In today’s market of economic uncertainty, equity market volatility, and ultimately higher taxes, investors are seeking investment solutions that provide stability, consistency, and tax efficiency. The days of significant allocations to alternative hedge funds that have lack of transparency, long lock-ups, and illiquidity are all but gone. In a shift reminiscent of the 1950s and 1960s, allocations to the municipal bond market are on the rise.

The credit market dislocations have pushed municipal returns to very attractive levels on an absolute and relative basis. Municipal bond yields have traded as high as 130 percent of Treasury bond yields while providing high levels of transparency and exceptional quality, even during this recession. However, assessing and measuring the value of a municipal investment requires a bit of extra work.

One may consider many different measures, including credit quality, interest rate sensitivity (duration), return volatility, and diversification. One of the most important and obvious, however, is the value of tax-exempt income. The value of tax-exempt income has taken on a higher profile because federal and state taxes are on the rise and it’s reasonable to assume that trend will continue (see figure 1).

Tax-Free Income is King

As investors in high tax brackets seek investment solutions, they are looking for tax efficiency. The interest on municipal bonds is exempt from federal income and (usually but not always) state and local taxes, depending on the bondholder’s state of residence. Investors residing in states with high state income tax rates such as California, New York, and Massachusetts have the added incentive to hold bonds issued by municipalities within their home states. However, this consideration should be viewed in the context of other factors such as concerns about credit diversification, bondholder liquidity, and supply constraints.

Tax Implications and the TEY

The comparative cost of buying in-state versus out-of-state municipals depends on the investor’s state income tax rules and rates. In most states, the interest income on in-state municipal bonds also is exempt from that state’s income tax; however, most states impose a tax on interest income from bonds issued by out-of-state municipalities. Generally, the higher the income tax rate in a given state, the less economic advantage there is to holding out-of-state municipals.

Taxable equivalent yield (TEY) is the standard used to evaluate and compare tax-exempt yield of in-state and out-of-state municipal bonds. TEY describes the taxable return that equates to a particular tax-exempt yield, taking into consideration the investor’s tax bracket. The simplest TEY calculation calls for dividing the tax-exempt yield by 1 minus the investor’s federal tax bracket.

For example, consider a 5-percent, longer-maturity municipal yield and assume the current top federal rate of 35 percent.

\[ \text{TEY} = \frac{0.05}{1.0 - 0.35} = 0.0769 \text{ or } 7.69\% \]

This means that an investor must receive 7.69 percent on a taxable investment to equal that of the 5-percent federally tax-exempt municipal investment. This does not take into consideration, however, the potential quality upgrade of using municipal bonds rather than more-volatile corporate bonds.

State Taxes Also Matter

State taxes generally are deducted on the federal tax form, and this requires adjusting the state tax rate. This is accomplished by multiplying the state tax rate by 1 minus the federal bracket. Adding the adjusted state tax rate to the federal tax rate gives the total effective tax rate.

Deductions could be limited. In many states the state income deduction is disallowed at higher income levels. These higher-income taxpayers must add back these deductions when computing state income taxes and may not be
Investable to derive the full benefit of deducting taxes paid.

For example, consider a high-income New York State investor who has invested in a municipal bond yielding 5 percent. The marginal state tax rate for this investor is 7.7 percent, while the federal tax rate is still 35 percent.

The TEY for this top-bracket New York State investor would be calculated as follows:
1. Adjust the state rate: 0.077 
   \( (1.0 – 0.35) = 0.05 \) or 5%
2. Add the adjusted state rate and the federal rate: 0.05 + 0.35 = 0.40 = 40%
3. TEY = 0.05 + (1.0 – 0.4) = 0.0833 = 8.33%

The adjustment for high-income investors moves the TEY from 7.69 percent to 8.33 percent. This suggests that the state exemption is worth about 64 basis points in taxable equivalent yield. This is a big difference and also happens to be similar to the long-term performance of the stock market. But let’s not stop just yet.

