



Looking Beyond Yield: Understanding Taxable and Tax-Exempt Bonds

Yield tells only part of the story. A disciplined fixed income strategy considers the after-tax income a bond delivers and how each holding fits within the broader portfolio. By carefully balancing taxable and tax-exempt securities, investors can build a bond allocation designed not simply to generate income, but to preserve efficiency, manage risk, and support long-term wealth objectives.

When evaluating a bond investment, yield is often the first number investors consider. It's straightforward, easy to compare across securities, and it appears to offer a clear measure of return. But for sophisticated investors, the yield printed on a bond is often not the number that matters most.

What ultimately matters is not the yield a bond advertises, but the post-tax, active income that remains. Understanding which bonds generate taxable income and which offer tax-exempt interest requires a more strategic approach for interpreting after-tax outcomes.

The Core Distinction

Bonds generally fall into two categories. Taxable bonds, which include corporate bonds and U.S. Treasuries, pay interest that is subject to federal income tax. Tax-exempt bonds, most commonly municipal bonds, issued by states, cities, and local agencies, pay interest that is typically exempt from federal income tax. These bonds help local governments fund important infrastructure projects and are often attractive investment vehicles due to their tax-advantaged status.

The Key Metric: Tax-Equivalent Yield

A direct comparison between a taxable bond and a municipal bond can be misleading if the analysis stops at the headline yield.

Consider a municipal bond yielding 4% vs. a corporate bond yielding 5.5%.

At face value, 5.5% is higher than 4%, indicating that — without strategic insight — the corporate bond would seem preferable, offering a stronger return.

Not necessarily.

To properly determine the relative value, we need to calculate the municipal bond's tax-equivalent yield. In short, this metric estimates the yield a taxable bond would need to offer to match the after-tax income of the municipal bond.

$$\text{Tax-Equivalent Yield} = \frac{\text{Tax-Free Yield}}{1 - \text{Marginal Tax Rate}}$$

For an investor in the top 37% federal tax bracket, a municipal bond yielding 4% would have a tax-equivalent yield of roughly 6.35%. By understanding tax-equivalent yield, the same 4% Muni now looks much more attractive than the taxable bond yielding 5.5%.

A Closer Look at Munis

Developing a tax-aware fixed income strategy requires looking beyond headline yield. For high earners, the interaction between taxable and tax-exempt securities can meaningfully influence after-tax outcomes.

Municipal bonds are often associated with tax-free income, but that characterization is not universal. Certain municipal securities may be subject to the Alternative Minimum Tax (AMT), which can reduce or eliminate the expected tax advantage.

Thoughtful portfolio construction considers these nuances. Working with an experienced advisor can help align fixed income allocations with long-term portfolio objectives, while carefully managing the impact of taxes along the way.

The Importance of Diversification Within Your Bond Portfolio

Bonds are often viewed as the stabilizing component of a portfolio. While they generally exhibit lower volatility than equities, fixed income investments are not without risk.

Bonds can look deceptively similar on the surface, but the underlying risks vary considerably. Municipal bonds, for example, span a large range of issuers and revenue sources — general obligation bonds backed by a municipality's taxing power, revenue bonds tied to a specific project or income stream, and essential service sectors (hospital bonds, airport bonds, toll road bonds) each carry their own risk profile.

Concentrating too heavily on a single issuer, geographic region, or sector can expose a portfolio to unnecessary risk. An investor who holds a large position in a single city's revenue bonds, or who has accumulated a cluster of airport bonds across several issuers, may not realize how correlated those holdings are — or how vulnerable they'd be to a single adverse event.

The same principle of diversification applies across bond types. A well-constructed fixed income portfolio typically blends taxable and tax-exempt bonds, varies in maturity, and spreads credit exposure across multiple sectors and issuers. Yield matters, but so does resilience.



The Bottom Line

Bonds play a central role in many portfolios, providing income, diversification, and potential stability during periods of market volatility. Yet their effectiveness correlates with thoughtful design. The right mix of taxable and tax-free bonds will depend on your income, your overall financial plan, and your tax goals.

Our team at Endeavor approaches your fixed income strategy with the same level of care and discipline as the rest of your portfolio. Anything less leaves clients vulnerable to unnecessary tax drag.

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Diversification does not ensure a profit or guarantee against loss.

Investing in commodities entails significant risk and is not appropriate for all investors.



The Woodlands | Houston, TX
2001 Timberloch Place, Suite 500
The Woodlands, TX 77380
Phone: 281.326.9902

Abilene, TX
406 Lone Star Drive
Abilene, TX 79602
Phone: 325.672.9230