Puerto Rico – America's Greece?

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On July 9, we published an article on Greece's financial crisis, which has been brewing for years but reached a climax that threatened Greece's membership in the Eurozone. One month later, investors' attention has now turned to another credit crisis precipitated by the recent default by Puerto Rico. Puerto Rico's bonds had been in junk territory since February 2014.

Like Greece, Puerto Rico is a small, over-indebted economy. It faces a chronically slow economy with workforce participation at only 40%[1]. Flocks of people are leaving the island, which makes supporting their debt increasingly difficult as the tax base shrinks. Given the parallels to Greece, it is no wonder Puerto Rico has been labeled America's Greece. However, unlike Greece's crisis which was Euro-centric, the Puerto Rico default hits closer to home for U.S. investors.

Unlike Greece, Puerto Rico's municipal bonds are more widely held by U.S. investors due to their higher yields and "triple tax-exempt" benefits, which provide exemptions to federal, state, and local income taxes. According to Morningstar data, roughly half of the U.S. open-end municipal bond funds hold some exposure to Puerto Rico's debt ranging from less than 1% of assets to nearly 50% of assets. Including debt held by taxable funds, the U.S. open-end bond mutual funds collectively own more than $11.4 billion of the island's debt, or just over 15% of its outstanding issuance. This may seem like a lot, but the entire outstanding debt of Puerto Rico is just 2% of the estimated $3.6 trillion municipal bond market. It is only a lot to an investor's portfolio if they hold the bonds directly or hold a fund with a large exposure to the bonds. Per Morningstar, fund families with significant exposure to Puerto Rico are Oppenheimer and Franklin.[2]

Based on Bloomberg data, the mutual funds and ETFs used in Wealthcare Capital Management's (Wealthcare) investment programs currently have a relatively small current exposure to Puerto Rico, as shown in Table 1. The active investment grade municipal bond funds have a trivial allocation, and the investment grade index bond ETFs have no current exposure. The high yield managers have higher exposure to Puerto Rico; albeit, at 2.6%, the exposure is still relatively small. The high yield managers are used in Core-Plus allocations, but not Core allocations.

Table 1 : Wealthcare Municipal Bond Holdings

Description	Ticker	Vehicle	Asset Class	Exposure to Puerto Rico	Date of Portfolio
iShares National AMT-Free Muni Bond	MUB	ETF	Investment Grade Bonds	0.00%	Aug-15
SPDR Nuveen Barclays Municipal Bond ETF	TFI	ETF	Investment Grade Bonds	0.00%	Aug-15
SPDR Nuveen Barclays ST Muni Bd ETF	SHM	ETF	Investment Grade Bonds	0.00%	Aug-15
American Century IntermTrm Tx-Fr Bd Inv	TWTIX	Mutual Fund	Investment Grade Bonds	0.56%	Mar-15
American Funds TaxExempt Bond F1	AFTFX	Mutual Fund	Investment Grade Bonds	0.52%	Jun-15
Deutsche Managed Municipal Bond S	SCMBX	Mutual Fund	Investment Grade Bonds	0.55%	May-15
Market Vectors High-Yield Municipal ETF	HYD	ETF	High Yield Municipal Bonds	2.64%	Aug-15
Deutsche Strategic High Yld Tx-Fr S	SHYTX	Mutual Fund	High Yield Municipal Bonds	1.64%	May-15
T. Rowe Price Tax-Free High Yield	PRFHX	Mutual Fund	High Yield Municipal Bonds	0.41%	Mar-15

Note that defaulted bonds continue to trade, but at prices based on expectations for a partial recovery as part of a restructuring. Active managers may buy defaulted bonds if they believe the expected recovery amount compensates them for the risk of potential loss. According to a recent Bloomberg News article, distressed debt buyers and hedge funds now own about 30% of the Puerto Rico's debt.[3]

[1] The World Bank Group. "Labor force participation rate, total (% of total population ages 15+) (modeled ILO estimate)." Access Aug. 2015. http://data.worldbank.org/indicator/SL.TLF.CACT.ZS/countries/PR?display=graph

