The Hidden Costs of Retail Purchases in Municipal Bonds

Executive Summary

– Despite recent innovations providing greater access to bond markets, the tax-exempt municipal bond investor base is still dominated by retail buyers.

– Independent research on retail transactions has shown an average loss in income of 0.55%. \(^1\) In a low-rate environment, this number reflects a substantial potential disadvantage to retail bond buying.

– These costs could potentially be avoided by accessing bonds through mutual funds or ETFs. ETFs have a distinct advantage in that shares of the fund can be exchanged without the need to incur any transactions in the institutional market.

– In a low-yield environment, retail transaction costs can be a significant cause of erosion of potential returns.

\(^1\) Based on MSRB data from Jan. 1, 2020, through Sept. 30, 2020.
Hidden Risks

Owning individual bonds has its risks and rewards. However, buying a bond may also entail an unseen transaction cost that might not always be clear to purchasers. This transaction cost exists because individual bonds are not typically sold with a commission. Instead, a markup is built into the bond price.

This report offers a transparent look at these hidden transaction costs for U.S. municipal bonds. To determine these costs, we used large, recently issued investment-grade bonds tracked by the S&P National AMT-Free Municipal Bond Index and the S&P AMT-Free Municipal Index Series, and high-yield municipal bonds tracked by the S&P Municipal Bond High Yield Index, in conjunction with bond transaction data provided by the Municipal Securities Rulemaking Board (MSRB). This information can help market participants compare the cost of buying individual bonds to the cost of investing in bond alternatives, such as mutual funds and ETFs.

From Jan. 1, 2020, through Sept. 30, 2020, the average implied transaction cost of buying an individual municipal bond of investment-grade quality was 0.72% for retail buyers, compared with the average implied transaction cost of 0.17% for institutional trades. With yields on investment-grade municipal bonds averaging less than 2% during this timeframe, the difference in trade costs was 0.55%.

Exhibit 1: Transaction Costs Based on Trade Size

Source: MSRB. Data from Jan. 1, 2020, to Sept. 30, 2020. Municipal bond effective spreads are computed daily for each bond as the difference between the average (volume-weighted) dealer-to-customer buy price and the average (volume-weighted) dealer-to-customer sell price. Chart is provided for illustrative purposes.
Trade Data as Illustrations

Some examples of actual trades occurring on the same day illustrate the challenge for individual market participants with respect to the cost of trades. Selecting large, recently issued bonds from both the S&P National AMT-Free Municipal Bond Index and the S&P Municipal Bond High Yield Index, Exhibits 2 and 3 depict the large variances between yields based on the different trading costs incurred by retail transactions versus institutional transactions. During periods of market volatility, these variances become even more significant. During the market disruptions that started in March 2020, the differences in costs between retail and institutional transactions for investment-grade bonds nearly tripled in size from the typical ranges. For high-yield bonds, transaction costs remained elevated throughout the period, with minimal transactions taking place during the March disruption.

Exhibit 2: Transaction Costs of Investment-Grade Municipal Bonds (CUSIP 64990FPV0) Same-Day Yields for Retail Trades versus Institutional Trades

Source: MSRB. Data from Jan. 1, 2020, to Sept. 30, 2020. Retail transactions are categorized as customer-to-customer transactions taking place on the same day and in sizes less than USD 100,000 and are represented with blue text; institutional transactions are dealer-to-dealer transactions taking place on the same day with no minimum size and are represented with purple text. Chart is provided for illustrative purposes.
What Are the Implications?

Individual bond transactions may not always be efficient when compared with buying or selling mutual funds or ETFs, for which there may be lower—or no—transaction costs. The structural benefits of ETFs allow for shares to be exchanged, thereby eliminating the need for any transaction costs.

With yields remaining low, these costs could be significant causes of erosion in actual returns (see Exhibit 4). These costs could become even more of an erosion of actual returns if the buyer sells the bond prior to maturity.
Exhibit 4: Illustration of Yield Erosion Due to Trade Costs for Investment-Grade Municipal Bonds

Exhibit 5: Actual Income Stream on USD 100,000 Investment over 10 Years

Source: S&P Dow Jones Indices LLC. Data as of September 2020. Chart is provided for illustrative purposes.

How Is This Cost Calculated?

– Daily trade data provided by the MSRB is used to generate the transaction cost data.

– To measure dealer transaction costs, only dealer-to-dealer trades of the same bond during a single trading day are used. There is no trade par size minimum or maximum used for the dealer transaction cost calculations.

– To qualify for the retail trade analysis, a bond that is a constituent of the previously mentioned indices must have at least one retail customer buy transaction and one retail customer sell transaction on the same trading day. Only trades of USD 100,000 face value or less are included in the retail trade analysis.

– In the event that multiple buy or sell transactions are made to or from retail customers on the same day, the weighted average price by trade face value is used in the calculation of the transaction cost.

Conclusion

Bond markets have continued to evolve to provide solutions for individual investors. These solutions include greater insight into the market to understand and unlock yield. Municipal bond markets have slowly moved to benefit individual investors, but as we have illustrated, there are potential disadvantages when buying and selling individual bonds.
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