Municipal bond geographic diversification

A smart play

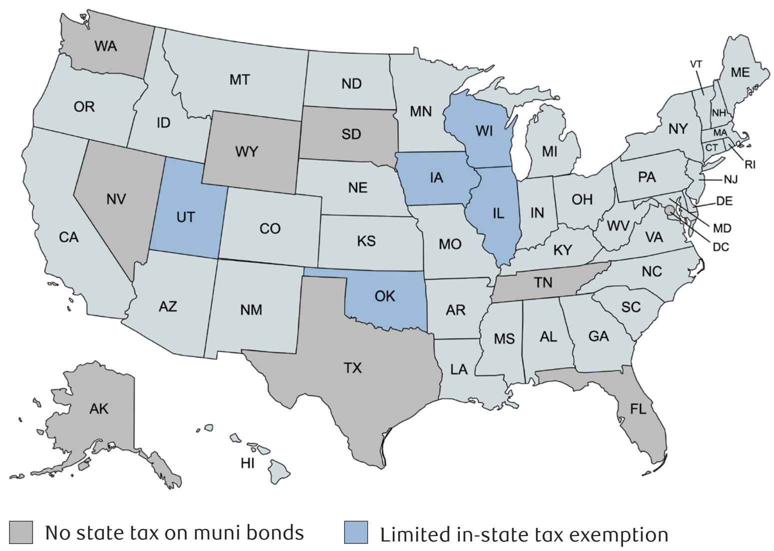
Investors' desire to minimize their tax burden is a fundamental tenet of municipal bond investing, but this desire can lead investors to focus exclusively on municipal bonds issued within their home states. Unfortunately, in doing so, investors break a cardinal rule of investing and subject themselves to unique state-specific risks that could have been avoided if their portfolios were geographically diversified.

Moreover, as the map at right shows, residents of several states do not receive any tax advantage from buying in-state municipal bonds—either because their income is not taxed, or because they don't benefit from a state tax exemption on in-state municipal bond interest. Therefore, residents of those states should be indifferent to the municipal bond's state of issuance.

While the risk-mitigation benefits of geographic diversification are numerous, the upside can be magnified when investors achieve comparable taxable-equivalent yields on out-of-state bonds. Depending on the investor's marginal state income tax rate, realizing taxable-equivalent yields on out-of-state bonds is surprisingly attainable.

No in-state tax advantage

State tax policies for municipal bonds



Source - RBC Wealth Management

History is littered with examples of unforeseen events such as industry obsolescence, technological shifts, and irresponsible political policies that have compromised local, state, and regional credit quality. Such events can lead to rating downgrades and price declines for impacted municipalities. In our opinion, municipal bond investors can minimize these pitfalls by geographically diversifying their portfolios.

States and municipalities are intertwined

There can be a meaningful correlation among all governments within a state because most state-level decisions have a trickle-down effect on lower levels of government. Therefore, an investor cannot diversify away from a state-level induced risk simply by purchasing more discrete names within that state. A perennial example is underfunded pension liabilities that many states ultimately must address. These pension challenges will require difficult decisions that may entail diminished state support for all its local municipalities. In turn, all local governments within these states could experience varying degrees of financial pressure.

Single-state portfolios exclude opportunities

Portfolios restricted to a single state also limit investment opportunities by excluding all municipalities located outside a state's borders. As a result, investors may not be maximizing their returns because they are foregoing thousands of out-of-state options. We view the municipal market as a cornucopia of quality issuers. However, the sheer number of issuers, especially infrequent issuers,

For important disclosures see page 3.

makes the market somewhat inefficient and increases the prevalence of yield opportunities.

Investors also may not fully appreciate that municipal issuers in states without income taxes must offer higher yields to attract investors, because these states do not have a native buyer base. (Absent a state income tax, in-state investors are indifferent to geographic location because they are not subject to state tax consequences.) Conversely, in affluent states where income taxes are relatively high, municipal yields are frequently suppressed due to high demand from in-state buyers seeking to shelter income. The confluence of these circumstances often means that there are more advantageous investment opportunities outside an investor's home state.

Yield equivalency is achievable

Superficially, it makes logical sense to purchase in-state bonds in order to avoid taxes; however, in many cases it is possible to realize the extra yield necessary to offset the tax liability on out-of-state municipal bonds.

Consider an investor deciding between two municipal bonds, one issued in their home state and the other outside it; the bonds are of similar credit quality, and both are exempt from federal tax. Purely from a yield perspective, the investor should be indifferent to the investment choice if the out-of-state bond's taxable-equivalent yield is at least equal to the in-state bond's yield. Of course, this hypothetical comparison ignores the added fundamental benefits of geographic diversification.

