

# A pragmatic, multi-asset approach to tax-sensitive investing

## Federated Hermes Multi-Asset Group

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### Key takeaways

- We believe it is essential for taxable investors to consider both pretax and after-tax total returns when evaluating an investment strategy.
- Municipal interest is generally exempt from federal income tax, and qualified dividends are taxed at preferential rates.
- Municipal bonds and equities have tended to exhibit low correlation.
- This historically lower co-movement of the two asset classes may serve to reduce overall portfolio volatility and increase opportunities for tax-loss harvesting.

Taxable investors often weigh the need for current income against the benefits of deferring income for potential long-term capital gains through greater equity exposure. A blended approach — combining tax-exempt municipal (muni) income with dividend-paying equities that qualify for preferred tax rates — has potential to materially increase the after-tax income an investor keeps while preserving meaningful participation in equity upside.

## The appeal of a municipal bond/qualified dividend equity blended portfolio

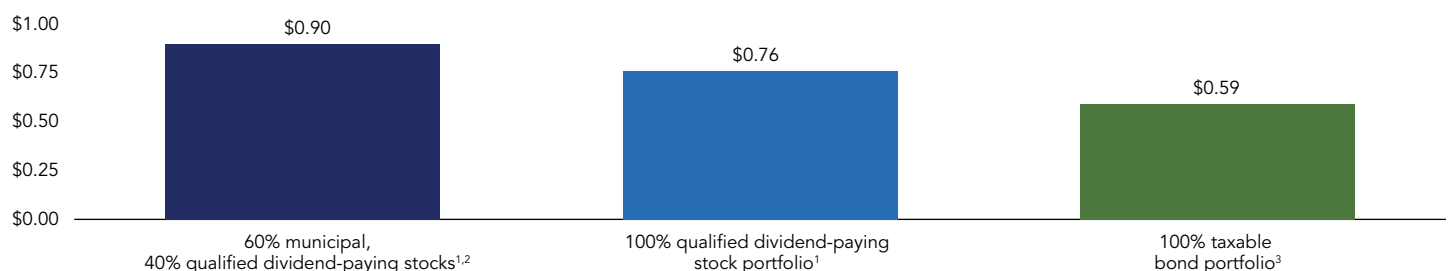
### The potential to keep more

For taxable investors, it is essential to consider both pretax and after-tax returns when evaluating a strategy, as every tax situation is different. Municipal interest is generally exempt from federal income tax, and qualified dividends are taxed at preferential long-term capital gains rates (typically 15% or 20%, depending on the taxpayer's bracket). When combined, these two income streams could potentially produce a higher tax-equivalent income profile than wholly taxable bond income or equities alone for many investors in higher tax brackets.

### Equity upside potential with tax-efficiency

A portfolio that shifts its allocation from 100% munis to a mix of 60% munis and 40% qualified dividend equities can typically preserve a large portion of the income advantage. Exhibit 1 below shows how approximately \$0.90 of every \$1.00 of pretax income can be retained, while adding equity upside potential that can drive long-term capital appreciation.

Exhibit 1: Amount of ordinary dividend income retained after federal income tax (cents per dollar)



• In this example, investors would keep more of their dollar investment when compared to either a taxable bond or a dividend-paying stock portfolio.

<sup>1</sup> Qualified dividend income (QDI) taxed at 23.8% (includes the 3.8% tax on net investment income) is assumed for the purposes of the illustration. The federal tax rate on qualified dividend income for non-corporate taxpayers with taxable income in excess of prescribed thresholds is 20%.

<sup>2</sup> Hypothetical allocation. Municipal is allocated by US Fixed Income (Municipal) and Cash/Cash Equivalents (Municipal).

<sup>3</sup> Taxable bond portfolio assumes a 37% tax rate plus the 3.8% tax on net investment income.

Tax information presented is generic in nature and should not be considered advice. Consult your personal tax advisor regarding your situation.

Source: Federated Hermes, Inc. For illustrative purposes only.

