

Auction Rate Securities – Understanding the Risks

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.

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.

Failed 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.

Best 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 securities provide more liquidity and fewer drawbacks, we believe the yield advantage available does not adequately compensate investors for the inherent risks.

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