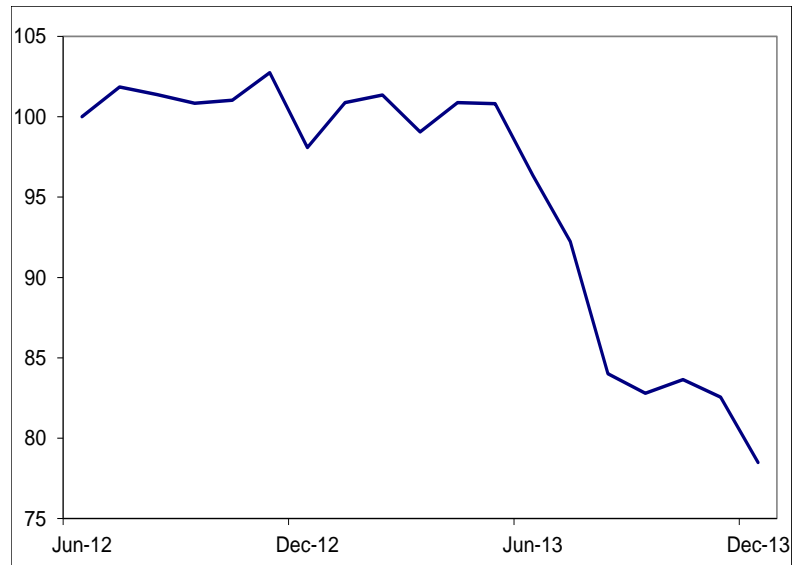


## Puerto Rico creditors are considering what's next. Shouldn't you?

### Introduction

Investors have awoken to the Commonwealth of Puerto Rico's persistent budget and pension deficits as some of the Commonwealth's largest creditors are reportedly meeting in New York to evaluate the circumstances. Cascading market values on roughly \$70 billion of bonds related to the territory are indicative of concerns, including the risk of default. Below, we offer a few thoughts on the evolving situation:

- Despite modest structural reforms Puerto Rico's population and economy both continue to contract. Facing continued deficits, Puerto Rico remains dependent upon capital markets to refinance maturing debt.
- Detroit's bankruptcy filing has heightened concerns over the potential fallout in the event of a default. One primary difference -- Puerto Rico cannot file for bankruptcy.
- Absent bankruptcy resolution, bondholders are exposed to several paths if Puerto Rico is unable to meet its obligations. Renegotiate payment terms? Seek relief in the courts? Pursue US Government intervention?



**Fig. 1** The Barclay's Puerto Rico Municipal Bond Index shows the debt's negative performance since mid-2012

Source: Barclay's

- Ratings risk remains a significant near-term threat. Moody's now has Puerto Rico "under review" for downgrade to "junk" status, and should report back to investors in the next two months.
- Puerto Rico-related debt remains widely held by individual investors and almost three-quarters of Municipal bond mutual funds (Bloomberg), including many labeled as state-specific in nature. A downgrade to 'junk' status may spark another wave of selling and additional price volatility.

### How to Respond

Exposure to Puerto Rico faces further downside risk (in the event of default) as well as upside potential (should the territory manage to fulfill its debt obligations). Either way, sailing will be anything but smooth. The volatility and potential returns leave Puerto Rico-related debt looking a lot more like stocks than like bonds. We have not owned any bonds related to Puerto Rico for several years. We continue to help new clients transition out of such high risk exposure to more traditional and conservative portfolios. If you do choose to hold on to Puerto Rico-related investments, whether within funds or individual bonds, be prepared for continued headlines and volatility.