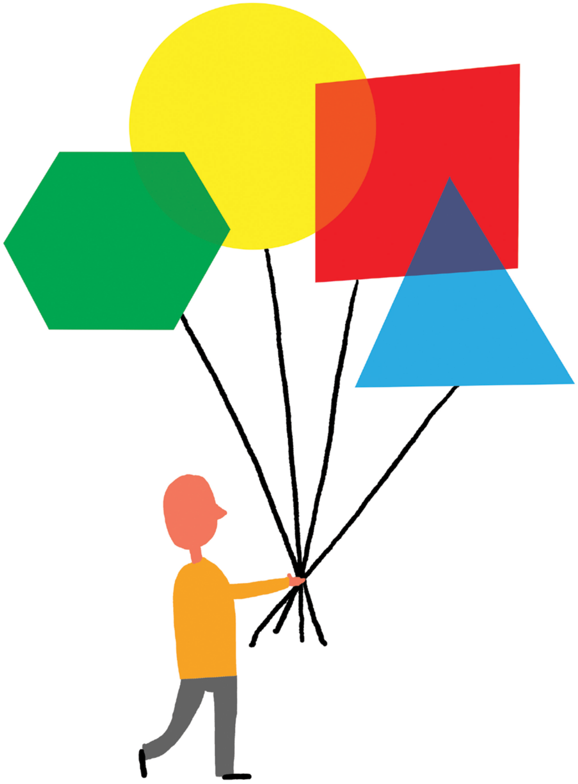

PERSPECTIVE

Celebrating Sui Generis

BY JUSTIN MARLOWE

In December 2010, Meredith Whitney, the Wall Street analyst who famously predicted the financial crisis of 2007 to 2008, appeared on *60 Minutes* and declared that 50 to 100 major U.S. states and localities would default on their municipal bonds in the coming months. More than $60 billion flowed out of municipal bond mutual funds during the next few weeks in one of the largest sell-offs in market history.

Fortunately, if a recent trend in the municipal market technology continues, these types of abrupt, market-wide dislocations might be a thing of the past. That's both a challenge and an opportunity for state and local finance professionals.

The famous "Meredith Whitney sell-off" is a wonderful illustration of what makes the municipal bond market fascinating to some and frustrating to others. Today there are roughly one million individual bonds sold by more than 50,000 individual issuers, backed by dozens of revenue streams and credit enhancements. That's orders of magnitude more variety than corporate bonds, U.S. Treasuries, or other fixed-income investments. Simply put, each municipal bond is sui generis, the timeless Latin phrase to describe something that's "of its own kind."

But none of that uniqueness was on the minds of investors who heard Meredith Whitney and ran for the exits. They sold shares in municipal bond mutual funds as fast as they could, presumably with limited knowledge of whether those funds held the specific bonds that might be headed for trouble.

Critics say this type of sell-off illustrates one of the municipal market's big flaws. Investors cannot keep track of hundreds or thousands of individual governments, especially when financial and other information about those governments can be difficult to acquire. Instead, critics argue, state and local governments ought to make investors' job easier by sticking to simple bond structures backed by robust, generic revenue streams. They believe such streamlining will produce lower cost of capital and better accountability for taxpayers. Market proponents say these eccentricities are unavoidable, given the countless variations in state statute and local policy. They believe the market is far from perfect, but it works well enough, all things considered.

Fortunately for municipal bond investors, some recent advances in financial market technology are helping to split the difference between these views.

Municipal bonds are at the core a retail market. People buy them to save for retirement, college, and other future financial needs. That's why roughly 70 percent of the $4 trillion in outstanding municipals are held, directly or indirectly, by individuals.

That's why there's a massive investment advisory industry to help individual investors buy munis. For decades that industry's go-to product has been mutual funds. Hundreds of mutual funds cater to muni investors, including nearly 100 funds focused on individual states to maximize investors' tax advantages.

Mutual funds come with two big disadvantages, though. For one, investors don't control what goes into the fund's portfolio—that's the portfolio manager's job. And even more important, if everyone else sells their shares at once, the fund's value can decline quickly. For proof, look no further than the Meredith Whitney episode.

In a perfect world, individual investors could realize the tax benefits, safety, and sophisticated investment management of a mutual fund, but with more direct control over the portfolio's composition and management strategy. In the real world, a "separately managed account" (SMA) achieves just that.

An SMA is, in effect, a private mutual fund. High-net-worth individuals willing to invest seven or eight figures can hire a portfolio manager to manage their bonds like a mutual fund. They specify the investment goals, and the portfolio manager regularly buys and sells bonds to keep the portfolio aligned with those goals. It's also common to see muni SMAs designed around particular themes like sustainability or social impact.

Of course, this is easier said than done. A typical SMA portfolio manager tends to dozens or even hundreds of individual portfolios, each with its own time horizon, risk preference, and tax concerns. Those portfolios will hold some, but not all, of the same bonds. Some portfolios don't overlap at all. Following thousands of individual bonds and how they interact is like a giant game of three-dimensional chess.

That seems daunting, but it's much more tractable with help from new financial technology. SMA portfolio managers today have powerful algorithms that can identify specific bonds that address a specific investment objective for a particular portfolio. Need an AA-rated, short duration bond from a rural North Carolina school district with excellent test scores? Today's portfolio management systems will find bonds that fit the bill, scan the dozens of broker-dealers who might have those bonds to sell, reanalyze the portfolio, and then sell a different bond that no longer meets that investor's objectives, all with just a few keystrokes. This type of integrated analytics and execution capability was unheard of in the municipal market until now.

> The far more important take-away is that the growth of SMAs means all municipal bonds can find a home.

These technological breakthroughs have unleashed explosive growth in muni SMAs. Securities and Exchange Commission (SEC) data show that in January 2018, there were roughly $500 billion (in 2023 dollars) of assets under management in individual investor muni SMAs. In January 2023, it was a little less than $900 billion, and some estimates have it exceeding $1 trillion. In 2018, the ten firms with the highest muni assets under management in SMAs held around $150 billion (in 2023 dollars). Today they hold $350 billion. That's a 133 percent increase in just five years. Today, there are approximately 4,200 investment advisors in the muni SMA business. That's up from about 3,600 in 2018. As expected, much of this growth has come at the expense of traditional mutual funds. Mutual funds held a little less than a trillion dollars in municipals at the end of 2018. At the end of 2022 they held $746 billion.

What does this mean for state and local finance professionals? SMA portfolio managers need the most recent information possible about your financial position, fiscal policies, capital investment plans, and so forth. That means debt management fundamentals like reliable financial reporting and proactive investor relations are more important than ever.

But the far more important take-away is that the growth of SMAs means all municipal bonds can find a home. Calls to standardize bond structures or to adjust borrowing strategies to accommodate investment expectations seem less salient when every big investor has a private mutual fund. For today's municipal bonds, with apologies to Meredith Whitney, sui generis might just be OK.

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