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Puerto Rico Wins With Worst Riskless Return: Muni Credit.

Debt of junk-rated Puerto Rico is beating the entire $3.7 trillion municipal-bond market in 2014 and all U.S. states. Take volatility into account and the securities come in dead last.

Bonds from the struggling commonwealth have generated a 12.1 percent total return this year through Sept. 15, beating the 7.4 advance for the broader market, according to S&P Dow Jones Indices. Yet after factoring in price swings using Bloomberg's risk-adjusted return calculator, Puerto Rico's gain is only 1.6 percent, compared with 4.7 percent for the entire market.

The last-place showing underscores the risk-reward tradeoff of the bonds, which are tax-exempt nationwide and carry yields rivaling those on Venezuela bonds. While the swings are luring hedge funds, traditional muni investors such as AllianceBernstein Holding LP and Vanguard Group Inc. are balking as the island tries to boost its economy and repay $73 billion of debt.

"We don't think we're being compensated enough at these prices to be a buyer, given the risks we see," said Guy Davidson, who helps manage $30 billion of munis at New York-based AllianceBernstein. "And that's even true for our high-yield funds."

Rally Temptation

A two-month rally in Puerto Rico debt hasn't been enough to draw AllianceBernstein back to the territory. The company cut its holdings to zero after Governor Alejandro Garcia Padilla's June proposal of a new debt-restructuring law, down from a 2 percent allocation at the start of the year, Davidson said.

"Their ability to pay this debt is largely going to be dependent on their economy starting to grow," Davidson said.

An index that tracks Puerto Rico's economy has contracted by 19 percent since 2006, according to the Government Development Bank, which handles the commonwealth's debt sales. Compounding the challenge, the population has shrunk for eight straight years, to 3.6 million, as people move to the U.S. mainland, according to U.S. Census data.

Puerto Rico bonds have rebounded from record lows set in July following passage of a law allowing some agencies, including the Electric Power Authority, to restructure obligations.

Restructuring Pick

Prepa, as the utility is known, picked New York-based turnaround firm AlixPartners LLP this month to help repair its finances. It must file a debt restructuring plan by March 2.

Uninsured Prepa bonds maturing in July 2040 traded yesterday at an average price of 56.36 cents on the dollar, up from a record low 38.14 cents on July 7.

Ten-year Puerto Rico obligations yield about 8.6 percent, equivalent to a taxable 14.3 percent for investors in the top federal income bracket, Bloomberg data show. Similar-maturity dollar-denominated bonds for Venezuela, which has the world's highest inflation rate and plunging foreign reserves, yield about 14.4 percent.

Those interest rates are attracting buyers of risky securities.

Hedge funds bought the bulk of the commonwealth's $3.5 billion general-obligation sale in March, the municipal market's largest speculative-grade borrowing ever. More than 60 alternative fund managers hold about $16 billion of commonwealth debt, according to an August Fitch Ratings report.

Yield Response

The price swings attract hedge funds because they're looking for price appreciation, said David Tawil, co-founder of hedge fund Maglan Capital LP, which holds the island's general-obligation bonds.

Puerto Rico "provides a pretty compelling investment opportunity," said Tawil, who oversees a $75 million fund in New York. "There's a fair amount of identifiable financial reforms that could go ahead and be carried out and yields would respond as a result."

A group of 28 hedge funds, including Brigade Capital Management LLC, Fir Tree Partners, Monarch Alternative Capital LP and Perry Capital LLC, hold more than $4.5 billion of Puerto Rico securities, according to Russ Grote, a Washington-based spokesman who represents the coalition at Hamilton Place Strategies.

The group is "a potential source of financing to assist the commonwealth and the governor as they continue their efforts to improve the island's financial position," it said in a statement last month.

Fund Pullback

Puerto Rico may need to tap that financing as it plans to sell $900 million of notes in the next 30 days.

The hedge funds and alternative investors are stepping in as mutual funds, which own about 17 percent of all municipal debt, have pulled back. About 57 percent of U.S. muni mutual funds hold Puerto Rico securities as of September, down from 77 percent in October, according to Morningstar Inc.

The $9.8 billion Nuveen High Yield Municipal Bond Fund, the largest U.S. mutual fund focusing on lower-rated munis, hasn't held Puerto Rico securities since June 2013, according to John Miller, co-head of fixed income in Chicago.

Outside that fund, Nuveen holds $100 million of Puerto Rico debt, or less than 1 percent of its $94 billion of muni assets, down from 1.5 percent two years ago, Miller said.

The commonwealth's history of selling bonds to repay creditors is deterring Nuveen, even with the high yields.

"The island does have an uncanny ability to continue to convince different constituencies to enable them to extend, borrow more, extend more, borrow more," Miller said.

Vanguard's weighting is below benchmark levels because of recurring budget deficits and a flagging economy, said Chris Alwine, head of munis in Valley Forge, Pennsylvania. The company oversees $140 billion of state and local debt.

“We haven’t seen the economic growth,” Alwine said. “There’s still progress to be made.”

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