
Puerto Rico debt downgrade would not cause mutual fund exodus
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A downgrade of a large holding, such as Puerto Rico-backed debt, would not trigger a selloff at most mutual funds, said several fund managers when asked about their investment practices. A Barclay's Capital report published today also waived fears, based on an analysis of the top 16 holders of **Commonwealth of Puerto Rico** general obligation bonds.

"One of the interesting things that you see in some of the funds, they have a lot of leeway to engage in a lot of different types of strategies" including derivatives and sub-investment grade debt, said Joseph Fichera, a senior managing partner at Saber Partners. "They try to give themselves flexibility so there aren't fire sales, that's why you need to read the prospectus carefully."

Vanguard Group is allowed to hold up to 5% of the assets of its investment-grade municipal bond funds in below-investment-grade securities at the time of purchase, said a spokesperson. Vanguard has USD 25.6m of commonwealth general obligation debt in its **Intermediate-Term Tax-Exempt Fund**, according to a 31 January fund disclosure with the Securities and Exchange Commission (SEC). Generally a sale would be based on the risk tolerance of the investment manager as asset ratios are restricted based on rating at acquisition.

Many informed managers have already exited positions they are not comfortable with, according to the Barclay's report. Because the commonwealth has been on negative outlook for so long, investors, whether they think the bonds should be downgraded or not, have had plenty of warning from the rating agencies.

"As long as they fit the criteria at the time of purchase a subsequent downgrade does not mandate a sale of the bonds," said Ted Jaeckel, co-head of municipal mutual funds at **Blackrock**, which has USD 32.1m of commonwealth general obligation debt in its **iShares National AMT-Free Municipal Bond Fund**, according to the fund's website. Blackrock can hold the bonds "for so long as management deems it beneficial to the shareholder to do so."

This is standard practice, Jaeckel said. The Barclay's report corroborated, stating that limitations are based on time-of-purchase rating.

Invesco funds are generally not required to take any actions because of a ratings change to below investment grade, said a spokesperson for the company.

"When something is downgraded, where it counts in the fund was where it was when it was purchased," saidDan Solender, partner and director of municipal bonds for **Lord Abbett**, which holds USD 16.9m of commonwealth general obligation debt in its **Intermediate Duration Tax Free Fund**, according to a December 2012 disclosure with the SEC. "I've worked at a few places and everywhere I've worked it's been the same. I've never seen a prospectus that requires it (to be sold)."

Firms may have internal mandates that would force the selling, but the prospectus would not, Solender said. Generally firms are able to prepare for a downgrade and are not forced to liquidate their position.

Many prospectuses allow a portion of the holdings of the fund to be below investment grade, Solender said.

Oppenheimer Funds directed questions about its restrictions to the prospectus for each fund. The **AMT-Free Municipals** fund, which holds USD 47.7m of commonwealth general obligation debt, may purchase below-investment-grade bonds, but if a downgrade causes the value of below-investment-grade assets to exceed 25%, the fund will not be able to purchase any more investments in that category, according to its prospectus.

Asset Preservation Advisors would have to investigate, but does not have a mandate to sell bonds which are downgraded to below investment grade, said Paul Nolan, a senior municipal analyst.

Other commonwealth general obligation bondholders include **Franklin Advisors** and **United Services Automobile Association**, which declined to comment. **Nuveen Asset Management**, **VanEck**, **Waddell and Reed Financial**, **American Century Investment Management**, **Alliance Bernstein**, **John Hancock**, **Prudential Financial**, **Popular Asset Management**, **Putnam Investment Management** and**US Bancorp** did not respond to requests for comment.

A USD 304m tranche of Series 2011 public improvement bonds backed by the commonwealth's general obligation pledge which mature in 2041 last traded in round lots 16 April at 101.1 yielding 5.4%, according to Electronic Municipal Market Access. The bond was last rated BBB- by Standard & Poor's 13 March 2013 and Baa3 by Moody's Investor Services in December 2012. Puerto Rico has USD 23.8bn of general fund-related debt, according to the Series 2012A public improvement refunding bonds official statement, the most recent data available.

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