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CASE STUDY: “Buying” Bonds

BACKGROUND:

- There are three ways to put bonds into an investment portfolio:
 1. Buy individual bonds randomly from the “inventory” at brokerage firms that are not part of any ongoing game plan or process
 2. Buy a diversified portfolio via a mutual fund
 3. Gain a diversified portfolio of individual bonds via a Professional money manager
- Of the above choices, TRPG endorses numbers two and three and sees significant drawbacks to buying individual bonds from brokers.
- The bond market is far less liquid and not as efficiently priced as the stock market, which translates into higher bond transaction costs for self-directed investors.

THE PROBLEM:

Self-directed and broker-sold investors often miss the following:

- Investors are under the false assumption that purchasing bonds is a low cost, sometimes no cost transaction.
- Many brokerage firms maintain their own inventory of bonds, which in most cases are primarily used to meet customer needs. These bonds already have their “mark ups” built in, which does not allow for competitive pricing.
- Many investors think that when buying from a broker they are not paying commissions like they are with stocks, when in reality, the bonds are being sold with high built in “mark ups” and often from the firm’s inventory vs. searching the market for the best bond and pricing.
- Many times investors are buying bonds in small \$5,000 and \$10,000 increments. The hidden costs are highest when buying bonds at small sizes. The added cost is often 1-3% of the listed price.
- Even on bonds purchased in larger increments, it is often much higher cost to purchase via a broker as a result of the expenses buried in the bid/ask spread. Many investors only seem to care about the purchase price, which contains the mark up, and fail to inquire as to why there is such a gap between the purchase price of the bond vs. what they could sell the bond for the next day.
- “Laddering” bonds is a great strategy, but the rungs of the ladder typically break down when whoever sold the bonds ignores call features or extraordinary redemption features.

- While “buy and hold” may work with a high quality portfolio, this can have disastrous results for portfolios with lower rated bonds. Most investors buy bonds and never look back. Most brokers sell the investor a bond and never look back. “Call” provisions are often misunderstood or ignored until the last minute.
- Brokers will often sell a bond that is initially non-rated but sounds very strong. Some bond issuers cannot afford to pay the fees required to have their bonds rated. Others don't pay to have them rated because they won't like the rating.

THE ALTERNATIVE:

- The professional bond manager is free to search the marketplace for the best bonds available because:
 1. There is no bond inventory conflict of interest
 2. Compensation is not based on a commission from the bond issuer or brokerage firm, thus avoiding any conflict of interest
- The professional bond manager is typically able to squeeze the bid/ask spread on purchases to 0.25% vs. the 1-3% spread at the retail brokerage level.
- Bonds are purchased with much lower “mark ups” (expenses buried in the bid/ask spread), thus positioning the investor to potentially achieve a higher rate of return.
- Unlike most investors and brokers who buy and sell bonds without looking back, the professional bond manager analyzes each client's mutual fund or individual bond portfolio daily.
- In most cases, a diversified national portfolio of bonds that can provide the optimum rate of return, net after taxes, is preferred.
- Regardless of whether the client has a high quality ladder portfolio or an active managed portfolio, in all cases portfolios are reviewed and analyzed for credit quality, call issues, etc.

CASE STUDY:

We recently “put out for analysis and bid” a potential client's muni bond portfolio, which was spread across three different brokerage firms. The client had the bonds at three different firms under the assumption that this was lowering their risk. The old adage “don't put all your eggs in one basket” sounds good, but if implemented poorly doesn't always work.

Analysis

- Three of the bonds were suffering from known financial difficulties.
- One bond was in default!
- Too many “small lot” bond purchases that resulted in high cost at time of purchase.
- Little ongoing portfolio review taking place by any of the three brokers.
- Each broker does not know what bonds the other brokers have sold the client.
- Many similar maturity dates across the three portfolios, resulting in too high a cost structure for the lack of diversification taking place.

- Almost 50% of the entire portfolio was invested in lower quality bonds.
- Too much risk for the reward being delivered.
- Too much focus on Kansas bonds.
- Too many bonds (15%) callable on a short-term basis.

SUGGESTIONS TO CLIENT:

- Hire one professional manager (lower cost/unbiased) vs. retail broker approach (higher cost/biased).
- Move to larger issues and shorten maturities.
- Increase quality and diversify nationally.

SUMMARY:

- Things are not always as they seem in the investment business.
- Be aware of the pitfalls that exist when buying individual bonds on your own or from a traditional stock brokerage firm.
- If you own individual bonds right now, consider having TRPG retain a professional bond manager to analyze your portfolio and provide an analysis.