The table below shows, for each state, the yields required on out-of-state municipal bonds to offset the maximum state income tax compared to in-state municipal bonds of various yields. For example, for an Alabamian married couple filing their taxes jointly, an out-of-state municipal bond would need to yield 4.21% to equal a 4% in-state municipal bond. Interestingly, on average, investors must only realize 0.26% in additional yield on an out-of-state bond compared to an in-state bond that is yielding 4.0%. The actual additional incremental yield required will vary depending on the individual state's income tax rate.

Furthermore, because most states have graduated income tax rates, the actual additional yield necessary for an individual investor may be less than the maximum shown below. And, at the risk of getting into the weeds, the yields shown also do not account for local income tax rates that will impact some investors. But for the vast majority of investors, the table illuminates the possibility that geographic diversification may be achieved without sacrificing returns. This is especially feasible in states with lower income tax rates, because the state income tax consumes a smaller percentage of the out-of-state bond's investment return.

Strength through diversity

We believe municipal bond investing should be about more than just maximizing tax avoidance. Not only does exclusively owning home-state municipal bonds subject investors to unique state-specific risks, it also excludes potentially advantageous out-of-state

Out-of-state taxable-equivalent yield (TEY) required to equal in-state yield

State	Income tax rate (max.)	Out-of-state TEY required to equal in-state yield of:		
		3.00%	4.00%	5.00%
AL	5.00%	3.16%	4.21%	5.26%
AK	0.00%	–	–	–
AZ	2.50%	3.08%	4.10%	5.13%
AR	4.40%	3.14%	4.18%	5.23%
CA	13.30%	3.46%	4.61%	5.77%
CO	4.40%	3.14%	4.18%	5.23%
CT	6.99%	3.23%	4.30%	5.38%
DE	6.60%	3.21%	4.28%	5.35%
FL	0.00%	–	–	–
GA	5.49%	3.17%	4.23%	5.29%
HI	11.00%	3.37%	4.49%	5.62%
ID	5.80%	3.18%	4.25%	5.31%
IL	4.95%	3.16%	4.21%	5.26%
IN	3.05%	3.09%	4.13%	5.16%
IA	5.70%	3.18%	4.24%	5.30%
KS	5.70%	3.18%	4.24%	5.30%
KY	4.00%	3.13%	4.17%	5.21%
LA	4.25%	3.13%	4.18%	5.22%
ME	7.15%	3.23%	4.31%	5.39%
MD	5.75%	3.18%	4.24%	5.31%
MA	9.00%	3.30%	4.40%	5.49%
MI	4.25%	3.13%	4.18%	5.22%
MN	9.85%	3.33%	4.44%	5.55%
MS	4.70%	3.15%	4.20%	5.25%
MO	4.80%	3.15%	4.20%	5.25%
MT	5.90%	3.19%	4.25%	5.31%
NE	5.84%	3.19%	4.25%	5.31%
NV	0.00%	–	–	–
NH	3.00%	3.09%	4.12%	5.15%
NJ	10.75%	3.36%	4.48%	5.60%
NM	5.90%	3.19%	4.25%	5.31%
NY	10.90%	3.37%	4.49%	5.61%
NC	4.50%	3.14%	4.19%	5.24%
ND	2.50%	3.08%	4.10%	5.13%
OH	3.50%	3.11%	4.15%	5.18%
OK	4.75%	3.15%	4.20%	5.25%
OR	9.90%	3.33%	4.44%	5.55%
PA	3.07%	3.10%	4.13%	5.16%
RI	5.99%	3.19%	4.25%	5.32%
SC	6.40%	3.21%	4.27%	5.34%
SD	0.00%	–	–	–
TN	0.00%	–	–	–
TX	0.00%	–	–	–
UT	4.65%	3.15%	4.20%	5.24%
VT	8.75%	3.29%	4.38%	5.48%
VA	5.75%	3.18%	4.24%	5.31%
WA	0.00%	–	–	–
WV	5.12%	3.16%	4.22%	5.27%
WI	7.65%	3.25%	4.33%	5.41%
WY	0.00%	–	–	–
DC	0.00%	–	–	–
50-state average yield difference		0.19%	0.26%	0.32%

Source - The Tax Foundation, RBC Wealth Management investment opportunities. In fact, investors may actually improve the aggregate credit quality of their portfolios by geographically diversifying away from unpredictable state-specific risks that could wreak havoc on a single-state municipal bond portfolio.

The risk-mitigation benefits of geographic diversification are unquestionable, in our view, and these benefits are boosted if investors can realize taxable-equivalent yields on out-of-state bonds that are at least comparable to those on in-state bonds. Given the typically modest incremental yield necessary to achieve such results and the numerous yield opportunities within the fractured muni market, we believe such an outcome is possible for many investors.

Author

James Mann

Head, U.S. Fixed Income Strategies
james.mann@rbc.com; RBC Capital Markets, LLC

Disclaimer