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[Muni Junk Funds Boosting Liquidity to Avoid Taper Tantrum Redux.]

High-yield municipal bond funds are building cash positions and boosting holdings of easy-to-sell securities as a hedge against the risk of rising redemptions in the wake of Puerto Rico's default and higher interest rates.

Managers at Franklin Advisers Inc. to New York Life Insurance Co.'s MainStay Investments have increased cash, while OppenheimerFunds Inc. boosted its line of credit with lenders by $500 million. Nuveen Asset Management's $10.6 billion high-yield fund, the market's biggest, increased holding of debt from states such as California and New York, whose higher income-tax rates boost demand for tax-exempt debt.

"Eight of the last 10 weeks have been outflows, but you haven't seen really that much selling pressure as a result," said John Miller, co-head of fixed income at Nuveen in Chicago. "Perhaps that's an indicator people are prepared."

Puerto Rico securities have traded at speculative levels for more than a year, which has given fund managers time to pare holdings of the island and build cash. The long-building strains on the U.S. commonwealth, which has more debt per resident than any state, are also unique.

Neither Puerto Rico Governor Alejandro Garcia Padilla's announcement in June that the island commonwealth can't pay its $72 billion debt, nor its default on bonds issued by a government corporation have been a catalyst for big outflows.

Taper Tantrum

High-Yield municipal bond funds, which are the most likely to hold Puerto Rico securities, have lost 2.7 percent, or about $1.9 billion of assets under management since early May, according to a Aug. 10 research report from Citigroup Inc.

Year-to-date, high-yield funds have taken in more than $900 million, according to Morningstar Inc. data.

That's a big difference from 2013, when fears that the Federal Reserve would end its bond buying program led investors to yank more than $11 billion from muni funds that invest in below investment-grade, speculative grade and un-rated debt, according to Morningstar. The broad selloff in the bond market became known as the

"Taper Tantrum."

Bond prices rose Wednesday as minutes from the Fed's last policy meeting said most participants noted that conditions for a rate increase were improving. Barclays Plc's muni high-yield index has lost about 2.2 percent this year, compared with a 0.9 percent gain for the broad $3.6 trillion market.

“There have been outflows in high yield, but they haven’t been ruinous,” said Matt Fabian, partner at Concord, Massachusetts-based Municipal Market Analytics, a bond research firm. “Past crises were more systemic. The current crisis is Puerto Rico specific.”

Muni high-yield funds had an average cash allocation in June of 4.04 percent, compared with 3.17 percent for the same period in 2014, according to Morningstar data. Before the Taper Tantrum, the average was 2.13 percent.

Cash Cushion

Even so, many high-yield funds have adopted the boy scout motto: “Be Prepared.”

In the one-year period ending June 30, Franklin’s $2.1 billion California High Yield Municipal Fund reduced its Puerto Rico holdings by about 1 percentage to $57 million, while boosting its cash and cash equivalents almost fourfold to $173.5 million, according to data compiled by Bloomberg. MainStay Investments $1.74 billion high yield fund increased its cash equivalents 70 percent during the same period to $110.3 million.

Stacey Coleman, a spokeswoman for Franklin and Kevin Maher a New York Life spokesman, declined to comment.

Fund statements show that OppenheimerFunds, which held $4.6 billion of Puerto Rico bonds as of May 31, the most among muni funds, according to Morningstar, increased a revolving credit agreement to $2.5 billion last year. OppenheimerFunds also has a $750 million line of credit in the form of a committed reverse repurchase agreement facility.

Most Liquid

“As part of our effort to ensure liquidity in our municipal bond funds, OppenheimerFunds has a robust liquidity framework custom-built for each fund,” said spokesman Ray Pellecchia in an e-mail. “Under this framework, we assess each fund’s holdings, how those holdings would perform under stress such as outflows, and our means to meet potential outflows.”

Rather than boost cash and forgo returns, Nuveen’s Miller is increasing his allocation to high-yield debt from California and New York, states with high income-tax rates, which juice demand. The fund is also buying higher coupon debt, the average is 6.4 percent, sought by investors because it cushions the influence of interest rate movements on bond prices and provides higher income.

Narrower Spreads

California holdings in Nuveen’s high yield fund have increased to 20.4 percent as of July 31 from 17.6 percent, according to data compiled by Bloomberg. Miller has added California general obligation bonds, which have a bid-ask spread of two to four basis points, as well as debt issued for the Bay Area Transit Authority, a $1 billion desalination plant in Carlsbad and the Loma Linda University Medical Center.

“I’m not going to imply that every single California bond is liquid, but California is more liquid than other bonds around the country,” Miller said.

In New York, Nuveen owns $270 million of a $1.1 billion series of bonds issued to finance the construction of 3 World Trade Center. Bid-ask spreads, the difference between the highest price that a buyer is willing to pay and the lowest for which a seller is willing to sell, on the un-rated bonds are also two to four basis points.

Other sources of liquidity include bonds backed by a 1998 settlement with major tobacco companies, which are held by taxable total return bond funds and hedge funds. Hedge funds also own as much as 30 percent of the obligations of Puerto Rico and its agencies, Barclays estimates.

“Liquidity is much better than it was several years back, mainly because you have a lot more larger issuers and a lot more participants in the market,” said Dan Solender, who helps manage $17 billion as head of munis at Lord Abbett & Co. in Jersey City, New Jersey.

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