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Hidden Costs: Bond Markups

OVERVIEW

This article discusses bond pricing and costs for municipal and corporate bonds. Broker/dealers are permitted to charge undisclosed markups on bonds. For the first quarter of 2004, 97 of the 100 worst municipal trades included markups ranging from 6.753 percent to 15 percent.¹ Since the SEC does not yet have formal guidelines regarding bond markups, the practice of charging excessive markups when investors buy bonds and excessive markdowns when investors sell bonds is more prevalent than most investors realize.² The article also covers some of the reasons why individual investors might pay retail bond prices while high-volume firms typically pay wholesale prices for the same bonds.

Concealed Costs: Bond Markups and Markdowns

When investors see transaction fees on their trade confirmations and portfolio statements resulting from bond purchases, they might assume any stated fees were the bond's only cost, similar to a stock purchase. In reality, bond markups (and markdowns) are common practice in the industry (since markups are actually a part of a dealer's total compensation received for trading securities) but remain virtually unseen by investors.³ "The Bond Market Association says transaction costs range from 0.5% to 2.5% of the face value of the bond (\$5 to \$25 per \$1,000 of face value) for municipals, and from 1% to 3.5% (\$10 to \$35) for corporate bonds, meaning that the broker marks up each bond's price by that amount. Arizona State University finance professor Michael Joehnk says those estimates are 'pretty much on the low side.' He says 5% (\$50 per \$1,000 of face value) markups are customary on lots as large as \$25,000 and 7.5% (\$75) markups aren't unusual on thinly traded munis."⁴

As there is currently no legal requirement that markups/markdowns be disclosed to investors, one of the few ways to determine the percentage of markups/markdowns charged is to subscribe to a relatively costly financial information service, such as one provided by Bloomberg. Investors will also need the expertise to compare various bond transactions listed by such services (while making an additional investment of time spent to monitor such transactions). The levels of expense and complexity are typically out of the reach of an average investor.

Investors who are familiar with the costs of purchasing stocks might be surprised to find that the hidden costs associated with purchasing bonds can be even higher. Why is this so? First, bonds are

traded in an over-the-counter market where dealers trade with each other, which is different from the trades made by equity traders on an exchange (such as the NYSE) because they are not taking on extra risk by buying shares of stock and holding them in inventory. When bond dealers maintain an inventory of bonds, they take on the additional risk of attempting to sell bonds for more than the purchase price. Thus, reasonable markups are considered fair compensation for the bond dealer's risk of holding securities as interest rates fluctuate.

Next, when pricing bonds there is less **visibility**, meaning the amount of information available about stocks greatly outweighs information on bonds. "Most people cannot open up the *Wall Street Journal* and see what their metropolitan-area sewer revenue bonds cost."⁵ Finally, the available number of bonds greatly exceeds that number of stocks. For example, there were approximately 2,750 companies listed on the NYSE at the end of 2003.⁶ The Bond Market Association currently estimates that there are approximately two million separate municipal bond issues outstanding.⁷

Bond Markups/Markdowns Follow "Fair and Reasonable" Guidelines

In an April 2002 ruling, SEC administrative law Judge Lillian A. McEwen dismissed fraud charges brought by the SEC and MSRB (Municipal Securities Rulemaking Board) against a former Los Angeles broker. McEwen concluded that "markups and markdowns on municipal securities ranging from 1.87% to 5.64% were not excessive and did not violate the securities fraud laws."⁸ Although brokerage firms are legally allowed to charge undisclosed markups (such as the ones described in this case), we would argue that the practice takes advantage of investors who might not be aware that bonds commonly include markups from a broker/dealer, considering the markup charged may often be disproportionate to the riskiness of the position taken by the broker/dealer.

SEC lawyers responded to the ruling by filing a brief that vigorously disagreed with the judge's ruling: "An administrative law judge ignored bond experts, applied incorrect legal standards, and failed to determine whether a former broker acted negligently under the securities fraud laws by taking undisclosed excessive markups on municipal and other bond trades."⁹ We disagree with the court's ruling and agree with the SEC that markups of this nature are excessive.

