Municipal Bonds and Tax-Equivalent Yields

- Municipal bonds are usually only appropriate for those in the highest income tax brackets. Those at lower income tax brackets are better off enjoying the higher yields offered by corporates or U.S. Treasuries and paying the income tax derived from these types of bonds.
- If you purchase a municipal bond by an issuer in your state, the interest income is tax-free at both the federal and state levels.

When building a portfolio, it is important for investors to take into account the ability of various investments to build wealth over time (their growth potential) as well as their potential to generate income. Bonds are debt instruments issued by governments, institutions, or corporations that pay interest periodically, making them a great choice for investors looking for current income. One downside to most types of bonds, however, is that the income they generate is subject to taxes. Municipal bonds are one exception.

Municipal bonds (munis) are issued by states, counties, cities, and other government entities and can be categorized into general obligation bonds or revenue bonds. General obligation bonds are backed by the "full faith and credit" of the issuer or its ability to bring in tax revenue. Revenue bonds are backed by income generated from specific projects or agencies. These bonds are often issued by hospitals and airports and are typically considered riskier than general obligation bonds.

Regardless of type, municipal bonds can offer an aftertax equivalent yield that is meaningfully above other bond investments. Yield is usually expressed as a percentage and can be described as the cash distributed periodically from an investment—similar to an interest rate. Municipal bond income is often protected from federal and state income taxes, making these investments desirable for investors in higher tax brackets, but capital gains taxes must be paid if the bonds are sold for more than their purchase price. One way to compare municipal bonds with taxable bonds is by calculating the tax-equivalent yield, which represents the before-tax yield an investor would need to achieve on a taxable bond in order to match a given municipal bond yield.

The image depicts yields for long-term government bonds, long-term municipal bonds, and municipal bond tax-equivalent yields for three different tax brackets. During the time period studied, average municipal bond yields have been below average long-term government bond yields—5.3% compared with 5.9%. However, average tax-equivalent yields have ranged between 6.3% and 8.2%—depending on the tax rate. The higher an investor's marginal tax rate, the greater their tax-equivalent yield will be and the more desirable municipal bonds are as an investment. For example, an investor in the 35% tax bracket not investing in municipal bonds would need an investment producing an 8.2% before-tax yield in order to match a municipal bond yield of 5.3%. An investor in the 15% tax bracket would only need an investment producing a 6.3% before-tax yield. Historically, tax-equivalent yields for all tax brackets analyzed have exceeded long-term government bond yields.

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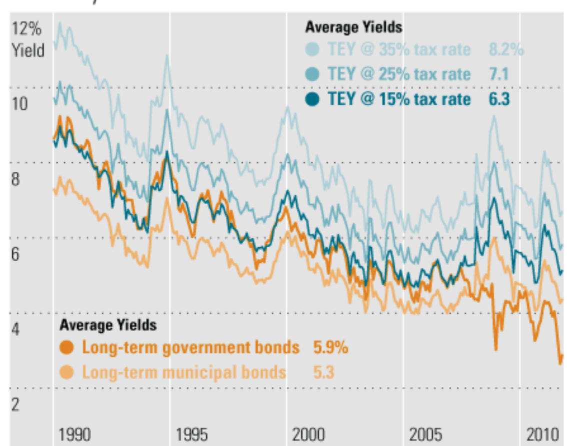
January 1990–October 2011



This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index. Past performance is no guarantee of future results. Government bonds are guaranteed by the full faith and credit of the United States government as to timely payment of principal and interest, while municipal bonds are not guaranteed. State taxes have been ignored in estimating tax-equivalent yields. Municipal bonds may be subject to the alternative minimum tax (AMT) and state or local taxes, and federal taxes would apply to any capital gains distributions.

Source: Long-Term Government Bonds—20-year U.S. Government Bond; Municipal Bonds—Barclays Municipal Bond 20-year index; Federal tax rates from the Internal Revenue Service.