INVESTOR'S DIGEST



# INVESTING 101

EXPANDING YOUR INVESTMENT KNOWLEDGE

# Here's everything you really need to know about the Cdn. bond market

*The big boys control 95 per cent of the action. But there's still room for the average Joe, says W.H. Cunningham, who believes investors can do even better than bond-fund managers*

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The bond market is largely invisible, being decentralized, over the counter and with no post-trade disclosure.

At the heart of the Canadian bond market is the Bank of Canada, which is in charge of monetary policy and open market operations in the foreign exchange, money market, and bond market.

Next come the money market "jobbers," whose role is to ensure the orderly maintenance of the money market, including the issuance of Government of Canada treasury bills.

The money market is defined as securities issued with a term to maturity of one year or less. Treasury bills are obligations issued by the various governments.

Primary bond dealers include BMO Nesbitt Burns, Casgrain and Co., CIBC World Markets and Deutsche Bank Securities.

### Dealers also jobbers

Many of the primary dealers are also jobbers. Among other things, they're required to bid for the auction of the Government of Canada's primary issues.

They do the bulk of the underwriting of new provincial and corporate debt and make markets in the complete array of fixed-income products.

They also service the fixed-income needs of the various institutional and retail investors by maintaining extensive inventories as well as bidding and offering on all sizes of blocks of bonds.

Individual trades can be in the hundreds of millions or for as little as $5,000.

The lion's share of the daily $23.5-billion trading volume takes place among the Big Six investment dealers and their institutional and global customers.

The market for individual investors is approximately five per cent of this total.

The other 95 per cent is in the institutional area. It's where the bank-owned dealers, plus a few ones not owned by banks, make wholesale markets in all the various fixed-income products to serve the investment needs of their institutional customers.

These customers include life insurance companies, chartered banks, pension funds, mutual funds, investment counsellors, governments and foreign investors.

It's worth pausing to note that the money these institutions have for investment represents the aggregate savings of individuals like you.

Your money is mixed in with everyone else's, thus giving the institutions very large sums to invest and trade.

A large percentage of this money is invested in fixed-income securities to satisfy actuarial requirements, match liabilities, and guarantee fixed returns.

With large blocks of money to invest, these institutions command the best prices. The investment dealers vie for this business.

Indeed, competitive tendering for bids and offerings is the norm. Individual trades exceeding $100 million are commonplace.

Naturally, the bank-owned dealers serve individual investors since they all have national sales forces of investment advisers (IAs).

There are another 205 members of the Investment Dealers Assc. who trade fixed-income securities.

There are large independent firms, such as Blackmont Capital and Canaccord, as well as a host of smaller dealers such as Watt, Carmichael and Odlum Brown.

Each of these firms has to find fixed-income products to satisfy their customers' needs.

The bank-owned dealers help. They offer, via electronic delivery, retail quantities and prices of the various fixed-income products.

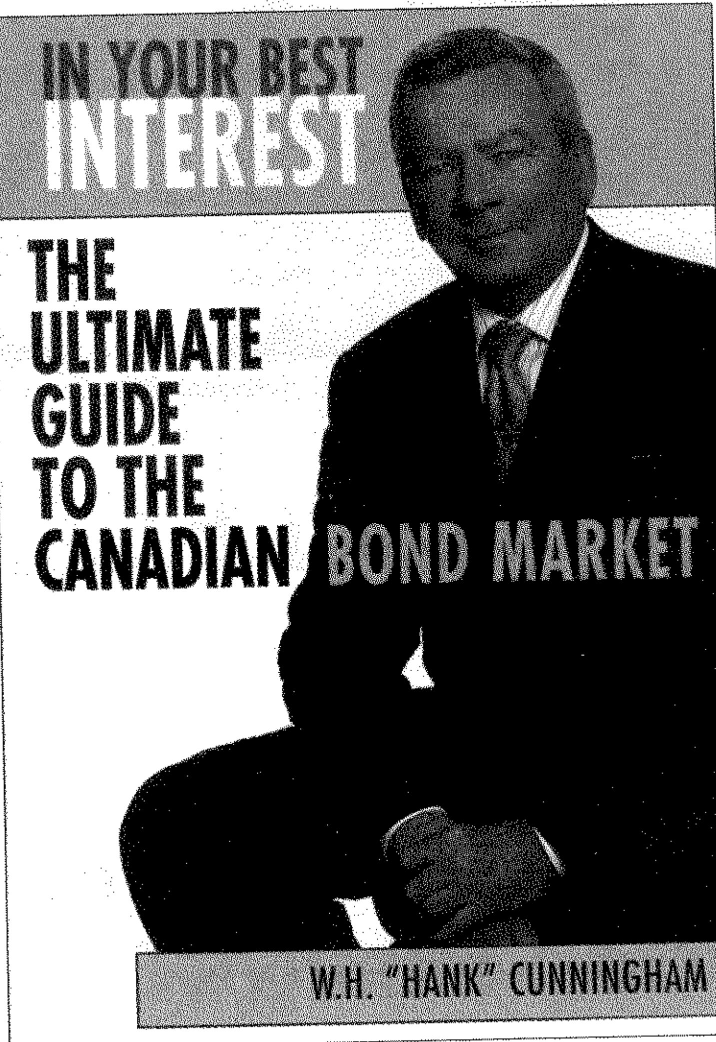
Several of the larger independents, such as Blackmont, Dundee, Canaccord and Odlum Brown, have their own specific fixed-income trading departments.

