Mutual Funds Stand to Gain as Muni Buyers Get First Look at Fees.

- **Markups on some trades will be disclosed starting May 14**
- **Trading costs can consume several months of investment returns**

On May 14, the municipal-bond market's biggest investors may be in for a shock.

That's when new rules will require brokerage firms to start disclosing some of the fees they charge individuals to buy and sell state and local government debt. Those fees, which firms build into the trades by marking the price up or down, can be substantial: They averaged about 1.1 percent on investment-grade bonds in 2016, or $1,100 for a $100,000 bond, according to S&P Global. With 10-year AAA bonds yielding 2.5 percent, those transaction costs can eat up several months of a returns.

The revelation could accelerate a shift toward mutual funds and other fee-based accounts by individual investors who own about $1.6 trillion, or 40 percent, of the outstanding municipal securities, more than any other group. That's because the fees they charge will look cheap compared with what it costs for individuals to trade on their own.

"Why pay a point to buy bonds when you can pay a few basis points a year to a mutual-fund provider and you get diversification and you don't have to worry about a singular credit risk that comes with munis," said Matt Fabian, a managing director at Municipal Market Analytics.

The new regulation from the Municipal Securities Rulemaking Board is the result of a push to inject more transparency into the state and local market, a haven for individuals seeking a safe source of tax-exempt income.

It comes as the shift toward professionally managed accounts has already gained steam as the record setting bankruptcies of Jefferson County, Alabama, Detroit and Puerto Rico heightened investors awareness of the risks associated with individual bonds. Mutual-fund holdings of state and local debt has nearly doubled since the end of 2008, during the height of the credit-market crisis, according to Federal Reserve Board figures.

But the impact of the fee disclosures may be limited in part by loopholes that regulators left in the new rules. Disclosure of mark ups to retail investors — both as a dollar amount and as a percentage of the prevailing market price — are required only when the dealer trades the same security that day. Moreover, the size of the dealer's trading must equal or exceed the size of the customer's transaction.

If a dealer had a bond in inventory and then sells it to a customer, that markup won't be disclosed. Nor will it be when a customer buys bonds issued on the first day of an initial offering.

Still, the requirements will affect a sizable number of trades. The MSRB, which writes regulations for the market, said it may affect more than 8,000 retail transactions each day.

The exceptions may bring some initial confusion, as markups are disclosed on some trades but not others. Brokers will need to spend time explaining the discrepancy and how the markups are calculated, said Patrick Luby, an analyst who follows the municipal securities industry for CreditSights Inc. And determining the market price used to gauge the markups can be complicated depending on when the trades occur.

“Asking them to take more time to explain a municipal bond trade isn’t a welcome proposition, because they’re already stretched pretty thin,” said Luby. Time pressures on brokers may also lead them to pitch clients fee-based accounts, he said.

Municipal-bond fund managers have welcomed the rule, anticipating that new clients may emerge when they see how costly it can be to build a portfolio of sequentially maturing bonds — a practice known as laddering — on their own.

“The perception up to this point is that laddering a municipal portfolio is ‘cheaper’ than hiring an active manager,” said Andrew Clinton, founder of Stamford, Connecticut-based Clinton Investment Management, which oversees $430 million of municipal bonds. “The clients never saw the actual transaction costs and assumed, inappropriately, that they were getting that service for free.”

Gurtin Municipal Bond Management charges 0.14 percentage point to ladder a portfolio, depending on the strategy, said chief executive officer, Bill Gurtin. His firm oversees $14 billion municipal assets.

“Not only are you getting proper execution and proper value, you’re also getting ongoing surveillance,” transparency of fees and returns, and a manager that, unlike a broker, is legally required to act in a client’s best interest, said Gurtin.

“It’s hard to argue that the resources behind a professional manager aren’t substantially greater than behind a broker buying bonds on behalf of a client,” he said.

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By Martin Z Braun

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