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Puerto Rico's Deepening Crisis Threatens High-Yield U.S. Funds.

(Reuters) – Puerto Rico's deepening financial crisis could speed up an exodus of money from U.S. municipal bond funds that have placed big bets on the cash-strapped Caribbean island.

Investors, for example, pulled $634 million from muni bond funds run by OppenheimerFunds during the first five months of 2015, according to Lipper Inc, a unit of Thomson Reuters.

And that was before Puerto Rico Governor Alejandro Garcia Padilla admitted Monday that the country's budget gap was bigger than thought and it could not repay more than $70 billion in debt.

Over the past year, funds run by Goldman Sachs Group Inc have increased their exposure to Puerto Rico to attract yield-hungry investors, U.S. regulatory filings show.

Before this week's bad news, veteran Eaton Vance bond fund manager Tom Metzold said Puerto Rico's problems could trigger a domino effect, partly from portfolio managers selling assets to meet investor redemption demands.

"I'm worried about that contagion effect," said Metzold, who's leaving his post July 31 to join muni bond insurer National Public Finance Guarantee Corp., a unit of MBIA Inc.

U.S. municipal bond funds are the largest owners of Puerto Rico debt, in a strategy that seeks high yield amid rock-bottom interest rates. The bonds are typically exempt from local, state and federal income taxes, widening their appeal to single-state funds that use Puerto Rico debt to diversify their portfolios while boosting income for investors.

To be sure, investing in Puerto Rico could be a winning strategy for those able to stomach the many recent episodes of tumult.

The $6 billion Oppenheimer Rochester Fund Municipals has generated a 1-year return of 4.81 percent, beating 91 percent of peers, using a mix of New York muni bonds (about 77 percent of assets), with much of the rest invested in Puerto Rico, according to Morningstar Inc.

The fund lost nearly 11 percent in 2013 as Puerto Rico's fiscal woes triggered an industry-wide sell off.

Nuveen Asset Management's exposure to Puerto Rico is about $330 million out of $100 billion in overall municipal bond assets. Nuveen says 100 percent of Puerto Rico debt is either insured, escrowed by U.S. treasuries or tobacco bonds.

By contrast, OppenheimerFunds, a unit of MassMutual Financial Group, mostly owns uninsured Puerto Rico debt. Its stable of Rochester muni bonds funds owns about $5 billion in Puerto Rico debt. That's the largest amount in the U.S. fund industry, making up 21 percent of the muni bond group's $26 billion in assets.

OppenheimerFunds declined to comment for this story. During the 12-month period that ended May 31, investors withdrew $2.73 billion from the muni fund group, according to Lipper.

Meanwhile, Puerto Rico's budget gap is estimated to surge to $7 billion by 2018, from about $3.7 billion in 2016, according to a report by former International Monetary Fund economists.

"Perhaps of greatest concern to investors is (the report's) inclusion of general obligation debt in debt relief," said Robert Donahue, a research analyst at research firm Municipal Market Analytics Inc.

Restructuring general obligation debt carries a heavy implication because most investors see those bonds as the safest among fixed-income securities.

By REUTERS

JUNE 29, 2015, 8:04 P.M. E.D.T.

(Editing by Bernadette Baum)