Puerto Rico: "Always the money owing"[i]

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The tropical island of Puerto Rico — *la isla del encanto*, the island of enchantment — has sunlight shining, hurricanes blowing and the third-largest debt behind California and New York.[ii] Its poverty rate is 45 percent. Three pension plans are 91% unfunded,[iii] and the island's population is declining. Tax-supported debt as a percentage of personal income in 2011 was a jaw-dropping 88.9%, compared to Illinois' 6%.[iv] Unemployment was 16% for fiscal year 2010, and per capita income was $15,203. Manufacturing and construction sectors continue to contract, in part due to the necessity to import oil[v] and most everything else. As the U.S. economy has improved, so has Puerto Rico's, with unemployment dropping to 13.9% in August 2013, compared to overall U.S. unemployment of 7.2%. Nevada has the highest jobless rate in the U.S., 9.5%, according to the Bureau of Labor Statistics. Though Puerto Rico is still sporting investment-grade ratings of triple-B minus, the outlook is grim.

While there are pockets of high debt throughout the U.S., Puerto Rico is of particular interest because of a certain benefit granted to territories of the United States. Their bonds are exempt from state, local and federal income taxes in every state of the union. If you are a resident of a high-tax state, the addition of Puerto Rico bonds gives you diversity without any additional taxes to pay. This feature has not gone unnoticed by mutual fund companies. About $70 billion of Puerto Rico debt is held by municipal bond mutual funds.[vi] This is the equivalent of 70% of its GDP.[vii] That means that owners of bond funds, exchange-traded funds and closed-end funds that contain bonds of primarily one state may find that they are owners of a substantial amount of Puerto Rico bonds as well. Single-state funds are required to hold at least 80% of their funds in bonds that are not subject to tax. The Puerto Rico bonds help meet that mandate.

Puerto Rico bonds have boosted the yield of single-state funds, but they expose shareholders to unanticipated risks of Puerto Rican politics and economic malaise.

Recognizing the problem

The Secretary of the Commonwealth of Massachusetts, William Galvin, is investigating the size of Puerto Rico holdings in Massachusetts municipal bond funds. The Puerto Rico bonds increase fund yields but add risk. Galvin said buyers of single-state funds may not have anticipated or received proper disclosures about the risk inherent in Puerto Rico bonds.[viii] The Securities and Exchange Commission has opened an investigation into whether funds holding Puerto Rico bonds have adequately disclosed the risks.

Even if adequate disclosures had been provided, many investors do not read disclosures. They are often more concerned with which bond fund might be the best-performing bond, and they might assume the disclosures are simply boilerplates.

The semi-annual report of the Oppenheimer Rochester Massachusetts Municipal Fund dated Sept. 8, 2012, details that 28.7% of the state fund's assets are invested in the Commonwealth's bonds, and an additional 6.4% was invested in sales tax revenue bonds, including Guam. The report did mention that Puerto Rico uses "an innovative lottery system to encourage the population to pay sales taxes on purchased goods." It mentioned Standard & Poor's downgrade of revenue-backed bonds issued by the Puerto Rico Aqueduct and Sewer Authority, but it did not mention that it was no longer investment grade at BB+. The semi-annual report was generally upbeat on Puerto Rico's fiscal management. The report noted that the governor "continued many of the positive fiscal management policies of his predecessor," including privatizing the airport. The report did not mention that Puerto Rico had already privatized two toll roads and was looking into selling its water, energy and other assets. These actions boosts current income but are not sustainable over the long haul.

The Municipal Securities Rulemaking Board is providing new information for investors. In its recent fact book,[ix] it showed that out of the top 20 most actively traded fixed-rate securities traded in 2012, 11 were Puerto Rican issues. When sorted by par amount, there were still 11 Puerto Rican issues. As a result, there is a lot of Puerto Rico inventory for sale. Puerto Rico bonds are being offered at better than 6% coming due as early as 2014. That is a 10% return to a taxpayer in the 40% marginal tax rate. And yes, there are bonds yielding better than 8 % tax-free. The only problem is that such a return reflects the uncertainty of actually being paid.

Closed-end funds

A significant amount of the Puerto Rico debt was packed into proprietary closed-end funds sold by a unit of UBS Financial Services to investors in retirement or nearing retirement.[x] They were sold to Puerto Rican residents nearing retirement who were attracted to the investment because of the tax benefits and high yields on the leveraged funds. Since Puerto Rico is a territory, the funds did not have to be registered under the 1940 Investment Company Act,[xi] so ordinary disclosures in the U.S. did not have to be made.

