

Fully Equivalent Taxable Yield (FETY)

Introduction to Investments
Prof S G Badrinath
Rates of Return – Review and More:
Part 3

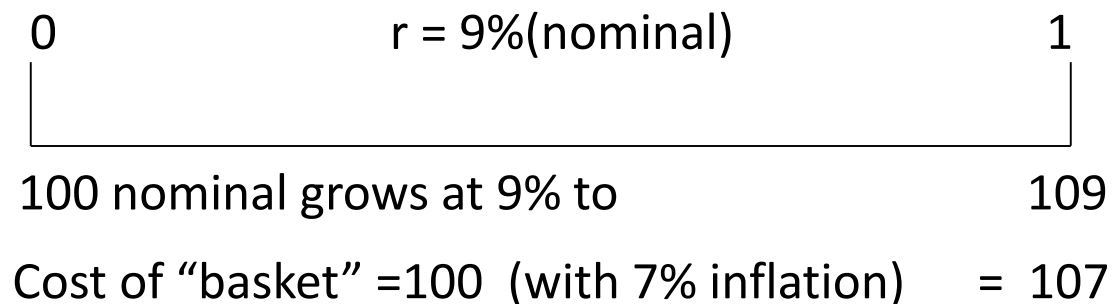
A CA bond has a yield of 6%, exempt from both federal taxes (@30%) and state taxes @10%.

To compare this with a corporate bond on which both federal and state taxes apply, calculate FETY as:

$$\frac{6\%}{(1 - 0.4)} = 10\%$$

Nominal and Real Rates of Return

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At time 1, the \$109 purchases $109/107 = 1.0187$ “baskets.” So in terms of purchasing power, the 9% return translates into 1.87% more “baskets” with 7% inflation.

$$\text{Or, real rate of return} = \frac{1 + \text{nominal rate}}{1 + \text{inflation rate}} - 1 = (1.09/1.07) - 1 = 0.0187 \text{ or } 1.87\%$$

Nominal and Real Rates of Return (Cont.)

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Common approximation:

$$\text{Real Rate} = \text{Nominal Rate} - \text{Inflation Rate}$$

To Investors, the Real, After-tax Rate of Return is the One to Consider.

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