Fully Equivalent Taxable Yield (FETY)

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

0 r = 9%(nominal) 1

100 nominal grows at 9% to 109

Cost of “basket” =100 (with 7% inflation) = 107

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.)

Common approximation:

Real Rate = Nominal Rate - Inflation Rate

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