

# CD or municipal bond?

Consider a more productive asset allocation strategy for your income needs

## Safe, but slow

Risk-averse investors who choose guaranteed certificates of deposit (CDs) often find comfort in the fact that their assets are not exposed to the ups and downs of the financial markets. But did you know that by investing too conservatively, you are also exposing your assets to the steady erosion of inflation and taxes?

Unlike bonds, which incur more risk, CDs offer a fixed rate of return, and the interest and principal on CDs generally are insured by the FDIC up to \$250,000.

## A better alternative

By redeploying assets that are in fully taxable vehicles, such as CDs, into a combination of one or more municipal bond funds, you may be able to generate an equivalent amount of income that is not subject to income taxes. And because municipal bonds historically have generated higher returns than CDs, you may not have to invest as much to generate that income, leaving additional assets to invest in a conservatively managed stock fund with the goal of outpacing inflation.

For some investors, investment income may be subject to the federal alternative minimum tax and capital gains taxes. Income from federally exempt funds may be subject to state and local taxes. Unlike CDs, municipal bonds are free from federal and in some cases state and local taxes.

## A conservative choice

In the following example, a hypothetical investor has \$100,000 available to invest.

Invest in CDs		Invest in municipal bonds	
Initial investment	\$100,000	Initial investment	\$14,000
Rate of interest*†	0.22%	Yield*‡	1.07%
Annual income	\$220	Annual income	\$150
Tax bill (35.8% bracket)	\$79	Tax bill (35.8% bracket)	\$0
After-tax income	\$141	After-tax income	\$150
<b>Money left over to invest</b>	<b>\$0</b>	<b>Money left over to invest</b>	<b>\$86,000</b>

This hypothetical example does not reflect the performance of any particular investment. These rates include the 3.8% surtax on net investment income which applies to taxpayers reporting more than \$200,000 (\$250,000) in modified adjusted gross income (MAGI).

\* Source: Bloomberg Index Services Limited as of 12/31/20.

† Average rate on a 6-month negotiable certificate of deposit (secondary market) as of 12/31/20, quoted on an investment basis.

‡ Bloomberg Barclays Municipal Bond Index, yield to worst as of 12/31/20.

**A much smaller investment in municipal bonds would have generated more after-tax income than a \$100,000 investment in CDs. In this case, the municipal bond investor would have had \$86,000 left over to invest in stocks or other assets.**

## Consider the tax-equivalent yield

The tax advantages of investing in municipal bond funds versus taxable investments such as CDs can be significant. The chart below shows the yield an investor would have to earn on a taxable investment to equal the yield on a tax-exempt investment, depending on the investor's federal tax bracket.

For example, if an investor in the 24% federal tax bracket owns a municipal bond fund with a current tax-free yield of 3%, the taxable-equivalent yield is 3.95%. The investor would have to place their money into a taxable investment yielding 3.95% in order to match the 3% yield being earned with the municipal bond fund after taxes are deducted.

### Municipal bond tax-equivalent yield chart

Federal tax rate	Tax-exempt yield					
	3.00%	3.50%	4.00%	4.50%	5.00%	5.50%
	Taxable-equivalent yield					
22.00%	3.85%	4.49%	5.13%	5.77%	6.41%	7.05%
24.00%	3.95%	4.61%	5.26%	5.92%	6.58%	7.24%
32.00%	4.41%	5.15%	5.88%	6.62%	7.35%	8.09%
35.80%*	4.67%	5.45%	6.23%	7.01%	7.79%	8.57%
38.80%*	4.90%	5.72%	6.54%	7.35%	8.17%	8.99%
40.80%*	5.07%	5.91%	6.76%	7.60%	8.45%	9.29%

\* These values include the 3.8% surtax on net investment income which applies to taxpayers reporting more than \$200,000 (\$250,000) in modified adjusted gross income (MAGI).

## Calculate your own potential returns

You and your advisor can use the space below to determine how much after-tax income an investment in CDs or municipal bonds would be likely to produce.

Invest in CDs		Invest in municipal bonds	
Initial investment	\$ _____	Initial investment	\$ _____
Rate of interest	_____ %	Yield	_____ %
Annual income	\$ _____	Annual income	\$ _____
Tax bracket	_____ %	Tax bracket	_____ %
Tax bill	\$ _____	Tax bill	\$ _____
After-tax income	\$ _____	After-tax income	\$ _____
<b>Money left over to invest</b>	<b>\$ _____</b>	<b>Money left over to invest</b>	<b>\$ _____</b>

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While all bonds have risks, municipal bonds may have a higher level of credit risk compared with government bonds and CDs.

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