

# Evaluating After-Tax Yield to Maturity Municipal Bond Returns

Municipal bonds are the only bonds that benefit from a triple tax exemption. Municipal bond interest is federally and in most cases state and locally tax exempt. Treasury bond interest, on the other hand, is exempt from state and local taxes but taxable at the federal level, and Corporate bond interest is taxed at all tax levels. For this reason municipal bonds are attractive to taxable investors. If you reside in a state with a state income tax there would be an additional advantage to invest in municipal bonds of that state. To compare the yields on Municipal, Corporate and Treasury bonds, one must convert the yield to maturity on the Municipal bond into a Taxable Equivalent Yield. Texas has no state income tax, therefore bonds issued in Texas usually have higher yields because they must compete on an after-tax basis with various states that do have a state income tax, which increases their attractiveness to residents of Texas.

Graph 1 shows the General Obligation (G.O.) municipal yield curve and its relationship with the yield curves of other fixed income securities. The slope of a normal yield curve rises gradually due to higher volatility and risks associated with longer maturities. Recently, the Treasury curve has been very flat and even inverted at times. Although there has been some flattening, the municipal yield curve is still positively sloped. Ten year bonds currently yield +32 basis points more than two year bonds in the municipal market while, ten year treasuries yield 5 basis points less than two year treasuries. In the municipal market you get paid for additional maturity risk.

As an example, the 10 year yield to maturity for municipal bonds is a 3.87% (Graph 1). On a tax equivalent basis if you are in the 35% tax bracket and there is no state income tax, that is 5.95%. That is the equivalent of 1.35% higher yield to maturity than treasuries and .70% higher yield to maturity than AA corporate bonds on a taxable equivalent basis.

This same concept is illustrated in the two scenarios in Table 1. In the first, you invest \$100,000 in a 4% coupon Texas Municipal bond. Your yearly income will be \$4,000 and you will owe no income taxes. In the second, you invest \$100,000 in a 5.5% coupon corporate bond which will generate \$5,500 of taxable income. However, if you are in the 35% tax bracket you will pay income taxes in the amount of \$1,925 on that income for a net after-tax cash flow of \$3,575. On an after-tax basis, the municipal bond is a better investment.

In addition to the higher after-tax yield, municipal bond default rates are much lower than corporate bonds, with historical municipal default rates at less than 1/2 of 1% and many of those defaults happening in private activity bonds, which Vaughan Nelson managers avoid. This compares with investment grade corporate bond historical default rates of around two times those of municipals. Therefore, a municipal bond rated AA has a significantly better underlying credit worthiness than a corporate bond also rated AA.

This is not to say that one should not invest in corporate bonds. If your current tax status puts you in a position where taxable income can be used, there should be an allocation to taxable bonds. One value of a full-time bond manager is the ability to structure a portfolio with both tax-free and taxable income customized specifically to your needs. Adjustments are then made in response to changes in yield relationships or your tax status.

At Vaughan Nelson, we have three professionals fully dedicated to managing fixed income portfolios, whether they are 100% taxable bonds, tax-free bonds or a combination of both due to tax circumstances. We are passionate about assisting you with meeting your current income needs and achieving your investment objectives.

Graph 1

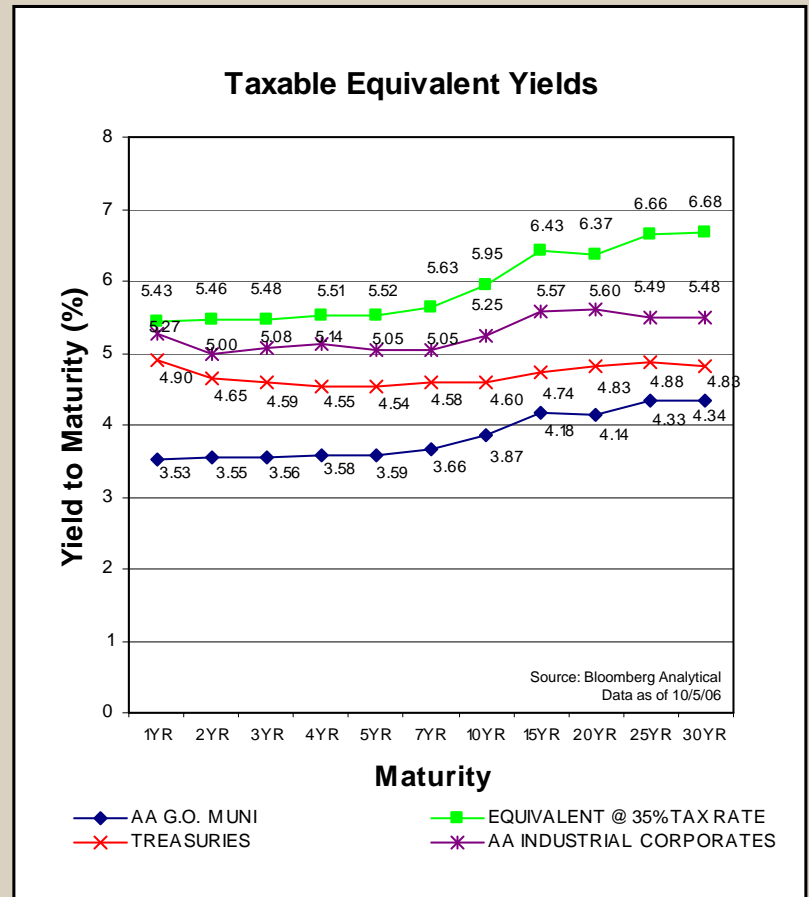


Table 1

After-Tax Income		
Invest \$100,000 in a 10 year maturity bond, at current market rates.		
	4% TX Municipal	5.5% Corporate
Annual Income	\$4,000	\$5,500
Less Tax @ 35%	0	1,925
After-tax income	\$4,000	\$3,575