WASMER, SCHROEDER & COMPANY

INVESTMENT ADVISORS

Puerto Rico: Greece of the West?

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PUERTO RICO: THE GREECE OF THE WEST?

Over the past year, municipal credit quality has come under fire with a number of people, most notably Meredith Whitney, calling for large increases in municipal bond defaults. As 2011 has marched on, we have actually seen fewer defaults than 2010 with numbers not close to the "hundreds of billions" that Whitney foretold in a 60 Minutes news report. The question remains though, "Will we see an uptick in defaults for vulnerable credits?" As we have articulated in numerous pieces over the past year, Wasmer, Schroeder & Company has not believed there would be a rash of defaults in the municipal sector in 2011 and we maintain that outlook. We do believe, however, that trouble is potentially on the horizon for one widely owned credit in particular, and its similarities to many of the weaker European nations are worth noting. This credit is the Commonwealth of Puerto Rico. While we do not believe that default is imminent, the potential does exist that Puerto Rico digs a financial hole so deep that there remains no way to get out. While our separately managed accounts have no exposure to Puerto Rico general obligation (GO) bonds or its public corporations (other than those which are pre-refunded or escrowed in US Government securities), we do believe that the widespread ownership of Puerto Rico's bonds, the large amount of debt outstanding and its high profile status could have far reaching implications for the municipal market as a whole if Puerto Rico were exposed to any severe fiscal stress.

HISTORY

Puerto Rico, meaning "rich port", was first claimed by Christopher Columbus for Spain in 1493 and for over 400 years was a colony/territory of Spain. In 1898, during the Spanish-American War, Puerto Rico was invaded by the US and was ceded to the US under the Treaty of Paris. In 1917 Puerto Ricans were made US citizens and in 1947 the US granted Puerto Rico the power to elect its own governor. Puerto Rico is officially an "unincorporated territory" of the US. This means that US Federal law applies to Puerto Rico despite having no voting representation in Congress. The Puerto Rican constitution declares that they are a Commonwealth of the US. This requires citizens to pay Federal taxes including Social Security and Medicare taxes, as well as import/export taxes and federal commodity taxes. Residents of Puerto Rico are not residents of a state or the District of Columbia and therefore are not qualified to vote in Federal elections[1].

Another major difference between Puerto Rico and the states is the fact that the populace may vote to dissolve their Commonwealth status, and unlike US states, this vote would not require the approval of the US Congress or state ratification to do so. While a remote risk, it is one unique to Puerto Rico and bears consideration by bondholders. Additionally, and most importantly for municipal bond investors, interest income produced by Puerto Rico's bond issues is tax exempt at the Federal, state and local level in any state in the US, thus making them desirable for those living in high tax locales.

[1] www.topuertorico.org

CURRENT ECONOMY

Puerto Rico's economy is largely dominated by the government and tourism with manufacturing and trade accounting for significant portions of the economy as well. Puerto Rico has historically been a poor territory in relation to US states; over 44%[2] (compared to 15% in the US[3]) of the population lives below the federal poverty line. This rampant poverty has also contributed to an extremely high crime rate with 22.5[4] murders per 100,000 people, worse than any US state. Puerto Rico was experiencing an economic slowdown even before the 2008 financial crisis occurred and their economic woes were exacerbated by the weak demand coming from the US and the rest of the world in the aftermath of 2008. Prior to the current governor's tenure, fiscal discipline was often ignored and large budget deficits were the norm, rising to $3.3 billion[5] in 2009 (2001 was the last year with a budget surplus). The vast majority of deficits were financed with borrowing as opposed to an effort of cutting costs, especially with the creation of "COFINA bonds"[6] which are backed by sales tax revenues and effectively subordinate GO bond holders through this new structure. As the table below shows, debt has consistently grown over the past several years by utilizing non-GO avenues to raise capital. While this has allowed lower borrowing costs, the pledging of revenue streams constrains budget flexibility in the future.

