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Focus on Puerto Rico

Are you unwittingly exposed to one of the potentially highest-risk issuers in the Municipal Bond market?

Though unknown to many investors, Puerto Rico is widely held, often in alarming amounts, in both National and State-specific Municipal bond mutual funds. Institutional and retail investors have historically invested in Puerto Rican debt for enhanced yield / income opportunities and to avail themselves of the Commonwealth's triple-tax-exemption status. That potential overweighting could cause outsize losses if investors flee Puerto Rican debt because of continued deteriorating credit quality.

You might look at your bond fund holdings and think they have nothing to do with the territory. In reality, bond managers have been buying Puerto Rican debt in record amounts, as lower interest rates have pushed many towards taking on additional risk in pursuit of incremental yield and income. Caprin's research finds several large state-specific municipal bonds funds with up to 14% exposure to Puerto Rico, as well as several national funds with even greater weightings.

A December report by Morningstar noted: "In fact, Puerto Rico should be a big concern for many single-state municipal funds." Puerto Rican debt, the report finds, populates 107 of the 117 state-oriented municipal closed-end funds tracked by Morningstar, with four of those allocations in the double-digits. Moreover, 320 of 384 open-end state-municipal funds also have some Puerto Rico exposure, approximately 60 of which have double-digit allocations.

"With this in mind," says the note, "the ubiquity of Puerto Rican debt is less surprising. Because fund investment mandates typically focus on whether 80% of income is state tax-exempt (not whether it is generated in-state), a 5% or 10% allocation to Puerto Rico is fully within bounds as an income-boosting tactic. SEC naming regulations do not stand in the way either: As long as at least 80% of income is state tax-exempt, the fund can keep its single-state name."

Puerto Rico's fiscal challenges are significant. Despite an improved 2011 operating shortfall of $1.6 billion, the Commonwealth has now run deficits and negative fund balances for more than 10 straight years. Aggressive cost cutting and restructuring continue to leave a projected imbalance through 2014. The Pension system is a mess, with recent attempts at reform amounting to sandbags ahead of a tidal wave. Pension obligations remain funded at a paltry 14% (far worse than any U.S. State), leaving a $25 billion liability. When combined with net tax-supported debt of approx $42 billion, the resulting liability is more than 6 times Puerto Rico's annual budget. That is plainly unsustainable.

Rating agencies have taken notice and have been steadily downgrading major Puerto Rican issuers. Many issuers now rest barely above junk levels, with Negative Outlooks suggesting more cuts may lie ahead. Any further downgrades may prompt forced selling of Puerto Rican debt and significant liquidity challenges.

The market is already feeling nervous about these imbalances and downgrades. According to Barclays, the Puerto Rican municipal bond index fell over 4.5% in December compared to a broader Muni market decline of -1.2%, fueled largely by Moody's mid-month downgrade to one level above junk. For the two weeks ended March 26, 2013, the Puerto Rican index declined 1.33% despite a slightly positive overall Muni market, with both Fitch and S&P announcing downgrades during that window. The potential for further downgrades and continued financial distress leaves the door open for continued volatility.

Caprin portfolios do not own Puerto Rico debt. We view the short-term opportunity for higher yield to be inadequate when weighed against longer-term challenges facing the Commonwealth and potential risks to bondholders; investors need to be aware of these risks lurking in their bond allocations. We think the market is giving them an opportune window to scrutinize their Muni holdings for Puerto Rican exposure, as well as other complacencies that could hit when the market turns. An ounce of prevention…

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