Bond Case Briefs

Municipal Finance Law Since 1971

WSJ: Intelligent Investor: What's Eating Munis?

Municipal bonds are beginning to look tempting — but investors who buy munis in haste can unwittingly hand over their first year's worth of income to their broker.

Fortunately, with a few simple steps, you can control that risk and maximize your net return.

Intriguingly, the health of many municipalities is improving even as tax-free bonds offer relatively attractive returns. Yields on the highest-quality, widely traded munis, triple-A-rated, 10-year "general obligation" bonds, have risen by 0.45 percentage point since May 1, according to Daniel Berger, senior market strategist at Municipal Market Data.

While U.S. Treasury yields have risen recently, "muni yields have truly skyrocketed," says George Friedlander, chief municipal strategist at Citigroup. "We're approaching the levels where retail investors will start to raise their hands again. The pent-up retail demand is very strong."

But you must proceed with caution, or you will get fleeced. Unlike on stocks, you don't pay a commission when you buy a municipal bond. Instead, you pay a "markup"—the difference between your broker's cost and the price you pay.

Unfortunately, most brokers don't disclose their markup. According to regulators and industry experts, you are likely to hear something like this instead: "I can get you this bond for a yield of 2.989%. You'd have to earn 4.83% on a taxable bond to equal that."

Because they focus too much on yield and not enough on price, "most retail investors have no idea how much they're getting charged on these trades," says Edward Reinoso, chief executive of Castleton Partners, an asset manager in New York specializing in municipal bonds.

Markups can be monstrous. Securities Litigation and Consulting Group, a research firm in Fairfax, Va., recently analyzed nearly 14 million trades of long-term, fixed-rate munis over a period between 2005 and April of this year.

The SLCG study shows that on one out of 20 trades, people who bought $250,000 or less in municipal bonds paid a markup of at least 3.04%—or approximately a full year's worth of interest income at today's rates. By comparison, you will pay less than $10 in commission to buy a stock at most online brokers, or 0.004% on a $250,000 purchase; a typical mutual fund charges management fees of about 1% a year.

Craig McCann, founder of SLCG, estimates that investors paid at least $10 billion in what he considers excessive markups—at least twice the normal cost to trade a given bond—since 2005. "That's more than a billion dollars a year needlessly transferred from investors to dealers' pockets," he says.

To be sure, of the approximately 1.2 million issues outstanding, only about 14,000 trade at all on any given day, according to the Municipal Securities Rulemaking Board, a regulatory body that oversees the muni market.

Brokers rightly point out that it can be difficult and costly to find any particular bond on a given day. Federal rules require that markups be “fair and reasonable” but don’t define those terms exactly.

Still, there is no reason why you should pay a much higher markup than someone else recently did for a similar-size trade in the same security.

The MSRB maintains a website, Electronic Municipal Market Access, or Emma, that shines some much-needed sunlight into this shadowy world.

Around 11:17 a.m. this past Tuesday, emma.msrb.org shows, a customer sold $100,000 in bonds issued by New York’s Triborough Bridge and Tunnel Authority; the customer received a price of $105.26. Around 3:15 p.m., the dealer that bought those bonds resold them for $108.26 — a spread of $3, or 2.8%, over the previous price. On Feb. 27, a customer sold $25,000 worth of the same bonds at $109.769 to a dealer who flipped them the next day for $113.213 — a fat markup of 3.1%. (Emma doesn’t identify any trader by name.)

“[Brokers] respond if they know you’re looking over their shoulder,” says Ernesto Lanza, the deputy executive director of the MSRB. “If you’re buying a bond, look at all the ‘customer bought’ trades to see what other customers paid. Then say to your dealer, ‘Try to match this.’”

That is what Phil Potter, an electrical engineer who lives in the Los Angeles area, does. “Just because the yield sounds good doesn’t mean you aren’t overpaying,” he says.

Using the Cusip, a nine-character mix of numbers and letters unique to each bond, Mr. Potter searches on Emma for the last few trades. If Charles Schwab, the broker where he buys munis, quotes a markup of more than 1.5% over those levels, Mr. Potter calls Schwab’s bond desk and tries to negotiate.

If the firm won’t budge, Mr. Potter walks away. But, he says, about 20% of the time he does get a better price.

“We always endeavor to show the best price to our clients,” responds Patrick Luby, a managing director in Schwab’s fixed-income department, “and in some cases, when clients ask, we’re able to improve the price even further.”

Then, and only then, will Mr. Potter buy. You should do the same.