Bond Rate Apples to Apples

March 14, 2023

You can be forgiven for scratching your head at the current bond market, and one of the more perplexing aspects of it is the yield curve in the municipal bond environment. According to Bloomberg, the current average yield on Muni bonds with a 1-year maturity is 2.66%. But let's say you want to take more risk and go out five years; what is your reward for taking that extra risk? It's actually negative; the average yield on 5-year bonds is currently 2.19%.

Of course, 'average' covers a lot of territories, from low-rated to high-rated, across different states and municipalities, covering a lot of different projects and funds. And the other thing you have to consider is the tax-equivalent yield of the Muni coupon vs. the more commonly quoted corporate bonds.

The what? Most municipal bonds are not taxed at the federal level, and if you happen to live in the state where they are issued, you also escape state taxation on their yields. So you have to factor in the fact that these yields are tax-free in order to compare apples (the tax-equivalent yield of the muni) to apples (the after-tax yield of the corporate bond).

Fortunately, there's an easy calculation engine on the web (go here: https://iqcalculators.com/calculator/tax-equivalent-yield-calculator/), where you enter the rate of return of the muni bond you're considering, and your own marginal tax rate, and it will give you the yield that you can compare with a taxable bond. Let's say you're in the 32% tax bracket (for joint filers earning more than $340,100) and you buy that 'average' one-year muni bond at a 2.66% yield. Plug in the numbers and you see that the corporate bond would need to yield 3.91% to provide a superior after-tax return. But if you're in the 22% marginal tax bracket (AGI above $83,550), then the corporate bond would only need to yield 3.41% to offer the same after-tax return.

Municipal bonds are not appropriate investments in a traditional or Roth IRA, where bond yields are not taxed each year regardless of what kind of instrument you purchased. But for taxable accounts, this calculation should be a consideration when you're investing in fixed-income individual bonds, funds or ETFs.

Sources:

https://www.investopedia.com/articles/investing/052715/muni-bonds-vs-taxable-bonds-and-cds.asp

https://www.bloomberg.com/markets/rates-bonds/government-bonds/us

https://iqcalculators.com/calculator/tax-equivalent-yield-calculator/

If you have any questions about this article or want to discuss your family finances, investment portfolio, or financial planning advice, please call on me anytime at my number (215) 325-1595 or you can click here to schedule a meeting.

Please feel free to forward this article and offer to anyone you know who might have financial questions or need some unbiased advice. Most financial advice is sales advice. In stark contrast, we are fee-only (non-commissioned) fiduciary advisors. We just provide truthful, unbiased advice to our clients.

Jeffrey Broadhurst
MBA, CFA, CFP
Broadhurst Financial Advisors, Inc.

Our physical and mail address:
1911 West Point Pike
P.O. Box 301
West Point, PA 19486-0301

Contact us:
Phone: (215) 325-1595
Email: jeff@broadhurstfinancial.com