



Municipal Bond Market: One of the last bastions of the Stealth Fee

Introduction

As investors contemplate the most prudent and cost effective method to purchase municipal bonds, we at RSW Investments, LLC would like to weigh-in on the two most prominent choices. Namely, acquiring bonds directly from a Financial Advisor (FA), or hiring a professional money manager to supervise the portfolio. Before beginning this commentary, allow me to be the first to state that my remarks are exceedingly self-serving. After all, RSW provides separate account municipal bond money management services on behalf of its clients. With that said, this composition should provide a key piece of information to aid investors with their decision process.

Build it yourself or hire a contractor?

Investors who purchase municipal bonds directly from a Financial Advisor (FA) could be paying fees that may not be obvious. Part of the reason for the additional expense arises from the lack of transparency that is inherent in the municipal market. For all intent and purposes the tax-exempt market can be described as two tiered, whereby “retail” transactions tend to occur at higher prices than “institutional” trades. Without the means to track the additional “spread” (cost) that is inherent in the marketplace, even the most astute Financial Advisors are unarmed in this relatively opaque market. Thus, when an investor agrees to purchase a municipal bond at a specified yield and price, the security comes “fully loaded”.

When clients review their monthly statements and scan their municipal bond trades they won't be able to identify the transaction fees. (In fact, quite often, they might assume that any stated fees were the bond's only cost, similar to a stock purchase.) In reality, bond “markups” are common industry practice, and considered part of a Broker/Dealer's compensation received for trading securities. In fact, there are two profit centers that are compensated at the client's expense. First, there is the firm's trading desk that builds in a “spread” or “markup”. Second, the client needs to pay the FA as he is compensated to shop the firm's inventory in search of the most attractive offerings. Again, this fee is also built into the offering price of the individual bond.

How does the “final” purchase price of the bond purchased by a broker compare with the one acquired by a professional money manager?

Just as a wholesaler buys goods at a reduced price compared to the end user, an active manager can buy bonds more efficiently. We at RSW, frequently observe a 1 to 2 point (1-2%) price difference between the two types of transactions. This means that if an individual had \$1 million to invest in the municipal bond market, and he constructed his portfolio using the services of a Financial Advisor the additional execution costs could range between \$10,000 and \$20,000. In the essence of full disclosure, a client would not pocket that entire amount using an active management strategy as an Investment Advisor does not work for “free”. However, there are many additional benefits to individuals who partner with professional money managers.



Specifically:

- RSW's strategy of buying premium coupon, callable securities, maturing in 10 to 15 years is designed to earn a higher level of coupon income as a result of the upward sloping nature of the municipal bond yield curve.
- Risk Management: Understanding, valuing, and trading the specific issuers that are selected for each portfolio can help achieve a higher level of diversification.
- The client's holdings are actively managed and monitored. Aside from the value that RSW's core portfolio management discipline can yield, carefully monitoring the issuer's underlying credit direction (stable/declining) is a key component of our focus.

RSW's predetermined sell discipline should seize the opportunities to harvest tax losses, and have a profound impact on after-tax total rate of return.

Bottom line: An independent Investment Advisor is not subject to the pricing of only one institutional trader at one particular broker/dealer. The money manager has the flexibility to "shop the street" and peruse the bond inventory of dozens of firms to uncover the best values. As the Investment Manager executes the transaction directly with the broker/dealer, the middleman is eliminated thereby shedding another fee.

In our daily lives many of us are confronted with one basic decision: build it ourselves or subcontract the project. However, unlike a project at home where there are savings to be garnered by fixing or building yourself, in the world of Tax-Free's it may actually cost you money and further, it may be difficult to determine just how much.

Sincerely,
Robert S. Waas

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