

# The Hidden Costs of Retail Purchases in Municipal Bonds

## Contributor

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## 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%. In a low-rate environment, this presents a substantial disadvantage to retail bond buying.
- Retail investors can avoid these punitive charges by buying 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.

## INDIVIDUAL INVESTORS ARE AT A DISADVANTAGE

Owning individual bonds has its risks and rewards. However, buying a bond entails an unseen transaction cost, which may not always be clear to retail investors. This transaction cost exists because 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.

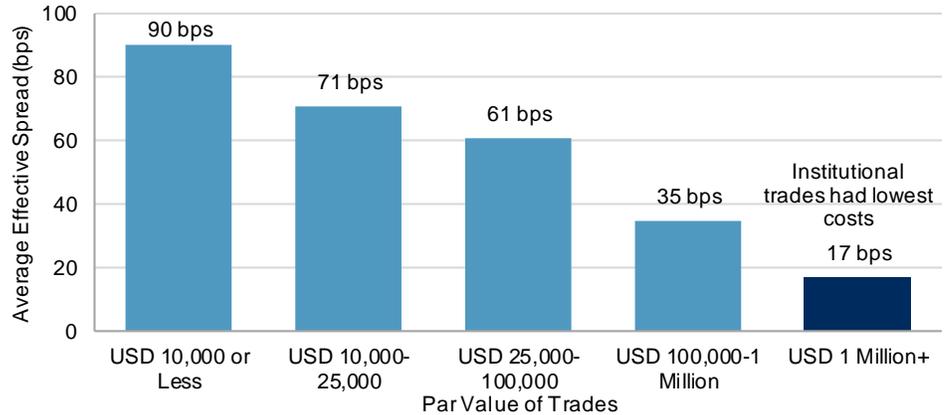
From Jan. 1, 2020, through Sept. 30, 2020, the average implied transaction cost of buying an individual municipal bond of investment-grade quality was 0.72% for retail investors, compared with the average implied transaction cost of 0.17% for institutional trades. With yields on investment-grade municipal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

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*The differences in costs between retail and institutional transactions for investment-grade bonds nearly tripled in size from the typical ranges.*

**Exhibit 1: Transaction Costs Based on Trade Size**

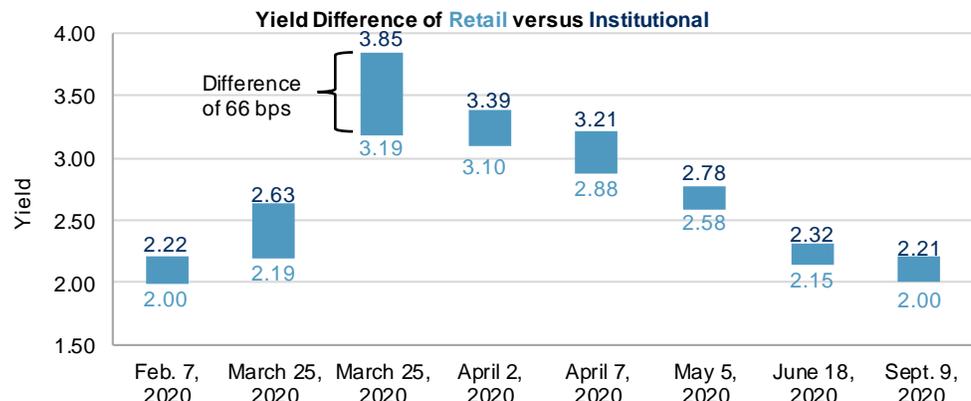


Source: MSRB. Data from Jan. 1, 2020 to Sept. 30, 2020. Municipal bond effective spreads are computed daily for each bond as the difference between the average (volume-weighted) dealer-to-customer buy price and the average (volume-weighted) dealer-to-customer sell price. Chart is provided for illustrative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

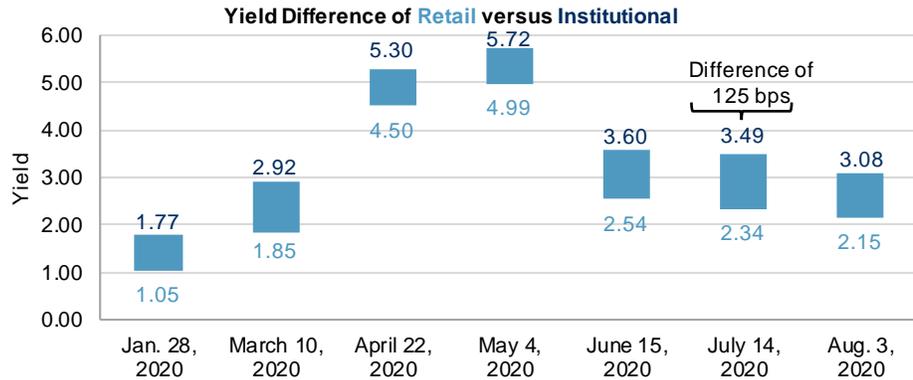
**Exhibit 2: Transaction Costs of Investment-Grade Municipal Bonds (CUSIP 64990FPV0) Same-Day Yields for Retail Trades versus Institutional Trades**



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 light blue text; institutional transactions are dealer-to-dealer transactions taking place on the same day with no minimum size and are represented with navy text. Chart is provided for illustrative purposes.

