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Auction Rate Securities - Understanding the Risks

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HIGHLIGHTS

- Auction Rate Securities are long-term bonds with interest rates that reset at pre-determined short-term intervals.
- McQueen Financial Advisors, Inc. has never recommended auction rate securities because they lack some important fundamental characteristics.
- Recent market turmoil plus some troubling traits continue to earn them a spot on our 'avoid' list.

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AUCTION RATE SECURITIES

Auction Rate Securities are long-term bonds with interest rates that reset at pre-determined short-term intervals. They were introduced over 20 years ago and the market has grown to well over \$250 billion. Typical issuers include municipalities, hospitals, utilities, housing agencies, student loan finance authorities and universities. Structured bonds are a more recent development and are backed by preferred stock, corporate debt or collateralized debt obligations. Auction rate securities typically offer high under-lying credit quality and many are enhanced with municipal bond insurance. They often have a final maturity date of 20 years or longer and are sometimes issued in perpetuity, with no stated maturity date. The collateral backing principal and interest payments varies significantly from issue to issue.

This growing market has been fueled both by issuers and investors. The auction market is attractive to issuers seeking variable rate, low cost financing. Investors choose auction rate securities because they offer a combination of high credit ratings and higher yields than money market instruments. The liquidity features of auction rate securities however, are substantially different than money market funds and traditional investments like CD's, Treasury Bills, commercial paper and agency discount notes. Money market funds are required by law to invest in highly liquid low-risk securities and are not allowed to buy auction rate securities because of their long stated final maturity dates. Investors wishing to liquidate individual money market instruments can solicit bids from multiple dealers because these securities have an established secondary market. In contrast, holders of auction rate securities own an illiquid security between auction dates and in the event of a failed auction. Further, trades can only be processed by the auction agent and not the broader market.

Even though some auction rate securities are backed by municipal bond insurance, the enhancement typically covers periodic interest payments and principal at the final (long) maturity date.

Under normal market conditions, the auction market is efficient and these securities have performed well. That said, we have never recommended auction rate securities because they lack some important fundamental characteristics. Recent market turmoil plus some troubling traits continue to earn them a spot on our ‘avoid’ list.

“Unlike some other money market instruments, auction rate securities have no tender feature. As such, holders do not have the right to ‘put’ their bonds back to the auction agent but can sell them at the auction, if there are sufficient buy orders.”

AUCTION PROCEDURES

Interest rates reset through a dutch auction at short term intervals, typically weekly, monthly or quarterly. Auction procedures are set forth in the prospectus or private placement memorandum and are carried out by an auction agent, usually a large bank or brokerage firm. Auction trades are placed at par and the bonds can be called at par on any auction date, at the issuer’s option. The dutch auction is a competitive bidding process that determines the new rate on each auction date. During the auction, the agent solicits buy and sell orders from clients and broker/dealers. Current holders who wish to retain their positions without regard to rate submit Hold Orders and will receive the new rate once it is set. Current holders can also place Hold Orders with a specified minimum rate, but they may be required to sell their bonds depending on competing orders. Sell Orders are placed by existing bond holders who wish to sell part or all of their investment. Potential new purchasers and current holders wishing to buy additional securities submit Buy Orders. During the auction, the agent ranks buy orders by their minimum acceptable rate. The rate for the upcoming period is set at the level that ‘clears’ the market, meaning the lowest rate that will place all of the bonds available for sale. Unlike some other money market instruments, auction rate securities have no tender feature. As such, holders do not have the right to ‘put’ their bonds back to the auction agent but can sell them at the auction, if there are sufficient buy orders.

SECONDARY MARKET TRANSACTIONS

Auction agents acting for their own account may buy and sell auction rate securities between auction dates but are not obligated to do so. There are no assurances that a secondary market will exist. As such, bond holders faced with liquidity needs should not rely on auction agents to purchase securities from them. Between auction dates, agents may decide to buy or sell securities or to fill cross-trades with other clients. As a general rule, sell orders between auctions are filled based on demand from other clients and may not be possible when auction agents are holding excess inventory. Incoming buy orders are first filled from the agent’s own inventory. As such, bond holders wishing to sell are subject to the agent’s ability to move their own inventory first, before working client sell orders.