[2] Foos, Elizabeth. "Puerto Rico Back in the Hot Seat." Access Aug. 2015. http://news.morningstar.com/articlenet/article.aspx?id=708465

[3] Bloomberg News: NYC Rips Hedge Funds Over Puerto Rico While Giving Them Billions, Aug. 8, 2015

Current exposure is an imperfect way to gauge impact of the default on performance, as a fund may have recently sold the troubled bonds at a loss. Table 2 shows recent performance of the funds. *Absolute* returns for 1-Month and 1-Year returns have been positive, which should dissipate fears that the Puerto Rico default had a significant negative effect to the total return of client portfolios. *Relative* returns to longer-term Treasuries (IEF) have also been good, with all but the short and mid-term muni funds (SHM,TWTIX) outperforming IEF on a 1-year basis. On 1-month and 1-week time frames, performance relative to IEF is mixed but competitive on average.

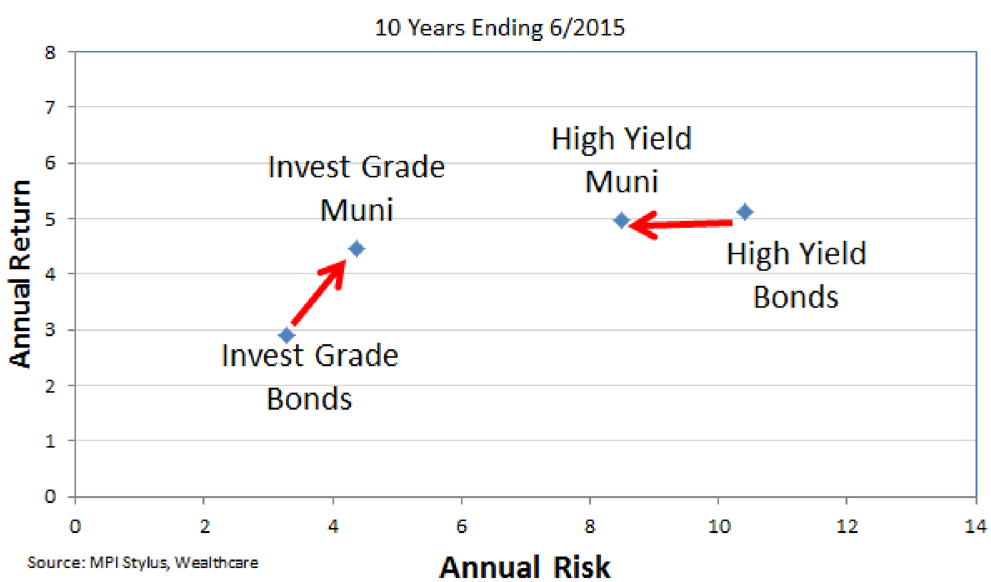
Table 2: Municipal Bond Performance

Performance as of 8/7/2015				
Description	Ticker	1 Week	1 Month	1 Year
SPDR Nuveen Barclays Short Ter	SHM	(0.2)	(0.1)	0.4
American Century Intermediate-	TWTIX	(0.1)	0.5	1.9
iShares National AMT-Free Muni	MUB	(0.4)	0.4	2.2
SPDR Nuveen Barclays Municipal	TFI	(0.3)	0.8	2.5
American Tax-Exempt Bond Fund	AFTFX	0.0	0.8	3.2
Deutsche Managed Municipal Bon	SCMBX	0.1	1.0	3.8
Deutsche Strategic High Yield	SHYTX	(0.0)	0.7	4.2
Market Vectors High Yield Muni	HYD	(0.2)	0.9	4.9
T Rowe Price Tax-Free High Yie	PRFHX	(0.0)	0.8	5.3
Average		*(0.1)*	*0.6*	*3.2*
iShares 7-10 Year Treasury Bond	*IEF*	*(0.7)*	*1.3*	*3.7*