## Decreased overall volatility and lower downside risk

Munis and equities have tended to exhibit low correlation to each other than equities with taxable corporate bonds (Exhibit 2). When combined in a diversified, actively managed portfolio, the potential creates a smoother return path and potentially smaller drawdowns during severe equity market stress, helping investors manage sequence-of-returns and income needs in taxable accounts.

## Tax management opportunities

Capital losses realized in the equity sleeve, for instance, can generally be used to offset realized taxable capital gains elsewhere in a portfolio (including gains realized on taxable sales of municipal securities) and vice versa. The historically lower co-movement of the two asset classes may increase the opportunities for tax-loss harvesting, as losses and gains in each asset class are less likely to occur at the same time across both sleeves.

## Correlations matter in multi-asset portfolios

Munis and many dividend-paying equity segments have low-to-moderate correlation, meaning they have tended to move independently of each other. By blending these exposures, an investor may reduce overall portfolio volatility without sacrificing a meaningful share of market upside.

### Exhibit 2: Bonds have shown low correlation to stocks over time

20-year correlation (As of 12/31/25)	1	2	3	4	5	6	7
<b>40% S&amp;P 500®/60% S&amp;P Municipal Bond Index</b>	<b>1.00</b>						
<b>S&amp;P 500®</b>	0.93	<b>1.00</b>					
<b>S&amp;P Municipal Bond Index</b>	0.62	0.30	<b>1.00</b>				
<b>Bloomberg US Aggregate Bond Index</b>	0.47	0.24	0.71	<b>1.00</b>			
<b>Bloomberg US Government/Credit Long Index</b>	0.43	0.22	0.66	0.94	<b>1.00</b>		
<b>Bloomberg US Long Treasury Index</b>	0.15	-0.06	0.52	0.86	0.86	<b>1.00</b>	
<b>Bloomberg US Long Credit Index</b>	0.62	0.44	0.69	0.88	0.88	0.93	<b>1.00</b>

■ Correlation with S&P 500®

Sources: Morningstar, Inc; Federated Hermes, Inc. As of 12/31/25.

The diversification principle has held during many periods when equities have experienced steep declines, with 2022 being the most notable recent exception. Muni bond/equity blended portfolios have tended to show lower peak-to-trough losses than pure equity allocations. The importance of bonds, beyond their hoped-for stabilizing effect during volatile periods, lies in their potential to generate income during market downturns. That quality is beneficial to investors who rely on their portfolios for income, helping them avoid forced, ill-timed asset sales in a down market to meet a sudden need for cash.

Portfolio construction is central to the successful implementation of a tax-sensitive multi-asset portfolio, encompassing careful security selection, appropriate position sizing, credit and duration management in the muni sleeve, and selection of dividend-paying equities that meet quality and dividend-sustainability criteria.

## Tax mechanics and preferential treatment

Interest from municipal bonds that are structured as federally tax-exempt (and not subject to alternative minimum tax) is generally excluded from federal taxable income. State and local tax treatment depends on the investor's state of residence and the issue's domicile. Dividends that meet the Internal Revenue Service definition of qualified dividend income (QDI) are taxed at preferential long-term capital gains tax rates — commonly 15% or 20% for many high-income taxpayers — which can be lower than ordinary income tax rates.

**Net Investment Income Tax.** The 3.8% net investment income tax (NIIT) on investment income applies at certain income thresholds and can affect the after-tax attractiveness of dividend and interest income; municipal interest typically is not subject to NIIT.

**Capital gains and tax-loss harvesting.** Capital losses realized in equities can offset taxable capital gains realized anywhere in the portfolio (including gains from the sale of municipal securities). Because muni interest is tax-exempt, losses do not offset muni interest. Still, they can be valuable for reducing taxable gains and managing taxable income arising from transactions in the account. Losses can also be harvested on the muni side, as part of active portfolio management. The bonds may trade below par, and losses can offset equity gains. We routinely sell assets in both equities and munis to offset gains. We should call out the balanced nature here.

