

ETF Industry Perspectives Q3 2025

A muni opportunity and the skinny on SMID-cap ETFs

Vanguard ETF Industry Perspectives is our quarterly in-depth commentary, with analysis of key trends and how they're affecting ETF investors.

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Key highlights

- **Fixed income spotlight:** High-grade municipal bond yields are near their highest levels in over a decade, stemming from market volatility and elevated supply to start the year.¹ This highlights an opportunity for municipal bond investors. As advisors consider possible ways to optimize their overall fixed income allocation, municipal bonds remain attractive. This is due partly to their domestic focus, which largely shields them from tariff-related risks. Investors have the flexibility to take advantage of potential opportunities across the tax-exempt yield curve with a growing range of low-cost, liquid municipal bond ETFs.
- **Equity spotlight:** Strong inflows into Standard & Poor's 500 Index ETFs over the past few years tell a clear tale: Investors have been favoring the S&P 500 for core equity exposure. That's all well and good, but it doesn't answer the question of how investors are rounding out their equity exposure with small- and mid-cap (SMID-cap) ETFs. Mindful that advisors can add value in this realm of completing equity exposure, we're laying out a range of choices available to investors for optimizing SMID-cap allocations. Our message is simple: Avoid the pitfall of overlapping with existing holdings, as it can lead to unintended portfolio consequences.

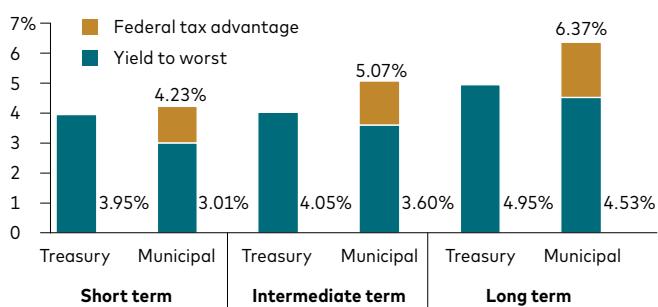
¹ Bloomberg, as of May 28, 2025.

Rising yields have created potential value in municipal bond ETFs

Tariff-related volatility early in the second quarter pulled down many asset classes. This development created potential investment opportunities, including in high-grade municipal bonds. Even preceding the tariff turmoil, relatively heavy issuance, coupled with limited demand, had already been contributing to the underperformance of muni bonds relative to other fixed income sectors.

Additionally, muni bonds loom large because their income derives from domestic revenue sources such as state income taxes, property taxes, road tolls, and power bills. This means much of the asset class is insulated from the cause-and-effect concerns surrounding tariff policies.

Treasury yields vs. tax-equivalent yields for municipal bonds



Municipal/Treasury ratios

Short term	Intermediate term	Long term
0.76	0.89	0.91

Notes: Tax-equivalent yield is calculated using a 40.8% tax bracket, which includes a 37.0% top federal marginal tax rate and a 3.8% net investment income tax to fund Medicare. Treasuries are represented by the Bloomberg U.S. 1-3 Year Treasury Index, Bloomberg U.S. Treasury 3-10 Year Index, and Bloomberg U.S. Long Treasury Index. Municipals are represented by the S&P 0-7 Year National AMT-Free Municipal Bond Index, S&P Intermediate Term National AMT-Free Municipal Bond Index, and S&P 10+ Year National AMT-Free Municipal Bond Index.

Tax-equivalent yield: The yield that a taxable bond needs to equal in order to match the yield on a comparable tax-exempt municipal bond. Tax-equivalent yield is the sum of yield to worst and the federal tax advantage of a tax-exempt bond or bond fund.

Yield to worst: The lowest yield a bondholder might receive if the bond held is redeemed before maturity while still complying with agreement terms.

Source: Morningstar, Inc., as of May 31, 2025.

Past performance is no guarantee of future returns.

Moreover, while the muni bond market is not fully safeguarded from an economic slowdown, the effects of a potential recession on the asset class would likely be limited, given strong fundamentals and the fact that almost three-quarters of outstanding muni debt is rated AA- or higher.² All the same, maintaining investment-grade exposures can help muni holders remain resilient to the risks of a slowdown or recession.

As of the end of May, muni bonds offered 97th percentile tax-equivalent yields relative to the past decade.³ Particular value prevailed in the intermediate- and long-dated parts of the yield curve, as shown in the chart displaying tax-equivalent yields.

