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Home-State Muni Funds Look Like the Obvious Choice. The Math Doesn't Always Agree.

For investors in high-tax states, the pitch for a single-state municipal bond fund sounds almost automatic. Buy bonds issued in your home state, and the interest is typically exempt from both federal and state income tax. Buy a national fund, and the portion of income from out-of-state bonds is usually taxable by your state. Double tax exemption beats single tax exemption, so the home-state fund wins.

Sometimes it does. But the answer depends on more than the tax exemption, and plenty of investors end up paying for the state exemption in ways they don't notice.

Start with the tax benefit itself, which is often smaller than it seems. The value of a state exemption is roughly the fund's yield multiplied by your state tax rate. If a fund yields 3.5% and your state rate is 6%, the exemption is worth about 0.21 percentage points of yield a year. That's real money, but it's not huge. For residents of states with top rates near 10% or above, such as California, New York City residents, or New Jersey, the value is larger. For residents of states with low or no income tax, it's small or zero, and a national fund is almost always the better choice.

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