Law of Unintended Consequences

Bond Regs Could Hurt Retail Bond Investing

By Michael Ruvo, President & CEO, BondWave

The increased regulation aimed at protecting the retail investor around individual bond investing has contributed to the substantial growth in fixed income packaged product adoption by advisors and could ultimately hurt the retail investor's access to individual bonds.

Fixed income investments often play a vital role in a well-diversified portfolio. Defensive in nature, they provide stability, income and diversification to other asset classes such as equites and real estate. While the importance of fixed income is rarely disputed, the ways in which an investor can access and implement a fixed income allocation is evolving. As the fixed income market continues to evolve and innovate, investors have many choices to consider such as individual bonds and packaged products like ETFs and mutual funds.

The complexity of fixed income investing and the fragmented market structure has traditionally left many advisors scratching their heads when identifying offerings for their clients. Notoriously opaque, advisors have utilized individual bonds, bond mutual funds and bond exchange traded funds (ETFs) with little consistency when it comes to fixed income allocation and portfolio construction.[1] This lack of consistency stems from many issues, such as limited fixed income education, the perception of product complexity and challenging client communication. Retail investors' use of individual bonds is already low. Direct household participation in the bond market has fallen to 1.3% in 2016, albeit from a relatively low level of 5% in 1989.[2]

Bond investing for many advisors is difficult to achieve successfully and the onslaught of new regulation like the Best Execution rules (MSRB Rule G-18 & FINRA Rule 5310), the Mark-up Disclosure Regulations, and the Department of Labor Fiduciary Rule leave many confused on the best steps to take with their fixed income allocations. While providing several benefits to retail investors like increased price transparency and, in some cases, lower fees, an unintended consequence of these new regulations could also severely limit access to this critical asset class for retail investors.

bondwave

Imagine that

[1] Cerulli Associates, *Bond ETFS: Financial Advisors Drive Use With Specialized Applications*
[2] MarketWatch, *What Types of Financial Assets Do People Hold?*

120 E. Liberty Drive, Suite 400 | Wheaton, IL 60187 | 877.795.2929 | 630.517.7000

Law of Unintended Consequences
Bond Regs Could Hurt Retail Bond Investing

Rise of Fixed Income ETFs

To satisfy investor demands and remain compliant with the new regulations, advisors have looked to ETFs and other index-based products as the new building blocks for portfolio construction. According to the 2017 Trends in Investing Survey by the Financial Planning Association, 88 percent of advisors either use or recommend the use of ETFs. The report goes on to state that almost half (49 percent) of advisors cite lower costs as the biggest advantage of ETFs, followed by tax efficiency (23 percent) and trading flexibility (14 percent).[3]

Looking specifically at fixed income ETFs, a recent iShares report notes that U.S. bond ETF assets have grown from $20.5 billion in 2006 to approximately $447 billion as of year-end 2016.[4] The report goes on to state that 87 percent of advisors currently use bond ETFs and half plan to increase their use in the next three years.

The trend in bond ETF adoption by advisors is tangible but is it always in the client's best interest, as the DOL rule mandates for retirement accounts?

So, what do you choose…?

Comparison: Individual Bonds, Mutual Funds & ETFs

There is no simple answer as investors' needs and scenarios vary widely. However, for some investors, a fee comparison raises questions about the appropriateness of bond funds or even ETFs. According to Morningstar, even in the most tax efficient pooled products, you are most likely to get a capital gains distribution in a bond ETF.[5]

Mutual funds present a different set of issues. They are generally less tax efficient than ETFs because all share creation and share redemption activity is done in cash. This means the funds need to buy and sell securities within the fund to handle the ins and outs. Most ETFs create and redeem shares on an in-kind basis so that the securities are sold outside of the fund. The in-kind process is less available for fixed income ETFs because of security supply constraints with respect to specific fixed income securities so they often do cash creations and redemptions which reduce tax efficiency.

Low-cost bond funds usually have management fees ranging from 0.3% to 0.6% per year, or lower. Generally speaking, you may be able to construct a ladder of individual bonds—that is, multiple bonds with different maturity dates—with a transaction fee at or below that of a bond fund. It is important to note that the fee for individual bonds is typically a one-time fee whereas bond ETFs and mutual funds accrue their fees on a daily basis. So, the length of holding periods become a critical component of the

[3] CNBC, *Exchange-traded funds are the go-to investment choice of advisors: Survey*
[4] Cerulli Associates, *Bond ETFS: Financial Advisors Drive Use With Specialized Applications*
[5] Morningstar, *Which ETFs Are Making Capital Gains Distributions This Year?*

120 E. Liberty Drive, Suite 400 | Wheaton, IL 60187 | 877.795.2929 | 630.517.7000

overall cost. Since bonds are typically held to maturity, holding periods tend to be long. However, bond fund managers can often purchase bonds in larger blocks with more attractive pricing (known as bid/ask spreads) than an individual investor. For proper diversification and efficiency, you'll generally want a minimum investment amount of $100,000 for a corporate or uninsured municipal bond portfolio ($10,000 per bond).[6]

Holistic View of Investing

The choice of utilizing a bond fund or individual bonds ultimately comes down to the individual investor preferences and specific investment goals; however, advisors need to proactively look to innovation and not rely on regulation to drive their clients' investment decisions.

With the advancement of fixed income technology solutions, the level of transparency, data insights and market intelligence will continue to evolve. Bond market professionals will have access to more advanced tools that enable them to efficiently manage and grow their businesses.

Increased access to better technology and more data, coupled with the growing need among market participants for greater efficiencies, should propel the growth of bond volumes based on a greater ease of use, higher degree of investor confidence, and much more intuitive tools. These capabilities will lead to not only greater efficiency, but also broader adoption of individual bond investments among advisors and investors. For this to happen, it is vital that regulation designed to protect the individual investor does not ultimately limit access to this critical asset class.

[6] Charles Schwab, *Investing in Bonds: Should You Choose Individual Bonds or Bond Funds?*

To learn more, please contact us at info@bondwave.com or by calling 630.517.7017

120 E. Liberty Drive, Suite 400 | Wheaton, IL 60187 | 877.795.2929 | 630.517.7000