These developments are partly a consequence of the high issuance and relatively muted demand already noted. They also reflect a dynamic of the muni market, where longer-term debt has persistently offered higher yields—not only because of term premiums, but also due to the heavy demand, from separately managed accounts and direct retail buyers, for shorter-term municipal exposure.

Comparative yields are reflected in the table that shows municipal/Treasury ratios of 76% for short-term bonds, versus 89% and 91% for intermediate- and long-term bonds, respectively.⁴ And that's before accounting for tax benefits. This means potential buying opportunities exist for high-earning investors keen on leveraging the tax-advantaged income of muni bonds.

Given the increasing number of available index muni bond ETFs, advisors can pick their spots with relative ease, choosing muni bond products that target specific parts of the curve, U.S. states, or credit-quality levels.

2 Bloomberg, as of July 2, 2025. Credit-quality ratings are measured on a scale that generally ranges from AAA (highest) to D (lowest).

3 Bloomberg, as May 31, 2025.

4 The municipal/Treasury ratio measures the percentage of the yield to worst of a given municipal bond or index relative to the yield of a commensurate Treasury bond or index. This means that at current ratio levels, many muni bonds are essentially offering tax exemption at little or no cost to investors.

For SMID-cap strategies, not all indexes are created equal

Flows into S&P 500 ETFs have been rolling in the past few years, often even when stocks were falling. The four largest S&P 500 ETFs combined have attracted more than \$460 billion over the past three years alone.⁵

These powerful flows have shown few signs of slowing so far in 2025, which helps bring into focus what's missing: namely, SMID-cap ETFs to round out strategic allocations to U.S. equities.

Our analysis of how advisors are constructing client portfolios shows that they are coalescing around similar approaches to gaining large-cap exposure, specifically through market-cap ETFs like those linked to the S&P 500, Russell, or CRSP benchmarks. But when allocating to SMID-cap stocks, advisor approaches vary between different market-cap indexes, niche small-cap products, and even active ETFs.

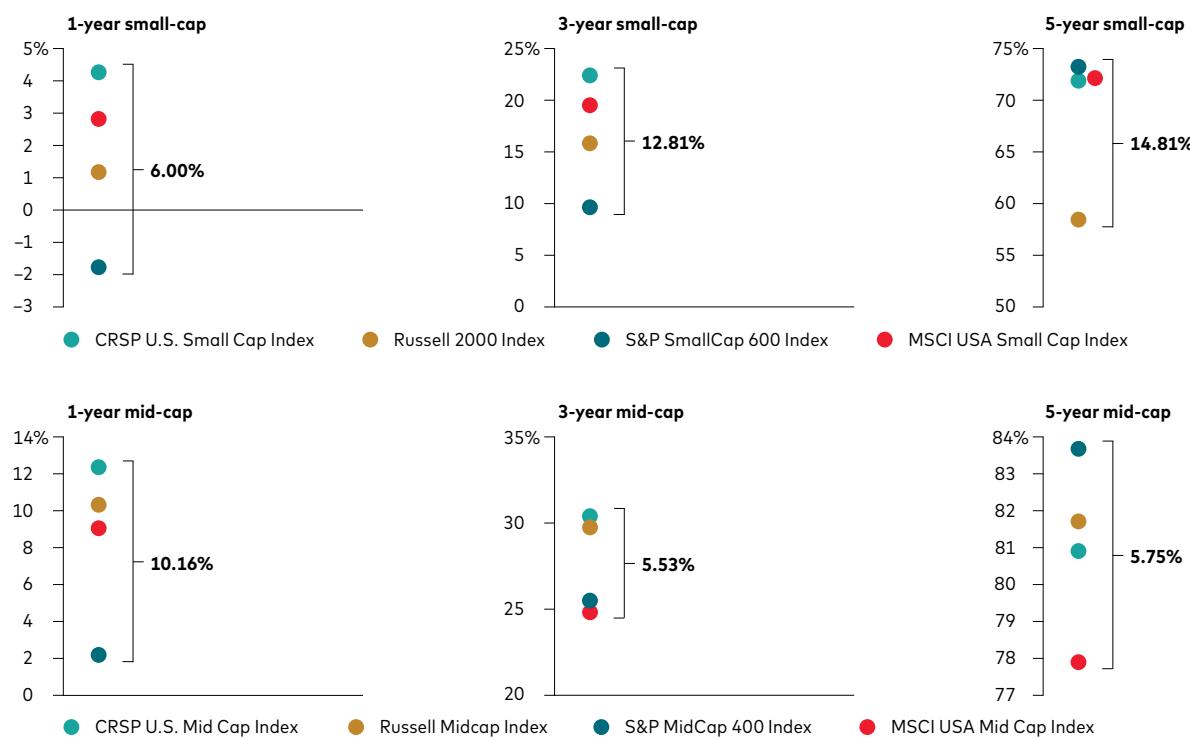
Whatever the approach, we believe advisors should avoid overlapping with their large-cap holdings. With market-cap indexes, choosing from the same family can be a helpful way to prevent unwanted portfolio tilts and outcomes.