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AUCTIONS

A supply/demand disparity occurs when there are more sellers than buyers and can lead to a failed auction. To prevent this, auction agents are allowed, but not required to place orders for their own account. Often, market participants depend on a single auction agent who manages the auction process. These banks and broker/dealers may act as agent on hundreds of bonds valued at several billion dollars. Faced with the prospect of holding too many auction rate securities, agents have allowed some auctions to fail. Previously rare, auction rate securities began to “fail” in 2007. Some, but not all auction dealers purchased bonds for their own accounts to support the market. Dealers quickly realized that they were accumulating very large bond inventories and stopped bidding at auctions.

When an auction fails, current holders must keep their securities until at least the next auction. During this period, a secondary market may develop if buyers emerge, but auction agents are not required to buy and sell between auction dates. Investors holding bonds as a result of a failed auction will receive the maximum interest rate specified in the official statement or private placement memorandum. The additional interest rate is intended to compensate holders for the lack of liquidity while they wait for a successful auction. The delay could be 7 to 90 days depending on the auction schedule, but an auction won’t clear until there are sufficient buyers. There can be no assurance that a failed auction bond will clear at the next auction. The result could be multiple failed auctions with no assurance as to when conditions will improve. Investors counting on the auction process to provide needed liquidity may be in for an unpleasant surprise. Several companies have already been forced to write down the value of failed auction rate securities. Continuing to hold an illiquid security can violate a holder’s investment policy, debt covenants or create regulatory issues.

SEC PROCEEDINGS

In 2006, the Securities and Exchange Commission imposed \$13 million in fines against 15 broker dealer firms for their auction agent practices. The actions leading to these fines included “allowing customers to place open or market orders in auctions; intervening in auctions by bidding for a firm's proprietary account or asking customers to make or change orders in order to prevent failed auctions, to set a “market” rate, or to prevent all-hold auctions; submitting or changing orders, or allowing customers to submit or change orders after auction deadlines; not requiring certain customers to purchase partially-filled orders even though the orders were supposed to be irrevocable; having an express or tacit understanding to provide certain customers with higher returns than the auction clearing rate; and providing certain customers with information that gave them an advantage over other customers in determining what rate to bid.” The firms neither admitted nor denied the charges.

“Until auction rate and money market preferred securities provide more liquidity and fewer drawbacks, we believe the yield advantage available does not adequately compensate investors for the inherent risks.”

PRACTICES

In April 2007, the Securities Industry and Financial Markets Association issued their “Best Practices for Broker-Dealers of Auction Rate Securities”. These Best Practices provide guidance for broker-dealers with respect to their auction procedures. Potential investors can obtain this document from the association’s web site at www.bondmarkets.com

ACCOUNTING TREATMENT

Given some of the liquid characteristics of auction rate securities, they had previously been classified as cash equivalents. However, because they have long-term stated maturity dates and the issuers are under no obligation to redeem them prior to maturity, auction rate securities should not be classified as cash equivalents. As noted earlier, recent uncertainties in the auction rate securities markets have resulted in widespread failed auctions. Even though investors may continue to receive interest payments while waiting for a cleared auction, there can be no certainty as to whether or when liquidity will improve. As such, some investors may be compelled to write down the value of their failed auction bonds. Although re-classification doesn’t affect cash flow, it could cause a holder to fall outside of their debt covenants or investment policy. In the extreme, an investor could face regulatory scrutiny related to their liquidity structure.

CONCLUSION

Clients planning to purchase auction rate securities, or holding failed bonds, should carefully evaluate the current market environment, their investment policy, liquidity needs, objectives, accounting issues and regulatory requirements. Also, they should consider whether an adequate back-up liquidity plan is in place in the event of a failed auction. Given these considerations, investors need to perform adequate due diligence and consider all of the risks involved in searching for higher yields. We encourage clients to be fully aware of auction procedures, the possibility of failed auctions, secondary market limitations and accounting treatment. Until auction rate and money market preferred securities provide more liquidity and fewer drawbacks, we believe the yield advantage available does not adequately compensate investors for the inherent risks.



About McQueen Financial Advisors, Inc.

