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## Home-State Muni Funds Carry Risks

By IAN SALISBURY

For investors in municipal-bond funds, choosing a fund tied to a single state can mean extra tax savings, but some financial advisers say it's not worth the risk.

Investors who own municipal bonds don't pay federal income tax on the bonds' interest payments. If the bonds are issued by the holders' home state or a local authority, investors may not owe state or local taxes, either.

But while many financial advisers think it's a good time to look for muni-bond bargains, high-profile financial problems in states like California, New York and New Jersey mean that this time around, investors might be better off in a more diversified national fund.

"You have to look around at what's happening," says New Providence, N.J., financial adviser Diahann Lassus. "Many state governments are struggling big-time."

The credit crisis has made muni yields unusually attractive. Vanguard Intermediate-Term Tax-Exempt Fund, one that several advisers cited for its low costs, currently yields about 3.7%, well above the 1.6% yield on five-year Treasuries. Municipal yields are typically lower than Treasuries because they don't reflect investors' tax savings.

For investors in the top tax bracket, these savings usually amount to 35% of interest income. In high-tax states, avoiding state and local taxes can often save another 5% to 10%.

But for many, reaching for those extra percentage points may not be worth it. The risk of defaults on municipal bonds is slight, but investors can see significant losses if a state's bonds are downgraded by ratings agencies. Moody's lists a "negative outlook" for six different states, including Kentucky, Ohio and Florida (which doesn't have a state income tax).

Advisers also have fears about a number of other big states, like New York, which faces declining tax receipts from Wall Street, and California, which is close to running out of cash amid a budget deadlock.

"The state of California is bankrupt basically," says La Jolla-based financial adviser Steven Cowen. "We can't pay our bills."

Of course, a state downgrade wouldn't directly affect all bonds in a state muni-bond fund, but only the fund's "general obligation" bonds. Other holdings may include "revenue" bonds backed by highway or bridge tolls or other receipts that can hold up even when a state faces a fiscal crisis.

The level of general obligation bonds in the state-oriented mutual funds varies widely. For instance, funds that focus on New Jersey have, on average, only about 6% of their holdings in general obligation bonds, according to fund researcher Morningstar Inc. Ohio-focused funds have more than a third in that type of bond.

Apart from broader diversification, advisers say having a much larger pool of bonds from which to pick gives national managers more chances to find bargains, a factor that could help make up for state funds' tax advantage.

Finally, investors themselves have a broader range of choices among national funds because there are many more of these than funds that focus on any particular state. That's especially true for investors from small states.

Linthicum, Md., financial adviser John Bacci says he's aware of a handful of Maryland-oriented muni funds, including offerings from T. Rowe Price and American Funds, but still prefers national funds. "There's a better variety of offerings," he says. "There's a better variety of managers."

Merritt Island, Fla.-based financial adviser Steven Podnos doesn't have to worry about state-specific funds for his local clients because Florida doesn't have an income tax. But he says the calculus comes out the same for clients in California and Pennsylvania.

"It's not worth it to limit your purchases to a single state," he says. "It's not a place to speculate. If you're looking for capital gains or appreciation, that's what equities are for."

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