Why Bonds Are Not For Retail

Fed Chairman Bernanke’s press conference on Wednesday was more interesting than usual. The decision not to “taper” (never a word the Fed has actually used) caught market participants by surprise. The Fed will continue to buy $85 billion of bonds every month until further notice. Perhaps the low interest rate bias of the presumptive Chairman Janet Yellen colored the debate. Those FOMC members keen to begin the Fed’s exit strategy might reasonably have felt it poor timing to taper when in just a few months Chairman Yellen might have to defend a policy moderation with which she did not agree.

Perhaps even more striking was the answer Bernanke gave to a question on when the Fed might reach its equilibrium interest rate of 4%. The FOMC publishes its members’ rate forecasts and from those you can derive what they think the yield curve out to about five years should look like. Bernanke noted that the consensus among members was that rates would be at around 2% at the end of 2016. He then added that it might take a few more years for rates to reach the Fed’s neutral rate of 4%. It was a quite extraordinary assertion, and even though Bernanke will not be around at the Fed for much longer, he bluntly told bond investors that it’ll be many years yet until yields are freed of government distortion and allowed to properly compensate investors for the risks of inflation and the costs of taxes. Holding bonds at current yields is unlikely to leave you better off in real terms than you are today.

Many large asset managers and brokerage firms have an enormous stake in seeing retail investors continue to plow their savings into this return-less asset class. Bond pricing is far more opaque than for equities. There’s no ticker tape that shows where a bond just traded. The typical individual investor buying a municipal or corporate bond is doing so through a broker with limited information about where the wholesale price is. In fact the inefficiencies of the municipal bond market are well known. In July 2012 the SEC issued its *Report on the Municipal Securities Market* and provided strong criticism both of the disclosure practices of issuers as well as the market structure itself. They described pricing to investors as “opaque”, noted the general unavailability of firm bid/ask quotes, and pointed out that price transparency available to the brokers was not similarly available to the clients.

Bond brokers like it this way because uninformed clients are more profitable for them. For many years the tailwind of the secular bull market in bonds has deflected attention from transaction costs incurred by retail investors that are far too high.

The end of falling rates and eventually the beginning of rising rates should cause retail buyers of individual bonds to take a much closer look at how much profit their broker is making from their business. The SEC’s report found transaction costs of up to 2% were common for retail investors. Brokers don’t have to disclose their profit on a trade if they acted as principal, which conveniently is often the case. If clients had to write a separate check for such amounts they would no doubt be shocked into demanding far greater transparency.

Meanwhile, the challenge is on for new and more creative ways to convince clients that they should maintain a significant allocation of their portfolios in fixed income, in the face of a Fed that intends to drive all the yield-based return out of bonds and a market structure that provides a good living to brokers who have access to much better price information than their clients.

In recent weeks, I’ve heard one firm argue that bonds have never delivered a negative return over any two year holding period over the past thirty years; this ignores the current very low level of yields from which the next two year holding period begins. Another firm acknowledged the poor return prospects in bonds but claimed they were still needed for diversification – in other words, losing money unpredictably is somehow helpful.

Many investors hold "low-risk" investment portfolios which are substantially in fixed income. This includes a friend of mine whose taxable trust yields 1.5%, coincidentally the same as the annual management fee charged by the trust company. While the IRS and the trust company are both benefitting from this arrangement, my friend regrettably is not.

The Fed's interest rate policies of recent years have so far turned out to be far more enlightened than many of their critics assumed. A slow but steady economic recovery has taken hold, and inflation has for now remained low. However, interest rates that are maintained at artificially low levels for an extended period should also spur investors to reconsider the appropriate allocation of their savings to fixed income and the significant drag that transaction costs represent.