

Bond Case Briefs

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What Investors Can Learn From Puerto Rico's Bond Default.

Hint: It can happen again.

There was a point in time when buying Puerto Rico's municipal debt seemed like a good idea. Enticed by bonds offering relatively high yields and exemption from federal, state, and local taxes, many U.S. investors jumped at the chance to buy up the commonwealth's debt. But then things started going sour in Puerto Rico, culminating in the ultimate no-no on the part of any municipality: a default.

That's right: After periods of coming extremely close, Puerto Rico finally defaulted on its municipal debt, paying just \$628,000 of the \$58 million it was supposed to dish out to bondholders in early August. According to Governor Alejandro Garcia Padilla, the island's \$72 billion in public debt simply isn't payable, and the general economic outlook is bleak. In fact, he has even gone so far as to say that Puerto Rico's economy is in a "death spiral." Talk about discouraging.

How we got here

In 2006, after Puerto Rico lost many of the federal tax advantages that attracted U.S. companies to the island, loads of businesses jumped ship, and things have gone downhill ever since. Unemployment is at 12% in Puerto Rico — more than double the average rate in the U.S. Residents, in turn, are saying adios to the island and seeking work on the mainland.

For years, Puerto Rico's municipal bonds have been trading well below par, and its credit rating is currently hovering in junk territory. The commonwealth has more debt than any U.S. state aside from California and New York, which both have significantly larger populations. During the past 10 years, the island has been forced to borrow at high rates and double its debt simply to stay operational.

What this means for muni bonds

A Puerto Rico debt restructuring would be the largest ever in the \$3.7 trillion municipal-bond market. Because Puerto Rico is a commonwealth, not a U.S. city or state, it cannot, by law, file for Chapter 9 bankruptcy protection. It also, as the governor has so eloquently stated, cannot pay its debts, which means that if there is indeed a restructuring, it won't be the neat, orderly type we're all used to.

Rather, we're more likely to see a series of lawsuits brought by investors clamoring for their money. It's good news if you're a lawyer, but if you're a Puerto Rico bondholder, not so much. Furthermore, a restructuring that proves remarkably unfavorable to bondholders could leave a bitter taste in investors' mouths, which could, in turn, impact the municipal bond market as a whole.

What we've learned

The silver lining in all of this — and you really have to want to see it — is that individual investors are getting a nice little crash course on what to do differently the next time around. For starters,

don't rely on the fact that municipal bonds boast historically low default rates. Though they are rare, we've seen more defaults happen in recent years. Remember Detroit, for example.

Secondly, in situations like the one Puerto Rico faces, don't count on a bailout. The whole "too big to fail" theory doesn't seem to be working thus far. In fact, Puerto Rico has been petitioning incessantly for Chapter 9 eligibility, only to have its pleas rejected.

Here's another takeaway: If you're going to tie up your money in long-term municipal bonds, you may want to choose issues that are insured. Most of Puerto Rico's debt does not fall into this category.

Furthermore, don't take comfort in the mistakes of the masses. Some investors chose not to sell their positions in Puerto Rico several years ago — before things got really ugly — because they assumed the hedge funds that owned large chunks of Puerto Rico's debt would either sue or demand favorable treatment for bonds in the event of a restructuring. But favorable treatment only goes so far when there's no money to go around. Holders of Puerto Rico's bonds are potentially looking at just \$0.60 on the dollar following a restructuring.

Finally, pay attention to your investments. Many holders of Puerto Rico bonds, to this day, are unaware that these bonds are taking up valuable real estate in their investment portfolios. More than 20% of American bond funds own Puerto Rico's debt, and they could be in for an unpleasant surprise depending on how much of a haircut bondholders take in whatever slapdash restructuring the island manages to pull off.

Right now, we don't know what the future will hold for Puerto Rico or its bondholders. If you're invested in the island's debt, however, it's fair to assume that you're in for a pretty rocky ride.

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