The Muni Trades That Pushed Pimco to the Top in Year of Distress.

Pacific Investment Management Co.'s high-yield municipal-bond mutual fund is jockeying for the top returns of 2015 after picking winners among pockets of distress. Here are the calls that put it there:

Puerto Rico, the junk-rated Caribbean commonwealth saddled with $70 billion of debt and a stagnant economy? Stay away.

Chicago, which lost its investment grade from Moody's Investors Service in May because its pensions are underfunded by $20 billion? Jump in.

Tobacco bonds, 80 percent of which Moody's predicts will eventually default as cigarette consumption declines faster than anticipated? A buying opportunity.

"Those were our big credit decisions," said David Hammer, who co-manages the $583 million fund with Joe Deane in New York.

The fund returned 5.9 percent through Friday, continuing a neck-and-neck race with Invesco Ltd.'s high-yield muni portfolio for the first-place title among open-end funds with at least $100 million in assets, data compiled by Bloomberg show.

Together, the decisions are a microcosm of the year that was in the $3.7 trillion municipal market. Bond buyers sought extra yield as interest rates remained near generational lows, yet many were hesitant to invest in Puerto Rico and Chicago until their financial paths became clearer.

Zero Puerto Rico

In Puerto Rico, the way forward only got murkier in 2015. So Pimco kept its allocation to commonwealth bonds at zero as Governor Alejandro Garcia Padilla said the island needs to restructure its debts to emerge from a severe fiscal crisis. This month, he said the U.S. territory could default on Jan. 1, when almost $1 billion of interest is due.

It took the Puerto Rico Electric Power Authority more than a year to reach a tentative agreement last week with bondholders and insurers to lower its $8 billion debt, showing how difficult such talks are without the threat of filing for bankruptcy. Getting Chapter 9 extended to the commonwealth hasn't gained traction in Congress. The U.S. Supreme Court in 2016 will rule on the island's Recovery Act, a measure allowing for the Puerto Rico's publicly owned corporations to restructure debt that was struck down in court.

"A key part of our decision to not invest in Puerto Rico up until now is the lack of a clear set of rules to provide Puerto Rico debt relief, which we think is inevitable," Hammer said. "We want to know what the rules are before we're willing to commit investor capital."

The call paid off: Junk-rated Puerto Rico bonds have plunged 13 percent this year, the third worst of all market segments tracked by Barclays Plc.

“I’d expect us to remain very cautious on Puerto Rico until we have a set of investable rules,” Hammer said. “There will be a lot of noise without a lot of clarity, and that’s not good for bond prices.”

Chicago as Junk

Some investors extended their caution to Chicago, the only big city besides Detroit that Moody’s deems junk. Some of its securities fell by more than 10 cents on the dollar in less than a week after the May downgrade, on speculation that Chicago would face a liquidity crisis because the rating cut exposed it to as much as $2.2 billion of payments to banks if it couldn’t refinance its debt.

Pimco saw it as a buying opportunity. The high-yield fund took a $9 million position in general obligations due in 2033 that the city issued in July, making it the fund’s sixth-largest single holding by Sept. 30, Bloomberg data show. The debt priced at 98.5 cents on the dollar to yield 5.64 percent. It last traded in October at 103.6 cents to yield 5 percent.

Chicago avoided a cash squeeze by refinancing. The securities went on to rally after Mayor Rahm Emanuel in October pushed through the biggest property-tax increase in the city’s history — $543 million over the next four years — to help pay the pension-fund bills at the root of the its distress. Emanuel, a Democrat who won re-election in 2015, had resisted raising the levy for years even though it was lower than surrounding localities.

“Our view was that we would get a property-tax increase out of Chicago, that it would go a long way in beginning to address their fiscal imbalances when it comes to underfunded pension liabilities, and that the market would reward Chicago for demonstrating that they have not just the ability but the willingness to raise revenues,” Hammer said.

While the city has challenges ahead, the property-tax increase “does fundamentally improve their credit outlook,” Hammer said.

Tobacco Overload

On the topic of credit outlooks, no major segment of the municipal market seemed to have a worse prognosis heading into 2015 than tobacco bonds.

The agencies that sold the debt, which is repaid from legal-settlement money that states and localities receive from cigarette companies, didn’t anticipate that smoking would decline as much as it has since they started issuing the securities more than a decade ago. Because of that oversight, four out of five will eventually default, Moody’s said in a September 2014 report.

While that could still be the case, failures to pay may be pushed back. Cigarette consumption held steady this year for the first time since 2006. That sparked a rally in the riskiest tobacco bonds: they’ve gained 14 percent in 2015, the second-best of any market segment.

That’s been a boon for Pimco because the three largest holdings in its high-yield fund are tobacco bonds from New Jersey and Ohio.

“The tobacco sector has had pretty significant outperformance versus the broader high-yield muni market,” Hammer said. “Tobacco is still pretty attractive versus other traditional, less-liquid, lower-rated muni names.”

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