Municipal Marketplace

Can single state portfolios be *advantageous*?

We often receive inquiries from clients and prospective clients about single state municipal bond portfolio management.

While such portfolios may have tax advantages (generally the bond interest is exempt from state and local taxation), we believe frequent drawbacks exist that could offset the local tax advantage. We have been a vocal advocate of the view that, in the long run, a national portfolio or a portfolio which has significant geographic diversification, may best serve the client's interest.

In-State Tax Benefits May Not Be All They're Cracked Up to Be

In most states, but not all, interest earned from 'in-state' municipal bonds is exempt from both federal and state income tax whereas interest received on 'out-of-state' bonds remains subject to state taxes. As a consequence, many investors from higher-tax states prefer to buy 'in-state' muni bonds. In addition, territorial bonds including Puerto Rico, Guam and the US Virgin Islands bonds are generally tax-exempt in most states. But the benefit of this state tax exemption may not be as great as it appears on the surface. For example, California exempts interest on its bonds from the state income tax, which tops out at 14.40% for the highest earners. Because of this high state tax rate, there is understandably strong demand for California munis. But this demand effect often causes California muni bonds to trade richer than they otherwise should. For reference, if a California bond yields 2.40% and an out-of-state bond yields 2.60%, the after-tax income advantage for a California investor investing in the California bond is only 0.17% (2.60% adjusted for the 14.40% California state tax equals 2.23%). At lower yield levels, this advantage compresses even further.

Thus investors should consider not only the level of the state income tax but also the yield of in-state bonds relative to comparable out-of-state bonds. Regardless of the level of the tax, we believe there are times when investors may be better served by paying the state tax and investing out-of-state.

Performance Impact of Limiting Your Investment 'Sandbox'

California and New York are the largest states in terms of total municipal bond issuance, as they each comprise over 15% of bonds currently in the Bloomberg Municipal Bond Index*. Other high-tax states are an even smaller component of the Index. A limited state focus may impact the ability of an investment manager to enhance performance by including opportunities from the rest of the nation.

Potential Diversification Benefits

Excessive portfolio concentration adds risk. We believe the same holds true for concentrating a portfolio in any one state. States and regions are prone to cyclical economic downturns, political events and natural disasters that can impact the credit strength and value of the bonds issued by the state. For this reason, we think a portfolio that is broadly diversified across geographic regions may be preferable to one that is more narrowly focused.

Our Approach

For the reasons we have outlined, we believe a *geographically diversified* portfolio could make economic sense for many investors.

Over time, bonds that are exempt from state and local taxation can be added to the portfolio when it is advantageous to the client. In the short run, there may be some tax cost to investing out-of-state, but we believe that in the majority of situations, after-tax return potential can be enhanced when the portfolio manager is given the maximum flexibility to select securities based on relative value and credit considerations.

We do recognize that some investors, especially those residing in high tax states, are particularly focused on tax minimization regardless of the arguments we have made here. With that being the case, we offer state-specific (100% in-state) and state-weighted (at least 50% of bonds in-state) portfolios to clients in high tax states which we feel have a sufficient amount of municipal bond issuance.

Currently those states are:

- **California**
- **New York**
- **New Jersey**
- **Pennsylvania**
- **Massachusetts**

*As of 4/30/2025.

Let's *Connect*

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KEY RISKS

Municipal Risk, Credit Risk, Issuer Risk, Interest Rate Risk, Liquidity Risk, Derivatives Risk, Leverage Risk, Counterparty Risk, Prepayment Risk, Extension Risk and Management Risk.

IMPORTANT DISCLOSURES

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Any investment that has the possibility for profits also has the possibility of losses, including the loss of principal.

There is no guarantee that the investment objective will be realized or that the strategy will generate positive or excess return.

Past performance is no guarantee of future results.

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