Municipal Bonds – A Longer-Term Perspective

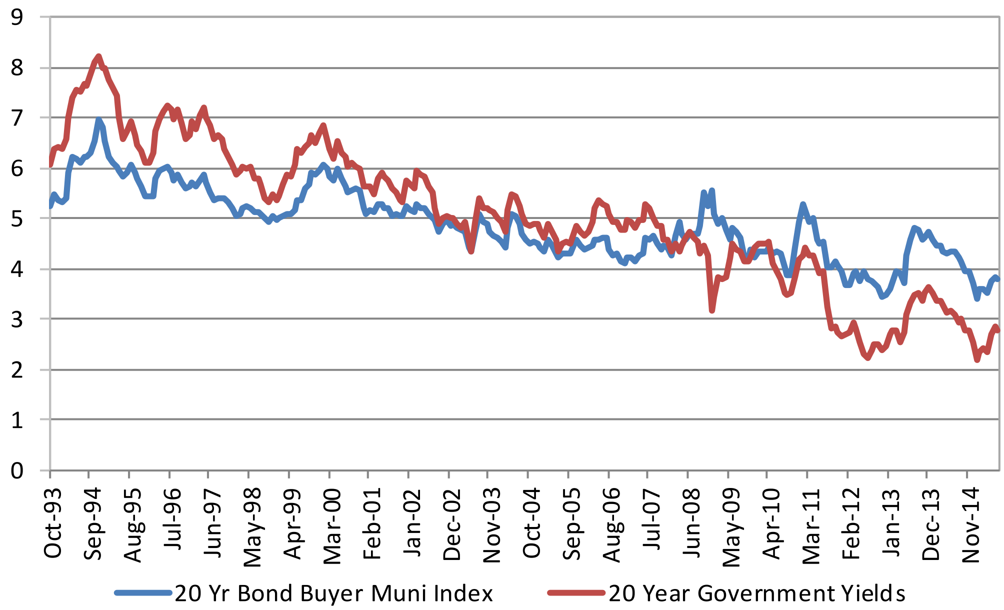
Given the potential negative sentiment surrounding municipal bonds, we thought it worthwhile to provide a brief look at the asset class in a relative context. Over the past ten years, investment grade municipal bonds and high yield municipal bonds on a tax equivalent basis have generated a better return/risk profile than taxable investment grade bond and high yield corporate bonds, assuming a 35% marginal federal tax rate applied to the taxable bond returns.

Historical Risk and Return



While the Historical Risk and Return graph demonstrates competitive historical performance, the market environment based on the historical yields of the 20-Year Bond Buyer Municipal Bond Index and the 20-Year Treasury indicates municipals offer attractive yields relative to treasuries, with a pre-tax yield pick-up of over 100 basis points. This yield pick-up is closer to 200 basis points after taxes assuming a 35% tax rate and is compensation for fear of future defaults and other market related factors.

Historical Yields



Source: Federal Reserve St. Louis

Historical Default Experience

Historically, investors' default rates for municipal bonds have been far below equivalently rated corporate bonds. Remarkably, the ten year cumulative default rate as of December 31, 2013 for BBB-rated municipal bonds was even less than the cumulative default rate for AAA-rated corporate bonds. Additionally, the cumulative default rate for high yield municipal bonds was 7.5% versus high yield corporate bonds at 32.4%.

10 Year Cumulative Default Rates		
	Municipal Bonds	Corporate Bonds
Aaa	0	0.48
Aa	0.01	0.99
A	0.06	2.72
Baa	0.37	4.41
Ba	4.11	18.69
B	17.48	39.16
Caa-C	16.88	63.77
Investment Grade	0.08	2.81
Speculative Grade	7.52	32.41
All Rated	0.14	11.58
Source: US Municipal Bond Defaults and Recoveries, 1970-2014		

While there will continue to be episodic defaults in the municipal market, the long-term case for municipal bonds remains solid, given attractive yields and favorable default experience.

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