OppenheimerFunds Sticks With Struggling Puerto Rico: Muni Credit.

(Bloomberg) — OppenheimerFunds Inc. is maintaining its bets on Puerto Rico as other municipal-bond investors flee, banking on the strategy that's made it a top performer over the past five years.

Bonds from Puerto Rico accounted for about $5.6 billion of the $26.2 billion invested across the money manager's 20 muni funds as of Jan. 1, according to data compiled by research firm Municipal Market Analytics. The 21.4 percent allocation compares with about 19 percent a year earlier, before Puerto Rico was cut to junk in February 2014, data compiled by Bloomberg show.

OppenheimerFunds has outperformed many of its peers since 2010 thanks partly to debt of Puerto Rico, which has been a core holding because it's tax-free nationwide and offers attractive yields. At stake is whether the gains can last as the island's electric agency moves toward restructuring and as officials struggle to revive an economy with a 13.7 percent jobless rate, more than double the U.S. average.

"The circumstances have changed, but their holdings are static," said Bob Donahue, a managing director at Concord, Massachusetts-based MMA who testified to a congressional panel last month about the island's finances. "Shareholders have seen the volatility — they've benefited during the good times and suffered during the bad."

Junk Limit

Kimberly Weinrick, an OppenheimerFunds spokeswoman in New York, declined to comment beyond the company's published statements on Puerto Rico.

OppenheimerFunds said in February 2014 that it couldn't add more junk bonds to some funds because Puerto Rico's rating cuts pushed it over its speculative-grade limit. The company has nine of the 10 highest-yielding muni funds focused on specific states, including those for Maryland and Virginia residents, Bloomberg data show. Those funds had 48 percent and 38 percent stakes in Puerto Rico as of Jan. 31, respectively.

Their managers wrote about the benefits of state funds in November, saying that "because each fund emphasizes in-state securities, your investments also help support projects close to home." Three paragraphs later, they mention holding Puerto Rico, Guam and the U.S. Virgin Islands.

Last year's downgrades "did not change Oppenheimer Rochester's opinion about the credit risk of Puerto Rico and its public authorities," the company said in its annual overview, released in January. OppenheimerFunds money managers "saw opportunities to ride out the volatility and clip highly favorable coupons."

Strategy's Reward

The managers have said they focus on tax-free bonds offering higher yields, such as debt from U.S.

territories and securities backed by cigarette shipments. Over the years, higher coupon payments can boost returns.

The strategy has paid off in terms of five-year annualized performance, Bloomberg data show. Excluding dedicated high-yield muni funds, the $2 billion Oppenheimer Rochester AMT-Free Municipal Fund is the best-performing national fund, while the $1.36 billion Oppenheimer Rochester California Municipal Fund tops open-end funds focused on the Golden State.

Among single-state funds outside of California and New York, which are marketed to residents for income excluded from state taxes, the Oppenheimer Rochester Minnesota Municipal Fund and the Oppenheimer Rochester Pennsylvania Municipal Fund have two of the three biggest five-year gains, Bloomberg data show.

The question for OppenheimerFunds is whether Puerto Rico bonds can keep generating outsize returns, said Beth Foos, a senior analyst at Morningstar Inc. in Chicago.

Beware Volatility

"These state-specific funds are achieving that tax-exemption while reaching for yield, which has been rewarded over the last several years," Foos said. "That comes with additional risk going forward with this particular issue in Puerto Rico. They've got very challenging budget issues that aren't going away."

Unlike the broad $3.5 trillion municipal market, Puerto Rico bonds haven't recouped losses suffered in 2013, when state and local debt fell the most in five years, S&P Dow Jones Indices data show. After falling a record 20.5 percent in 2013, commonwealth bonds gained 10.3 percent last year amid demand for high-yield munis.

The $3.5 billion of general obligations Puerto Rico issued a year ago have lost value. The debt priced at 93 cents on the dollar to yield 8.73 percent on March 11, 2014, Bloomberg data show. It traded Friday at about 83 cents, for a 9.93 percent yield.

Holding Rationale

For the Oppenheimer Rochester Maryland Municipal Fund, the company's most heavily concentrated in Puerto Rico, the island is depressing returns. It fell 13.7 percent in 2013, compared with a 1.4 percent slide for the S&P Maryland index. The fund has trailed 98 percent of peers in the past three years.

Even as the fund's net assets shrank to $63.5 million as of Dec. 31 from $67 million a year earlier, Puerto Rico holdings appreciated 1.8 percent to $30.3 million. That means 48 percent of the fund was dedicated to the island, up from about 44 percent.

The fund can invest as much as 25 percent in junk debt, according to its prospectus. It can exceed that limit if managers bought the debt while it was investment grade.

Dan Loughran, who leads the OppenheimerFunds muni group, explained the reasoning for the holdings in a September 2013 article in InvestmentNews: The commonwealth's constitution puts bondholders first in line and the island can't file for bankruptcy.

Investor Defense

Yet there's a growing chance that those rationales may crumble amid attempts by lawmakers to let some island authorities either restructure debt or seek Chapter 9 bankruptcy protection, MMA's Donahue said.

OppenheimerFunds is moving to defend bondholders. Along with investment funds of Franklin Resources Inc., it convinced a federal judge in San Juan to throw out the island's Recovery Act, which would've allowed some agencies to restructure.

Some of the largest muni investors trimmed Puerto Rico holdings since the territory lost its investment grades. Nuveen Asset Management, which oversees about $100 billion in munis, holds almost no commonwealth debt, while Vanguard Group Inc., which manages $140 billion of munis, cut its stake by about half, to $257 million.

Sam Katzman, who advises high-net-worth individuals as chief investment officer at Constellation Wealth Advisors in New York, said Puerto Rico hasn't been worth holding for 15 years.

Yet with interest rates close to generational lows and the top income-tax bracket the highest since 2000, the state funds' yields may lure buyers who haven't kept up with the island's financial struggles, he said.
OppenheimerFunds' holdings are in plain sight: Online fund summaries detail allocations to each state and territory.

"I always worry about what happens to the everyday investor," said Katzman, whose firm oversees $6 billion. "If the yield looks too high, figure out why. There's no free ride – – there's always risk associated with the reward you're getting. You have to pay attention. The information is there."

Bloomberg Muni Credit

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March 8, 2015

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