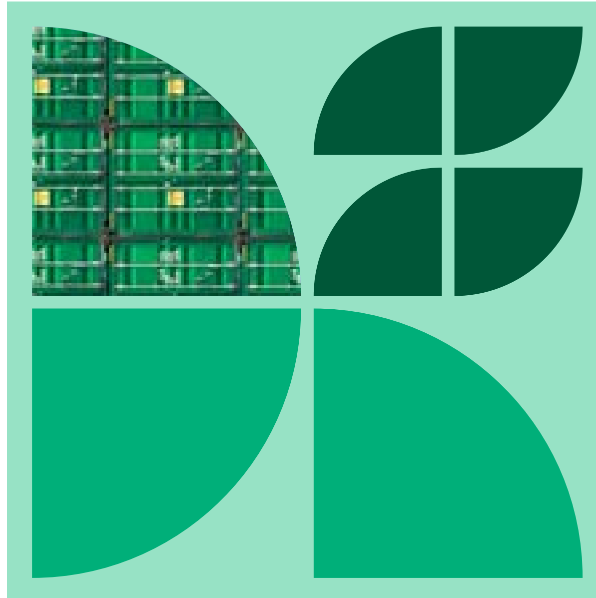
Municipal Bond Investing: The Institutional Advantage

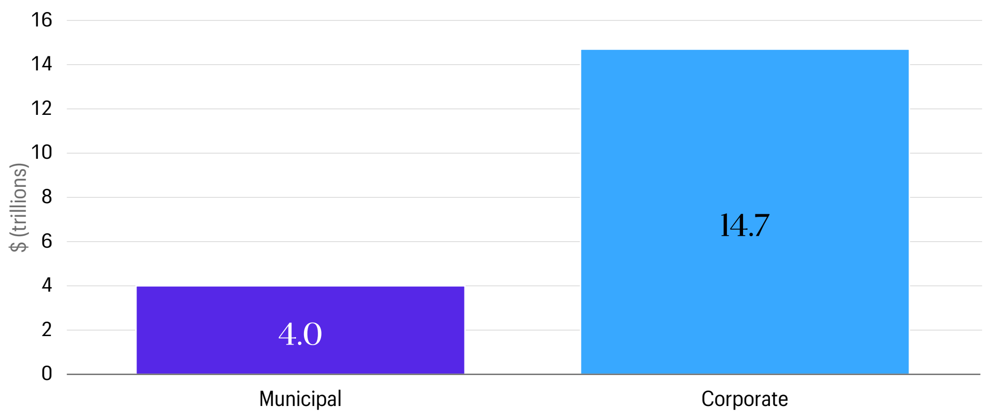


KEY TAKEAWAYS

- The municipal bond market is highly fragmented and is often characterized by its inefficiencies.
- Bond market inefficiencies frequently lead to sourcing challenges and higher transaction costs for individual investors.
- Institutions have many advantages when transacting in the municipal markets, which may offer a better experience for investors who leverage their capabilities.

With a market size of $4.0 trillion, municipal bonds represent approximately 9% of the total U.S. bond market. By comparison, corporate bonds have a market size of approximately $14.7 trillion—about 3.7 times larger than the municipal market (Exhibit 1).

EXHIBIT 1: U.S. MUNICIPAL AND CORPORATE BOND MARKETS



Sources: Allspring, Bloomberg Finance L.P., MSRB, SIFMA, and U.S. Federal Reserve Z.1 published 07-Dec-23

Based on this, investors could reasonably expect that the number of issuers and securities would be proportionately lower for the municipal bond market. Surprisingly, this is not the case. The municipal bond market is less than one-third the size of the corporate bond market, yet it has approximately 5 times the number of issuers and 33 times the number of individual securities and is dominated by retail ownership (Exhibit 2).

EXHIBIT 2: CORPORATE AND MUNICIPAL BOND MARKET DIFFERENCES

MARKET	NUMBER OF ISSUERS	MARKET SIZE ($T)	NUMBER OF SECURITIES	RETAIL OWNERSHIP
Municipal bonds	50,000	$4.00	1,000,000	70%
Corporate bonds	10,000	$14.70	30,000	30%

Sources: Allspring, Bloomberg Finance L.P., MSRB, and U.S. Federal Reserve Z.1 published 07-Dec-23

Why does this matter for investors?

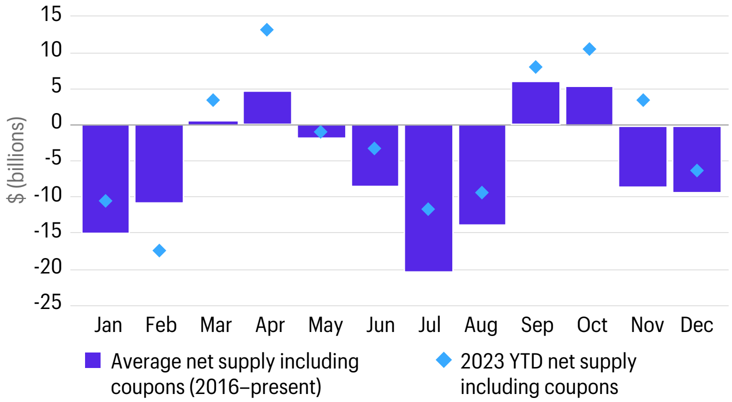
Unlike stocks, bonds trade over the counter (OTC)—meaning that there is no centralized location for trading, which can make the trading experience more cumbersome and costly for individual investors.