Don't mix index providers

A look at the chart comparing one-, three-, and five-year returns for different SMID-cap equity indexes illustrates how mixing and matching can potentially run roughshod over a client's expected returns.

For example, with small-caps, the difference between the highest- and lowest-returning indexes for one-year returns is 6 percentage points. On a five-year basis, the difference in cumulative returns for small-caps is 14.8 percentage points. For mid-caps, those one- and five-year deltas are 10.2 and 5.8 percentage points, respectively.

Comparative returns for different small- and mid-cap equity indexes



Source: Morningstar, Inc., from June 1, 2020, through May 31, 2025.

Past performance is no guarantee of future returns. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index.

⁵ Morningstar, Inc., as of May 31, 2025. The four ETFs are Vanguard S&P 500 ETF (VOO), SPDR S&P 500 ETF Trust (SPY), iShares Core S&P 500 ETF (IVV), and SPDR Portfolio S&P 500 ETF (SPLG).

The point isn't to find the highest-returning index, which can be impacted by nuances between index methodologies that might make one year's leader the next year's laggard. Rather, it is to employ indexes that are harmonious in their construction, thereby minimizing expected overlaps and reducing gaps in exposure that can tamper with expected returns.

Real-world approaches

If your client's money is part of the \$460 billion-plus that's moved into top S&P 500 ETFs over the past three years, perhaps the most direct way to complement the core is by implementing exposure to ETFs built around a completion index, such as the S&P Completion Index. This index targets SMID-cap stocks that aren't in the S&P 500. Accordingly, ETFs that track it can be simple options to potentially fill exposure gaps.

Alternatively, advisors can build their own beta using individual ETFs built around the S&P SmallCap 600 Index and S&P MidCap 400 Index. Advisors can potentially add extra value through applying this approach and, if warranted, leaning into or tilting away from benchmark exposures.

In the case of the Russell 1000 Index, completing U.S. equity exposure with the Russell 2000 Index integrates small-cap names into the exposure scheme and creates the possibility to fine-tune tilts. When using the CRSP U.S. Large Cap Index, completing exposure should involve other CRSP benchmarks, notably the CRSP U.S. Small Cap Index (since CRSP's methodology includes mid-cap stocks in its large-cap-branded index).

Some advisors might prefer more creative ways to obtain SMID-cap exposure. But whatever approach you take, just be mindful of how it intersects with your existing large-cap holdings.

Important information

For more information about Vanguard funds or ETF Shares, contact your financial advisor to obtain a prospectus or, if available, a summary prospectus. Investment objectives, risks, charges, expenses, and other important information are contained in the prospectus; read and consider it carefully before investing.

Vanguard ETF Shares are not redeemable with the issuing Fund other than in very large aggregations worth millions of dollars. Instead, investors must buy and sell Vanguard ETF Shares in the secondary market and hold those shares in a brokerage account. In doing so, the investor may incur brokerage commissions and may pay more than net asset value when buying and receive less than net asset value when selling.

All investing is subject to risk, including the possible loss of the money you invest.

Past performance is no guarantee of future results.

Investments in bonds are subject to interest rate, credit, and inflation risk.

Bond funds are subject to the risk that an issuer will fail to make payments on time, and that bond prices will decline because of rising interest rates or negative perceptions of an issuer's ability to make payments.

Prices of mid- and small-cap stocks often fluctuate more than those of large-company stocks.

Although the income from a municipal bond fund is exempt from federal tax, you may owe taxes on any capital gains realized through the fund's trading or through your own redemption of shares. For some investors, a portion of the fund's income may be subject to state and local taxes, as well as to the federal alternative minimum tax.

Funds that concentrate on a relatively narrow market sector face the risk of higher share-price volatility.

Be aware that fluctuations in the financial markets and other factors may cause declines in the value of your account. There is no guarantee that any particular asset allocation or mix of funds will meet your investment objectives or provide you with a given level of income. Diversification does not ensure a profit or protect against a loss.

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