Puerto Rico Lures Franklin as Equity Funds Buy Junk: Muni Credit.

Franklin Resources Inc. (BEN) is leading money managers in adding junk-rated Puerto Rico bonds to mutual funds that focus on equities or other asset classes, even as the island's main power utility moves to restructure.

The companies bought general obligations as prices on Puerto Rico securities set record lows this year on speculation the U.S. territory and its agencies would be unable to repay $73 billion of debt. The firms join hedge funds and other non-traditional buyers of municipal bonds who are purchasing the securities for their higher yields.

Investors are more comfortable holding the general obligations after lawmakers passed a balanced budget in June and shielded the bonds from a law allowing some public agencies to negotiate with investors, said Gregory Whiteley, who manages government debt in Los Angeles at DoubleLine Capital LP, which oversees about $52 billion. In trading yesterday, some obligations reached a six-month high.

"I don't think there's any immediate prospect for a default or a restructuring related to the general-obligation debt," said Whiteley, whose company owns Puerto Rico general obligations. "At the same time, it's got a pretty attractive yield."

Distressed Holding

Puerto Rico securities, which are tax-free nationwide, have been trading at distressed levels for about a year. The island's economy has struggled to expand since 2006 and its population has shrunk for eight straight years as residents move to the U.S. mainland.

Lawmakers in June approved a law that would allow certain public corporations, including the Electric Power Authority, to ask bondholders to take a loss. General obligations, bonds repaid with sales-tax revenue and debt of the Government Development Bank are exempt from the measure. Puerto Rico's constitution requires that it repay general obligations before other spending.

Prices sank after Governor Alejandro Garcia Padilla proposed the restructuring bill June 25. Electric Power bonds maturing in July 2040 traded July 7 at an average of 38.14 cents on the dollar, a historic low, data compiled by Bloomberg show. General obligations sold in March at 93 cents on the dollar traded as low as 84.4 cents July 3.

Franklin's Fund

The decline attracted Franklin, Whitebox Advisors LLC and DoubleLine mutual funds that include equities among their biggest holdings.

As of June 30, Franklin had $185 million of the March general obligations across 11 funds, including $72.5 million in its $25.5 billion Franklin Mutual Global Discovery Fund (TEDIX), according to

Bloomberg data. The fund allocates 87 percent of assets to stocks, including Apple Inc. (AAPL) and Merck & Co. (MRK)

Stacey Johnston Coleman, a spokeswoman at San Mateo, California-based Franklin, declined to comment.

While equity funds typically don't buy munis, they do purchase distressed securities for potential price gains, said Russel Kinnel, director of manager research at Morningstar Inc. in Chicago.

"From an equity perspective, it's very depressed and maybe you get a better price down the road and that's the appeal," Kinnel said. "They're simply betting that it's overdone."

Equity Strategy

Minneapolis-based Whitebox had $4.6 million of the March general obligations in its $1.1 billion Tactical Opportunities Fund (WBMIX) as of April 30, the latest data reported to Bloomberg.

The fund invests 62 cents of every dollar into stocks and sells the same amount short, according to Jason Cross, global head of equity strategies. Holdings include offshore rig contractor Transocean Ltd. (RIG), Bloomberg data show.

"If you look at where Puerto Rico yields are, compared to almost anything else in the world at this point, those yields look really attractive," said Paul Twitchell, global head of event strategies at Whitebox.

DoubleLine holds $2.5 million of the March general obligations in its $140 million Multi-Asset Growth Fund (DMLIX), Whiteley said. It's the fund's first purchase of munis, he said. The company bought at about 89 cents on the dollar, for a tax-exempt yield of about 9 percent, Whiteley said.

Yield Cushion

"At 9 percent you can suffer a fair amount of price erosion over the course of a year and still be ahead, but ultimately I think the general-obligation debt will be OK," he said.

The fund directed 34 percent of assets to mortgages and 22 percent to equities as of June 30. Munis accounted for 1.5 percent, all in Puerto Rico.

The March general obligations, which mature in July 2035, traded yesterday at an average of 91.6 cents, close to the highest since May 9, Bloomberg data show. The tax-exempt yield of 8.9 percent compares with an average taxable yield of 6.43 percent on similar-maturity corporate bonds rated junk, according to Barclays Plc data.

General obligations maturing in July 2026 reaching 78.9 cents yesterday, the highest since February.

The Electric Power Authority, the largest U.S. public-power utility by customers and revenue, must release a plan by March 2 to restructure its debt as part of an agreement with bondholders and creditors to extend bank loans that finance fuel purchases. The utility is also moving to reduce costs across operations.

Prepa's Challenge

Fitch Ratings on June 26 cut the agency, called Prepa, to CC, its third-lowest speculative grade. The utility used $41.6 million of reserves to pay bondholders July 1 after tapping money for capital spending to buy fuel.

Prepa bonds maturing July 2040 traded yesterday at an average of 50.1 cents after falling to a record of 38.1 cents July 7.

Puerto Rico securities have rebounded as investors look to pad returns with riskier debt as muni yields approach generational lows.

Munis sold on the island have earned 8.5 percent this year through Aug. 25, beating the 7.3 percent gain for the broader $3.7 trillion municipal market, according to S&P Dow Jones Indices. That compares with the S&P 500’s 9.7 percent advance in 2014, including dividends.

‘Beaten Up’

Bethesda, Maryland-based Calvert Group Ltd. had $500,000 of the March general obligations in its $1 billion Calvert Balanced Portfolio (CSIFX) as of April 30, Bloomberg data show. It has sold that debt and replaced it with taxable Government Development Bank bonds, said Matt Duch, a money manager at Calvert. The fund directs about 61 percent of assets to stocks, including Apple and FedEx Corp. (FDX)

The price declines piqued Calvert’s interest, Duch said.

“They had been unfairly beaten up,” he said.

The exclusion of commonwealth general obligations, Government Development Bank bonds and sales-tax debt from the restructuring law lured buyers, Whiteley said.

“What they want to do is make clear a strong commitment to repaying their general-obligation debt in full,” Whiteley said. “If that means the holders of some of the debt of other Puerto Rico agencies are at greater risk than they had before, then that’s the way it is.”

By Michelle Kaske Aug 26, 2014 5:00 PM PT

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