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Evaluation of Bond Risks – Other than default risk The complications of bond trading

At this point in the market cycle, we do not recommend most bonds due to interest rate risk – bonds lose money when rates rise unless held to maturity. Holding to maturity if rates are rising is an opportunity cost - holding lower rate bonds vs. newer bonds at higher rates.

Interest Rate Risk - How Much Could Bonds Lose?

Bond “duration” measures a bond's sensitivity to changes in interest rates. The key factors in measuring duration are maturity and coupon interest rate. The higher the coupon rate, the lower the duration. For example, a high yield bond has less duration and less interest rate risk than a muni bond of the same maturity. The 10-year Treasury now has a duration of about 9.1 years. A zero coupon bond or typical bank CD that only pays on maturity will have the same duration as its maturity.

Interest rates are near all-time lows, after declining over the last 34 years. In October 1981, the “benchmark” 10-year Treasury peaked at over 15%. By 1995, rates had fallen to a more long-term average of 6%. In July 2012, the rate hit a closing low of 1.46%. In 2015, the rate has bounced a bit around about 2%. The average rate since 1958 is 6.26%. Source JP Morgan Guide to Markets as of 6/30/2015

Change in Interest Rates

	1%	2%	3%	4%	5%
2	-2.0%	-4.0%	-6.0%	-8.0%	-10.0%
3	-3.0%	-6.0%	-9.0%	-12.0%	-15.0%
4	-4.0%	-8.0%	-12.0%	-16.0%	-20.0%
5	-5.0%	-10.0%	-15.0%	-20.0%	-25.0%
6	-6.0%	-12.0%	-18.0%	-24.0%	-30.0%
7	-7.0%	-14.0%	-21.0%	-28.0%	-35.0%
8	-8.0%	-16.0%	-24.0%	-32.0%	-40.0%
9	-9.0%	-18.0%	-27.0%	-36.0%	-45.0%
10	-10.0%	-20.0%	-30.0%	-40.0%	-50.0%

The table shows the expected loss in market value with rising interest rates.

For example, a bond with a duration of 7 years could lose 21% of its market value if interest rates rose by 3.0%. The longer the bond's duration, and the greater the increase in interest rates, the greater the loss.

Table Source: Forbes

Bond Premiums Above “Par.”

Most bonds today with the long-term decline in rates are priced at a “premium” to “par”. For example if a bond or bond portfolio has an average price of 104, it will gradually lose 4% in value (other factors the same), as it approaches maturity when it will be redeemed at par = 100. The higher the coupon rate of the bond (since you are paying a premium for the rate) will to some extent over time offset the premium difference. Further, the higher coupon rate will make the bond slightly less interest-rate sensitive. You should just know that the value will decline to par at maturity.

Inter-Dealer Pricing on Brokerage Statements

The price of bonds on your brokerage statements is called an “inter-dealer” price without markups or dealer spreads. This is not the price for you (or me) at the retail level. There is no centralized exchange in the fixed income market. As a result, financial institutions use “Inter-dealer brokers” (IDB’s) to provide pricing information.

Inside Look at Bond Trading

Because bond trading is complicated and costly on the retail side, I don’t believe I have ever bought individual bonds for any client, only sold them when a client already held them and wanted to sell.

“A bond trader at an investment dealer seeks to make a profit on his ‘trading book.’ The more money he makes, the greater his bonus.” <http://www.finpipe.com/trading-bonds/>

Scottrade has a good explanation:

“All bond trades in the secondary market (not new issues) incur sales charges. In the bond market, bond prices include commission. The difference between what you pay and what the dealer pays is the markup, which can be as high as 4% or 5% though markups on Treasuries are usually lower than 0.5%. More frequently traded bonds tend to have lower markups than less frequently traded ones. And, because bonds with lower interest rates are typically harder to sell, brokers generally charge higher markups to do so.”

