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Muni ETFs gain popularity, but are they a good fit?

Lower expenses a plus, but pricing variation poses risk

By David Hoffman

Exchange-traded funds that invest in municipal bonds are gaining in popularity, but some industry watchers think that mutual funds are a better option.

The ETF structure just isn't a good fit for the muni market, they said.

It can lead to pricing irregularities and doesn't lend itself well to active management — which some observers think is particularly well-suited to the muni market.

When it comes to the muni-bond market "there is no real advantage to the ETF structure," said Marvin Appel, chief executive of Appel Asset Management Corp. and vice president of Signalert Corp. Together, the two registered investment advisory firms manage more than \$300 million.

Despite such concerns, ETF providers are forging ahead with new muni offerings. They note that such ETFs have much lower expenses than muni mutual funds and that while some muni mutual funds outperform their benchmarks, the great majority don't.

GROWING LIST

Invesco PowerShares Capital Management LLC expects to launch a muni ETF that will invest at least 80% of its total assets in taxable muni securities eligible to participate in the Build America Bonds program created under the American Recovery and Reinvestment Act of 2009.

It will join a growing list of ETFs that are finding different ways to play in the muni market.

State Street Global Advisors late last month launched the SDPR Standard & Poor's VRDO Municipal Bond ETF (VRD), designed to provide investors with access to muni variable-rate demand obligations.

VRDOs, which are often issued with maturities of up to 30 or 40 years, are considered short-term instruments because they have a one-day or seven-day put feature that coincides with the timing of the daily or weekly yield reset.

Counting the new SSgA ETF, there are now 18 muni ETFs with total assets of \$4.7 billion, according to the Investment Company Institute.

Critics, however, think that it is a mistake for investors to jump on the muni-ETF bandwagon blindly.

The ETF structure is great for equities, but when it comes to an "inefficient" market such as muni bonds — pricing them can be difficult because even big muni issues don't trade as frequently as most stocks — the structure works against it, said Mr. Appel, author of "Investing with Exchange-Traded Funds Made Easy: A Start-to-Finish Plan to Reduce Costs and Achieve Higher Returns" (FT Press, 2008).

Unlike a mutual fund, an ETF trades throughout the day.

That isn't a problem when the prices of the underlying securities in an ETF are readily available, but when they aren't, it can cause an ETF's returns to deviate significantly from its benchmark's, Mr. Appel said.

That has happened.

Soon after the collapse of Lehman Brothers Holdings Inc. in September 2008, bond ETFs of all stripes — but particularly muni ETFs — were trading at unusually wide premiums and discounts to their net asset value.

The \$418.5 million Invesco PowerShares Insured National Muni Bond ETF (PZA) was trading with a premium above 3% last October. And the \$1.5 billion iShares National Municipal Bond ETF (MUB), from Barclays Global Investors, was trading at a discount of more than 2%.

"There is a degree of trading risk not present in mutual funds," Mr. Appel said.

That is why he avoids such ETFs.

"I generally prefer carefully selected open-end mutual funds or individual bonds."

Jim Lowell, editor of the monthly newsletter Forbes ETF Advisor, is of the same opinion, but he also espouses the use of mutual funds because they better accommodate active management.

There are only a handful of actively managed ETFs, none of which is a muni ETF.

An active manager, however, can take advantage of the inefficiencies inherent in the muni market, said Mr. Lowell, who also is a partner and chief investment strategist at Adviser Investments.

"I would say active management is as close to being essential in the municipal bond market as it gets," said Mr. Lowell, whose firm manages more than \$1 billion.

Active muni fund managers have shown their worth.

The \$4.9 billion **Legg Mason Western Asset Managed Municipals Fund** (SHMMX), from Legg Mason Inc., has consistently impressed.

Year-to-date through last Wednesday, it had gained 25.24%; it was up 16.97% for the 12-month period, 6.1% for the annualized three-year period and 5.68% for the annualized five-year period, according to Morningstar Inc.

Its benchmark — the Barclays Capital Municipal Bond Index — was up 13.88% year-to-date, 14% for the 12-month period, 5.09% for the annualized three-year period and 4.7% for the annualized five-year period.

LOST IN TRANSLATION

But those who support muni ETFs said that such examples are few and far between.

For example, for the one-year period through June, the Standard & Poor's National AMT-Free Municipal Bond Index outperformed 75.56% of general-muni-debt funds, for the three-year period, the index beat 78.31% of such funds, and for the five-year period, it beat 93.9% of such funds.

"I definitely would agree that the muni market is more opaque than other markets," said Matt Tucker, head of U.S. fixed-income investment strategy at iShares, the ETF unit of Barclays Global Investors. "But the challenge of opaqueness doesn't translate to alpha."

Although an inefficient market can provide active managers with the opportunity to outperform, it also increases the chances that they may underperform, he said.

As for the structural inefficiencies inherent in ETFs, Mr. Tucker said too much is being made of them.

The pluses associated with the ETF structure — characteristics such as transparency and low cost — outweigh any perceived negatives, he said.

For example, muni ETFs have an average expense ratio of about 0.25%, while their mutual fund counterparts have an average expense ratio of about 1%, according to Morningstar.

That gives muni ETFs a huge advantage over comparable mutual funds, Mr. Tucker said.

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**Average Annual Total Returns and Expense Ratios of
Legg Mason Western Asset Managed Municipals Fund (Class A shares) as of 3/31/10**

	YTD	One-Year	Five-Year	Ten-Year	Since Inception	Expenses (gross) *	Expenses (net) **
Excluding the effects of maximum sales charges	2.08%	17.88%	5.33%	5.70%	8.44%	0.67%	0.67%
Including the effects of maximum sales charges	-2.24%	12.87%	4.42%	5.24%	8.28%	–	–
Barclays Capital Municipal Bond Index	1.25%	9.69%	4.58%	5.58%	–	–	–

The performance shown represents past performance. Past performance is no guarantee of future results and current performance may be higher or lower than the performance shown. Investment return and principal value will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. For performance data current to the most recent month end, please see our Web site at www.leggmason.com/individualinvestors.

YTD (Year-to-Date) returns are cumulative figures and are not annualized. YTD returns are calculated from January 1 of the reporting year. Average annual total returns assume the reinvestment of all distributions at net asset value and the deduction of all Fund expenses. For performance including the effects of sales charges, Class A shares reflect the deduction of a maximum front-end sales charge of 4.25%. Performance would have been lower if fees had not been waived in various periods. Performance for other share classes will vary due to differences in sales charge structure and class expenses. All classes of shares are not available through all distribution channels.

* Gross expenses are the Fund's total annual operating expenses for the share class indicated as of the date of the Fund's most current prospectus and do not reflect fee waivers or reimbursements. These expenses include management fees, 12b-1 distribution and service fees, and other expenses.

** Because the Fund does not currently have fee waivers or reimbursements, gross and net expense ratios are the same.

An investor should consider a fund's investment objectives, risks, charges and expenses carefully before investing. For a free prospectus, which contains this and other information on any Legg Mason fund, visit www.leggmason.com/individualinvestors. An investor should read the prospectus carefully before investing.

The Barclays Capital Municipal Bond Index is a market value weighted index of investment grade municipal bonds with maturities of one year or more.

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Prior to October 5, 2009, the Fund was known as Legg Mason Partners Managed Municipals Fund. The Fund's investment objective, portfolio managers and investment strategy have not changed. Please see the prospectus for details.