THE BOND BUYER

December 3, 2018 www.bondbuyer.com

Commentary ESG, SMAs and munis: A major opportunity

By Hardy Manges

Municipal bond markets are growing more complicated. While assets under management continue to rise, the number of dealers has fallen by nearly one-third since 2009, placing the pressure of increasing liquidity demands on a smaller and smaller number of institutions. At the same time, external pressures including recent tax reform efforts have further shaken up the space and raised questions about what's next.

What's been less discussed is the substantial impact of two emerging trends: the growth of separately managed accounts and the increased focus on environmental, social, and governance (ESG) strategies. Together, these factors have upped the pressure and competition for managers as they work to source specific sets of securities at a specific cost.

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Separately managed accounts continue to grow

As of the first quarter of this year, more than half of all municipal fixed income assets were held in separately managed accounts according to data from BNY Mellon. In the past 10 years, municipal bond assets held in SMAs have grown from around $100 billion in 2008 to north of $500 billion, according to data put together by Citibank.

A major driver of this growth is the customization potential offered by SMA accounts. Through SMAs, investors can choose from a variety of options that best fit their needs and preferences. Likewise, financial advisors can tailor investment programs to individual clients while still providing the tax and diversification benefits of municipal bonds.

As the demand for custom strategies and approaches grows, we would expect to see increasing interest in SMAs. At the same time, the ever growing number of mutual funds, Exchange Traded Funds, and SMAs mean increasing competition for every basis point, both in terms of fees and returns. Taken together, institutions need to focus on best execution in order to stay competitive.

Why ESG and municipal bonds are a natural fit

According to US SIF, at least 17 fixed income SMA strategies with a focus on environmental, sustainable, and governance factors are currently available in the market. This growth matches a larger societal shift. From 2014 to 2016, the sustainable investing space rose 33% to nearly $9 trillion in assets. Interest also continues to grow, with 75% of the overall population, and 86% of Millennials, either somewhat or very interested in ESG strategies.

Interestingly, this alignment

forms a very natural fit with municipal bonds. A significant percentage of municipal bond projects include a focus on environmental, sustainable, or governance related factors. Examples include projects related to public hospitals or education, mass transit, and a variety of other options.

In the New York area alone, recent years have featured publicly funded projects including the expansion of La Guardia airport and the Hudson Yards development. Several of the buildings included in the new Hudson Yards development, including MarketAxess' home at 55 Hudson yards, will have LEED certification.

ESG strategies are a solid fit for SMAs as customized accounts allow for better screening of individual investments. For muni SMAs, investors and their advisors can screen for a number of ESG factors, and focus on specific impact investments.

The importance of electronic trading

Of course, the combination of SMAs and ESG screens means even more competition for a limited number of securities, a challenge that comes at a time of increasing complication in muni markets.

SMA managers with ESG screens need to be able to source the bonds efficiently and at a lower cost. Improving these issues is a key benefit of electronic trading. MarketAxess municipal bond e-trading platform is seeing an increasing number of market participants, reaching over $10 billion total trading volume since the launch in 2016 and a record October month of $1.2 billion.

All of this means a more efficient muni market for participants. As client demands, and the muni market as a whole grow more complicated, now is the time for managers to look for solutions and better execution. This will allow them to meet client needs for ESG strategies and beyond.

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