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Access for Investors: Retail Muni Pricing as Opposed to Institutional Bond Management

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An investor who has an account at a brokerage firm is at a severe disadvantage in the Muni market.

The Problem: The Retail Muni Pricing Model

The investor is a "captive account" for this firm. This means the client can only buy or sell the bonds that this firm offers him/her. The retail Muni trader is fully aware of this situation and uses hidden markups to incentivize his brokers to sell his inventory which generate profits for his trading account and his firm. Studies have shown these markups can be significant and will be influenced by such factors as maturity, quality, and block size. This creates an inherent conflict of interest between the broker who wants to maximize his commission on the trade and the client who should want to purchase the securities at the best possible price. The Municipal Securities Rulemaking Board (MSRB) created a website for investors so they could see how much the dealer marked up the bonds they bought. This was designed to increase transparency in the Muni market. However, wide bid/ask spreads and markups have continued to be the norm in the Muni market for retail clients.

MSRB Rule Changes and the Muni Market

A research paper entitled "Secondary Trading Costs in the Municipal Bond Market" by Lawrence Harris and Michael S. Piwowar was first published May 16, 2006. This paper discussed the high transaction costs for retail accounts for Muni bonds which averaged more than 2.0% per transaction. For example, the purchase of a $50,000 block of bonds would have markups of about $1,000. The paper concluded that these costs were significantly higher than similar-sized equity trades which might have costs of $5.00 to $25.00. Since this paper was published Mr. Piwowar had become the acting head of the SEC for the first part of last year until Jay Clayton took over. It should be no surprise that Mr. Piwowar supports lower transaction costs for purchases of Muni bonds by retail investors and has had significant influence in this regard at the SEC.

In response to pressures from the SEC, the Municipal Securities Rulemaking Board (MSRB) has initiated a new rule (G-15) which just went into effect in May 2018. This rule is called the "markup disclosure rule" and is designed to make retail transactions in the Muni market more transparent. This rule requires brokerage firms to disclose the mark-up or mark-down on purchases/sales of corporate, agency and municipal bonds by retail investors. These markups

above the prevailing market price of the bonds will be shown on confirms received by investors. Confirms also have a link to the MSRB site which shows the trade activity in the bonds which were just purchased or sold. The transparency caused by this rule will make it less attractive for brokers whose practices depend on large commissions for bond trades and will make fee-based models using Separate Account Managers more attractive for them going forward. It has become much more difficult for brokers to explain the markups in the bonds they sell, but even with increased transparency retail investors are still at a disadvantage to institutional investors. The client can say no to the transaction but is unable to put the dealer in a competitive situation to force a better price.

5 Trends in the Muni Market that Benefit Professional Bond Managers

1. **Scarcity:** Changes in the profitability of trading Munis caused by increased MSRB transparency requirements have had an impact on the amount of Muni bonds held in broker-dealer inventories for sale to investors. These inventories have fallen by about 65% during the last 10 years. The supply of new issues is also down due to changes in the tax laws which eliminate the use of tax-free bonds for refunding outstanding issues. This has reduced the new issue supply of Munis by about 20%-25%. This is making it more difficult for retail investors to find Munis at attractive levels. Access to bonds has become increasingly important. The best way to buy Munis is to purchase cheap negotiated new issues from the dealer who is bringing the deal to market. Investors who are retail clients do not have access to new issues from other dealers. They are limited to the inventory of the firm that holds their securities. Custodians such as Schwab, Fidelity, Vanguard, and TD Ameritrade are typically not underwriters of Muni bonds, so their clients do not have very good access to Muni product. They are limited to doing searches through the electronic feeds to these firms from other dealers.
2. **Credit Concerns:** During the financial crisis bonds which had been AAA-rated because they were guaranteed by an insurer or a bank were downgraded to much lower ratings. Insured bonds used to make up about 60% of the Muni market. Now insured bonds only account for about 5%-8% of the market and the maximum rating for an insurer is AA-rated. Investors know they can no longer rely on insurance to protect their bond portfolios. In addition, investors are now more aware of the problem of unfunded pension liabilities and other potential credit pitfalls. Credit analysis has become increasingly important for security selection and monitoring portfolios. This is best done by a market professional.

3. **Transaction Costs and Access to Bonds:** A retail Muni investor is a captive account for a brokerage firm. This means they can only buy and sell bonds with the dealer who has their account. They are not able to get competitive pricing which means they pay retail prices for their bonds. A professional investor is able to buy bonds at wholesale prices which lowers the transaction costs for the client. A Separate Account Manager also has access to cheaper negotiated Muni issues that other dealers are doing. The retail investor does not have access to these loans. High transaction costs are a drag on portfolio performance.
4. **Conflict of Interest:** The retail investor who buys and sells bonds through his broker-dealer is self-managing his/her own portfolio. Their salesperson is not a fiduciary and their interests are not aligned with the client's interests. For example, the dealer makes more money if the markup is bigger. However, it is the investor's interest to get the cheapest possible price. This conflict of interest is avoided with use of a Separate Account Manager.
5. **Disciplined Investment Process:** Most retail investors are yield focused and do not have a research-based process for managing their portfolio. These investors do not understand the different types of risk their portfolio is subject to. These risks include market or interest rate risk (duration), credit risk, and reinvestment risk. A professional bond manager knows how to structure a portfolio to get better results and has tools to help measure these different kinds of risk. Retail investors also do not typically have the knowledge to understand relative value as well as a professional, because they don't understand how to value optionality, coupon structure, duration, yield curve dynamics, or convexity. They also don't have the tools a bond professional has. These are tools such as a Bloomberg terminal, access to credit research, and the ability to compare returns to a benchmark index through the use of a portfolio accounting system.

The recent changes in MSRB disclosure requirements are designed to help retail investors lower their transaction costs. However, it confirms the fact they have been paying too much for their bond transactions and are at a disadvantage in the marketplace. The combination of this change as well as the factors mentioned above will likely continue the existing trend of working with a professional Separate Account Manager instead of working with a broker-dealer.

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