The Effect of Municipal Market Liquidity on Mutual Fund Holdings

Investors owning shares of municipal bond mutual funds could suffer share price erosion if portfolio managers are forced to sell bonds to raise funds.

Over the past few years several factors within the municipal bond market have changed which could significantly affect market liquidity. Investors with holdings in municipal bond mutual funds should be aware of the potentially negative risks to their investments.

Market liquidity has changed significantly in recent years and investors should consider the following:

- There are fewer dealers participating in the municipal market.
- Dealers are becoming less willing to provide liquidity.
- Going forward, the market may experience periods of illiquidity.
- Mutual fund investors could suffer falling share prices because of forced participation of portfolio managers into an illiquid market.

Number of Dealers

According to a Municipal Securities Rulemaking Board (MSRB) report, the number of dealers engaging the municipal market has shrunk significantly since the financial crisis of 2008-2009. Specifically, the number of dealers dropped 32% from 1,967 MSRB-registered dealers to only 1,346 in 2017, a 621 decline. Clearly with fewer dealers in the market, liquidity will be compromised.

Dealer Balance Sheets

The same MSRB report indicates that dealer balance sheets are down by 67% since 2006. Decreased capital commitment that is dedicated to balance sheet is a direct reflection of a decrease in dealer willingness to provide liquidity. This decline can be attributed to a number of factors. First, changes to dealer capital commitment requirements and leverage ratios as a result of Dodd Frank initiatives have decreased the ability for dealers to carry larger balance sheets. Second, spread tightening has decreased dealer profitability. Naturally if the amount of revenue dealers can generate from their balance sheet decreases, they become less willing to take the risk of owning paper.

Source: MSRB, June 2018

Buy-Side Participation

Arguably, buy-side participants serving as de-facto liquidity providers in the market have increase significantly in recent years. Since such participants use anonymous electronic platforms or broker relationships, it is very difficult to identify verifiable data points. Anecdotally, however, we have observed an increase in certain patterns that indicate that buy-side accounts are providing liquidity. For example, MSRB Trace price prints indicate that bonds which have traded following the RFQ (request for quotation) process do not reappear as offerings or show corresponding prints indicating placement with customer accounts. Additionally, we have spoken directly to accounts which have indicated that they are active on such platforms in exactly this fashion.

This fact is meaningful as it provides evidence that buy-side accounts are filling the void vacated by dealers with regard to providing market liquidity. However, the devil is in the details. We concede that buy-side accounts are filling this void, but this dynamic is market dependent. As you may recall during the financial crisis, market liquidity virtually evaporated as sellers aggressively sought liquidity. Our contention is that when (not if) buy-side accounts experience fund withdrawals, they will not only be precluded from providing liquidity, but will become net sellers themselves.

Throughout much of the past 2-year period, mutual funds have experienced very strong capital inflows. Recently, this has started to change as evidenced by 6 straight weeks of mutual fund redemptions. If this pattern continues, portfolio managers will no longer be providing their current level of liquidity to the market but will be seeking liquidity themselves. Thus, all participants will be challenged to sell product into a significantly less liquid market.

Mutual Fund Shareholders

Individuals that own shares in municipal bond mutual funds could suffer share price erosion if portfolio managers dealing with redemptions are forced to sell bonds to raise funds. Investors that own individual bonds would not be forced to participate in such sales since they can ride out liquidity events without being forced to sell.

In short, investors can avoid the negative implications of this scenario by building a custom bond portfolio for which they can control the purchase and sale decision-making process.

Source: "Dealer Participation and Concentration in Municipal Securities Trading," Municipal Securities Rulemaking Board (MSRB), June 2018. www.msrb.org