This is especially true for municipal bonds. An outsized number of bonds and issuers helps make the municipal markets relatively more fragmented, opaque, and less liquid. Ultimately, this can lead to greater complexity in sourcing and accessing bonds as well as higher associated transaction costs.

Seasonality of cash flows and bond sourcing

A distinctive attribute of the municipal bond market is its seasonality of supply and demand (Exhibit 3). Net supply entering and leaving the municipal markets can be volatile. Depending on the season, supply and demand dynamics can change drastically, which can affect market liquidity and the ability for investors to source and access bonds. Institutions have an advantage because they typically have access to large pools of inventory that an individual investor wouldn't have.

EXHIBIT 3: MUNICIPAL BOND MARKET SEASONALITY

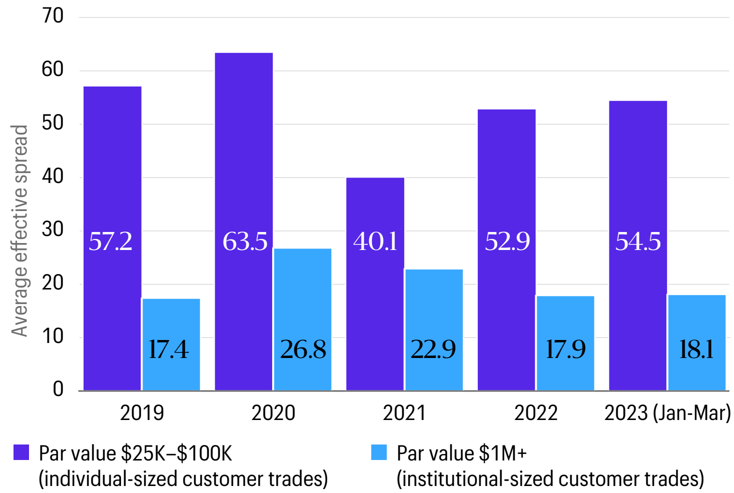


Source: Allspring, Siebert Williams Shank & Co., as of 31-Dec023. Cash flows = new issues – (bond calls + maturing bonds + coupons); average cash flows 2016–2023.
Past performance is not a reliable indicator of future results.

Trade size and associated costs

Cost of trading is also an important consideration for investors seeking to trade in the municipal bond market. Bid/ask spreads can be materially different depending on trade size. Anything less than $1 million is generally considered a retail odd lot trade, and trades of greater than $1 million are considered institutional round lot trades. Because the municipal bond market has such a significant retail presence, the vast majority of transactions are for $100,000 or less. In Exhibit 4, MSRB (Municipal Securities Rulemaking Board) uses proxies to help define two segments of the market—individual-sized and institutional-sized customer trades. Investors trading $25,001–$100,000 (individual-sized customer trades) are at a significant disadvantage relative to large institutional investors ($1 million or more) on average in terms of trading costs. As seen, these differences would account for an **average effective spread for individual investors of almost three times that of the average effective spread for institutions**. This is an important distinction for an asset class where every basis point (100 basis points equal 1.00%) matters when seeking to maximize income and total return, particularly during periods of heightened interest rate volatility.

EXHIBIT 4: MUNICIPAL BOND INDIVIDUAL VS. INSTITUTIONAL AVERAGE SPREADS BY TRADE SIZE

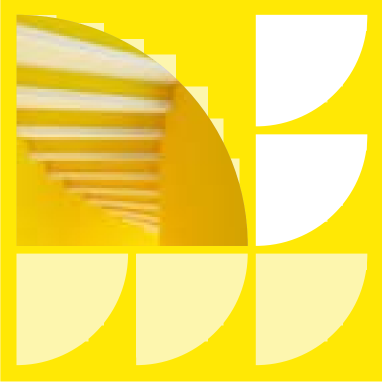


Source: MSRB analysis with data obtained from MSRB's RTRS database. Effective spread for fixed-rate municipal securities customer trades—by trade size as a percent of midpoint customer trade price, January 2019–March 2023. Proxies for individual and institutional customer trades are defined by MSRB.

How can institutions help?

There are several ways that institutions can help offer a better experience for buyers and sellers in the municipal bond space. The most impactful are highlighted here:

- **Long-standing and wide-ranging relationships with bond dealers**
- **Access to large pools of inventory**
- **Use of block trading or "trading in size" to reduce trading costs**



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- $280B+ in taxable fixed income assets across institutional and retail strategies

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