Losses can also be harvested on the muni side, as part of active portfolio management. The losses resulting from bonds sold below par can be used to offset equity gains. Positions can be sold in both equities and munis to manage taxable gains, underscoring the balanced nature of the approach.

## Why at least 50% in municipal securities matters in pooled vehicles

### Tax-advantaged pass-through requires a municipal predominance.

In pooled vehicles structured to pass on tax advantages to shareholders, there is typically a requirement that a majority of assets be invested in municipal securities to maintain the vehicle's tax-advantaged profile at the shareholder level. That structural requirement helps ensure that most of the income generated by the vehicle can be treated as tax-exempt to investors (subject to prospectus terms and the specific holdings).

### Exhibit 3: Taxable equivalent income

#### Seeking to keep more of your income

	Income earners < \$545.5k/\$613.7k+*	Income earners < \$640.6K/\$768.7k+*	Income earners > \$640.6k/\$768.7k+*
<b>Regular income tax bracket</b>	35	35	37
<b>Capital gains**</b>	18.8	23.8	23.8
<b>Dividend income tax</b>	18.8	23.8	23.8
<b>Muni tax</b>	0	0	0
<b>Amount of \$1 Dividend Income Retained after Federal Income Tax</b>			
<b>50%/50% Muni/stock allocation</b>	<b>\$0.91</b>	<b>\$0.88</b>	<b>\$0.88</b>
<b>100% Dividend paying stocks</b>	\$0.81	\$0.76	\$0.76
<b>100% Taxable bonds</b>	\$0.61	\$0.61	\$0.59

\* Includes 3.8% healthcare tax for investment income. \*\* Preferential capital gain rate breakpoints no longer line up with the ordinary income brackets. The 20% rate applies to Singles with taxable income in excess of \$545,500 and Married Filing Jointly with taxable income in excess of \$613,700.

Pairing equities and muni bonds provides a favorable risk/after-tax return profile versus other equity or fixed income alternatives in various tax environments. Muni bonds are exempt from the 3.8% investment tax imposed by the Healthcare bill.

The table above is hypothetical and calculated for illustrative purposes only. The table assumes stock and muni tax exempt bond dividend yields are equal. Equity dividends may qualify for the federated dividend income tax rate per category shown. Investors may be subject to healthcare tax on dividends and capital gains. No muni bond income is subject to the healthcare tax, federal income tax, the federal alternative minimum tax or state and local taxes. Any capital gains or personal income tax payable are taxed at the applicable rates and excluded from above calculation. As of 3/31/26.

Pairing equities and muni bonds provides a favorable risk/after-tax return profile versus other equity or fixed income alternatives in various tax environments, as seen in Exhibit 3.

**Trade-off example.** Converting a 100% muni allocation into a roughly 50% muni/50% dividend-paying equity allocation can preserve the majority of the tax-advantaged income (e.g., retaining approximately \$0.88 of each pretax dollar in after-tax terms for many high-income investors), while materially increasing total return potential through equity appreciation. This trade, for example, might make sense for many high-net-worth clients who want a tax-efficient income stream without sacrificing significant capital growth potential.

## Who can benefit from this strategy

	Description
<b>Who is most likely to benefit from this investment approach?</b>	<ul style="list-style-type: none"> <li>High-net-worth investors in taxable accounts seeking tax-advantaged monthly income plus meaningful long-term equity upside potential.</li> </ul>
<b>What are some scenarios that could benefit?</b>	<ul style="list-style-type: none"> <li>Clients relying heavily on and facing high marginal tax rates.</li> <li>Investors wanting to reduce volatility in taxable account withdrawals without losing equity upside potential.</li> <li>Individuals in tax brackets where qualified dividends are taxed favorably, and municipal bond tax exemptions provide clear value.</li> </ul>
<b>Scenarios that are not a fit.</b>	<ul style="list-style-type: none"> <li>Investors using tax-deferred accounts (IRAs, 401(k)s) where tax characteristics matter less.</li> <li>Investors with short investment horizons who prioritize capital preservation above all else.</li> </ul>

