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Municipals: The Hidden Costs of a Passive Approach

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Cost efficiency is an important element of portfolio construction, but while minimizing costs is a sensible investment objective, within municipal portfolios, an overemphasis on fees may ultimately be counterproductive for some investors.

Passive municipal strategies offer exposure to the broader municipal market at a seemingly negligible cost relative to active municipal strategies. However, these strategies tend to exclude significant portions of the investible universe, have inherent structural index biases, and lack the flexibility to exploit market inefficiencies.

AS A RESULT

A passive approach to municipals has tended to lag an active one over time, resulting in many investors leaving meaningful alpha on the table.

The growth of exchange-traded funds within active investment strategies has catalyzed significant asset growth in the municipal space. Investors have increasingly embraced municipal ETFs not only for the potential benefits of active management in a fragmented and inefficient market, but also for the structural advantages of the ETF wrapper.

Below, we explore key reasons why active management in the municipal bond market can provide some meaningful advantages — justifying its fees through a broader opportunity set, greater portfolio flexibility, and the potential for improved risk-adjusted returns.

Structural Limitations of Passive Municipal Strategies

Passive municipal strategies are designed to replicate index performance at minimal cost. However, index construction methodologies often impose meaningful constraints on portfolio composition. Common exclusions include alternative minimum tax (AMT) bonds and sectors such as tobacco settlement bonds, housing, charter schools, prepaid gas, and health care.

While these exclusions are generally intended to simplify portfolio construction and reduce complexity, they can also narrow the investable universe, reduce yield potential, and limit diversification benefits, resulting in an unintended deviation away from the risk-return characteristics of the municipal asset class.

Capitalizing on Market Inefficiencies

Despite its more than $4 trillion size, the municipal bond market remains structurally inefficient. Its fragmentation across more than one million individual CUSIPs, combined with a highly diverse issuer base and a predominately retail investor composition, contributes to persistent pricing inefficiencies across maturities, sectors, and credit tiers. Investor demand is often concentrated in highly rated, liquid securities and select portions of the yield curve, creating relative value opportunities in less efficiently priced segments of the market.

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Active managers are well positioned to capitalize on these inefficiencies. Unlike passive strategies, which are bound by index construction rules, active managers can assess relative value, adjust duration exposure, rotate across sectors, and exploit supply–demand imbalances as market conditions evolve. Recent market dynamics have created opportunities in longer-duration bonds, select new municipal bond issues (i.e., prepaid gas), and premium high-coupon bonds with favorable call protection. Identifying and capturing these opportunities requires analytical rigor, flexibility, and security selection — active management capabilities that passive strategies generally cannot replicate.

Active Management's Edge in Municipal Markets

The case for active management is reinforced by historical performance; below are the percentages of active municipal strategies that have outperformed passive municipal strategies over a 3-, 5-, and 10-year period.

89%	90%	87%
3 - Year	5 - Year	10 - Year

Source: Morningstar. Data as of 30-Jun-26. Data represents the percentage of active managers (includes both ETFs and open-end mutual funds) that outperformed the median passive manager for each of the 4 national municipal categories (Muni National Short, Muni National Intermediate, Muni National Long, and High Yield Muni). Percentages in the chart are calculated using the average of the 4 category medians. For open-end mutual funds, only the lowest expense share class was included in the analysis. **Performance data shown represent past performance and are no guarantee of future results.**

THESE RESULTS SUGGEST

The benefits of active management — improved security selection, sector and credit quality allocation, and duration and yield curve positioning — have historically more than offset the incremental fee.

Conclusion

Passive municipal ETFs may be low cost, but they are not costless. While they offer cost efficiency, daily portfolio transparency, and enhanced liquidity, their broad-based approach to municipal market exposure can leave meaningful alpha opportunities untapped. In a fragmented, inefficient, and highly nuanced market, active municipal ETFs combine the structural benefits of the ETF wrapper with the flexibility to pursue opportunities where passive strategies may miss. We believe the more relevant question for investors may not be "What is the fee?" but "What opportunities am I missing?"

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