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Puerto Rico Is Outlier for Wealthy Fleeing Tax Hit: Muni Credit.

Financial advisers to some of the wealthiest Americans see struggling Puerto Rico as an outlier in the \$3.7 trillion local-debt market, leading them to add municipal bonds as the steepest federal tax rates in more than a decade loom.

Puerto Rico's downgrade to junk this month influences investors nationwide as the U.S. commonwealth's debt is held in 70 percent of municipal mutual funds. Money managers for high-net-worth clients say they're more focused on the improving fiscal outlook for mainland issuers. States and cities benefiting from a growing economy are mending their finances almost five years after the longest recession since the 1930s.

Last year's rally in stocks helped drive municipal debt to the worst annual losses since 2008. Now, less than two months before the deadline for filing individual returns, tax-exempt securities are gaining appeal as some top earners face levies on debt interest payments are as much as 24 percent higher than for 2012.

"People are going to be shocked by their tax bills this year," said Patrick Bittner, head of investment-grade fixed income for Silvercrest Asset Management Group, a New York firm whose average client has about \$33 million with the company. "More people will seek out tax-free income, which makes muni bonds more valuable."

Individuals' Role

Increased demand from individuals, who own about 60 percent of the municipal market either directly or through mutual funds, may add momentum to a 2014 rally in local debt that has driven benchmark yields close to the lowest since June. Munis have earned 2.8 percent this year, after a 2.6 percent drop in 2013, S&P Dow Jones Indices show.

Detroit's record bankruptcy filing in July and bets on rising interest rates fueled \$58.4 billion in outflows from muni-bond funds in 2013, the most since at least 1984, according to Investment Company Institute data. The trend has reversed this year, with the funds adding \$589 million in January.

"All of the selling has created opportunities," said Dave Grecsek, New York-based director of investment strategy and research at Aspiriant, a wealth-management firm overseeing more than \$7 billion.

Individuals usually buy munis for their tax-free income. The bonds are generally exempt from federal, state and local taxes for residents in most states where they're issued. Puerto Rico bonds are exempt from federal, state and local levies nationwide, explaining why the territory's finances have an impact beyond the shores of the Caribbean getaway.

April Bill

This year, high earners face bills due by April 15 that for the first time include federal tax increases that took effect last year: a top marginal rate of 39.6 percent, up from 35 percent; and a 20 percent tax on long-term capital gains and dividends, up from 15 percent. The top tax bracket hasn't been this high since 2000.

The increases coincide with a new 3.8 percent tax on investment income applied to top earners last year as a result of the 2010 health-care law.

"With tax rates at these high levels, long munis offer investors attractive after-tax income," Philip Condon, head of U.S. fixed income and munis at Deutsche Asset & Wealth Management in Boston, wrote in a report this month. "There is no fixed-income alternative with similar opportunity."

Clients' Demand

With the top federal tax rate reaching 43.4 percent when including the new tax on investment income, the 2.61 percent yield on benchmark 10-year munis is equivalent to a taxable interest rate of 4.61 percent. Treasuries of that maturity yield 2.74 percent.

As clients increasingly demand tax-free income, municipal credit is strengthening, said Brendan Connaughton, chief investment officer at advisory firm ClearPath Capital Partners in San Francisco.

"State governments are improving and improving at a dramatic pace," he said.

Tax collections have probably grown for 16 straight quarters, according to the Nelson A. Rockefeller Institute of Government in Albany, New York. Meanwhile, 60 issuers defaulted for the first time last year, down from 107 in 2012, data from research firm Municipal Market Advisors show.

Asset Switch

Aspiriant has trimmed equities for some clients and shifted into munis, especially for residents in high-tax states such as California, New York and New Jersey, Grecsek said. The Standard & Poor's 500 index of shares is little changed in 2014, after a 29.6 percent gain in 2013.

The firm's typical client has about \$10 million in investable assets, and munis average 20 percent to 30 percent of holdings, he said.

For some advisers, the extra yield on Puerto Rico bonds may be worth the risk.

Puerto Rico general obligations due in July 2041 traded yesterday with an average yield of 7.79 percent, the lowest since November, data compiled by Bloomberg show. The extra yield investors demand over benchmark munis was 3.9 percentage points, down from 5 percentage points at year-end.

Debt of the self-governing commonwealth has rallied as officials said they plan to issue about \$2.9 billion of general-obligation bonds next month to satisfy cash needs through mid-2015.

Credit View

S&P cut the island to speculative grade on Feb. 4, followed by Moody's Investors Service and Fitch Ratings amid concern that the territory won't be able to repay investors as its economy contracts.

Bill Hayes, a principal at Charles Carroll Financial Partners in Kingston, Massachusetts, said he'd buy the island's debt for clients if it becomes available to more than institutions.

“Any coupon above 5 percent would be a wonderful opportunity,” Hayes said.

For advisers such as Sam Katzman, chief investment officer at Constellation Wealth Advisors in New York, Puerto Rico bonds are still too risky.

He said he’s looking for revenue bonds with a AAA rating or two steps lower, that yield at least 3.5 percent and have durations of five to 10 years.

“People are crossing the 50 percent threshold,” he said of combined federal and state levies. “The idea of sheltering income becomes more attractive and the intrinsic value of munis becomes more attractive.”

By Margaret Collins Feb 24, 2014 5:00 PM PT

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