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When Muni Bonds Outside Your State Make Sense.

Higher yields, diversification may help influence those decisions.

Most people buy municipal bonds issued by an entity in their home state because the interest paid is generally exempt from federal and states income taxes.

With the changes in the tax code, getting that state income tax exemption is important for people who live in high-tax states like New York and California. The new tax law capped state and local tax deductions to $10,000, so for these residents, buying municipal bonds from entities in their state can help lower their taxable income.

But sometimes it makes sense to buy municipal bonds that aren't issued in the state where you reside, even if you live in a high-tax state. Fixed-income experts say there are several reasons to think about adding municipal bonds from other states.

Diversification. Duane A. McAllister, managing director and senior portfolio manager at Baird Advisors in Milwaukee, says having a mix of muni bond exposure helps protect investors from regional economic swings. If an investor lives in the New England area and there's a recession there, Texas may be doing well.

"We talk about U.S. economic growth, but it's not uniform," McAllister says. "There are times when a particular state may be over or underperforming whatever is occurring on a national basis."

Mark Paris, chief investment officer and head of municipal strategies for Invesco Fixed Income in New York, says there are a lot of projects in different states that can offer fixed-income investors attractive yields. Invesco likes infrastructure projects such as toll roads in Texas, bridges in New York state and hospital bonds in Florida.

"You're investing in the essential services end in the revenue section," he says. "You don't have to worry about the pension issues" that can bog down other types of municipal bonds.

Certain states also issue more bonds than others. A big state like California or New York have a lot of credit offerings to choose from, versus a state like Connecticut or Virginia, Paris says. Residents of smaller states may have limited choices.

Every investor is different, but McAllister says having a portfolio made up of half in-state municipal bonds and half national bonds is a good place to start.

"You're lowering your overall risk because not everything is in one particular state," he says.

States with economic turmoil. Some states, like Illinois, New Jersey or Connecticut with high debt levels may make it undesirable for residents to buy municipal bonds. Although defaults are rare, they do happen, McAllister says.

Paris concurs. "Those are places where we make a very strong argument for you to start to look at

the national marketplace," he says. "We certainly don't think that they're going to go into the default, but there could be downgrades of their credit."

Shocks can happen to seemingly healthy regions, too. Orange County, California's bankruptcy filing in 1994 is one example. It was a Triple-A rated bond, but as interest rates rose, some of the county's shakier holdings lost value, affecting the entire portfolio. "It eventually worked out," McAllister says. "But oooh, I can tell you there were lots of sleepless nights for investors there. And that's not what you sign up for."

That said, investors with more risk appetite might be willing to look at a state like Illinois because some triple-A rated municipalities or universities may be penalized because of the overall economic strife and have to offer higher yields, says Jason Ware, co-founder and head of institutional trading at 280 CapMarkets in San Francisco.

Higher yield. Yields on munis vary, and some may yield higher than what is currently available in-state. If the yield is high enough, giving up the tax-free status may be worth it, the sources say. To figure it out, McAllister says take the bond's yield, subtract the number one, then divide by your state tax rate.

For example, if the yield was 2 percent and the state tax rate was 5 percent, it would get you 2.10.

"So I need to find a bond that yields 10 basis points more," he says.

Ware says some states that don't have an income tax offer higher yields because there's less demand from residents for tax-free income. Municipal bonds from Washington, Nevada and Texas can sometimes fall in this category.

Demand can also make home-state bonds less attractive. Paris says there's a lot of demand for California muni bonds because of the tax-code changes, so yields are lower. To get a sense of prevailing yields, look at the daily Municipal Market Data scale. California general obligation bonds are trading around 3 percent, just above the top of the Municipal Market Data scale, which is at 2.97 percent. But Texas bonds generally are trading at 3.25 to 3.30 percent.

"You get about 10 percent more interest going into a national bond right now outside of California," he says.

When considering buying out-of-state municipal bonds, work with a financial advisor to understand your effective state income-tax rate.

"They'll have understanding of what's available in the market which help lead to them making the best decision in terms of deciding how they fit in a portfolio," Paris says.

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