

How to Buy Individual Bonds: A Fixed-Income Toolkit

by Hildy Richelson, Stan Richelson



Once you've learned about bond basics and reviewed the vast number of bond choices, you're ready to make decisions on how to invest your funds in bonds. Basically, you have two choices: You can purchase individual bonds, or buy them packaged together as funds. Both choices offer certain advantages.

The most compelling reason to buy individual bonds is that bonds come due at a defined time. Unlike bond mutual funds of any kind, individual bonds pay their face value in cash at maturity.

Need a large chunk of cash for a tuition payment on the 15th of December 10 years from now? Buy a bond that matures on December 1, 2017.

Planning to retire? Buy a continuing series of bonds that come due when needed. The list is almost endless.

When you purchase individual bonds, you get to select the specific characteristics of the bonds that you wish to own.

The question, of course, is how to buy them?

You can purchase Treasury debt and U.S. savings bonds directly from the TreasuryDirect Web site, or from many commercial banks. Or you can check out sources of information on the Internet for municipal and corporate bonds before talking to brokers.

This article gives you guidelines for evaluating Web sites and for locating a bond broker.

Buying On-Line

The federal government offers the only unfettered bond-purchasing avenue open to you as an individual investor. Created in August 1986 by the U.S. Bureau of the Public Debt, TreasuryDirect (www.treasurydirect.gov) is a book-entry securities system that allows you to maintain accounts directly with the U.S. Treasury. This system lets you purchase all newly issued Treasury bills, notes, and bonds at auction without paying a commission. Also available at TreasuryDirect are EE and I savings bonds and TIPS.

With the growing popularity of the Internet, TreasuryDirect has become even more accessible and user-friendly. You can open your TreasuryDirect account on-line by filling in an account form on the spot. When your bonds come due, you can automatically reinvest your principal if you have given written instructions to do so. Interest flows to the account you designate. When you order bonds on-line, cash will be withdrawn from your bank or brokerage account to pay for them. You can also sell your bonds through this account.

With the successful implementation of TreasuryDirect and the advent of day-trading stock buyers, it was widely assumed that buying bonds on-line would also evolve into a simple matter of a single click. As it turns out, that assumption was wrong. Individual retail clients don't have free access to purchase bonds on-line—without a broker, individuals can purchase only new-issue Treasuries. Thus, while the Web allows you to check sites and view bond prices and offerings, in most cases you still have to use a broker to finalize your trade.

Pricing Information

Price transparency in the bond markets gained momentum from the House of Representatives' Bond Price Competition Improvement Act of 1999. Responding to this new law, the site www.investinginbonds.com was established. This site provides current prices on bonds that have traded more than four times the previous day.

Keep in mind that for bonds to do this, there must be quite a large supply of them available. This limits the number of postings because most bonds trade infrequently. The site also allows you to track the history of specific bond issues to see how they performed and how their prices compare to similar securities. The database does not allow you to check for daily price swings in the broad marketplace.

The Municipal Securities Rulemaking Board (MSRB), which was established by Congress in 1976, has stipulated that before making the purchase, bond purchasers have the right to receive “all material” information about a security available to brokerage firms. A material event might be notice of a pending downgrade resulting from economic weakness in a source of revenue that might negatively impact your bonds. This kind of information does not fit into the formats currently used on Web sites dedicated to bond offerings. For example, only a few sites give access to an offering statement.

Although Web sites have become more sophisticated, the problem remains that the obligatory material to be posted on them is not easily understood.

The MSRB further stipulates that brokers must recommend bonds to you that are “suitable” to your needs, and it is still the MSRB’s position that trading in the electronic marketplace be limited to those who can make informed investment decisions without the services of a broker. It is not enough to declare yourself “informed” and say that you’re willing to take on the risks. The Web site needs to verify that you will meet your obligations as its host company defines them: that you understand what you’re buying and are able to pay for the bonds. With each transaction, they must also verify that you chose “suitable” bonds.

“Wait a minute,” some might protest, “It is possible to buy bonds on-line. I just bought some last week.”

Well, yes, you may think you have, but what you actually did was to tell a clearing broker to buy the chosen bonds for you. This is an expensive process because you now have two middlemen instead of one: the broker and the Web site managers.