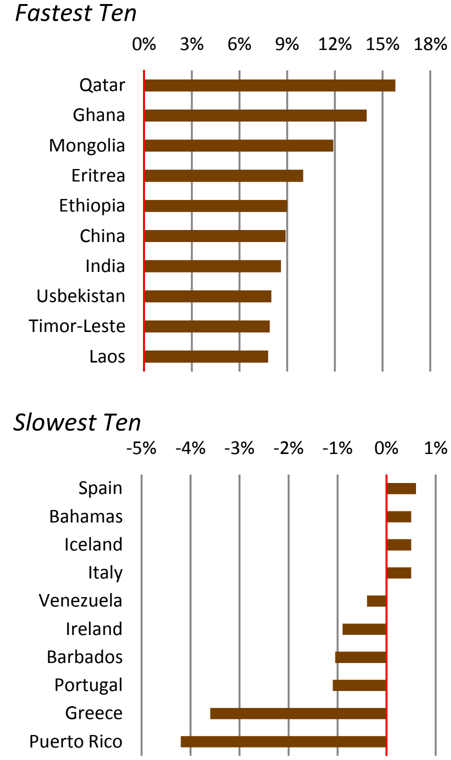
ITEM	DECEMBER 08	DECEMBER 09	DECEMBER 10	$ DIFFERENCE (2010-2008)
Central Government Total	**14,228**	**13,208**	**12,782**	**(1,446)**
Constitutional	9,006	9,511	9,193	187
TRANSs and TRABs	2,500	900	900	(1,600)
Extra-constitutional	2,721	2,797	2,689	(32)
COFINA (net)	**6,306**	**11,544**	**14,218**	**7,912**
Public Corporations Total	**26,596**	**27,358**	**28,195**	**1,599**
PRASA	2,827	3,144	3,473	646
PREPA	6,031	5,858	7,781	1,750
PRHTA	6,344	6,240	6,120	(224)
PRRBA	3,124	3,300	3,324	200
PRIFA	1,853	1,828	1,798	(55)
PRPA	59	56	46	(13)
Other and Debts with DGB and Private	6,358	6,932	5,653	(705)
Municipalities	**2,838**	**3,139**	**3,331**	**493**
Debt not supported by General Fund	**6,489**	**5,407**	**5,358**	**(1,131)**
Debt, Grand Total	**56,455**	**60,656**	**63,884**	**7,429**

Source: Government Development Bank for Puerto Rico

[2] www.topuertorico.org
[3] US Census Bureau
[4] Associated Press
[5] Office of Management and Budget
[6] COFINA is the Spanish acronym for the Puerto Rico Sales Tax Financing Corporation, an independent instrumentality of the Government of Puerto Rico created in 2006

The economy of Puerto Rico remains weak and a drop in Gross Domestic Product (GDP) is expected for the current fiscal year. Unemployment, despite falling from its highs, is still at a crippling 15.4% as of September 2011 and the labor participation rate of 40% is far below the US average of 64%. The value of construction permits has fallen approximately 23% year-over-year, although trade and tourism have rebounded with growth of 5.2% and 17.8% year-over-year, respectively. Most troubling, and of great importance to the government's finances, are the unfunded pension liabilities of Puerto Rico. For fiscal year 2010, the two largest government pension plans, Public Employees and Teachers, were funded at 8.5% and 23.9%, respectively; whereas the average US state's funding ratio is 75%. The government has put plans in place to help ease this burden by converting to a defined contribution plan, increasing the employer contribution rate every year for the next ten years and reducing government payroll numbers. Despite these changes, it is still estimated that the pension funds will become insolvent as early as 2019. Outstanding public debt has increased by 9% per year over the past ten years, far greater than the Commonwealth's rate of growth. Debt service costs remain a manageable 6.5% of expenditures but much of the Commonwealth's debt is back-end loaded, putting a greater burden on future generations. [7,8,9]