In May 2012, UBS settled with the SEC because it allegedly "made misleading statements to investors, concealed a liquidity crisis and masked its control of the secondary market for 23 proprietary closed-end funds."[xii] Though UBS did not admit wrong-doing, it did pay $29.7 million in disgorgement, interest and penalties. Now it is being sued again by a law firm on behalf of clients. The funds were sold to retirees to provide income for retirement. The investors often borrowed money to buy the funds, while the funds contained their own leverage. Since the value of the funds has declined with rising interest rates, investors were asked to pay down their personal leverage but found they were unable to sell the funds.

What many investors do not understand is that high-yielding leveraged closed-end funds pay out more than they earn. For example, "imagine a fund is earning $0.60 per share on a starting $10 asset base, but paying out $1 annually. The net asset value (NAV) per share is depleted by $0.40 per year, making it increasingly impossible to earn the starting amount, and raising the unearned deficit over time."[xiii] If interest rates rise, the NAV of the fund drops. As the fund is depleted, the market price may decline below the NAV. Closed-end funds containing Puerto Rico bonds have suffered this double whammy.

Who is to blame?

When times are good, everyone is smiling and there is plenty of cash to spread around. In bad times, we want to know who is to blame. Lax fiscal policies are at the core of the problem. Puerto Rico's politicians succeeded by building showy edifices like a stadium and sports arena. They bloated the public payroll and borrowed money to pay off existing debt and fund the public payroll since 2000. Taxes were not consistently collected, and there were many exemptions and loopholes.

Most of all, the economy was funded by easy access to borrowing. There was great demand for Puerto Rico paper in the United States because it yielded so much more than stateside debt and it was tax-exempt in all states. The underwriters were happy to oblige, and the rating agencies maintained high enough ratings to let the game continue. However, BlackRock's municipal bond group expects Puerto Rico to reach junk bond status sometime in 2014.[xiv] Wells Fargo analysts echo that concern, stating: "Below investment grade municipal bonds are far more speculative in nature than the investment rated universe, and are not suitable for most investors."[xv]

Will the U.S. government bail Puerto Rico out? That is a slippery slope, and states like California and Illinois, could soon follow, so it is not likely that will be offered.

At the Scarsdale Investment Group we have not recommended or purchased Puerto Rico bonds for 12 years. This is not because we thought that Puerto Rico would imminently default. Rather, we did not like the low ratings and the Commonwealth's ubiquitous and growing debt. We view an investment in bonds as a way to control risk, not to make outsized returns.
We don't know if or when Puerto Rico might default. The government and its entities may stumble along like zombie banks for an indefinite time. We believe that even with the present return of 8% or more, the bonds are not worth the risk that liquidity will dry up just when you decide you need to sell or that your bonds might be involved in protracted litigation. Neither possibility provides peace of mind.

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[ii] “Puerto Rico Pobre,” *The Economist*, October26, 2013, p.84.
[iii] David Lieberman. “Puerto Rico – What do you think of? *Advisors Capital Management, LLC,* 10/22/13.
[iv] “Puerto Pobre,” p.84.
[v] Commonwealth of Puerto Rico: Public Improvement Refunding Bonds, Series 2012 B General Obligation Bonds, Preliminary Offering Statement.
[vi] Mike Cherney. “Investors chase Bargains in Munis,” *The Wall Street Journal.* October 14, 2013. P. C1.
[vii] “Greece in the Caribbean,” *The Economist*. October 26, 2013, p. 14.
[viii] Kelly Nolan. “State Probes Puerto Rico Bond Sales,” *The Wall Street Journal.* October 10, 2013. p. C5.
[ix] Municipal Securities Rulemaking Board 2012 Fact Book.
[x] Bruce Kelly. “UBS Puerto Rico funds plummet,” *InvestmentNews*. October 7, 2013.
[xi] Robert Slavin. “UBS Puerto Rico Investors Complain Over Disclosures.” *The Bond Buyer. September 24, 2013.*
[xii] Robert Slavin. Op. cit.
[xiii] Donald Cassidy. “Protect Your Capital: Never chase High Yield,” *AAIIJournal.* July 2013.
[xiv] Oliver Renick. “Puerto Rico on Road to Junk: BlackRock,” *The Bond Buyer,* October 17, 2013.
[xv] Patrick Early and Patrick Stoffel. “Fixed Income Strategy,” *Wells Fargo Advisors*, September 3, 2013.