The Web sites charge fees similar to those of discount brokers. More traditional bond brokers charge only a spread. In addition, the Web sites must verify that you chose suitable bonds; if they’re deemed unsuitable, the trade has to be unwound—somehow.

In the event that the MSRB reverses its position and allows you to trade on-line without dealing with a middleman, you should know that most of the trading sites do not own the bonds that they trade and that the bonds are screened and priced for retail trade.

Individual brokers are beginning to show their inventory on-line, but the only way you will know whether you’re getting a good deal is to shop around. Don’t assume that just because the trading platform you’re using shows bonds from many dealers, you are getting the best buy. Also, the Web sites do not allow you to bid for the bonds at a lower price. That right is reserved for brokers.

Visiting a Web site offering bonds, however, can help you clarify your thinking. Remember, despite what brokers may say, all of them sell bonds to make money. It's your job to figure out how they do it and to decide whether you're okay with their share.

Brokers who charge a flat fee for service are probably also making a "spread," the difference between the current market price and the cost of purchase.

Other brokers charge only a spread, although they sometimes tack on a service charge that is not figured into the yield (remember, bonds are bought and sold on yield). The only way you can know if you're getting a good price is to compare the offerings of a few different brokers, whether you view the bonds on-line or talk to a broker in person.

If you do not see what you want to purchase, your broker might be able to check the "pick list," which is a trading platform dealers use to trade among themselves.

Real-Time Prices

Although sites that post offerings for sale may be helpful with regard to pricing, they may also be quite misleading. The offering levels will not automatically change with the fluctuation of interest rates. Just like the offering sheets that were mailed out weekly, the posted prices of the bonds given on the site might be out of date. When you click to purchase the bond, the bond might not be there anymore, or the price might have changed. The broker might be just testing the waters to see what kinds of offers are made for the bonds.

Even dealers have problems with bond purchases on the Internet. If there is an offering of 100 bonds, and someone sells 50 bonds on the telephone in the office, there are now only 50 bonds left. Before the broker can update the screen, someone else is clicking on the 100-bond offering on-line. The selling broker is now "short 50 bonds." They can either cancel the trade in the office, try to find the bonds somewhere else, or tell the wire service: "I am such an idiot! I have only 50 bonds to sell." Customers and the wire service are not happy when the broker tells them that they have to break the trade. They can do that only so often.

Although you may have access to on-line trading, it is best if you find your bonds on-line but talk to a broker to purchase them. A broker might be able to offer you a discounted price or a better deal on bonds owned by the firm. Particularly attractive deals may never be posted on-line because they can be easily sold, thus, saving the broker the cost of posting the item. Some firms charge extra to talk to a broker. You will have to decide what is in your best interest.

The best on-line databases allow you to set the criteria and limit the number of offerings that pop up. For municipals, for example, you might want to choose a state and a maturity and yield range. The more restrictive your criteria, the fewer offerings you will see.

At www.fidelity.com, you can access screens of all the major bond categories. You can check their offerings even if you are not an account holder there. Go to Research, Fixed Income, and then pick the individual bond type you want to review. Set your criteria, and away you go.

A good on-line service will give you detailed call information, including sinking funds and extraordinary calls. However, no matter how good the Web site, there may be details that you are missing that a broker can tell you.

Choosing a Broker

Although being unable to trade on-line is a disappointment for consumers who are active traders, there are certain comforts in talking to a knowledgeable person about your investments. Not surprisingly, professional traders often find value in talking to one another as well. If they put in a trade electronically, they may follow it up with a phone call to discuss specific issues presented by the purchase. Relationships among brokers are especially important when they need to work out problems with a trade.

Given that the opportunities for unlicensed investors to trade bonds on an Internet exchange are quite limited, it behooves bond buyers to select a broker to do so. "It vexes me to choose another guide," the writer Emily Brontë once wrote. Although it might vex you too, it could translate into extra money and profits if you do it right.

The Right Brokerage Firm

How do you find a good bond brokerage firm? You can check with friends and family to find out if they have a firm they like working with. Ask if the brokerage firm is a member of the Securities Investor Protection Corporation (SIPC). This member-supported insurance company provides limited customer protection in case of bankruptcy, although it does not protect against trading losses. The brokerage firm may also have additional insurance, adding protection above the levels provided by SIPC.

