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NYT: Determining the Markup on Municipal Bonds.

Most of the market news you hear tends to be about stocks, but bonds are just as useful a tool for most investment portfolios. One type in particular, the municipal, or “muni” bond, remains very popular. These bonds are issued by local governments, they’re often tax-exempt and they can be relatively low risk. But muni bonds come with a catch: You may be entering a dark and dangerous world when you go through the process of buying one.

Part of that world includes what the industry refers to as a markup. In the simplest terms, when brokers sell muni bonds to clients, they have the option of charging the client more than the original price. It’s the equivalent of buying at wholesale and selling at retail, and it’s not that much different from what you see when you walk into the grocery store. The problem is that it’s almost impossible to determine the markup, and it can vary from transaction to transaction.

The price you pay for the bond, including the markup, has a direct impact on the return you’ll earn as the owner of the bond. While markups are common, it isn’t always clear how much they tend to be. A [recent Wall Street Journal story](#) tried to shed some light on this and found that “individual investors trading \$100,000 in bonds of a municipality, such as Washington State, in December paid brokers an average ‘spread’ [or markup] of 1.73 percent, or \$1,730.” Given that these bonds don’t generate huge returns, the markup could potentially absorb an entire year’s interest.

I saw the sales process firsthand when I worked for a large brokerage firm in the mid-1990s. During training, I often asked grizzled veterans what advice they had for a rookie. I was particularly curious about how we were supposed to decide which bonds to buy for a client’s portfolio.

The answer I got more than once was something like, “Go to the list of bonds we keep in inventory and see which one pays you the most.” So instead of seeing which bond would be best for the client, I was supposed to figure out which one had the highest markup and would deliver the highest compensation for me and the firm. I could actually adjust my commission up or down without the client really having a clue.

There were limits to how much I could charge without raising eyebrows, but the federal rules only required that markups be “fair and reasonable,” whatever that means. I couldn’t find any other guidelines to help me decide what to charge one client versus another.

I also discovered that most prospective clients didn’t know the markup existed. They said “their guy” didn’t charge them anything to buy bonds. To hear these clients tell it, the brokerage industry was suddenly filled with nonprofits. Even if people had known about the markup issue, they had no way of verifying what they were told. The bond market was (and is) that opaque.

Most of the people I’ve worked with in the industry since then have managed this conflict by being transparent. They’ve told clients what they get paid and agree on what everyone thinks is fair, but the process is still filled with conflicts. Like Warren Buffett said, “Never ask your barber if you need a haircut.” It’s pretty clear who the answer will favor.

Based on what I've just outlined, it might be tempting to swear off muni bonds. But instead of never buying a muni again, I suggest you shine some light on the subject. Now that you know markups exist, you can start a conversation with your broker or adviser. Start by asking questions that help you understand what and how you're paying for a transaction or advice.

Don't be afraid to ask, "What does it cost me to buy this bond?" If you get the answer, "Nothing," I would run. Find a new adviser. Surely it's costing you something, and it may be included in the fee you pay for advice, but that's a different answer than "Nothing."

You can go a step further and ask, "Did your firm mark up this bond before you sold it to me?" Again, it's about transparency, not right or wrong. You need to be in on the discussion about what's fair and reasonable. We all understand that conflicts exist, but we need to make sure they're out in the open.

Transparent advisers will have no problem with specific, pointed questions, and asking them gives you the chance to level the playing field a bit. For now, the world of muni bonds may still be opaque, but it's your money, and you have the right to know where it goes.

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