QUICK TAKE ON FIXED INCOME

Q: ARE YOU AWARE OF THE HIDDEN COSTS IN MUNICIPAL BONDS?

A: A markup is the difference between the price paid by a broker/dealer and the price a bond was sold to a client. Broker/dealers are permitted to charge fair and reasonable markups on bonds. Unfortunately, these markups do not have to be disclosed to the client. Because of this, the nominal ticketing fee on the client's trade confirmation is often assumed to be the only cost, similar to a stock purchase. With markups not having to be disclosed, it is not surprising that many investors are surprised when they find out the true costs associated with purchasing bonds. Bonds are traded in an over-the-counter market where broker/dealers trade with each other. By comparison, equity markets trade on an exchange (such as the New York Stock Exchange). Because there is no centralized exchange for bonds, pricing is more opaque and difficult to determine. As a result, bond dealers have an advantage over retail investors, and many exploit this by charging large markups without the client's knowledge. Let's take a look:

The example above illustrates how the investor received a price of 113.18, which equates to a yield of 2.64 percent. The dealer, on the other hand, purchased the bond at a significantly lower price of 111.50, or a 2.80 percent yield. The dealer marked each bond up to $1.68, or $3,360 in total of which the client had no knowledge. This is a common practice. A 2014 Wall Street Journal article cited a study that showed that individual investors trading $100,000 in bonds of a municipality paid brokers an average spread of 1.73 percent, or $1,730.

We work with BAM's Fixed Income department, which functions as a Registered Investment Advisor and, as such, cannot legally charge markups on any bonds purchased for clients. This doesn't totally eliminate markups, however, because bonds still need to be purchased from other dealers in the market. What BAM's Fixed Income Desk can do, though, is drive those markups down as much as possible by putting our dealers in competition for each trade, which can drive down the per-bond price and is in stark contrast to what is illustrated above.

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