Bond Investing

How brokers are compensated for selling bonds depends on the capacity in which they are acting in the transaction. Most bond transactions are originated by a broker-dealer, which can act as a principal if it sells bonds from its own inventory, or it can act as an agent when it buys or sells bonds on the open market on a client's behalf. The firm is compensated differently in each case.

Selling Bonds As a Principal

Many broker-dealers keep inventories of bonds that they purchased through public offerings or on the open market. Because the broker-dealers own the bonds, they can mark up the prices when they are sold, which means the bond buyer pays a price that is higher than what the firm paid to purchase the bond. Markups are a legitimate way for broker-dealers to make a profit. Clients are not privy to the broker-dealer's original transaction, so they have no way of knowing how big of a markup they are paying or even if they are paying any markup. In many instances, clients purchase bonds from a broker-dealer under the impression that there is no cost other than a small transaction fee. Typical markups range from $2.50 - $15.00 per bond (e.g., per $1,000 par amount).

When a client purchases a bond as a new issue, everyone pays the same price for it, because the broker-dealer's markup is included in the par value price of the bond, and there are no separate transaction costs.

For example, if the par value of a bond is $100.00 and the "markup" to the broker-dealer is $10.00 the client would pay $101.00 for that bond (e.g., per $1,000 par amount).

Selling Bonds As an Agent

When a client wants to buy a bond that is not owned by the broker-dealer, the purchase has to take place on the open market. In this capacity, the firm acts as an agent for the client to buy the bond, for which it charges a commission. The commission can range from 1 to 5% of the market price of the bond. Commissions earned by the broker-dealer must be disclosed to the client when the transaction is confirmed. Commissions vary widely depending largely on the type of debt security being purchased as well as the length of maturity. Commissions can be as low as $0.10 - up to $20.00 per $1,000 par amount of the issue.