Despite the legality of markups/markdowns, we remain concerned about the ramifications inherent within such an environment. Cases filed against brokerage firms and advisors related to bond transactions increased in 2003. "NASD [National Association of Securities Dealers] statistics show that arbitration cases involving corporate bonds jumped 40% to 353 cases in 2003, up from 253 cases in 2002. That was the highest percentage increase for all security types involved in arbitration cases, including mutual funds, which rose 37%, and common stock, which rose 24%."¹⁰

There are still no clear legal guidelines on when a markup/markdown becomes excessive nor any regulations requiring disclosure of markups/markdowns to an investor, which we consider more important than the percentage of markups charged. If broker/dealers were required to itemize markups/markdowns and investors could see the costs, would broker/dealers charge excessive markups/markdowns as frequently? The MSRB mandates that "each broker, dealer and municipal securities dealer ... shall make a reasonable effort to obtain a price for the customer that is fair and reasonable in relation to prevailing market conditions"¹¹ but does not enforce rigorous disclosure requirements.

Bond Markup Example

The following screen shows the volumes and prices of 11 bond transactions for a municipal bond listed on the aforementioned Bloomberg monitoring and reporting service.

Time	Sale Type	Par	Volume	Price	Yield	Assumed Settle
09:40	Sale to Customer	100,000		102.133		
11:31	Sale to Customer	50,000		100.564	3.920	
12:23	Sale to Customer	500,000		100.706	3.900	
12:28	Sale to Customer	10,000		102.000		
12:35	Sale to Customer	150,000		100.706	3.900	
13:23	Sale to Customer	250,000		100.963	3.864	
13:32	Sale to Customer	100,000		101.833		
13:55	Sale to Customer	50,000		101.000	3.859	
14:50	Purchase from Customer	250,000		100.034	3.995	
14:52	Inter-Dealer	250,000		100.134		
16:52	Inter-Dealer	300,000		100.150		

Figure I: Bloomberg Screen

Figure I illustrates the difference between prices dealers pay versus individual customers. As shown above, the prices paid by customers versus dealers for the same bond issue were noticeably higher. For example, the three dealer transactions on the bottom of the list received the lowest prices of all the trades for that period. By comparing the lowest price paid by the dealer (\$100.034) to the highest price paid by a customer (\$102.133), we find that the customer paid a markup for those bonds (approximately \$2,000 for the trade) — one we consider to be excessive. The customer who purchased 50,000 at \$100.564 paid a markup of approximately \$225. Broker/dealers forge stronger relationships with each other by participating in numerous high-volume transactions and dealing in higher average transaction sizes, so those firms receive better pricing when they purchase or sell bonds.

Summary

For many high-net-worth investors, individual bonds can be an important part of a portfolio. However, excessive markups/markdowns can adversely affect the overall value of a portfolio. For an individual investor, being aware that hidden costs and pricing disparity exist is the first step to creating a cost-effective bond portfolio.

- ¹ Kevin Olson, **2004/Q1 Worst 'Two-Trade' Bid/Offer Spreads**. Olson maintains a public service information site that advocates fair disclosure of municipal bond disclosure information.
- ² A markup (or markdown) is the difference between the price dealers transact among other dealers and the price the customer pays.
- ³ “Advisers who sell bonds to their clients say a major problem with bond sales is lack of disclosure of markups from the brokerage firms and dealers that sell them.” Sara Hansard, **Bond Arbitration Cases Boom; More Cases Expected as Interest Rates Rise**. *Investment News*, February 2, 2004.
- ⁴ Elizabeth Roy, **Bonds Primer: Focus on Transaction Costs**. *TheStreet.com*, November 27, 1998.
- ⁵ Hansard.
- ⁶ NYSE Overview Statistics, www.nysedata.com/factbook/.
- ⁷ The Bond Market Association, http://investinginbonds.com/muni_bond_prices.htm.
- ⁸ Lynn Hume, **Judge Dismisses SEC Case Against Former Broker, Rules Markups Not Excessive**. *The Bond Buyer*, May 1, 2002.
- ⁹ Lynn Hume, **Enforcement: SEC Lawyers Defend Markup Standards, Seek Reversal of Ruling**. *The Bond Buyer*, July 10, 2002.

¹⁰ Hansard.

¹¹ Municipal Securities Rulemaking Board, Rule G-18, www.msrb.org.

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