



Municipal Bond SMAs: Personal Attention, Institutional Scale

With interest income generally exempt from federal—and in some cases state and local—income taxes, municipal bonds can be an attractive investment for high-net-worth individuals in search of tax-exempt income.

Individual investors have long been the primary source of demand for municipal bonds given the tax advantages on offer; households hold about 70% of outstanding securities both directly and through mutual funds and exchange-traded funds (ETFs).¹ For investors with substantial assets, direct ownership has long been preferred over commingled funds, and direct ownership increasingly has taken the form of separately managed accounts (SMAs). While muni SMAs had just \$100 billion in assets under management in 2008, this figure surged to an estimated \$1.2 trillion in 2025—more than a quarter of the muni bond market as a whole.²

The job of the financial advisor has grown more complex in recent years as the industry has adopted a more holistic approach to client relationships that emphasizes a range of comprehensive, high-touch services beyond portfolio construction. Concurrently, advisors have increasingly recognized that partnering with an external SMA manager can facilitate this shift while also adding value to their practices.

Providing investment solutions backed by institutional-quality credit research, risk analytics and trading scale, municipal bond SMAs, in our view, are a particularly compelling option for advisors seeking attractive after-tax outcomes for their clients.

KEY TAKEAWAYS

- In pursuit of tax-exempt income, municipal bond SMAs provide high-net-worth investors with investment solutions backed by institutional-quality credit research, risk analytics and trading scale.
- The SMA structure combines the potential benefits of institutional management with the direct ownership of individual munis, providing clients and their advisors with transparency, liquidity and enhanced control.
- Guided by insights from financial advisors, SMA managers can help optimize a client's potential after-tax income and preserve wealth over the long term. Beyond tax considerations, however, limiting a manager's investment discretion may diminish the impact of professional expertise and negatively affect portfolio returns.
- Partnering with an external SMA manager can help advisors focus on comprehensive client services beyond portfolio construction and ultimately may add value to their practices.

1. Source: Municipal Securities Rulemaking Board; data as of September 30, 2025.

2. Source: IMTC; data as of October 21, 2025.

Investment Solutions Aligned with Client Needs

The \$4.4 trillion municipal bond market—with 50,000 issuers and more than one million bonds outstanding—is large, highly fragmented and inefficient.³ The resulting dispersion of yields and prices for similar bonds, in our view, represents an opportunity for active investment managers to apply their underwriting skills—amplified by institutional access to bonds, better pricing and lower trading costs—to build muni bond portfolios that may be more likely to deliver better returns than through other methods.

Commingled vehicles such as mutual funds and ETFs provide the potential benefits of institutional management mentioned above but lack the capacity for the individual tax management that high-net-worth investors want and need. SMAs, in contrast, combine the potential benefits of institutional management with the direct ownership of individual muni bonds, a structure that provides clients and their advisors with the transparency, liquidity and enhanced control needed for customization. Despite these features, muni bond SMAs often carry lower management fees than actively managed mutual funds and ETFs.

Owning munis in an SMA can help advisors optimize clients' potential after-tax income while preserving wealth.

By reflecting an investor's specific circumstances and tolerances, muni bond investment through an SMA structure can help advisors optimize clients' potential after-tax income while preserving wealth. As described below, some SMA structures can offer customization beyond tax management—but these limits to a manager's investment discretion could weigh on outcomes.

Tax efficiency. While income that is free from federal taxes has long been the calling card of municipal bond investment, not all muni bonds have this feature. In 2025, for example, 90% of municipal issuance was tax exempt; the remaining 10% was taxable for all investors or incurred taxes only for high earners exposed to the alternative minimum tax (AMT).⁴

Private-activity bonds—revenue bonds in which more than 10% of the proceeds are applied to private business use—such as the construction of affordable housing or dorms for a private college, are generally taxable for AMT-paying investors. General-obligation and public-purpose revenue bonds, meanwhile, typically shield investors against all taxes at the federal level. There is nothing inherently wrong with investing in taxable munis—more often than not they will offer higher nominal yields as compensation—but their impact on after-tax yields can vary significantly based on an individual's circumstances and must be carefully considered when constructing a portfolio.

