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**Auction Rate Securities – Understanding the Risks**

Auction rate securities are long-term bonds or preferred stocks that outwardly resemble money market investments because their interest rates reset at pre-determined short-term intervals. They were introduced over 20 years ago and the market has grown to well over $250 billion. 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. Interest rates reset during periodic dutch auctions held weekly, monthly or quarterly. During the auction, an agent (typically a large bank or broker/dealer) solicits buy, sell and hold orders from clients and other dealers. The agent then ranks orders by their minimum acceptable interest rate. In this competitive bidding process, the rate for the upcoming period is set at the level that 'clears' the market, meaning the lowest yield that will place all of the bonds available for sale. Under normal market conditions, the auction market is efficient with liquidity provided both by a vast pool of potential buyers and auction agents willing to buy any unsold bonds for their own account. However, the ability to sell a bond, both during the auction and between auctions is best described as conditional. This is because holders do not have the right to 'put' bonds back to the auction agent but can sell them at the auction, if there are sufficient buy orders. In order to fulfill a client's sell order, the auction agent must either place bonds with other investors or buy them for their own account. As recent market events demonstrate, investors counting on the auction process to provide needed liquidity may be in for an unpleasant surprise.

A supply/demand disparity occurs when there are more sellers than buyers and can result in a failed auction. To prevent this, auction agents are allowed, but not required to place orders for their own account. Auction agents may administer hundreds of auctions 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, at least 60 auctions involving as much as $6 billion in securities have failed in 2007. When an auction fails, current holders must keep their securities until at least the next auction. During this period, a secondary market may develop, but bond holders faced with liquidity needs should not rely on auction agents to purchase securities from them between auction dates. Investors holding bonds as a result of a failed auction typically receive a higher rate of interest, which is intended to compensate them 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. Depending on supply/demand issues, bond holders who need to sell between auction dates may receive less than par value. Even though some auction rate securities are insured, the coverage does not impact liquidity, but protects only interest payments and principal at the final (long) maturity date.

Given some of their attributes, auction rate securities had previously been classified as cash equivalents. However, because they have long-term stated maturity dates and issuers are under no obligation to redeem them, auction rate securities are now commonly classified as short-term investments. Failed auction holdings are particularly troublesome, because there can be no assurance as to whether or when liquidity will improve. Faced with illiquid holdings, companies may face some difficult challenges. Even though failed auction bonds continue to pay periodic interest payments, the lack of liquidity could cause a holder to fall outside of their debt covenants or investment policy. In the extreme, investors needing liquidity could be forced to borrow funds or sell auction rate securities at a discount. We are also somewhat concerned with possible regulatory scrutiny related to a company's liquidity structure.

Until auction rate securities provide more liquidity and fewer drawbacks, we believe the yield advantage available does not adequately compensate investors for the inherent risks.  We have never recommended them because they lack some important fundamental characteristics.  Recent market turmoil plus some troubling traits continue to earn auction rate securities a spot on our ‘avoid’ list.

Jim Craven
McQueen Financial Advisors, Inc.