Tax-equivalent yield: An overlooked advantage in municipal bonds

EAGLE | Asset Management

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The municipal bond market offers tax-exempt income, an essential benefit for investors to keep in mind when comparing municipal bond investments with other fixed-income securities.

The key is understanding the **tax-equivalent yield** of municipal bonds.

What is tax-equivalent yield?

The tax-equivalent yield is the interest rate a taxable bond, such as a corporate bond, would need to provide to equal the yield on a similar tax-exempt bond such as a municipal bond.

A **tax-exempt multiplier** can be used to compare the income from municipal bonds with the pretax yields of money market, corporate bond, or Treasury bond investments. The multiplier adjusts a tax-exempt bond's yield to measure it against an equivalent taxable investment.

The appeal of tax-equivalent yield is highlighted in higher tax brackets.

- Investors in higher tax brackets receive greater value from tax exemptions as tax-equivalent yields rise. That said, the tax-equivalent yield calculation can help compare municipal bond yields with taxable investments for investors in any tax bracket.
- If the yield of a taxable investment is higher than a municipal bond investment's tax-equivalent yield, then the taxable investment may be more favorable (purely from the perspective of yield).

Municipal Bond Yield-to-Worst	2.50%	3.00%	3.50%	4.00%	4.50%
Tax Bracket	**Tax-Equivalent Yield**				
10.00%	2.78%	3.33%	3.89%	4.44%	5.00%
12.00%	2.84%	3.41%	3.98%	4.55%	5.11%
22.00%	3.21%	3.85%	4.49%	5.13%	5.77%
24.00%	3.29%	3.95%	4.61%	5.26%	5.92%
27.80%*	3.46%	4.16%	4.85%	5.54%	6.23%
35.80%*	3.89%	4.67%	5.45%	6.23%	7.01%
38.80%*	4.08%	4.90%	5.72%	6.54%	7.35%
40.80%*	4.22%	5.07%	5.91%	6.76%	7.60%

Source: Eagle Asset Management, as of 11/17/23

*A 3.80% net investment income surcharge is imposed on single filers with adjusted gross income in excess of $200,000 and married joint filers with adjusted gross income in excess of $250,000, which means that an investor in the 32% tax bracket (incurring the additional 3.80% surcharge) will have a tax-equivalent yield of 6.23% from a municipal bond with a yield-to-worst of 4.00%.

How is it calculated?

Tax-equivalent yield is determined by dividing a municipal bond's yield by 1 minus an investor's federal tax rate.

$$\text{Tax-equivalent yield} = \frac{\text{Municipal bond yield}}{1 - (\text{tax rate})}$$

We believe understanding tax-equivalent yield is a key tool for investors seeking to optimize both the income and tax-savings potential of municipal bonds.

Disclosures

Risks associated with Fixed Income investing:

Municipal securities typically provide a lower yield than comparably rated taxable investments in consideration of their tax-advantaged status. Investments in municipal securities may not be appropriate for all investors, particularly those who do not stand to benefit from the tax status of the investment. Please consult an income tax professional to assess the impact of holding such securities on your tax liability.

Interest on Municipal Bonds is generally exempt from federal taxation and may also be free of state and local taxes for investors residing in the state and/or locality where the bonds were issued. However, bonds may be subject to federal alternative minimum tax (AMT), and profits and losses on tax-exempt bonds may be subject to capital gains tax treatment.

Many investors consider bonds to be "risk free" investment vehicles. Historically, bonds have indeed provided less volatility and less risk of loss of capital than has equity investing. However, there are many factors that may affect the risk and return profile of a fixed-income portfolio. The two most prominent factors are interest-rate movements and the creditworthiness of the bond issuer. Bonds issued by the U.S. government have significantly less risk of default than those issued by corporations and municipalities. However, the overall return on government bonds tends to be less than these other types of fixed-income securities. Investors should pay careful attention to the types of fixed-income securities that comprise their portfolio and remember that, as with all investments, there is the risk of the loss of capital.

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Definitions

A bond's current yield is calculated by dividing its coupon payments (and other annual income) by its current price. This represents the theoretical return that could be expected by an investor purchasing the bond and holding it for a year. However, current yield calculations ignore the bond's face value, and they do not represent the actual return that an investor could receive by holding the bond to maturity.

Yield to worst is a measure of the lowest possible yield that can be received on a bond with an early retirement provision. It is a type of yield that is referenced when a bond has provisions that would allow the issuer to close it out before it matures. The yield to worst metric is used to evaluate the worst-case scenario for yield at the earliest allowable retirement date. It is always less than yield to maturity because it represents a return for a shortened investment period.

About Eagle Asset Management

Eagle Asset Management provides a broad array of fundamental equity and fixed-income strategies designed to meet the long-term goals of institutional and individual investors. Eagle's multiple independent investment teams have the autonomy to pursue investment decisions guided by their individual philosophies and strategies.