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When Muni Bonds Outside Your State Make Sense.

Falling interest rates and the appeal of diversification are two reasons to look elsewhere.

CHANGES IN INTEREST rates and shaky state and local finances in the wake of the pandemic roiled the municipal bond market earlier this year.

That may give muni bond investors more reasons to look outside of their home state as they seek to diversify their holdings.

Municipal bonds are generally tax-free at the federal level, and residents who buy munis issued in their home state can avoid state and local taxes, which makes them appealing to fixed-income investors, particularly in high-tax states.

Market watchers say there are several reasons to look further afield for muni investments now. Here are some things to consider:

- The muni market dropped in the first quarter.
- Out-of-state muni bonds may be better buys.
- Mutual and exchange-traded funds offer diversity.

The Muni Market Dropped in the First Quarter

The economic shutdown caused by the pandemic hit the muni market hard as state and local governments were suddenly seeing mass unemployment and tax revenues dry up in the first quarter.

“No one knew what the ramifications were going to be with everyone staying home,” says Jason Ware, head of institutional trading and one of the founders of 280 CapMarkets. “How would that affect sales tax collections? Income tax collections? Airports not having any traffic?”

To keep stock and debt markets from free-falling and the economy from plunging into a deep recession, the Federal Reserve slashed interest rates to near zero and embarked on quantitative easing. One of the Fed’s early measures was to step into the muni bond market to inject liquidity by buying up muni bonds and offering a muni liquidity facility for cash-strapped entities to help them meet obligations. The State of Illinois and New York’s Metropolitan Transit Authority took financing at the time.

The muni market has stabilized since then, but the outlook is uncertain as the finances for many state and local governments take a hit from falling tax receipts, says Duane McAllister, managing director and senior portfolio manager at Baird Advisors. There are hopes for another stimulus package from Congress to help local governments, but that may not come until after the presidential election in November, if a stimulus bill passes at all.

Out-of-State Muni Bonds May Be Better Buys

The traditional rationale for why investors may want to buy muni bonds outside of their home state has to do with portfolio diversification and whether or not an investor's home state has a state income tax, Ware says. States without an income tax won't impose taxes on the bond's income, so there's an incentive to look nationally.

Wesly Pate, portfolio manager at Income Research + Management, says it makes sense now more than ever to look out of state with interest rates ultra-low.

"As yields have declined, the value of the tax exemption has declined with it," he says. "The actual tax rates are now less applicable than the actual starting yield."

McAllister agrees that the tax efficiency of in-state muni bonds is lower simply because yields dropped after rates fell.

That means investors should focus more on finding an attractive after-tax yield on the state level rather than worrying about any tax benefits by buying in their state. Pate says investors can speak with their financial advisor about setting their risk parameters as they look to build a diversified muni bond portfolio.

McAllister offers a quick calculation that buyers can use to see what type of after-tax yield they should seek to offset the lack of a tax exemption. For example, in California, the highest marginal income tax rate is 13%. If an in-state bond yield is 1%, the investor can subtract their tax rate from 100 to get 87. Divide the bond yield of 1% by 0.87 to equal 1.15%. If the bond outside of California can earn at least another 15 basis points or more, the buyer "is no worse off by not having the tax exemption," he says.

Investors who go shopping outside of their home state in search of higher-yield bonds also need to examine the credit quality of the issuer, which is more important now than ever because of the financial restraints caused by the pandemic, experts say. High yields often equate with low credit quality, and if a municipality's economic outlook worsens, low-credit-quality entities are at higher risk of default.

The impact of the pandemic may take time to filter through state and local governments, says Michael Wagner, co-founder and chief operating officer of Omnia Family Wealth. In addition to creditworthiness, investors should also consider the source of the bond's revenue. He says revenue bonds that back essential services or infrastructure projects may be more secure than general obligation bonds that are usually backed by property-tax revenue.

Mutual Funds and Bond ETFs Offer Diversification

Steve Azoury, financial advisor and owner of Azoury Financial, says adding muni bond mutual funds and ETFs are a way for retail investors to get exposure to bonds outside of their state. More specifically, Azoury likes offerings from Nuveen for national muni bond funds.

He says one of his favorite muni bond mutual funds is the Nuveen All-American Municipal Bond Fund (ticker: FAARX), which invests mostly in investment-grade debt. He notes that the fund has been around since 1997 and comes with a low annual expense ratio of 0.5%, which means it costs $50 per year for every $10,000 invested. "It's a consistent performer as it's in the top 20% of funds available and is a low-risk investment," he says.

Another selection is the Nuveen Intermediate Duration Municipal Bond Fund (NUVBX), which invests in investment-grade, intermediate-term muni bonds with a targeted weighted average effective duration between 4 1/2 and seven years, he says.

The advantage of buying mutual funds versus owning bonds outright is the diversification aspect, he says. Many funds own hundreds if not thousands of bonds. If there are muni defaults, the impact is lessened by the fact that the default is offset by other holdings.

“Bankruptcies in municipalities are rare, but they do happen,” Azoury says.

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