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Puerto Rico's Crisis Deals a Blow to Municipal-Bond Funds.

Puerto Rico's debt headache isn't confined to the island. Some of the largest mutual funds have placed sizable wagers on the U.S. commonwealth's municipal bonds.

One fund, in fact, had nearly half its assets in Puerto Rican debt.

Now, investors are bracing for losses after the island's governor said Puerto Rico can't pay its debts. Already, some of the Puerto Rico holdings in the mutual funds are touching record lows.

In a low-interest rate world, Puerto Rico's bonds have offered investors juicy yields over the past several years. Puerto Rico's \$3.5 billion in general-obligation bonds issued in 2014 initially had a yield of 8.7%. The yield on 10-year U.S. Treasury notes, by contrast, hovered between 2% and 3% last year.

But now investors are getting a fast lesson on the risk that comes with those sorts of high yields. More than half of all U.S. municipal-bond funds, or 298 of 565, have invested in Puerto Rico's debt, according to the most recent fund holdings compiled by Morningstar.

Municipal-bond mutual funds run by OppenheimerFunds and Franklin Resources BEN -0.24% Franklin Templeton Investments have the highest exposure to Puerto Rico's debt, Morningstar says. OppenheimerFunds and Franklin Templeton respectively hold roughly \$4.5 billion and \$2.3 billion of Puerto Rico's \$73 billion in municipal debt, according to the most recent Morningstar data.

The mutual fund with the biggest exposure, a roughly \$230 million fund called the Franklin Double Tax-Free Income Fund trading under the ticker "FPRTX", had about 47% of its assets in Puerto Rico debt at the end of the first quarter, the highest on Morningstar's list. OppenheimerFunds' Oppenheimer Rochester line of funds have between 2% and 37% of their assets in Puerto Rico's debt.

Of Wells Fargo's 14 municipal-bond funds, ten have wagered on Puerto Rico's debt, and 20 of Eaton Vance's 27 muni funds have invested in Puerto Rico's bonds, according to Morningstar.

Puerto Rico bonds pay interest that is exempt from federal taxation and have the ability to issue bonds exempt from federal and state taxes in every state. By contrast, most muni-bond interest is exempt from both federal and state income taxes only if the investor lives in the state where the bonds were issued.

A spokesperson for OppenheimerFunds said that its among creditors that have offered Puerto Rico's governor "numerous creative and viable solutions to the current fiscal situation," and said the firm is "disheartened" by the governor's recent comments. He added: "We expect Puerto Rico to act within the tenets of the law, including the Commonwealth's Constitution, and are ready to defend the previously agreed to terms in each and every bond indenture."

A spokesperson for Franklin Templeton said in an email that they "are currently analyzing the report, and we are waiting to hear more from the governor on next steps."

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