

Taking Stock: Taxable, tax-free yields aren't much different

by Malcolm_Berko

Dear Mr. Berko: I have just about \$100,000 to invest short-term (about 18 months) in a money market fund or tax-free money market fund. Please tell me if you think the Vanguard Taxable Money Market Fund 5.26 percent is a safe fund. And please tell me if the Vanguard Tax-free Money Market Fund paying 3.55 percent is a safe fund. I'm in the 35 percent tax bracket and I can't figure out if I'm better off owning the Vanguard Taxable or the Vanguard Tax-free Money Market. Would you please help me out here? My CPA says it doesn't make any difference between investing in the taxable fund vs. the tax-free fund.

M.S.

Springfield, Ill.

Dear M.S.: Vanguard's Taxable Money Market Fund (MMF-\$1) is among the best on the Street with a current yield of 5.26 percent. To the best of my knowledge this MMF has zero exposure to the subprime stuff or to that queer 30-day commercial paper issued by the venal Kohlberg, Kravis & Roberts and or commercial paper issued by villainous private equity firms, which may also implode. The Vanguard folks are too smart to get caught with trash like that.

While there are other MMFs with higher yields (up to 5.6 percent) I'm willing to accept a little lower yield because Vanguard has exceptional liquidity and because its reputation stands behind the \$1 value of its money market fund. I'm comfortable owning it.

And Vanguard's Tax-Exempt MMF that yields 3.55 percent and is a steady Eddy with over \$21 billion in assets - equal to the net worth of college dropout Paul Allen, co-founder of Microsoft. This Vanguard fund is rock solid, managed as if it were a Swiss bank. Interest is paid monthly and Vanguard has never, never, never had a default or missed an interest payment. I'm comfortable owning this MMF, too.

Your third question asks: would Vanguard's tax-free MMF, yielding 3.55 percent, provide you with more spendable money than Vanguard's taxable MMF, yielding 5.26 percent? The answer is: Yes - but not by much!

The math is simple and here's the formula to convert a tax-free yield into an equivalent taxable yield in your 35 percent tax bracket. Subtract your 35 percent tax bracket from 100 percent and the result is 65. Divide that 65 into the 3.55 percent tax-free yield and the resulting 5.46 percent is the taxable equivalent yield. For example if you get a 5.46 percent taxable yield on \$100,000 you will earn \$5,460. Because you are in the 35 percent bracket your taxes you gotta pay the Internal Revenue Service on the earnings (35 percent times

\$5,460) - \$1,911. So you get to keep (\$5,460 minus \$1,911) \$3,549, or 3.549 percent. Now if you put that \$100,000 in the tax-free MMF paying 3.55 percent you keep \$3,550 which is \$6 more than \$3,549. So basically the small difference of \$6 makes it a cold-water wash.

However, you might consider putting your \$100,000 in the T. Rowe Price Yield Tax-Free High-Yield Fund (PRFHX-\$11.54) that has \$1.7 billion in assets and yields 4.81 percent. PRFHX is a medium-risk, medium-quality, tax-free fund that has very little change to its net asset value over the years. I've watched this fund for nearly 10 years and during its worst year (its only been down once) the fund's NAV only lost 5.1 percent, the dividend has been remarkably consistent and like Vanguard it's a no-load fund with top tier management and excellent customer service. A \$100,000 investment in the non-taxable 4.81 percent PRFHX is the taxable equivalent to earning 7.4 percent if you are in the 35 percent tax bracket. To express it another way ... if you are in the 35 percent tax bracket you must have taxable earnings of 7.4 percent (which is fairly high these days) to net 4.81 percent after taxes. That sounds like a swell deal to me.

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