Impact of Higher Taxes Ahead

Now that we’ve looked at the value of municipal income based on today’s rates, let’s take it one step further and examine the value based on what we think tax rates might be in the future.

First, we already know that Congress and the Obama administration will not extend the Bush administration tax cuts, so the current top tax bracket of 35 percent will return to 39.6 percent in 2010. Indeed, multi-trillion-dollar stimulus programs plus the Troubled Asset Relief Program (TARP) bailouts may require taxes to rise even further. But this wouldn’t be precedent-setting. Figure 2 highlights the peaks in marginal federal tax rates during the 1950s and 1960s. Many states also are planning to raise taxes. Indeed, New York State recently proposed a new top state bracket of 8.97 percent for taxpayers with income above $500,000.

If we imagine top tax rates of 40 percent at the federal level and just 8 percent in New York State, TEY increases to 9.06 percent.
1. Adjust the state rate: 0.08(1.0 – 0.4) 
   \( = 0.048 = 4.8\% \)
2. Add the adjusted state rate and the federal rate: 0.048 + 0.4 = 0.448 = 44.8%
3. TEY = 0.05 + (1.0 – 0.448) = 0.0906 = 9.06%

This is a very compelling return, particularly when compared to stock market returns and stock market volatility.

Does a 5-percent municipal bond really exist? Yes. When the municipal market must digest new supply or has thin trading periods, yields across various maturities and quality have exceeded 5 percent. An extreme example was in November 2008 when benchmark AAA 10-year municipal bond averages exceeded 5.3 percent. The 20-year AAA yield reached 6.10 percent, and AA and A yields were even higher.

The Reality of Diversification

After looking at the TEY, your first inclination might be to buy a 100-percent state-specific portfolio. The reality is that the municipal market is a credit market. The days of AAA insured bonds and no defaults likely are behind us.

The historic events of the past two years, including the dramatic shift in institutional demand, the decline of the monoline insurers, challenged fiscal budgets, and the recession, are all risks that didn’t exist just a few years ago.

While the historic default rate for high-grade municipal bonds is very low, a prolonged recession and structural changes in the market could negatively impact credit stability and increase municipal portfolio risks. Indeed, some states and regions have more default than others.

According to Standard & Poor’s, the top 15 states in default incidence all have default rates two or more times the overall municipal market average, making a portfolio composed exclusively of bonds of any one of those states theoretically a higher-risk portfolio. Diversification helps reduce this risk and is preferable even when an investor is in a high-tax-bracket state.

Incidence of risk within a particular state typically derives from a number of factors including the following:
- Common regional economic variables (e.g., the auto industry in Michigan, the technology bust in Silicon Valley, the oil industry boom and bust in Texas and Oklahoma)

![FIGURE 2: TRENDS IN TOP TAX RATES](image-url)

Source: The Atlantic & Tax Foundation

© 2009 Investment Management Consultants Association. Reprint with permission only.
• State-specific political dynamics (e.g., Proposition 13 in California, Taxpayers Bill of Rights in Colorado, ballot initiatives in Massachusetts and Oregon)
• State regulatory constraints (e.g., eminent domain and oversight of municipal finances vary by state)
• Disasters with regional impact (e.g., Hurricane Katrina in Louisiana, Mississippi, and Alabama; 9/11 in the New York metropolitan area)

Diversification across multiple states does not necessarily cause a sacrifice in yield. There are numerous opportunities to buy out-of-state municipal bonds that can equal or even exceed the adjusted yield for a high-tax state.

For example, on March 31, 2009, two long-term, AA-rated general obligation (GO) bonds, each due in 2039, were trading at the very different yields. One was a high-demand New York State GO with a yield of 4.99 percent, and the other was a less-in-demand Las Vegas Performing Arts Center GO with a yield of 6.03 percent.

