Bond Case Briefs

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The Curtain Is Lifted For Municipal Bond Markups.

Summary

- FINRA Rule 2232 requires municipal bond markups.
- Bond transaction fees examined.
- Market impact yet to be seen.

As of May 14th, 2018, FINRA Rule 2232 went into effect which requires broker dealers to disclose on customer confirmations their markup for principal trades executed within the same day. Previously, these markups were not disclosed and were rarely discussed. Since bonds are bought and sold on a yield basis, if an investor was looking for a certain yield, maturity, and credit quality, brokers would make sure they achieved these goals while still making a mark-up for themselves. Sometimes this markup was minuscule as is the case with high quality, very short-term bonds. Sometimes it was as much as 3% as it would be on a highly speculative, long dated bond. Dealers would buy bonds in the open market and mark the price up to their clients to cover their expenses and earn a living.

Now some of you may be saying 'what if I was looking for 5% and I could really get 6%, but my broker's undisclosed markup ate away at that return?' If that was occurring, your broker is a jerk (to put it politely). I am not here to defend anyone who does/did that. I am here to defend the reasonable fee charged on the onset of what is typically a multiple year and often a many decade long investment.

In many of the articles I read about the implementation of Rule 2232, the example that I always see is that a customer who invests $100,000.00 and is charged a 1% mark-up will now see that $1,000 one-time fee disclosed on their trade confirmation. This is true, that is how this new rule should work. Without a doubt, there will be some initial and significant sticker shock to seeing this markup printed on an investor's trade confirmations. "$1,000 for one phone call WTF?!?" What needs to be explained clearly by brokers and understood by investors, is that this is a one-time fee, in contrast to the annual fees charged by other competing products.

I read often that bond investors should look to bond funds or bond ETFs to avoid the fees that come with purchasing individual bonds. Fees that many deem too steep. Let's use the example of the $100k invested and the 1% fee charged and dig a little deeper. Let's assume, for argument's sake, that an investor is looking for a 20-year bond. Not too short, not too long, right in the meat of the yield curve to give a fair representation of an average bond investment time frame. The 1% fee charged at the outset of this investment breaks down to just 0.05% annually. Now, compare that to the 0.36% charged by the Fidelity Intermediate Municipal Income Fund (MUTF:FLTMX), or the 0.09% charged by the Vanguard Tax-Exempt Bond ETF (NYSEARCA:VTEB), or the 0.25% charged by the iShares National AMT-Free Muni Bond ETF (NYSEARCA:MUB). One percent on the onset of the investment doesn't stack up too bad. Now, bonds can be called in early, or might need to be liquidated by investors prior to maturity, which would increase the transactional annual fee. That I cannot argue with. If you are a true buy and hold investor, transactional fees, on annual basis, are very reasonable.

Fixed income investments, overall, are the buy and hold portion of an investor's portfolio. Meaning they are not bought and sold frequently to capture short-term gains (as one could do in the stock market) and generate mark ups for broker dealers. Rather bonds are purchased to preserve capital and/or to generate a predictable amount of income over a longer time frame.

I hope that the implementation of this rule does not kick off a large wave of investors moving into bond ETFs from traditional bond portfolios. I feel that these products are a square peg in a round hole. That they appear to accomplish the same goals as individual bond investing but do so by sacrificing certain objectives. We will see how the market reacts.

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