The STANLEY LAMAN Group, Ltd.

BOND SPREADS – Hidden Costs

As the stock market's bull run enters its 10th year and interest rates begin to rise, many investors are evaluating their bond and equity allocations. In doing so, investors should understand how to maximize Bond and Cash Portfolio Yields. To this end we offer a couple of lesser known areas of the market for improving yields.

Chapter 1 - Fees

Despite intense focus on fees, investors are often unaware of the spread or mark-ups they are paying when they purchase a municipal, corporate or Treasury bond and in some cases even a money market instrument from a broker. In fact, we believe that even few brokers know how much their customers are overpaying given that they probably are not shopping or engaging in price discovery for their clients.

This fee can be more impactful on returns than trading costs or manager fees for equity investments in an environment where the 10-Year Treasury Rate is roughly 2.83%.
Bonds are not traded on a centralized exchange but rather from inventory or allotments from hundreds of broker dealers that hold the bonds in their inventory. As such, professional bond managers have the ability to compare the price being offered against hundreds of other sellers in the marketplace.
A recent U.S. News and World Report Article[1] claimed that some online brokers mark-up a bond anywhere from 0.5 percent to as high as 2 or even 3 percent, depending on the order size. Our experience shows that full-service broker mark-ups are even higher.

For example, an investor received a quoted return for a 90-Day T-Bill of 1.88% from his full-service broker. By diving deeper, we found the same instrument could be purchased at a price to generate a 1.95% return. If rolling three month T-Bill investments, the added .07% return generates an additional $720 over a 12-month period for a $1 Million investment.
A spread, or price differential, of .07% for the most liquid, easily available, transparent instrument in the world begs the question of what an investor is paying for a more obscure State General Obligation Municipal Bond, which can be in excess of 5% in our experience.
This mark-up, or spread, is one of the reasons investors see a bond that was just purchased showing a loss on their monthly brokerage statement.

The impact of the spread can be more impactful for a shorter-term portfolio in which bonds roll off and are reinvested continually.

Chapter 2 – Supply and Demand

Municipal Bonds in particular are impacted by supply and demand, as well as Government Bond Rates. The municipal bond yield curve has remained much more positive than the U.S. Treasury curve, which is good news for municipal bond investors.

Even with rising interest rates, municipal bond prices have been less affected than taxable yields because of steady demand for tax-exempt bonds.

The buyer can capture more taxable equivalent yield by extending the maturity or duration of the buyer's portfolio. However, with the Federal Reserve continuing to raise interest rates, the investor needs to be cautious because the net effect of a longer maturity could result in falling market values as rates rise.

New issue supply in municipal bonds is down over 18% year-to-date. However, with the recent corporate tax rate cut from 35% to 21%, several insurance companies, banks, etc., have opted to sell-off or purchase fewer municipal bonds, thus creating an increased flow of secondary bonds.

Many retail broker dealers only inventory new issues. With supply falling, the cost to the buyer has been either a higher dollar cost or a lower yield. As yields go down, prices go up.

As a result of our ability to directly watch offerings in the secondary market, we have had recent success in purchasing obtaining 10 to 20 bps greater yield because of the increased secondary supply. We pass this along to our clients. An extra twenty basis points on $500,000 produces an additional $1,000 a year in income.

In closing, we believe that Bond Yields can be improved significantly by understanding the Market and reducing transaction fees. We recommend using a knowledgeable manager versus buying instruments from a captive Broker.

[1] US News and World Report – 'Bond Trade Fees Are in Spotlight', June 19, 2018