



Letter to the Editor: Trading Costs for Fixed Income Mutual Funds

The following is in response to our article [Using Trading Costs to Identify Better Mutual Funds](#), which ran on November 13, 2007.

Dear Editor,

You should expand your analysis of mutual fund trading costs to fixed income funds. Assuming a bid/ask spread of 5 basis points and a five year duration, to swap the whole portfolio would cost $\frac{1}{4}$ point. In the low yield world we find ourselves, one needs to be really smart to earn back a 0.25% deficit. There are not many people with that kind of consistency. For your analysis, you could assign bid/ask spreads based on the kind of fund and apply them to the average duration of the fund. Yes, bonds do mature so part of the turnover is from that, but that could be backed out as well using the average maturity. The bottom line is that a high turnover intermediate duration high quality bond fund is bound to lag over time.

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Greg Kadlec, author of the study and a professor at the Pamplin College of Business, Virginia Tech, responds:

I agree that a similar study on the relation between trading costs and performance for bond funds would be of interest. The primary roadblock for such a study is the lack of data for measuring bond trading costs – which vary across issuer (Treasury vs Muni vs Corporate) maturity and trade size. This data limitation is the primary reason why there are hundreds of academic studies on equity trading costs but only a handful of studies on bond trading costs. If we were to conduct such a study I would anticipate one major difference in the results for bond funds vs equity funds. It is my understanding (from academic literature and discussions with practitioners) that, in contrast to the diseconomies of scale in trading costs for equities, there are economies of scale in trading costs for bonds. So, in the context of bond funds, bigger funds should perform better (all else equal). There is some evidence to support this (see Philpot et al. The Financial Review vol 33 1998).

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