If I contact a bond trading desk (Pershing, AAM, etc.) to sell a bond that a client holds, the bond desk will put it out for bids from bond traders looking for a buyer. (“Desks” are actually trading floors of major firms), I will be asked how much of a mark-down I want. You never see the commission (called markup/down or bid-ask spread) - it is already in the price. Since I don’t seek to be a bond rep, I say only enough markdown to cover the trading fee I am charged as a rep, not any commission for me. Of course, all the trading up the chain to the institutional markets all make additional spreads on your sale.

Highlights of Related Articles

Individual Bonds: What the Bond Traders Are Hiding

“For 3 years, I worked on one of the best and largest bond trading desks in Chicago.

“For most individual bonds the markup when trying to purchase the bond or markdown when trying to sell the bond is very large. Municipal bonds often tend to be the worst because they are lightly traded. With no liquidity, it becomes very difficult to negotiate a better price. (Gives examples of trades he tried to do).

“There is usually a 1% – 5% markup on bonds by broker-dealers. If you want to sell your bond, a broker-dealer will mark down the price of your bond, paying you slightly less than the current value. They will subsequently sell that bond at a price above the market value. That means the institution is making money, but the customer or individual is losing big. You’re basically at the whim of whatever price the broker-dealer you are trading with wants to purchase or sell the bond at. To drive this point home, at the end of this article, there is a graph and a chart showing the trading activity. A blue dot is the price a customer was able to buy the bond from an institution or broker-dealer, and a red dot was the price they were able to sell to this institution. This activity is the norm as opposed to the exception in this marketplace and it forces you into a buy and hold strategy just to make the trade cost effective.”

(He then describes how an individual investor can use professional managers just as I recommend to avoid these large retail spreads) <http://investorsolutions.com/knowledge-center/investment-vehicle/individual-bonds-what-the-bond-traders-are-hiding-2/>

Shouts on Bond-Trading Floor Yield to Robot Beeps

By NATHANIEL POPPER OCTOBER 19, 2014 (New York Times)

“The face of automation on Wall Street is a computer hooked up to nine blinking screens that goes by the name Quantitative Market Maker, or Q.M.M. Until last year, the work that Q.M.M. performs was handled by human traders at JPMorgan Chase, who would shout prices into a phone and yell “Done!” when the trade was executed.

“Now, Q.M.M., which sits on the same floor as those traders in a Midtown Manhattan skyscraper, can come up with the same prices in a fraction of a second. When it completes a trade, it emits a jingling cash register sound, making the trading floor sound like an arcade.

“The rise of Q.M.M. points to sweeping changes in one of the most profitable and powerful corners of Wall Street: the fixed-income trading desks where bonds and derivatives like interest rate swaps are bought and sold, generating \$80 billion of revenue at the biggest banks last year.

“These trading desks have long been the noisy, competitive heart of Wall Street, and JPMorgan’s operation has been the biggest in the world in recent years, bringing in \$15.5 billion in revenue last year.

“But these desks have been so profitable — and so loud — in part because fixed-income trading has largely remained a human business, with each trade negotiated and executed by individuals, generally on the phone. Now, bond trading is quickly moving in the direction of stock trading, which was transformed by automated trading into a low-margin business years ago.

“In the past, JPMorgan resisted this sort of change, pushing to maintain the more human style of trading that made it money for years. But the bank ended up losing some of those battles to the computers and had to race to catch up.

“JPMorgan is far from the only bank racing to stay ahead of the big changes sweeping the fixed-income markets.

“This summer, Barclays appointed the head of its heavily automated stock trading desk to lead its much bigger and less automated fixed-income operation in the hope that he could help transform those desks. And at Morgan Stanley, the two new co-heads of the fixed-income division created a new “e-markets” team almost as soon as they were appointed last year.

“As the market changes, humans won’t become obsolete. Q.M.M. is monitored constantly by a person who makes sure that the prices it delivers make sense. And another trader takes the Q.M.M. prices as a starting point for larger trades.

“The bank is involved in experimental efforts like Project Neptune, a collaboration among financial firms aimed at making it easier to find specific bonds electronically.” <http://dealbook.nytimes.com/2014/10/19/shouts-on-bond-trading-floor-yield-to-robot-beeps/>

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