McQueen Financial Advisors, Inc. (MFA) is a leading nationwide provider of financial advisory services that has been serving financial institutions since 1999. An SEC-registered investment advisory firm, MFA works only for financial institutions. We provide our services to institutions throughout the United States, with assets ranging from \$20 million to over \$5 billion.

Charles N. McQueen, President

Charley McQueen founded McQueen Financial Advisors in 1999, to provide specialized services to financial institutions. Charley has more than 14 years of experience serving as a portfolio manager, asset liability management consultant and strategic consultant to financial institutions. Today, his company advises more than 100 clients and manages investment portfolios with a combined value of nearly \$1 billion. McQueen Financial Advisors serves clients in thirteen states across the United States.

Charley serves on the Associate Advisory Council of the Michigan Association of Community Banks, is a frequent speaker at financial institution conferences and has provided training and board education on investments, Asset/Liability Management, Mortgage Servicing Rights Valuations, branch valuations, asset sales and strategic planning. Along with providing education to financial institutions, Charley provides educational training to several CPA firms. He is a frequent presenter to financial institutions boards, attending well over 1,300 client board meetings.

Charley is a graduate of Western Michigan University, with a BBA in Management and Economics.



Craig M. Sicilia, Managing Director

Craig is McQueen Financial Advisors chief investment officer and head portfolio manager. He is responsible for overseeing the firm's security transactions that average nearly \$700 million a year in purchases and sales. Along with portfolio management and security analysis, Craig consults with clients on risk management, loan sales, servicing valuations on commercial loans and customized consulting projects.

Previously, Craig was Vice President at JPMorgan Securities, Inc. He was a member of a Financial Strategies team in Detroit, Michigan and responsible for managing relationships with banks, credit unions, taft-hartleys, municipalities and schools. The majority of his time was spent assisting clients with asset allocation, investment analysis, portfolio structuring, security sales and interest rate risk decisions. Craig worked for J.P. Morgan (formerly Bank One, First Chicago NBD Corp, NBD Bank) from January 1991 through March 2006.

Craig is a graduate of Oakland University, with a BBA in Management.

James G. Craven, Vice President



Jim is an investment advisor whose responsibilities include interest rate risk management, consulting, portfolio management, fixed income analysis and valuation services. Jim also manages the firm's Mortgage Servicing Rights Valuation division and has completed hundreds of valuations for institutions around the country, including bank valuation for goodwill impairment testing.

Jim has over 20 years of experience in the financial services industry. Prior to joining McQueen Financial Advisors, Jim worked at Fifth Third Securities and JPMorgan Chase (and successor firms). At JPMorgan, he was a member of the Bank Strategies Group. In that capacity, Jim provided analytics and fixed income investments primarily to banks, credit unions, insurance companies and investment advisors. While at JPMorgan, Jim also consulted clients on derivatives and structured financing.

Jim is a 1983 graduate of Eastern Michigan University.



Heather L. Ciurla, Vice President of Operations & Chief Compliance Officer

Heather joined McQueen Financial Advisors, Inc. as an Investment Advisor, and is the firm’s Chief Compliance Officer. Heather is responsible for Asset/Liability Management reporting and general consulting services. Heather is also a seasoned portfolio manager assisting in daily trading activities. Heather started in the investment business in 1999, working with JPMorgan Chase & Co. in Delaware as an investment agreement manager for municipalities.

Heather has a bachelor’s degree in Business Administration in Economics from Western Michigan University.



Diane E. Knudson, Marketing Consultant

Diane is responsible for managing and directing all of McQueen Financial Advisors, Inc. marketing campaigns and client marketing programs, as well as providing Strategic Consulting services.

Diane began her career in the business-to-business telemarketing industry. As a Marketing Manager, she was responsible for developing, implementing and launching marketing campaigns, developing and evaluating benchmarks and marketing channels, and advising on corporate marketing strategies.

Diane graduated from Christopher Newport University with a B.A. in International Relations and holds a Masters of Arts in Organizational Management from the University of Phoenix.



Heather N. Schepperly, Financial Consultant

Heather joined McQueen Financial Advisors in 2008 after working for the past sixteen years in the customer service industry. Heather is responsible for all areas of office management, as well as assisting with Asset Liability Management and Investment Portfolio Management services.

Heather has a degree in Business Administration from Kalamazoo Valley.

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