## Implementation considerations

- **Allocation rules and monitoring.** Establish a strategic allocation target (for example, a majority muni holding to secure tax pass-through in pooled vehicles) and apply tactical adjustments for duration, sector and credit quality within the muni sleeve to reflect changing rate and credit environments.
- **Duration and credit management.** Active duration decisions and sector/credit selection in munis can meaningfully affect yields and volatility. Managers can position across the yield curve, and across revenue, general obligation and sector credits, to help balance income and capital preservation goals.
- **Equity sleeve selection.** Favor dividend payers with sustainable payouts, strong balance sheets and valuation discipline. Limit concentration risk through position size caps and diversification across sectors (excluding asset classes that may complicate the dividend tax profile, such as REITs, if the goal is QDI).
- **Ongoing tax planning coordination.** Tax-loss harvesting programs benefit from coordination with the client's broader tax plan — tax lots, wash-sale rules, state tax considerations and the timing of sales all matter. Close collaboration with a tax advisor is recommended.

## Keeping more of what you earn

A thoughtfully constructed blend of tax-exempt municipal income and qualified dividend equities can help investors keep more of the income they receive today while retaining meaningful participation in equity market upside for longer-term growth. This approach needs a combination of preferential tax treatment, potential diversification benefits from a portfolio of assets with relatively low correlation and tactical tax-loss harvesting opportunities. Provided personal tax circumstances, investment horizon and risk tolerance are in alignment, this solution may be attractive for investors seeking a tax-efficient monthly income stream without sacrificing the potential for capital appreciation.

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## Disclosures

Bond prices are sensitive to changes in interest rates, and a rise in interest rates can cause a decline in their prices.

There are no guarantees that dividend-paying stocks will continue to pay dividends. In addition, dividend paying-stocks may not experience the same capital appreciation potential as non-dividend paying stocks.

Muni bond income is not subject to the federal income tax or the federal individual alternative minimum tax.

Diversification does not assure a profit nor protect against loss.

Investing in equities is speculative and involves substantial risk.

Tax information presented is generic in nature and should not be considered advice. Consult your personal tax advisor regarding your situation.

## Definitions

**Alternative minimum tax (AMT)** is a part of the US tax system designed such that higher-income individuals pay a minimum level of tax, even if they use deductions, credits, tax-exempt investments and other tax benefits to reduce their regular tax bill.

**Duration** is a measure of a security's price sensitivity to changes in interest rates. Securities with longer durations are more sensitive to changes in interest rates than securities of shorter durations.

**Yield curve** depicts the comparative yields of securities in a particular class according to maturity. Securities on the long end of the yield curve have longer maturities and durations.

**Bloomberg US Aggregate Bond Index** is an unmanaged index composed of securities from the Bloomberg Government/Corporate Bond Index, the Mortgage-Backed Securities Index and the Asset-Backed Securities Index. Total return comprises price appreciation/depreciation and income as a percentage of the original investment.

**Bloomberg US Long Credit Index** measures the performance of investment grade, US dollar-denominated, fixed rate, taxable corporate and government related bonds with maturities of 10 years or more.

**Bloomberg US Long Government/Credit Index** is a long-duration bond benchmark that tracks US dollar denominated, investment grade, fixed rate Treasury, government related, and corporate bonds.

**Bloomberg US Long Treasury Index** measures the performance of US dollar-denominated, fixed rate debt issued by the U.S. Treasury with maturities of 10 years or more.

**S&P 500®** is an unmanaged capitalization-weighted index of 500 stocks designated to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

**S&P Municipal Bond Index** is a broad, market value-weighted index that seeks to measure the performance of the US municipal bond market. The index includes bonds of all quality — from "AAA" to non-rated, including defaulted bonds — from all sectors of the municipal bond market.

Indexes are unmanaged and cannot be invested in directly.