



“ Safe Money Report ”

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Eight Things Your Broker May Not Tell You About Bonds

1. What you are *really* paying to buy the bond.

Bonds are red-hot. Moderate growth, scant inflation and lingering concerns about Asia's economic woes are luring more and more people to fixed-income investments. Besides, they're so much more civilized than those nasty stocks, right?

Don't believe it. For one thing, bond brokers don't have to reveal their "markups," the commission-like profits they charge you. In a typical transaction (known as a "principal" trade), a broker buys a bond at one price and sells it to you at a higher one, pocketing the difference. When brokers buy bonds from you, they do the opposite, charging a "markdown." Because most bonds do not trade on an exchange, investors have little way of knowing what the prevailing market prices are without shopping around.

According to research by InterVest, institutions such as banks and insurance companies paid in excess of \$41 billion more than they should have on corporate bond markups between 1995 and 1997. And individuals are even more vulnerable, as any bond purchase under \$1 million is considered an "odd lot" and subject to a higher markup.

The National Association of Securities Dealers requires only that markups be "fair." That leaves brokers elbow room to push the envelope. While most don't, plenty do. One Florida firm, Noble International Investments, charged customers excessive markups -- as high as 90% -- on foreign

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corporate bonds in 1995. The NASD fined the firm \$5,000 and ordered it to pay \$24,167 in restitution. (Noble's president, Nick Pronk, calls the violation "an isolated incident.")

The Securities and Exchange Commission and the NASD have been passing reform proposals back and forth for four years. For investors unwilling to hold their breath for a resolution, the best way to avoid markups is to bypass brokers altogether. The government sells Treasury notes and bonds commission-free through its Treasury Direct program. Call your local Federal Reserve branch, or the Bureau of Public Debt¹ at 202-874-4000 (www.publicdebt.treas.gov on the Internet). You can also buy bonds through a so-called agency trade, in which your broker connects you with a seller and charges you a set commission, typically \$50.

2. "I get paid to dump my inventory into your account."

Excessive commissions are only the beginning. Investors also need to watch out for the incentives brokers may be given to sell you one bond over another.

Brokerages, through their bond desks, routinely buy bonds in huge chunks from the government, companies and municipalities. The firms hold them as "inventory," later trading them on the market or selling them to clients. Sometimes, even if they can get clients a better price in the open market, brokers will push a bond from their inventory because they can make more on the markups that way.

You have to ask if the bond is being recommended on its own merits or because the brokerage house owns it. Also, ask your broker if there are any incentives tied to his recommendations. "If they lie, it's fraud," says Steve Wallman, a senior fellow at the Brookings Institute and a former SEC commissioner.

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3. "Your long-term investment may be short-lived."

Despite their appeal as a safe haven from the vagaries of stocks, bonds have their own added risk. When interest rates plunge, as they have for a year, many bonds can be "called" by their issuer -- that is, they are paid off before their maturity date. Now that a full-fledged refinancing boom is under way, and companies, homeowners and municipalities are repaying higher-cost debt and taking out new loans at lower rates, that's exactly what's happening.

This is bad news for bondholders. When a bond is called, you're repaid at the issue price -- "par" -- or par plus a small premium. You face a loss if you bought the bond above its face price, or a loss of any gains if the bond rose after you bought it. Also, since interest rates are falling, you'll have to reinvest at a lower yield. Be especially wary of high-yield, or "junk," bonds since companies try to pay down their high-interest debt as soon as they can. Since mortgage-backed bonds can be called at any time, investors should check the interest rates on the mortgages in the bond's portfolio.

4. "You don't need this government bond fund I'm selling you."

It's true that funds may well be a safer way to go when investing in corporate, muni, or mortgage-backed bonds, but when it comes to Treasuries and certain other government bonds, they're probably a waste of your money.

"With government bond funds, there's no credit risk, so what is the fund manager doing? He's making guesses on interest rates that are more often than not incorrect -- and you're paying through the nose for his advice. To wit: Four of the five biggest general government bond funds with a maturity between five and 10 years each charges a 4.75% load, on top of expenses and 12b-1 marketing fees -- and each failed to beat the returns of a five-year Treasury during the past

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three, five and 10 years ended Jan. 31. **Fidelity Government Securities (FGOVX²)**, the one that beat the five-year bond's returns, has no load, no 12b-1 fee and the lowest expenses of all five. Coincidence? You decide.

5. "Warning: This 'low risk' bond fund can be hazardous to your wealth."

Besides being expensive, government bond funds are not as safe as they sound. They tend to load up on mortgage-backed bonds such as Ginnie Maes to increase their yields. While these bonds are backed by the government, they add another, more volatile dimension of sensitivity to changes in interest rates.