Individuals, especially those in high-tax states, may further benefit from the preferential tax treatment of bonds from issuers in their state of residence. Leveraging this advantage is not without its challenges, however. With muni bond issuance dominated by California, New York and Texas, investors in other states may find the investment pool lacking in depth, while those living in states with low or no state income taxes, like Texas and Florida, derive no additional tax benefits from staying home. Triple-tax-free income—federal, state and local—may be accessible to residents through bonds issued by cities, counties and local agencies, but these generally have even less diversification potential.

3,4. Source: SIFMA Research; data as of December 31, 2025.

Importantly, the tax management activities of an SMA manager are not limited to a client's muni bond exposure. Unlike commingled structures such as mutual funds/ETFs, the underlying securities in an SMA are owned directly by the investor, who in turn only pays taxes on capital gains generated by their own holdings. Moreover, SMA managers—guided by the holistic view into a client's overall portfolio provided by the financial advisor—can implement tax-loss harvesting plans to reduce an investor's tax liability broadly, such as selling bonds for a loss that can be used to offset capital gains from investments in other asset classes. Meanwhile, the tax-lot selection available to SMA clients can help optimize both the harvesting of losses and the realization of gains and help improve long-term after-tax returns.

Credit risk management. Municipal bonds—whether general obligation bonds backed by the full faith and credit of the issuing municipality or revenue bonds funded from specific cash flows—historically have had very few incidents of default relative to corporate issues. The default rate for muni bonds over a five-year horizon was just 0.08% compared to 7.06% for global corporates, and even high yield munis alone, at 4.55%, had a superior default rate relative to corporate offerings.⁵

While securing differentiated yield at the upper end of the muni bond quality spectrum can be a challenge, we believe bonds rated AA and A generally offer skilled underwriters an attractive blend of income and resilience. Return potential may be further enhanced by diversifying credit risk across both investment grade and high yield munis. Diversified exposure to individual high yield munis can be a challenge in most SMA accounts, given their size, but the inclusion of a high yield completion fund can make such exposure feasible.

A completion fund is not unlike a traditional open-end mutual fund, but access is limited to SMA clients and the fund carries no additional management fees. By commingling assets across SMA clients, a completion fund can provide individual accounts with diversified exposure through fractional ownership of a professionally managed portfolio of high yield muni bonds. The individual bonds held in the completion fund cannot be tailored to the needs of individual SMA owners, but we believe an allocation of 20% can boost portfolio yield and return potential over time without sacrificing the account's tax efficiencies.

A completion fund within an SMA can help provide diversified exposure to individual high yield munis.

Interest rate risk management. Like all fixed-coupon securities, municipal bonds carry interest rate risk. Duration is a common measurement of the sensitivity of a bond's price to changes in interest rates that managers closely oversee against an evolving interest rate environment. Importantly, they will manage portfolio positioning across the yield curve, as interest rate changes can affect varying bond maturities differently. Beyond risk management, effective yield curve positioning can also enhance income potential.

For municipal bond portfolios, convexity is another key concern, particularly as rates have normalized in recent years. While duration assumes a linear relationship between bond prices and interest rate changes, convexity captures the curvature of the relationship (i.e., how a bond's duration changes as interest rates change). While a number of factors can influence a bond's convexity, including price, coupon, yield and time to maturity, callability is among the most impactful, and nearly 90% of municipal bonds issued in 2025 had call provisions, typically at par after 10 years.⁶

In contrast with the positive convexity of non-callable bonds, callable bonds tend to exhibit negative convexity. As a result, interest rate changes have an asymmetrical price impact on callable bonds, with greater exposure to the downside. This is to say that a bond's duration contracts when rates fall, muting price increases, and extends when rates rise, amplifying price declines.

