

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, certificates of deposit (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	\$31,000
Rate of interest*	1.27%	Yield†	2.65%
Annual income	\$1,270	Annual income	\$822
Tax bill (36.8% bracket)	\$467	Tax bill (36.8% bracket)	\$0
After-tax income	\$803	After-tax income	\$822
Money left to invest after initial investment	\$0	Money left to invest after initial investment	\$69,000

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).

Average rate on 6-month negotiable certificates of deposit (secondary market), as of 12/31/16, quoted on an investment basis.

* Source: Bloomberg.

† Source: Bloomberg Barclays Municipal Bond Index; yield-to-worst, as of 12/31/16.

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 \$69,000 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 25% federal tax bracket owns a municipal bond fund with a current tax-free yield of 3%, the taxable equivalent yield is 4%. The investor would have to place his or her money into a taxable investment yielding 4% 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						
25.0%	4.00%	4.67%	5.33%	6.00%	6.67%	7.33%
28.0%	4.17%	4.86%	5.56%	6.25%	6.94%	7.64%
33.0%	4.48%	5.22%	5.97%	6.72%	7.46%	8.21%
36.8%*	4.75%	5.54%	6.33%	7.12%	7.91%	8.70%
38.8%*	4.90%	5.72%	6.54%	7.35%	8.17%	8.99%
43.4%*	5.30%	6.18%	7.07%	7.95%	8.83%	9.72%

* These values include the 3.8% surtax on net investment income that applies to taxpayers reporting more than \$200,000 for single filers (\$250,000 for married couples filing jointly and qualified widow(er)s) 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:	\$ _____
Money left over to invest:	\$ _____	Money left over to invest:	\$ _____

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