That's when nightmares can happen. In 1994 the Piper Jaffray Institutional Government Income Portfolio plunged in value after a surge in interest rates hammered the fund's huge holdings in mortgage derivatives. Minneapolis-based Piper paid a reported \$138 million to settle claims that it misled investors about the fund's risks. The company declined to comment. In 1996 NationsBank spent about \$30 million to settle investors' claims that they were misled about the risks of two of the bank's funds, which were also hurt by mortgage derivatives. NationsBank blames "a unique market situation when interest rates rose at an unprecedented rate" in 1994.

With fund managers under the gun to beat their peers and the market, some may pursue riskier investments. That means investors need to scour prospectuses. The SEC requires only that funds invest at least 65% of their assets in their objective. **Strong Government Securities (STVSX³)**, for example, had 14.5% of its assets in corporate bonds at the end of January. It highlights the indisputable fact that you need to know exactly what you owe.

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6. "Your tax-free municipal bonds may be taxable..

The days when municipal-bond holders could expect virtual immunity from the IRS are over. The agency can now tax muni investors when it finds that the bonds don't comply with tax laws and it can't reach a settlement with the issuer.

In February the U.S. Supreme Court let stand a ruling in favor of a 1990-91 IRS audit that found the 1985 bond offering's proceeds had been misappropriated. When the housing authority refused to pay \$3.71 million in taxes, the IRS sent a notice to the Riverside muni holders, telling them they had to pick up the bill. One of the starkest implications of the ruling is that bondholders can be held liable for the actions of the issuer or underwriter after the bonds are sold,

More and more muni holders may find their investment backfiring as the IRS steps up its investigation into the effects on tax compliance of "yield burning" -- the controversial practice of inflating muni offering prices by driving down bonds' yields. The agency is studying about 265 municipal issues, and has told more than 100 issuers that their bonds may be taxable.

It's no longer true that virtually all muni bonds issued are or will remain tax-exempt. As a result, investors now need to pay closer attention to the reputation and financial background of issuers and underwriters.

7. "...and, um, so may your tax-free muni funds."

Some municipal-bond funds invest in so-called private-activity bonds, which are often used to help fund the building of airports and stadiums. Unbeknownst to many investors (and some brokers), those bonds pay income that is subject to the alternative minimum tax⁴ (AMT), which

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was designed to prevent taxpayers from taking advantage of deductions and other breaks to pay little or no federal income tax.

Some examples: 82% of the interest paid by **Alliance's Municipal Income Fund National Portfolio** (ALTHX⁵) is taxable as AMT. Income from the Schwab Municipal Money fund and Schwab Florida Municipal Cash Trust is roughly 42% to 46% taxable, respectively, as AMT. (Snapshots are not available for these funds.) Interest payments from muni funds that own private-activity bonds can push the investor's income to a level where he or she at least has to file an AMT form and possibly has to pay the tax itself.

While the alternative minimum tax may not inspire much dread in you now, that could soon change. Congress estimates that as many as 8.5 million people will have to pay the AMT by 2007, up from just 605,000 in 1996.

8. "Your high-yield fund is full of foreign junk."

In the post-Michael Milken era, junk bonds enjoy a rehabilitated image. The makeover was made possible by their stellar returns and declining default rate. Merrill Lynch's High-Yield index has been up an average of 12.1% per year during the past 10 years, compared with 30-year Treasury bonds' 9.7% annual return. Meantime, default rates worldwide ran under 2% during the past few years, far below their 3.4% average since 1970, according to Moody's.

Hungry for high yield and confident that corporate America's balance sheets are stronger than ever, investors have never been bigger junk-bond junkies. Today a record \$109.4 billion is invested in junk-bond funds, more than triple the Milken-era peak in June 1989. Junk bonds are being issued at a pace that's set to smash last year's record, according to research firm Securities Data.

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So what's the problem? High-yield mutual funds are loading up on riskier foreign junk bonds, particularly those from emerging markets -- making up as much as 15% of assets, according to Mark Wright, a senior analyst at Morningstar. And some funds own huge amounts of junk-rated debt issued by emerging-market governments. This debt is all the more risky because of currency fluctuations. One reason for the migration is that junk yields in the U.S. aren't as juicy as they used to be because balance sheets and the economy are stronger. That's got some managers, frustrated by not getting more for the amount of risk they take on, shopping abroad. With continuing economic trouble in Asia expected to push global default rates toward 2.5% this year -- and with emerging markets at a much higher risk -- junk could get more turbulent.

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