These companies have sufficient capital and technology resources to assemble, maintain, and offer a wide range of fixed-income securities to meet the needs of their IAs' customers.

Blackmont, for example, has a department of four professionals, who have enough capital to maintain inventories of approximately $100 million.

They manage these aggregates on a fully hedged basis to eliminate market risk for the firm and to offer competitive prices at all times.

Also, in a typical sales force, some clients are selling securities that others will be buying.




Knowing this, the trading department will keep and hedge the sold securities for later resale to its own sales force rather than to the large investment dealers.

**In Your Best Interest**

*By W.H. "Hank" Cunningham*

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This is an efficient way to do business and customers benefit through better prices. Running to and from the wholesale market for every small transaction is costly.

Yet, that is what the smaller dealers must do as they lack the personnel or capital to keep an inventory themselves.

It's also worthwhile pointing out the different philosophies of the various investment dealers regarding their treatment of individual fixed-income investors.

Most bank-owned dealers treat their retail customer base as a captive audience. As such, they charge more for individual bonds than the smaller, more focused firms.

What you need to know is whether the financial institution you're dealing with treats the retail fixed-income market as a profit centre or not.

The best ones work at growing the business through value-added service and competitive prices. Make a point of ascertaining what approach your financial institution uses.

Also, there are interdealer brokers whose role is to act as middlemen, facilitating anonymous trades among the jobbers, primary dealers and investment dealers. These parties trade among themselves to offset transactions done with clients.

Lastly, we come to the individual investor whose needs are served by the different financial institutions.

Individuals have their own specific reasons for buying fixed-income products directly: to generate income, to plan for retirement and to provide safety of principal.

They may need income in a foreign currency, they may wish to speculate on the price movement of bonds, or they may want to invest for future educational needs.

Direct investment by individuals in the bond market totals more than $100 billion. In fact, if GICs and bank deposits are included, this total increases to more than $900 billion.

Why go through the bother of purchasing individual, fixed-income securities? Why not take the easy route and invest in a nice bond mutual fund?

### Funds lack certainty

The answer to the second question is that it's not in your best interest to do so! Bond funds simply don't offer the certainty required in retirement planning; their performance is erratic and the management fees are too high.

Sadly, there are too few IAs with sound enough working knowledge of fixed-income markets. Their line of least resistance is to recommend bond funds because they're an easier sell with attractive fees.

However, such funds aren't the ideal choice for the individual investor. Fixed-income products are better. Here are five reasons why:

(1) Fixed-income products have specific maturity dates. You know the exact date when your principal will be returned to you and what your yield will be for the term that you hold this security.

Contrast this with bond funds: They don't have a specific maturity date, nor do they have a specified income level.

Investors don't know what their investment will be worth at any moment or what it will be worth when they actually need their money back.

Bond fund managers are constantly tinkering with their portfolios, shortening term, extending term and trading for capital gains. This makes for ineffective planning.

(2) Bond funds charge management fees averaging roughly 1.8 to two per cent annually. This takes a big bite out of an investor's income and return.

Contrast that with individual products, where there's a one-time fee at the time of purchase (averaging one per cent) with no further fees until they mature and the money is reinvested or if they're sold before maturity.

(3) The long-term results of "professional" bond-fund management are unimpressive.

First, it's a well-documented fact that no one is 100 per cent sure where interest rates are going. All forecasters, traders and market commentators are right some of the time, but nobody is right all of the time.

### Guesswork abounds

Yet, this doesn't stop portfolio managers from guessing. And it only takes a couple of bad guesses for performance to suffer.

Second, there is indexing in the bond-fund management business too, as brave portfolio managers huddle around the different bond indices in order to look good in the performance game.

They strive to beat the index as well as more than half their peers so they'll be able to market above-average performance.

As well, consider that bond funds are required to calculate an annual return since they lack a fixed maturity date.

Investors owning individual bonds don't have to worry about annual returns since their yield and maturity date are known at the time of purchase.

(4) Bonds come in a wide range of maturities, from 30 days to more than 30 years, allowing for appropriate retirement planning and ladder building.

But because bond funds lack a maturity date, investors don't know how much money they will have when they need to redeem their units.

(5) Bonds can be sold at any time, should raising money become important or other opportunities present themselves.

Daily trading volume averages some $23 billion, with the major investment dealers maintaining bids and asks on the complete array of fixed-income products that have been issued.

By contrast, mutual funds can only be redeemed daily.