It is probably not a surprise to hear that all brokerage firms are not alike. As in every other field, there are specialists—in this case, those who deal in particular kinds of bonds. While any broker can purchase bonds on your behalf, not all can execute the purchase or sale at the same price. Remember, most bonds trade in an over-the-counter market.

Criteria to Consider

Seek a brokerage firm that trades the kinds of bonds you want to buy and is willing to accommodate your investing style. You need to shop around in order to determine which firm has the kind of inventory you require.

Some brokerage firms make the retail municipal market their specialty, though they may also offer other kinds of securities. They may have a specific regional orientation, specialize in national market bonds, or specialize in lower-quality bonds. Retail firms deal in smaller lots of bonds, and their salespeople are usually quite knowledgeable.

The brokerage firm may tell you that it handles all kinds of securities, but once you see the firm's offerings you will know whether it provides the kinds of bonds you want along with good service and prices. The firm may not be able to offer you new issues if it does not participate in the selling syndicate.

Final steps in a thorough due diligence might be to ask for a description of the broker's typical client and then ask to talk to some of the broker's longer-term clients. The SEC provides a toll-free hotline operated by the Financial Industry Regulatory Authority (FINRA) for a background check of brokers or sales representatives. Call 800-289-9999 or visit their Web site at www.finra.org.

The broker can screen bonds to meet your specifications. If you are in a high-tax state, for example, you may want to see bonds only from that state. You might have a particular maturity or rating in mind. Similarly, you would customize your search on the Web by selecting the criteria that match the kind of bond you seek. The broker will help you think through your options and then will show you the offerings that might match.

Once you've gathered a list of potential candidates, begin thinking in terms of the relationship. A brokerage firm may be outstanding, but it is a flesh-and-blood person with whom you will be dealing. To find a good individual broker, speak to the sales manager and ask for a recommendation. Then ask about the broker's experience with and amount of time allocated to bond trades. That experience is important because, when choosing a broker, you are seeking to establish a mutually profitable, long-term relationship. And because this relationship is founded on money (your principal and their income) it's worth taking some time to make sure it's a solid one.

Using a Stockbroker

Just because you purchase stocks from a particular broker, don't assume that broker is the wisest choice for purchasing your bonds. Many stockbrokers do not know about or have little interest in bonds.

Stock buyers who use discount stockbrokers believe that they can also purchase bonds at a discount from the same source as well. Unfortunately, there are no discount bond brokers. Bond brokers generally act as principal in a sale, which means that they buy the bonds for their own account and then sell them for a profit. Contrast that procedure with the purchase of stock, in which the broker acts as an agent, bringing together the buyer and seller for a disclosed fee, called a commission.

If you're convinced that you want to purchase individual bonds, be wary of any broker who tries to shift you into stocks or who strongly suggests packaged investments like mutual funds, unit investment trusts, and exchange-traded funds. This kind of recommendation indicates that the broker is not really interested in selling bonds, either from a lack of expertise or a belief that bonds don't generate enough money to warrant attention. These instruments do make sense in certain situations (for instance, if you're buying certain securities such as junk bonds, Ginnie Mae mortgage securities, or TIPS for some income as well as inflation protection), but if you are certain you want to purchase individual bonds, you need to find the appropriate broker for those needs.

Evaluating Bond Prices

Trading bonds is not like trading stocks. Stocks can be bought at uniform prices and are traded through exchanges.

Most bonds trade over the counter, and individual brokers price them. For example, since the vast number of municipal bonds trade infrequently, you will probably never find three or more dealers offering the same bonds. This can make it difficult to compare prices, not only for municipals but also for other market sectors.

However, with the advent of Investinginbonds.com and real-time reporting of many trades, investors are well on their way to such transparency. It also helps that Fidelity Investments has chosen to disclose its fee structure for bonds, making it clear what it will cost you per trade. Fidelity charges \$1 to \$4 per bond. Some on-line brokers charge a flat fee, ranging from \$10.95 at Zions Direct to \$45 at TD Ameritrade. Depending on the number of bonds trading, one may be more favorable than another.

