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## Likely Default of Puerto Rican Utility Haunts Brokers, Muni Fund Managers.

The widely expected default of a Puerto Rican utility continues to weigh on some investment managers.

One in four U.S. municipal bond funds hold some exposure to the debt of the utility, the Puerto Rico Electric Power Authority or Prepa, a self-funded utility that provides electricity to nearly 1.5 million households and businesses on the island.

The approximately $1.7 billion in Prepa bonds held by mutual funds is a drop in the bucket for the $553 billion U.S. muni bond fund industry. And the exposures generally account for less than 1% of the total portfolio.

But 39 mostly single-state and high-yield funds have weightings around or above 2%, according to an InvestmentNews analysis of data from Morningstar Inc., including funds from OppenheimerFunds and Franklin Templeton Investments. Those funds account for about $33 billion in assets.

"Yields are not that high in fixed income," said Morningstar analyst Kiran Lalani. "It's a yield boost to add some of these bonds."

For single-state funds, managers are also limited in the number of securities they can buy and tend to fill out the rest of portfolios such as the Oppenheimer Rochester Maryland Municipal Fund (ORMDX) or Franklin New Jersey Tax-Free Income (FRNJX) with more Puerto Rican debt, according to Ms. Lalani.

The commonwealth said in an Oct. 30 report that the island's power utility may use its authority under a law passed by local lawmakers in June that would allow it to ask bondholders to take a loss.

Franklin Templeton Investments and OppenheimerFunds have both filed lawsuits in federal court alleging the debt-restructuring law is illegal.

Puerto Rico's debt-laden woes seem to have weighed on fund companies, too.

Oppenheimer's $26 billion muni operation saw nearly $5.3 billion in investor redemptions in the 12 months ended Sept. 30, according to Morningstar, while Franklin's $68 billion muni business saw nearly $4.9 billion in outflows over that time period.

Spokespeople for both firms declined to comment.

The Prepa securities are also a central subject in ongoing arbitration cases against brokers at firms including a UBS AG affiliate by investors who say they were sold Prepa bonds that subsequently lost value, according to Lawrence L. Klayman, a lawyer representing some investors in those cases.

A UBS spokesman did not respond to a request for comment.

Ms. Lalani, the Morningstar analyst, said that most fund managers have taken a cautious approach to the territory and reduced their exposures.

John V. Miller, the co-head of fixed income at Nuveen Asset Management, said in August that his firm had “reevaluated” its use of Puerto Rican securities in fixed income portfolios.

“At a minimum it’s a high-yield play, if not a distressed-debt play, therefore it would only be a good fit in certain portfolios,” he told InvestmentNews.

He said the firm had declined to participate in a lawsuit against the legality of Prepa’s debt restructuring.

“It’s a little bit academic in nature,” said Mr. Miller. “Let’s say it is unconstitutional, where’s the money going to come from to pay the debt back?”

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