QUICK TAKE ON FIXED INCOME

HORNE
WEALTH ADVISORS

Q: Can it be appropriate to buy out-of-state bonds?

A: In most states, municipal bond interest is exempt from federal and state taxes as long as the investor is a resident of the state where the bond is domiciled. Because they are avoiding state income taxes, many investors have a false belief that in-state munis are always the best option. In many situations, BAM's Fixed Income Desk has actually seen investors pay more for the state tax exemption than the tax savings is worth. California and New York, for instance, have very high state income tax rates, and their bonds trade very expensive relative to other comparable out-of-state bonds. Municipal bonds issued in states with high state income tax rates are in greater demand because of in-state investors driving up their price. In many cases, BAM's Fixed Income Desk is able to purchase out-of-state bonds and pick up a greater after-tax return and add some geographical diversification to the portfolio.

For example, consider two similar high-quality investments for a Missouri resident in the highest tax bracket:

- An O'Fallon, Mo., general obligation bond rated AA by S&P with a 4 percent coupon maturing March 1, 2023, is yielding 1.41 percent. It is exempt from state income tax because the client is a Missouri resident. This equates to a tax-equivalent yield of 2.49 percent.

- A Denton, Texas, general obligation bond rated AAA by S&P with a 5 percent coupon maturing March 15, 2023 is yielding 1.60 percent. It has an after-tax yield of 1.50 percent at the top Missouri state income tax rate of 6 percent. The tax-equivalent yield works out to 2.65 percent.

Both bonds are exempt from federal taxes, but only the O'Fallon bond is exempt from state and local taxes. To determine which bond is best for the client, the after-tax yield needs to be evaluated. In the above situation, it's worth purchasing the Denton bond because its after-tax yield is 10 basis points higher than the in-state O'Fallon issue. The Denton bond also carries a tax-equivalent rate that is 19 basis points higher.

There are a handful of states (notably Texas, Florida, Washington and Nevada) that have no state income tax. Those states, as a result, tend to trade quite cheaply in the markets, making them attractive to investors.

Because BAM's Fixed Income Desk builds customized bond portfolios for clients, we evaluate which bonds will provide the best after-tax yield. In many cases, we are able to purchase out-of-state municipal bonds with a similar credit, maturity and coupon at a higher after-tax yield for investors.