**Exhibit 3: Transaction Costs of High-Yield Municipal Bonds (CUSIP 592250AN4)**

*Transaction costs remained elevated for high-yield bonds, with minimal transactions taking place during the March disruption.*



Source: MSRB. Data from January 2020 to September 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 light blue text; institutional transactions are dealer-to-dealer transactions taking place on the same day with no minimum size and are represented with navy text. Chart is provided for illustrative purposes.

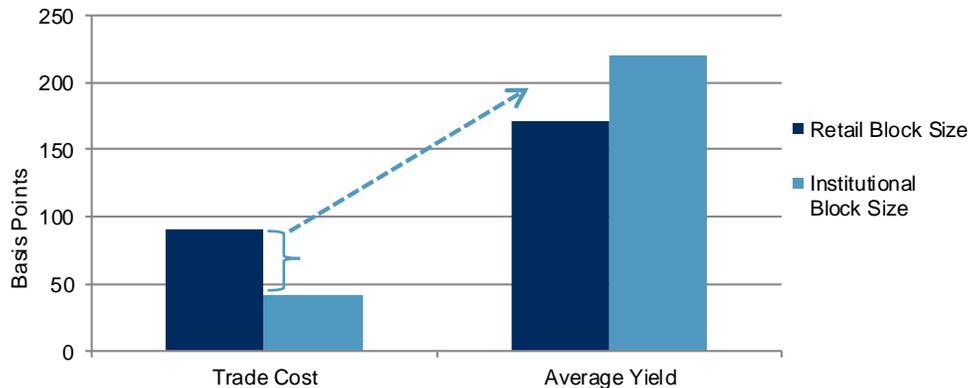
*The structural benefits of ETFs allow for shares to be exchanged.*

**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.

*With yields remaining low, transaction costs could be significant causes of erosion in actual returns.*

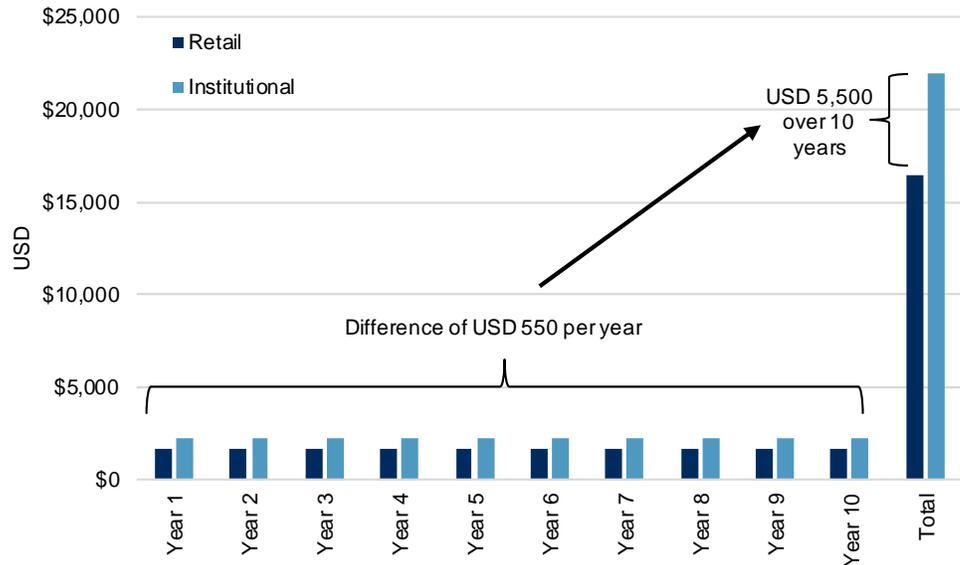
**Exhibit 4: Illustration of Yield Erosion Due to Trade Costs for Investment-Grade Municipal Bonds**



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

Furthermore, while this difference in trade cost occurs at the time of purchase, the impact persists throughout the life of the investment. Exhibit 5 shows the annual and total impact on the income stream that an individual would forgo by incurring an additional transaction cost of 55 bps at the time of investment.

**Exhibit 5: Illustration of Income Stream on USD 100,000 Investment over 10 Years**



Source: S&P Dow Jones Indices LLC. Chart is provided for illustrative purposes.

*While this difference in trade cost occurs at the time of purchase, the impact persists throughout the life of the investment.*

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

*Municipal bond markets have slowly moved to benefit individual investors, but there remains a distinct disadvantage when buying and selling individual bonds.*

**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 there remains a distinct disadvantage when buying and selling individual bonds. Transaction costs show a significant gap between retail and institutional investors. This translates into significant yield disadvantages that could deprive retail investors of potential income through the life of their investment.

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