

Municipal bond buyers must shop carefully

But local investment pro says Puerto Rico's securities are trouble

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It's a scary time for municipal bond investors.

Declining home values and fewer building permits are among the factors driving down revenue from property taxes and fees.

Almost anywhere you look, the collections that fund interest payments to municipal bondholders are declining, said Michael J. Steppe, a partner at Brookfield Investment Partners LLC.

A veteran money manager, Steppe has some simple advice for potential muni bond buyers and some scary information for holders of Puerto Rican bonds.

He says muni buyers should seek communities with:

- Upscale demographics, with attractive housing and residents who will make every effort to pay their taxes.
- A solid financial position, modest debt levels and no patterns of deficit spending.
- A vibrant, diversified economic base with a significant number of jobs.

"It you can find communities with these characteristics, it will be fine, even though this is a difficult environment in general," Steppe said.

Some bonds may not be fine, though.

Steppe says he's concerned about Puerto Rican bonds.

"We think the pressure is intense here in the U.S. Think what it's like when almost half the population is below the poverty line," Steppe said.

Bonds issued by the self-governing U.S. territory have been a popular option for individual investors for decades because of their triple-tax-exempt, purported AAA status. And brokers like them because of the high commissions they provide, Steppe said.



Michael J. Steppe

But the bonds' AAA status comes from insurance provided by companies whose investment portfolios include municipal bonds, Steppe said. The true underlying ratings for Puerto Rican bonds in the market - Baa3 from Moody's and BBB from Standard & Poor's - are just above junk status, he said.

If the ratings fall below investment grade, it will force institutional holders to sell because of their investment guidelines. The remaining investors would be stuck holding junk bonds that would be very difficult to sell, Steppe said.

That would leave those investors relying heavily on their interest payments to make the bonds a reasonable investment.

Puerto Rico is a poor country, with a 13% unemployment rate and significant debt, Steppe said. Standard & Poor's estimates Puerto Rico's debt is nearly 34% of gross national product.

About 20% of Puerto Rico's population is employed by the government, and businesses that were lured to Puerto Rico by tax incentives - such as drug companies - aren't likely to grow there, Steppe said. Add the probability

that the United States won't bail out a territory with no say in general elections and no voting representative in Congress, and you get a sell recommendation.

But Steppe's convinced: Unless you're holding pre-refunded issues backed by U.S. Treasuries, you should consider selling your Puerto Rican bonds.