GDP GROWTH FORECSTS, 2011

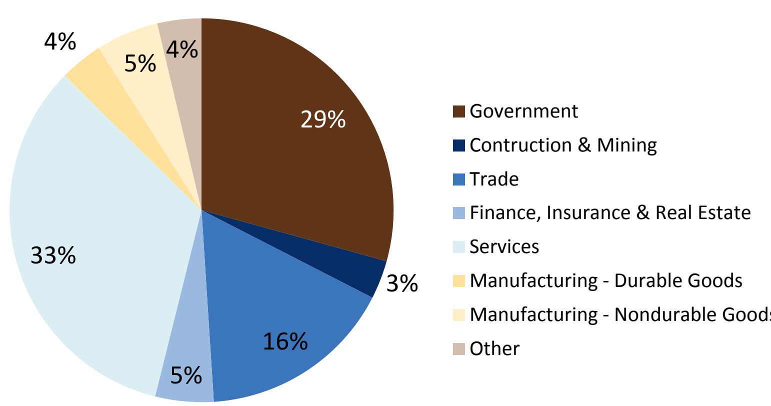


Source: The Economist

On the positive side, Governor Luis Fortuño has made it a goal to get the Commonwealth's fiscal house in order. He has implemented a number of permanent and temporary tax increases. He has also cut government expenses and payroll over the past two years by 19% and 16%, respectively[10]. A hiring freeze across all agencies has been implemented as the government payroll of Puerto Rico is notoriously bloated and accounts for approximately 30% of Puerto Rico's entire payroll. While the governor expects to achieve a balanced budget in 2013 and create a rainy day fund by 2014, slower than expected growth and/or political considerations (including the fact that Governor Fortuño is trailing his more liberal challenger in recent polls), could

PAYROLL EMPLOYMENT

Source: Government Development Bank for Puerto Rico, as of 11/9/2011



7 Office of Management and Budget
8 Bureau of Labor Statistics
9 Government Development Bank for Puerto Rico
10 Office of Management and Budget

derail some of the fiscal conservatism demonstrated by the current administration. Debt burden continues to rise and until this begins to drop or the economy begins to grow faster than the rise in debt, the Commonwealth of Puerto Rico is heading for a possible fiscal tipping point.

COMPARISON TO THE PORTUGAL, IRELAND, ITALY, GREECE, SPAIN (PIIGS)

While 2008 was all about the problems in the US and its banking system, 2011 has been characterized by the European Union (EU) and its banks. While the EU struggles with how to create an orderly default in Greece and investors remain skeptical as to whether other EU nations such as Italy and Spain will be able to escape massive debt repudiation, we see similarities between these weak EU countries and Puerto Rico. As the table below illustrates, Puerto Rico's economic and debt statistics are far more grim than the most leveraged states in the US but are approaching levels seen in the PIIGS.

	Debt to GDP/GSP	Debt Per Capita	Unemployment Rate (%)	Per Capita Income	Debt to Income Ratio
Puerto Rico*	31%	$7,837	15.40%	$13,675	57.3%
Massachusetts	8%	$4,606	7.30%	$51,302	9.0%
Hawaii	8%	$3,996	6.40%	$41,661	9.6%
Connecticut	8%	$4,859	8.90%	$54,877	8.8%
New Jersey	7%	$3,669	9.20%	$51,167	7.2%
Greece	166%	$34,103	12.60%	$27,360	124.6%
Portugal	106%	$16,402	11.00%	$24,710	66.4%
Ireland	109%	$35,122	13.70%	$32,740	107.3%
Italy	121%	$38,025	8.40%	$31,090	122.3%
Spain	67%	$17,539	20.10%	$31,550	55.6%

* Does not include Public Corporations which have an additional $28 bln in debt

Sources: Deutsche Bank, State of Connecticut General Assembly, Bureau of Labor Statistics, Bureau of Business & Economic Research at the University of New Mexico, European Commission, The Economist, World Bank

