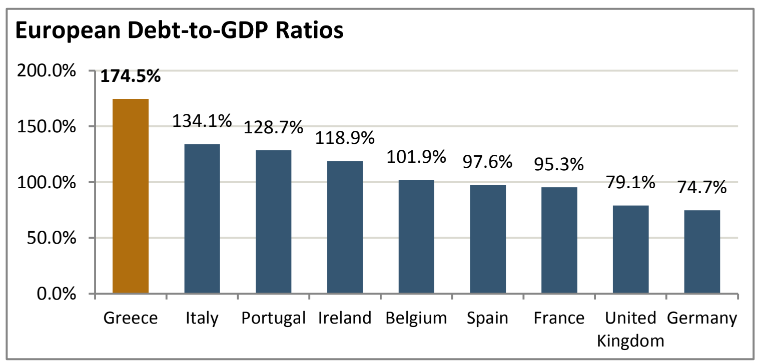
"If you're trying to get out of debt, you have to be willing to treat everything as expendable."

Phil McGraw (aka 'Dr. Phil')

In late June, two debt crises caught the attention of investors everywhere. Greece appeared to be close to the precipice of an unprecedented default on loans to the European Union (EU) governing bodies. In a less headline grabbing announcement, the Commonwealth of Puerto Rico declared that it needed to renegotiate and lower its debt commitments to creditors. While very different, the backgrounds of these two cases share several similarities. Both governments, emboldened by new leaders and available capital, issued excessive debt. Weak local economies and aversion to any market stimulating reforms in both Greece and Puerto Rico reduced the likelihood of higher growth and tax revenues. In this piece we will summarize the challenges faced by each and some possible implications.

Greece is one of the smallest and underdeveloped economies in the EU comprising 2.2% of EU population and 1.3% of EU GDP. Yet, after its inclusion in the EU more than 30 years ago, it was, for a time, able to borrow funds at interest rates very close to those of much bigger and stronger countries such as Germany and France. This tempted politicians to borrow ever increasing amounts, to finance a bloated bureaucracy and to avoid measures to reform its tax system and improve its competiveness. As a result, its debt is now a staggering €317 billion, which is over 170% of its GDP, significantly higher than other EU members.

Greece has the advantage of belonging to the EU, which recognizes its strategic benefit as a buffer location, adjacent to Russia and the Middle East. However, the amounts owed by Greece to various European bodies including the European Central Bank (ECB), the International Monetary Fund (IMF), and the European Financial Stabilization Fund (EFSF), are extremely large in relation to the size of its economy, and may require substantial write-downs of principal and interest.



Source: Central Intelligence Agency – The World Factbook

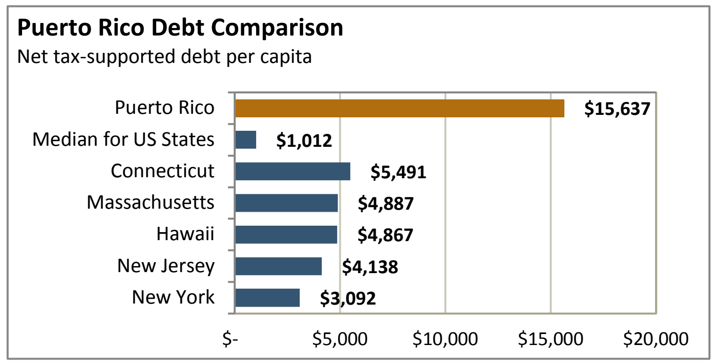
When a borrower cannot repay its debts, the eventual cost is determined through negotiations with its creditors. This process and its resolution will take time; however, the cost of the Greek bailout may have more immediate repercussions for all members of the EU. As the Greek crisis intensified recently, the euro moved lower versus the dollar and spreads of southern European debt, such as Italy and Spain, rose modestly vs. high quality German obligations. Certainly, Greece and other struggling EU economies will pay a much higher cost of borrowing in the future. In addition, the EU will institute structural reform to avoid a replay of a similar situation with another profligate government.

The Greek voters decisively rejected the terms of the original EU bail-out offer on July 5th. Critical negotiations have started to enable the Greek banks, which closed on June 29th, to provide limited withdrawals and to avoid a July 20th default on roughly €4 billion of debt to the ECB. If no agreement is reached by this imminent default date, Greece may face the prospect of creating a substitute currency and exiting the EU. As of this writing, EU nations and the Greek government reached a tentative agreement to provide up to €86 billion of funding in exchange for fiscal measures including higher sales taxes and pension reform. These measures require formal approval and, while not a certainty, appear to be a far better alternative than a Greek exit from the EU.

Markets reacted favorably to this news. However, we expect continued volatility as these negotiations and their implementation progress. Given the relatively small economic impact of Greece to the EU, we do not anticipate any significant long term impact to the major developed European economies or stock markets.

Puerto Rico, which has outstanding municipal debt of $71 billion, has the unique status of being a Commonwealth, not a state, which means that its citizens pay no Federal Income taxes. In addition, for tax-sensitive investors, its bonds have the added attraction of not being taxed by any Federal, state or municipal authorities. Successive governments in Puerto Rico issued a steady stream of bonds to offset current budget shortfalls and take advantage of market demand for its debt. Like Greece, few moves were made to address a large and expensive bureaucracy, inadequate tax collections, and a shrinking private sector. As a result, the Commonwealth's debt per capita is three times that of any US state.

Puerto Rico has the advantage of being a territory of the US. However, as a Commonwealth, it has no power to declare bankruptcy in order to adjust its debt burdens. This is similar to other US states which, under current legislation, are not able to declare bankruptcy.



Note: Median does not include Puerto Rico
Source: Moody's Investor Services & The Washington Post

Legislation passed in 1984 grants states the power to allow agencies and municipalities to seek Chapter 9 bankruptcy protection. However, Puerto Rico was excluded from this provision. In the US, the cities of Detroit, Michigan and Stockton, California along with many utilities, water districts and other municipal units have experienced bankruptcies. Given the current undefined environment, bankruptcy protection may be a better alternative. However creditors, mostly US municipal bond investors, may believe that a better outcome will be achieved using current Puerto Rico laws as compared to Chapter 9 bankruptcy.

The price of Puerto Rico bonds fell 15-20% on news of a suggested debt restructuring. Over the next two months debt service obligations total $554 million with limited, if any, access to additional financing. The government has indicated it will propose a restructuring plan by the end of August which may involve a combination of debt reduction, revised (lower) interest rates and lengthening of repayment periods.

Investors will penalize the Commonwealth's bond ratings in the future. More importantly, they will also demand more from other states or municipalities without a strong balance sheet.

Note to Aureus Clients

Exposure to Greece on behalf of our clients is very limited. We have no direct exposure to Greek debt or equities, and have never invested directly in Greece. In the Aureus Fund II and Aureus International Series, two managers have exposure to Greece. Overall these positions amount to less than 0.5% of Aureus Fund II assets and less than 1.2% of Aureus International Series assets. We expect these external managers to exercise caution going forward with these investments.

We do not hold any bonds of, and have never invested in the debt issued by Puerto Rico. Our sub-advisor, Breckinridge Capital Advisors (BCA), has avoided investing in Puerto Rico, despite the high yields available, because they were concerned with credit quality. We expect BCA to continue to utilize its own strict standards in the future.