

Many bond investors 'trapped' in closed-end funds

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*L*ocal losses could total 'hundreds of millions,' while P.R. mutual funds down \$1.648 billion so far this year

Financial Institutions Commissioner Rafael Blanco said this week that the erosion of Puerto Rico government-bond prices has sparked a liquidity problem in shares of closed-end mutual bond funds, and that his office is prepared to relax leverage rules in an effort to try to protect investors.

Since Jan. 31, Puerto Rico's mutual funds, with big investments in government bonds, have lost \$1.648 billion in value, totaling \$9.191 billion as of Aug. 31, according to the Financial Institutions Commissioners' Office (OCIF by its Spanish acronym).

However, these figures don't take into account the deeper erosion in bond prices that began earlier this month, which some financial experts say could add up to "hundreds of millions of dollars" in losses for local investors.

Closed-end mutual funds can use borrowed funds for up to 50% of a fund's investment, and during market events, this figure can increase to 55%, Blanco said. Nonetheless, this month's hit to Puerto Rico government-bond values has increased the leverage in some funds to more than 60%. The funds can seek a waiver when limits are exceeded, and Blanco said his office is prepared to grant them.

"If we don't, we will just force a sale that will hurt the investor, and we don't want to do that," he said.

The OCIF won't give a "blank check," but is willing to grant 30-day waivers until the market stabilizes, he indicated.

Blanco acknowledged there is currently little to no liquidity in local closed-end mutual bond funds, many of which carry tax benefits tailored for Puerto Rico residents, which limits the potential pool of buyers.

"Remember that song, 'Hotel California?' You can check out, but you can never leave," Blanco said, referring to the difficulty some investors are having trying to exit their closed-end fund investments. "With open-ended funds, you can sell at any time, but not with closed-end funds," he added.

This month's losses hit Puerto Rico resident investors hard because closed-end mutual funds employ leverage, borrowed funds, to drive up returns for the brokerage and clients. When bond values hold steady or increase, the use of leverage boosts profits, but when bond values drop, the losses are increased with the amount of leverage employed.



*Financial Institutions
Commissioner Rafael Blanco*

When losses are too steep, investors have to put up more equity in the event of a margin call or their investments will be liquidated.

Blanco said it is impossible to know exactly how much money has been lost by local investors, but attorney Jeffrey Erez said losses totaled "hundreds of millions of dollars."

Erez said that many local investors were "essentially margined in two ways," because the closed-end funds employed margins, and many investors used borrowed dollars to buy into the funds.

"There is a tremendous amount of illiquidity. It is hard to get a bid to sell. Essentially, a lot of people are trapped," said Erez, a partner of the Miami-based Sonn-Erez law firm, which specializes in security fraud cases.

During the current bond downturn, some investors not only lost all their money, but also wound up owing the brokerage firms money, Erez said.

UBS Asset Managers of Puerto Rico, the market leader in closed-end funds, was particularly hard-hit, but Santander and Popular securities also run closed-end funds, with large holdings of Puerto Rico bonds also experiencing losses, CARIBBEAN BUSINESS sources said.

Attorney Harold Vicente said he is preparing legal action on behalf of a number of UBS clients. Meanwhile, Sonn-Erez has teamed up with local firm Aldarondo & López Bras and will be giving orientation to investors on potential legal remedies they can pursue, attorney Eliezer Aldarondo said.

Last year, the Securities & Exchange Commission (SEC) charged UBS Financial Services Inc. of Puerto Rico and two of its executives with making misleading statements to investors, concealing a liquidity crisis and masking its control of the secondary market for 23 proprietary closed-end mutual funds. UBS Puerto Rico agreed to settle the SEC's charges by paying \$26.6 million into a fund for harmed investors.

Last week, U.S. brokerage firms warned 40,000 brokers and financial analysts about the risks of investing in the commonwealth.

UBS, Wells Fargo and Raymond James Financial are among the companies that are warning brokers and financial analysts about the risk of investing in Puerto Rico, the Wall Street Journal reported. UBS is even making investors sign a waiver acknowledging the risks before buying Puerto Rico bonds.