TEY for the New York bond for a high-income New York resident investor was 8.31 percent. But TEY for the Las Vegas bond for the same investor was 9.27 percent. This is 96 basis points better on an equivalent yield basis. In this case, the out-of-state bond would have provided a better tax-adjusted return.

Supply and Liquidity Issues in Portfolio Diversification

Supply. States with large populations, such as New York, California, Florida, Illinois, and Texas, typically are among the top issuers of municipals each year. States with smaller or more-sparse populations, such as New Hampshire, Delaware, Vermont, and Montana, issue very little municipal debt each year. Investors residing in states with strong municipal bond demand due to high state-tax rates but limited supply (e.g., Connecticut, Maryland, Georgia, Vermont, New Hampshire) often find in-state bonds expensive— that is, these bonds are lower yielding than their comparable out-of-state counterparts. When supply shortages are acute in these states, the yield on in-state bonds will tend to be so low that out-of-state bonds become attractive even after paying the state tax on the interest. In addition, the scarcity of bonds in these states makes it almost impossible to properly diversify a portfolio, and concentration risk becomes significant.

Liquidity. Not all municipal bonds of similar rating, maturity, and coupon rate trade exactly alike. There are in excess of 65,000 issuers and 1.5 million different Committee on Uniform Securities Identification Procedures (CUSIP) numbers in the $2.5-trillion municipal bond market with a wide diversity of structures, secondary market disclosure practices by issuers, and dealers willing to make active secondary markets or hold bonds in inventory. Each of these variables has an impact on liquidity, i.e., the ability of an investor to buy and sell efficiently, quickly, and with minimal cost. This was obvious in 2007 and 2008, when liquidity in many municipal sectors nearly dried up for weeks at a time.

Utilizing bonds of issuers outside the investor’s home state can enhance overall portfolio liquidity by expanding the universe of available bonds from which to choose. It’s for this reason that we strongly suggest investors, even in high-tax states, consider diversification out-of-state.

A Practical Approach

We strongly advocate taking advantage of the tax-exempt municipal bonds of a client’s home state, especially in an environment of rising federal and state taxes. However, we don’t think it’s prudent to commit to a 100-percent in-state bond portfolio.

In the past few years of market dislocation, broader diversification has helped reduce return volatility and provided better liquidity. As a practical matter, a target at least 50 percent of resident bonds is appropriate in a state that meets specific criteria of sufficient issuance, quality, liquidity, and comparable yield. In some states such as Maryland, Georgia, California, Virginia, and New York, that percentage could be higher, even as much as 70 percent. However, in states that don’t meet these criteria, holdings could be as low as 10 percent or less. Each criterion is driven by investor objectives, time horizon, and aversion to risk. This is why a cookie-cutter approach does not maximize after-tax returns or meet the specific needs of high-net-worth investors.

Chip Norton is managing director, fixed income strategies, with Wasmer, Schroeder & Company, Inc. in Naples, FL, which specializes in fixed-income portfolio management for high-net-worth families, institutions, and wealth managers. He earned a BS in finance from the University of Vermont. Contact him at cn@wasmerschroeder.com.

Endnote

1 The taxable equivalent yield (TEY) measures what an investor would have to earn (yield) on a taxable (or fully taxable) investment in order to match the yield provided by a tax-exempt municipal bond. The TEY is only one factor that should be considered when purchasing a security and is meant to be used only as a general guideline when determining taxable equivalent yields for agency and treasury securities. The state tax rates shown represent the maximum state income tax in each state. Some states have lower tax rates within each federal tax bracket in relation to income level and type of filing. If state tax rates are lower than posted, taxable equivalent yields may be lower than shown. The effective combined rate assumes that the taxpayer itemizes deductions. The factors do not adjust for: the phase-out of itemized deductions for certain high-income taxpayers; the yield to maturity factoring in market discount or market premium; or the effect, if any, of the federal alternative minimum tax (AMT).