5. Source: Moody's Ratings; data as of August 4, 2025.

6. Source: SIFMA; data as of February 5, 2026.

Convexity has a number of implications for municipal bond portfolio management, including potential upside and downside, relative value versus Treasuries and performance in volatile environments. Convexity may be carefully managed at the portfolio level by actively leveraging the diversity of the coupon stack across potential interest rate scenarios. For example, an emphasis on lower-coupon bonds—which have greater convexity—when rates are biased lower would extend portfolio duration and could provide a tailwind during rate rallies. So, too, could bonds trading at deep discounts, which often demonstrate positive convexity given how far out of the money they are. Higher-coupon bonds, in contrast, can shorten duration and help mitigate selloffs.

Customized diversification. A diversified muni bond portfolio will typically include both general obligation bonds and revenue bonds. While general obligation bonds help finance the operations of the issuing municipality and are backed by its taxing power, revenue bonds are typically linked to a specific project or end-use across education, healthcare, housing and other public works. Due to individual considerations, some investors may prefer to avoid bonds linked to certain activities—such as fossil fuel projects or tobacco settlements—or to favor others—such as those supporting mass transit or sustainable water. While AMT affects only a relatively small number of US taxpayers, subjected investors may elect to avoid these bonds in their SMA.

Some SMAs allow clients to sidestep specific types of municipal bonds in their accounts. However, we would warn that limiting a manager's discretion may diminish the impact of professional expertise and negatively impact portfolio returns.

Limiting a manager's discretion in an SMA may diminish the impact of professional expertise and negatively impact portfolio returns.

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Risk Disclosures

All investments involve the risk of loss of principal.

Investments in bonds are subject to interest-rate risk and can lose principal value when interest rates rise, while they typically increase their principal values when interest rates decline. Bonds are also subject to credit risk, in which the bond issuer may fail to pay interest and principal in a timely manner, or that negative perception of the issuer's ability to make such payments may cause the price of that bond to decline.

Municipal bonds are subject to credit risk, interest rate risk, liquidity risk and call risk. However, the obligations of some municipal issuers may not be enforceable through the exercise of traditional creditors' rights. The reorganization under federal bankruptcy laws of a municipal bond issuer may result in the bonds being cancelled without payment or repaid only in part, or in delays in collecting principal and interest.

The information is not intended to provide and should not be relied on for accounting or tax advice. Any tax information presented is not intended to constitute an analysis of all tax considerations.

Diversification does not guarantee investment returns and does not eliminate the risk of loss.

Alternative minimum tax (AMT) sets a limit on the tax benefits that can be claimed by individuals who exceed specific income thresholds.

AA credit rating—as used by S&P Global Ratings and Fitch Ratings—is an investment grade rating on a bond considered to have a very strong capacity to meet its financial commitments. The equivalent rating from Moody's Investor Service is Aa.

A credit rating—as used by S&P Global Ratings and Fitch Ratings—is an investment grade rating on a bond considered to have a strong capacity to meet its financial commitments but that is somewhat susceptible to adverse business, financial and economic conditions. The equivalent rating from Moody's Investors Service is A.

A **credit rating** is an assessment provided by a nationally recognized statistical rating organization (NRSRO) of credit worthiness of an issuer with respect to debt obligations, including specific securities, money market instruments or other bonds. Ratings are measured on a scale that generally ranges from AAA (highest) to D (lowest); ratings are subject to change without notice. Not Rated (NR) indicates that the debtor was not rated and should not be interpreted as indicating low quality.

Default rate is the percentage of loans or bonds in which the borrower/issuer failed to make scheduled interest or principal payments, typically measured over a trailing 12-month period.

Duration is a measure of a bond price's sensitivity to changes in interest rates.

Exchange-traded funds (ETFs) are listed investment vehicles that seek to provide exposure to a benchmark, index or actively managed strategy.

High yield municipal bonds are debt securities issued by states, cities, counties and other public entities that offer a higher rate of interest due to their perceived higher risk of default.

Investment grade municipal bonds are debt securities issued by states, cities, counties and other public entities perceived to have a relatively low risk of default.

Tax exempt means that the interest component of a bond's debt service payments is exempt from federal and sometimes state and local income taxes for the bondholder.

US Treasury securities are debt instruments backed by the full faith and credit of the US government.

Indexes are unmanaged and do not incur management fees or other operating expenses. One cannot invest directly in an index.

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