



Broad Muni-Bond Exposure at a Modest Fee

This ETF is a solid option for comprehensive exposure to the investment-grade municipal-bond market.

By Phillip Yoo

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Suitability

iShares National Muni Bond (MUB) provides representative exposure to the investment-grade, tax-exempt U.S. municipal-bond market at an attractive price. It efficiently tracks the S&P National AMT-Free Municipal Bond Index and enjoys a sustainable cost advantage over its peers. But its market-cap-weighting approach leads to a geographically concentrated portfolio, exposing the fund to state-specific risks. And there is an even cheaper alternative tracking the same index. That said, this is still a solid offering that earns a Morningstar Analyst Rating of Bronze.

Because the fund weights its holdings by the amount of outstanding debt, the portfolio skews to the most-indebted regions. As a result, negative regional events, such as Detroit's bankruptcy (2013) and Hurricane Sandy (2012), can have an outsize impact on the fund's performance. At the end of December 2016, the fund had greater exposure to California and New York than its municipal national intermediate Morningstar Category peers.

The fund's geographic risk is partially offset by its relatively conservative and diverse portfolio. More than 80% of the fund's assets are invested in securities rated AA or above. Most peers take greater credit risk, though it has a similar interest-rate risk profile to the category

average. The resulting portfolio offers a lower yield to maturity than the category average. In addition, it doesn't invest in bonds issued by U.S. territories, including Puerto Rico, and spreads its risks across more than 3,000 holdings.

This fund has successfully tracked its underlying index since its 2007 inception. From inception through December 2016, the fund has gained 3.97% annually, lagging its benchmark by 0.15%. This gap is less than the fund's management fee of 0.25%. The fee is cheaper than 95% of its category peers' and gives the fund a durable edge. It has posted an annualized return of 2.8% for the past five years through December 2016, compared with 2.6% of the category average. On a risk-adjusted basis, it has performed on par with its peers.

Fundamental View

The municipal-bond market's outlook is mixed. Excluding Puerto Rico, where the fund does not invest, municipal payment defaults have totaled \$1.4 billion for the year to date through Sept. 14, 2016. That's below the 10-year average (from 2006 to 2015) of \$2.3 billion, according to Bank of America. However, total state tax revenue fell by 2.1% year over year as of June 2016, mainly attributable to low growth in sales tax and income tax receipts per the Nelson Rockefeller Institute of Government. In addition, state budgets continue to face uncertainties in the aftermath of the election.

The most debt-ridden states and localities make up the largest positions of this fund because of its market-capitalization approach. This geographic concentration makes the fund

susceptible to adverse state-specific events including local politics and natural disasters. The fund's stakes in California and New York are twice its typical category peer's. Even though Californian voters approved the seven-year personal income tax increase and the four-year sales tax increase in November 2012, many municipalities in California continue to face budget headwinds. Additionally, the fund's interest-rate risk can change over time since the index weights its holdings by market cap and doesn't have a maximum maturity limit. The fund's duration has fluctuated over its life from 4.7 years to 7.5 years.

The portfolio's high-quality and diverse holdings help mitigate its geographic concentration risk. Bonds rated AA or higher take up about 80% of the fund's assets. In contrast, the typical municipal intermediate-bond fund invests roughly half of its portfolio in AAA and AA buckets. This fund should outperform during down markets when credit spreads widen, but it will also likely lag in strong markets when credit spreads tighten.

At the end of December 2016, both the fund's yield to maturity (2.68%) and tax-equivalent yield to maturity (4.44%) exceeded the Barclays U.S. Aggregate Bond Index's yield of 2.05%. This tax-equivalent yield is the yield that a taxable-bond fund would need to offer to equal the muni-bond fund's tax-exempt yield for an investor in the highest federal (39.6%) tax bracket.

The fund has performed relatively well in recent years. Its five-year annual return through December 2016 beat 60% of its peers. Its risk-adjusted performance over that period is in line with the category average. One of the most significant contributors to the fund's performance has been its low fee. Given the fund's sustainable fee advantage and conservative portfolio, it should continue to offer attractive category-relative performance over time. The fund could be a good complementary holding for an investor's core fixed-income allocation because municipal bonds are excluded from broad, investment-grade bond funds.

Portfolio Construction

The fund tracks the S&P National AMT-Free Municipal Bond Index, which offers market-cap-weighted exposure to the U.S. investment-grade tax-exempt municipal-bond market, but it excludes bonds subject to the Alternative Minimum Tax. It earns a Positive Process rating because it accurately represents its target market, promotes low turnover, and skews toward the most-liquid securities, which keeps transaction costs low. Bonds must be a constituent of a deal that originally amounted to at least \$100 million at offering and have a minimum par amount of \$25 million. In addition, each bond must have at least a calendar month and a day until maturity or a call date to be included. Securities issued in U.S. territories, including Puerto Rico, are excluded. The index weights its holdings by market capitalization and rebalances at the end of each month. Nearly 80% of the benchmark's constituents have a credit rating of AA or higher. The fund holds bonds from 44 states and the District of Columbia. Issuers from California (22%), New York (20%), and Texas (9%) comprise the three largest groups in the fund's portfolio. The bonds are issued by state and local governments, and proceeds are used to finance a variety of projects including transportation (15%) and utilities (14%).

Fees

The fund has an expense ratio of 0.25%, which is among the lowest in the muni national intermediate Morningstar Category, supporting a Positive Price rating. In fact, this fund is cheaper than 95% of its category peers and is considerably lower than the 0.80% category average fee. From inception through December 2016, the fund has trailed its benchmark by 0.15% a year, slightly less than its expense ratio. This efficient tracking is partly attributable to the fund's low portfolio turnover. In the most recent fiscal year, the fund turned over about 10% of its assets, while the corresponding figure for the category average was just under 33%.

Alternatives

Vanguard Tax-Exempt Bond ETF (VTEB) tracks the same index as MUB for a lower 0.12%

expense ratio. Like MUB, this fund uses a sampling approach to follow the benchmark.

MUB is by far the largest and most-liquid intermediate-term municipal-bond exchange-traded fund. The second-largest intermediate muni ETF is Market Vectors Intermediate Municipal ETF (ITM) (0.24% expense ratio). Both funds take comparable credit and interest-rate risks.

Investors looking for even longer duration municipal bonds might be interested in SPDR Nuveen Barclays Municipal Bond ETF (TFI) (0.23% expense ratio). Because of its longer duration, this fund is part of the muni national

long category. Virtually all of this fund's assets are invested in bonds rated AA or higher. Its conservative portfolio offers a lower yield than MUB.

Gold-rated Fidelity Intermediate Municipal Income Fund (FLTIX) (0.36% expense ratio) is run by a strong investment team and sports an impressive long-term track record. This fund has a shorter duration than MUB, making it slightly less sensitive to interest-rate movements.

About the Author

Phillip Yoo is a passive strategies analyst on Morningstar's manager research team.