4 Hidden Risks of Do-It-Yourself Bond Investing

The attractive nature of higher all-in yields across bond markets has led many investors to buy individual bonds for their portfolios this year. While this may be a good time to increase the bond weighting in a portfolio, how it is done can be as important as when it is done. Foregoing professionally managed bond funds could lead to investors holding less than ideal securities and missing out on even greater opportunities.

We acknowledge the surface-level advantages of buying individual bonds, such as purchasing them at a discount and seeing them appreciate to par value over their holding period. However, many retail investors are unaware of the hidden risks and opportunity costs of this decision and how it can affect their ability to maximize the current opportunity.

Four hidden risks of Do-It-Yourself (DIY) bond investing:

1. Buying the "leftovers"
2. Higher transaction costs
3. Lack of diversification
4. Lost opportunities

Buying the "leftovers"

Bonds are traded over the counter, which means you need access to a bond dealer who can facilitate buying or selling your bond of choice – unlike equities, where buyers and sellers have better price transparency on a more centralized exchange. Without a centralized exchange structure, retail investors do not have the same reference point for the prices they receive from bond dealers, and relationships with these dealers are built over time through the frequency, volume, and size of trades.

Institutional managers who trade at a much larger scale often get first pick at new issues and much better access to secondary issues than the average retail investor. This means retail investors often get some of the less desired inventory after large institutions and large fund companies have already selected and bought the securities they believe are attractive.

Practically, this means many bonds that have relatively attractive features, like investor-friendly embedded options and the highest quality collateral, to name a few, are scooped up before coming to the retail desk. To truly take advantage of the current opportunity, these types of features are important and can add significant returns to an investor's portfolio.

Higher Transaction Costs

There is a large misconception that buying individual bonds helps investors and investment advisors “maximize yield” by escaping the fees associated with managed funds. The numbers paint a different story.

We recently conducted a detailed study to identify the difference between the average retail investor’s cost of execution compared to our own. The study revealed that on average, we pay approximately $0.50 less than a retail investor on a $100 par bond in the ***new issue market***. A similar difference was also realized in the ***secondary market***, where on average, RPIA could buy at prices $0.25 lower than a retail investor and sell at prices a similar amount higher. These differences in price can have a material impact on the return, which only multiplies as portfolio turnover increases.

RPIA vs. Retail Investors

Hypothetical Bond “XYZ”			
Term	10 Years		
Mid-market Price	$98.00		
Duration	7.5 Years		
Transaction	RPIA	Retail Investor	RPIA’s Lower Transaction Cost
Purchase Price in Primary Market	$98.03	$98.50	**-$0.47**
Sell Price in Secondary Market	$97.76	$97.50	**-$0.26**

For illustrative purposes only.

Purchasing a fund may come with explicit fees, such as management fees and the costs of operating the fund itself. But once you factor in a manager’s implicit savings (which get passed onto investors) when owning attractive discounted bonds at a larger scale, the cost of DIY investing may be less cost efficient than many investors might perceive.

Lack of Diversification

When retail investors buy bonds individually, they are typically buying Canadian government or corporate bonds to limit exposure to foreign currency risk and also because many domestic bond desks may only have a limited selection of global securities. Canadian bank bonds are a popular choice among retail investors, but Canadian investors are notorious for having "home bias," which is particularly true with overweight investments in the banking sector across the asset mix. This does not bode well for diversification.

In contrast, global fund managers have a much broader opportunity set and the expertise to select the right issuer and the right type of security. A large corporation usually has a single ticket that investors can follow and buy, but may have hundreds of bonds, each with different characteristics and claims to the issuer's collateral. Not all securities of the same issuer are made equal and the need to analyze the differences and nuances between individual securities is paramount to avoiding unnecessary complications.

Fund managers are at a significant advantage when it comes to security selection with experienced credit research teams dedicated to analyzing sectors and security types to identify the best opportunities. The ability to utilize hedging instruments also allows institutional-quality managers to reduce risk in the portfolio. This allows them to confidently access attractive opportunities from a diversified set of global issuers, resulting in a diversified and better-insulated bond portfolio.

Lost Opportunities

Finally, although individual bonds can offer some protection from interest rate risks if held to maturity, they also limit flexibility to adapt to the evolving market environment should better-yielding securities become available. The ability to actively trade with conviction and speed provides institutional investors with more flexibility in building resilient portfolios.

Earlier in the year, many retail investors jumped into bonds when yields looked attractive and as though rates were peaking. Today, those yields are higher and discounts are notably larger, making the opportunity cost that much more glaring. Actively traded funds have the benefit of on-going liquidity and flexibility to adjust to the evolving market conditions to capture these fast-moving opportunities.

Final Takeaways

Although buying individual bonds may seem compelling in the current environment, understanding these under-the-surface risks is essential to choosing the right investment solution and ensuring investment portfolios can generate the best value, especially for long-term investors.

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