The fee disclosures, however, do not reveal the spreads between the buy and sell price embedded in the transaction that some dealer is making in the pipeline. Keep in mind that only by comparison shopping can you find the best deal, after all fees are taken into account. Other sites may not charge any fee, but rather embed their profit in the spread.

Does this take time and energy?

Yes.

Making money takes time. One way to make money is not to spend it. You will have to decide if learning the ropes and doing due diligence is worth your time.

Nature of the Marketplace

The bond market is a dealer-to-dealer market, one in which firms hire traders to deal in specific types of bonds. A brokerage firm might have Treasury, corporate, and municipal bond desks. The desk is a euphemism for a group of traders sitting in a room in front of computer monitors who specialize and trade in a particular portfolio sector of bonds.

The broker, often referred to as the account manager, discusses the bonds with you, and the trader is the person who actually buys and sells the bonds. When the account manager wants to give you a price break, he consults with the trader, who is the one who must agree to it.

When the broker owns the bonds being sold to you, there can be some flexibility in the price, depending on the price the trader paid and the current market direction.

For example, if a broker owns 35 bonds and you want only 25 (\$25,000), he might give you a price break if you bought all 35 instead of leaving him with an odd lot of 10. If the broker owns 25 bonds, they might be sold all or nothing (AON). If you're shown equally interesting bonds from different dealers, one of them might be willing to give you a break on the price. Remember that brokers want to sell you bonds, but they need to make a living, too. They won't work for nothing, no matter how nice a person you are.

If a trade is "done away," meaning that the broker has to purchase the bonds from another brokerage firm, you will pay two spreads in the transaction instead of one. Discount brokerage firms tack on a fee in addition to the spread because they purchase most of their bonds from other firms.

Wholesale Versus Retail

The bond marketplace is divided into wholesale or institutional markets and retail markets. In the wholesale market, corporate, agency, and Treasury bonds trade in million-dollar blocks, with \$100 million blocks not infrequent. Municipal bonds trade in \$100,000 blocks, by comparison.

In an odd twist, bigger is not necessarily better when it comes to buying bonds. In buying small odd lots of an issue, individual buyers often get a better price than institutional traders buying large blocks. That's especially true for municipal bonds.

At the same time, do not assume that you're getting a better deal just because it's an odd lot. Volume discounts do not apply to municipal bonds when you're buying, but if you're selling, size does matter. Larger lots fetch a much better price.

You can do better purchasing off-the-run Treasuries, the older issues that trade less frequently than new-issue Treasuries in the secondary market. That's because newly issued Treasuries are used as trading vehicles because of their large lot size and liquidity. Your best Treasury deal, however, is the new issue, if you can time your purchase with the auction. If your broker charges you a fee, you can always go to TreasuryDirect and purchase your bonds there if it is worth your time and effort.

New-issue municipal bonds may also be well priced because often, though not always, you're getting an institutional price and structure. A bond structure refers to the coupon size (for example, 4% or 5%) and whether the bonds are selling at par or a premium. Institutions prefer premium bonds because they have better trading value. Premium bonds are priced to the worst-call yield, often resulting in a higher yield-to-maturity than discount bonds. Individuals tend to like par bonds selling close to face value because they like to know their semiannual interest payments are just that—all interest—instead of a mix of interest and return of principal. New-issue bonds may also have longer call protection than secondary market offerings.

New-Issue Order and Confirmation Details

When you put in an order to buy bonds of a new issue, which is called an expression of interest, you legally commit to buy the bonds if they're issued as described. Should interest rates rise between your order date and the bond's issue date, you're still expected to accept them. If the bond offering changes in any way, the broker will come back to you to describe the terms of the deal. If you like the new terms, you buy the bonds. If not, you're no longer obligated to purchase them.

Once you've made your bond selection, you'll receive a confirmation in the mail. Although each broker confirmation is slightly different, they all contain the same information. The bond description includes the amount purchased, trade and settlement dates, the unit price, accrued interest, total cost, and whether the bond is callable or not. Treasury bonds settle the next day, whereas corporate and municipal bonds settle three days after the trade, although the broker may be able to arrange for extra days to settlement if you ask. All bond issues are assigned a CUSIP number, the equivalent of

a Social Security number for the bonds. Your account number printed at the top of the slip should be put on your check if the cash is not already in your account.