Structurally, Puerto Rico has many similarities to these European nations including, but not limited to, a bloated government workforce, large unfunded pensions, extremely high unemployment rates, large debt levels as a percentage of income or GDP, and weak tax collections. While none of these metrics is at the point to limit Puerto Rico's ability to borrow in the financial markets, the possibility exists that their current trajectory could lead to a crisis of European proportions. Continued government job cuts which are not offset by private payroll growth and reduced benefits could lead to unrest similar to what has been seen in Europe. Proceeds of Puerto Rico's borrowing are being used to pay previous debts as opposed to building infrastructure or creating economic growth. Of the close to $8 billion in COFINA borrowings in 2009-10, 94% was utilized to pay existing debts and deal with deficits. Municipal borrowing in Puerto Rico is close to $64 billion as of 2010. While not all is directly tied to the government of Puerto Rico, the vast majority of this debt has some connection. Based on this metric, debt per capita is a whopping $17,265 which is more than that of Portugal, close to that of Spain, and well above Puerto Rico's low per capita income[11].

Despite having a fiscally conservative governor, the history of Puerto Rico is one littered with cronyism and irresponsible fiscal choices. Furthermore, Puerto Rico remains an extremely impoverished territory and growth prospects remain dim. While the similarities between the PIIGS and Puerto Rico are glaring, it is important to note that important differences do exist, most notably the fact that the banking system in Puerto Rico is not threatened at the current time. Many US banks have operations in Puerto Rico and the

[11] Government Development Bank for Puerto Rico

Government Development Bank continues to expand its balance sheet and manage liabilities reasonably well. Also, at least currently, there is no desire among investors to shed Puerto Rico debt and their upcoming debt maturities remain manageable without the balloon type payments we see in many European nations and some areas of the corporate bond market. Still the trajectory remains troubling; if Puerto Rico's fiscal problems are not aggressively dealt with by the end of the current decade, the municipal market could be faced with a significant credit hurdle.

CONCLUSION

Many investors are comfortable holding Puerto Rico debt despite their low ratings (which are mostly in the 'BBB' and 'A' categories) because of the belief that if they got into severe fiscal trouble the US Congress may bail them out. As a Commonwealth they have no access to municipal bankruptcy and there is no implicit or explicit guarantee of the debt by the US government. Does this mean that Congress would not come to their aid? Not necessarily, but in an increasingly contentious political environment with fiscal conservatism running rampant, the odds of a bailout seem far less likely than a few years ago. Additionally, as we have seen with Jefferson County, AL and Harrisburg, PA, local politics can play an important role in the willingness of governments to pay.

Puerto Rico's growing debt burden and pension liabilities may become so large that no action besides restructuring can be taken to resolve their fiscal issues. We hope that Puerto Rico continues on its path to fiscal responsibility but are keenly aware of the risks, both economically and politically, to Puerto Rico bonds and their credit ratings if things do not improve materially and quickly.

About the Firm: Wasmer, Schroeder & Company, Inc. (WSC) is an independent and employee-owned Florida S-Corp. WSC was incorporated in 1987 and registered as an investment advisor on July 29, 1988 with the U.S. Securities and Exchange Commission. The Firm's corporate headquarters are in Naples, Florida, where the tax exempt Portfolio Management team, Client Services, Operations, IT, Accounting, Compliance, Marketing and Administration reside; our taxable Portfolio Management team is located in Cleveland, Ohio; and Client Relationship offices in Exton (Philadelphia area), Pennsylvania and Lake Oswego (Portland area), Oregon. Specializing in fixed income separate account portfolio management for high net worth individuals, wealth management groups and institutions, including foundations, endowments and retirement plans, WSC has $4.02 billion in assets under management, as of 09/30/11. The Firm works with clients and their advisors to provide taxable and tax exempt fixed income portfolio solutions to meet their needs.