Bond Case Briefs

Municipal Finance Law Since 1971

Bonds Versus Bond Funds: Minnows Versus Sharks.

Brokerage firms like to tell clients they should buy bonds instead of bond funds, but that is rarely a good idea. Investors almost always have an advantage buying a mutual fund's portfolio of bonds rather than buying bonds directly.

Treasury bonds are an important exception. The Treasury market is extremely large and liquid, its structures are as simple as they come, and most brokerages charge modest fees to buy and sell them at very fair prices. For pretty much everything else, the cards are stacked against you.

Time Is Relative

The appeal of Treasury bonds to many do-it-yourself investors is that the former have fixed maturity dates, and the U.S. government has always made good on paying back principal when that time comes. What may be less obvious is that with a few exceptions, most other bond sectors carry features–such as the option for borrowers to refinance or pay off debt early–that make the timing of principal return much less certain. That goes for most municipals, mortgage securities, and corporate bonds (though the latter often carry some financial penalties designed to compensate investors for the option).

The chief risk associated with an embedded option is that you'll get your money back early at just the wrong time–when market yields are low, the incentive for borrowers to refinance is high, and by definition reinvesting the money at a good rate is most difficult.

What may be less obvious is the cost associated with that option. Think of it this way: When you purchase a bond with an option attached, you're actually buying the bond and simultaneously selling the borrower an option (to refinance). You'll never see the price of the option broken out, but the bond's price–and by extension its yield–will have the value of the option baked in. As such, an identical bond without the option would carry a lower yield and a higher price.

The difference isn't trivial, and no institutional investor would ever pay the same price for those two bonds. In fact, they put tremendous effort into figuring out how much that option is worth and how much more yield they should get from the borrower to account for it.

It's not plain-vanilla math, though, and the number is by definition an estimate. That's because most borrowers' decisions are based on the level of interest rates when they have an opportunity to refinance. Every homeowner with a mortgage knows that it will only make financial sense to refinance when rates get low enough, but that pinning down when that's going to happen or how low they're going to get can be as difficult as predicting the weather.

As such, the process for pricing an embedded option is especially complex for plain-vanilla mortgages that can be refinanced at any time. And institutional investors know that unless they know what it's worth, the market will always look to underpay.

The Return of Your Money

While we know the U.S. Treasury is a safe bet to pay you back, the risk of being stiffed exists with just about every other kind of bond. Knowing how to handicap that risk is another laborious exercise requiring skill, knowledge, and experience. Most fund managers have teams of analysts spending most of their time looking into the finances of bond issuers whether large or small, municipal, corporate, or otherwise. It would be almost impossible for any individual to devote the amount of time and effort to replicate that work, and even if one could, the cost of doing so would likely be well beyond any benefit one might get from going it alone.

Here too, though, the practical risk often isn't actually whether you're going to get your principal back, but rather how much extra yield you should demand in exchange for the risk that you won't. And keep this in mind: While most individual investors don't bother buying mortgages directly, the fact that many do choose to purchase corporate and municipal bonds on their own also means there are plenty of parties–including brokers, corporate borrowers, or mutual fund managers–who make it their business to sell debt to investors who don't know that number and to whom they can sell bonds without paying anywhere close to it.

Buying in Bulk

Let's say for the sake of argument, though, that you still want to buy a bond with an embedded call option and some level of credit risk and that you've even somehow managed to get confident in the yield number that you're going to demand. Unless you're going to invest a ton of money all at once, it's nearly a sure bet that you're going to have to give up some of that yield in the form of higher trading costs that you won't see broken out from a bond's price either.

The data will look different for every sector and time period, but the phenomenon is well-established. Vanguard has studied the relationship between trade size and pricing among municipal bonds at least three times in the past 15 years, and the data have always borne out that the smaller the bloc the higher the cost, and you generally won't get institutional-level pricing on a single purchase until you're above the $1 million range. And in the case of municipals, roughly 70% of trades are under $50,000, which means most people are giving up the pricing advantage they'd get by throwing in with other investors in a fairly priced fund.

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