THE WALL STREET JOURNAL.
WSJ.com

October 23, 2015, 12:12 PM ET

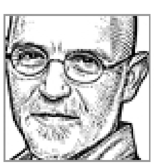
Huh? It Costs How Much to Trade a Bond?

ByJason Zweig

Christophe Vorlet

One reliable way to mint money is to charge customers hefty prices for your services without ever itemizing the bill.

Welcome to the corporate-bond market, where the costs of trading are about as transparent as the waters of the Big Muddy River after a hard rain.



The Intelligent Investor
By Jason Zweig
COMMENTARY

Most investors own bonds through mutual funds or exchange-traded funds. But the household sector, including individual investors, still holds nearly $430 billion in corporate bonds, according to the Federal Reserve. If you buy bonds directly, it's vital to keep trading costs from devouring your income, especially in today's world of scrimpy interest rates.

Lawrence Harris, a finance professor at the University of Southern California and former chief economist at the Securities and Exchange Commission, has just completed a study of how expensive corporate bonds are to trade.

Prof. Harris analyzed bond-price quotations gleaned through Interactive Brokers Group, the deep-discount brokerage firm where he is a member of the board of directors, and trade data from the Financial Industry Regulatory Authority. He estimates that individual investors are paying bond dealers and other middlemen an average of $7.72 per $1,000 of principal value to buy corporate bonds. If you paid that much to buy stocks, 200 shares of a $50 stock would run you at least $77.20 in trading costs—instead of the roughly $10 that you would pay at most online brokerage firms.

Corporate bonds yield an average of 3.3%, according to Barclays. So Mr. Harris's analysis suggests that trading costs consume roughly the first three months' worth of income on the average corporate bond—assuming you pay your broker only to buy but not to sell.

The structure of the bond market is "terrible," says Prof. Harris. "Corporate bonds are ridiculously expensive to trade," he says, "because dealers get the best prices for themselves, then deliver crappy prices to customers."

Anyone can see how investors get nicked by consulting the Trade Reporting and Compliance Engine, or Trace. Developed by Finra, which oversees how investments are marketed to the public, Trace shows the prices at which bonds are bought and sold, within 15 minutes after the trade.

You can view recent trades at www.finra.org/industry/trace by clicking "Corporate Bond Data," then searching for the securities you are interested in.

At 12:38:53 p.m. this past Thursday, according to Trace, a dealer bought $30,000 of 6.5% bonds issued by Lowe's Cos., maturing in 2029, from a customer at $124.419 per $100 of principal value—the lowest price those bonds had traded at in more than a week. Three seconds later, a dealer sold $30,000 worth—presumably the same firm selling the same lot of bonds—to another dealer for $125.044.

The first dealer appears to have pocketed the difference in price, or "markup," of $6.25 per $1,000 of principal value. The firm made $187.50 in three seconds, at what appears to have been zero risk to itself.

Around the same time, the bid-ask spread on Lowe's common stock on the New York Stock Exchange was two cents per share. Adjusting for the difference in price between the two securities, the bond was at least 20 times more expensive to trade than the stock.

If you invest directly in corporate bonds rather than in bond mutual funds or ETFs, there are a few ways you can limit your trading costs.

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First, hold your bonds to maturity so you avoid the expenses of selling. Stick to high-quality debt, generally rated A or better by credit-rating firms such as Moody's or Standard & Poor's.

William Rockett, a managing director of income solutions at Charles Schwab, suggests asking your broker to give you the total cost to buy a particular bond you're interested in. Then go to Trace and see the last price it traded at. If your broker's quote is more than, say, 25 cents higher, you may be able to get a better deal elsewhere.

Michael Ziegelbaum, head of electronic fixed-income trading at Mizuho Securities in New York, recommends "good old-fashioned bargaining."

If your broker quotes you a price of $101.50, offer $101 or $100.75. Just as you can enter a limit order for a stock that stipulates the highest price you are willing to pay, you can—and should—place limit orders for bonds as well.

Be careful, though: Some brokerages may levy a surcharge if you place a limit order or ask to trade through an account representative rather than the website. Fidelity Investments, on the other hand, lets you set a limit order at will—and even offers a glimpse of pending bids and offers in the market—when you request a bond trade online.

If you deal with a broker directly, make him or her "work the order," trying to get you a better price. Set a limit and give your broker a day or more to haggle for you. As Mr. Ziegelbaum puts it, "You're buying bonds that you'll hold for five or 10 years or more. What's your rush?"

*— Write to Jason Zweig at **intelligentinvestor@wsj.com**, and follow him on Twitter at **@jasonzweigwsj**.*