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Seven Facts... and Fiction About Auction Rate Securities

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INTRODUCTION:
Broker-dealers market Auction Rate Securities (ARS) to corporate clients as yieldier alternative investments to high-quality cash management vehicles. While the securities' yield advantage over very short-duration (generally 28 or 35 days) bonds is possible, the brokers often fail to point out the price an investor pays in terms of liquidity given up, opportunities lost along the yield curve, as well as accounting complexity.

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Broker-dealers have an embedded interest in marketing this product because of higher fees they receive than those from government and high-quality corporate issues. The question corporate CFOs need to ask themselves is: How do we benefit from providing liquidity for the issuers and higher banking fees to the auction dealer?

We believe a portfolio of ARS from a single auction dealer presents a unique set of risks for clients whose primary objectives are preservation of capital and sufficient liquidity.

Below we examine the seven claims broker-dealers frequently pitch to corporate investors, and the facts about the true risk and reward of ARS.

1. *"ARS are highly liquid"*
FACT: ARS were created so that investors replace traditional liquidity providers (banks) as the primary supplier of cash for states and towns in certain activities such as student loans. Investors need to understand that unlike taxable variable demand notes (VRDNs), ARS are not legally putable.

ARS gained popularity after municipal issuers found banks either raised the prices of providing backup liquidity, or simply refused to issue lines of credit all together. The backup liquidity is necessary should an investor decide to put a VRDN back to the issuer. By eliminating the put feature, investors' ability to get out of an ARS is at the mercy of the auction dealer and the success of each Dutch auction.

There is not a reliable, or liquid, secondary market for ARS. The fact that money market funds (2a-7 funds) are barred by the SEC to invest in the asset class eliminates the largest group of liquidity providers for this product.

2. *"The auction dealer will buy back your bonds at par"*
FACT: Auction dealers may agree to buy back bonds from investors in order to support the market, but they are under no legal obligations to do so, nor are they committed to pay you at par. Since a single dealer generally markets ARS exclusively, other dealers are unlikely, and unwilling, to bid on the securities of other dealers. Investors need to analyze the creditworthiness of the dealer prior to investing to ensure the dealer will maintain adequate liquidity and market making capabilities for the duration of the investments.

Sometimes even a financially sound dealer may decide not to support liquidity for ARS due to business concerns. There is no legal recourse against them if this situation does occur.

3. *"A failed auction is virtually impossible"*
FACT: Even though the chance of a failed auction is remote, the probability has increased as the product gains popularity with issuers in recent years.

Dealers may, and do, provide the clearing bid (hold securities until the auction process clears the position) sufficient to ensure the success of each auction. As more issuers migrate to this asset class, it becomes increasingly difficult, and costly, for the dealers to provide the clearing bid. They will do so as long as they remain committed to the marketing of the product and the dealer itself is in a strong liquidity position with ample financial flexibility.

A failed auction occurs if there is a lack of demand and no clearing bid is received. Existing investors would continue to hold their bonds at a maximum rate set in the official statement until sufficient bids are entered to set a clearing bid at the next auction.

4. ***"ARS are short-term investments"***
FACT: Even though ARS are frequently marketed as cash management vehicles, they are legally long-term debt or preferred stocks. The maturity on these bonds could be as short as 30 years or as long as perpetual.

Money market funds are prohibited from buying ARS because the SEC regulates allowable investments to 13 months or less, for which ARS almost never qualify.

We have had feedback from some clients that their auditors believe ARS should be classified as long-term securities on their financial statements, not as cash equivalents. Corporate clients need to evaluate whether the reclassification will significantly alter the characteristics of their investment portfolios.

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5. ***"ARS rated AAA have very little credit and liquidity risk"***
FACT: Prudent and conservative investors tend to steer clear of new asset classes that have not been stress tested in real life situations to see how well the "bells and whistles" of investor protection actually fare. The situations may include disruptions of the capital markets, evaporating market liquidity, crisis of investor confidence, economic recession, bankruptcy court litigations, etc.

The fact that most ARS go through orderly Dutch auctions in normal market conditions provides little assurance of liquidity in times of distress when other avenues of access to cash shut down.

CLAIM NO. 6: INVESTING IN ARS ELIMINATES THE NEED FOR FEE-BASED ACCOUNTS.
FACT: Marketable securities, other than direct obligations of the U.S. Treasury, bear credit and liquidity risks. The Modern Portfolio Theory (MPT) favors a portfolio of diversified assets with dissimilar risk characteristics over assets of common risk profiles in order to reduce risks unique to the specific asset classes.

Despite the claim that ARS are backed by high-quality collateral with relatively low credit risk, their common exposure to municipal issuers marketed by the same auction dealers with similar rate reset structures expose investors to risks unique to these constituents.

Investors can significantly reduce credit risk by investing in a portfolio of high-quality securities in different asset classes. A portfolio manager constructs a portfolio that caters to the unique risk tolerance, liquidity needs and investment time horizon of the specific client; actively monitors cash flows and reinvestment of interest payments; updates the client on credit developments of underlying securities; and rebalances the portfolio on an ongoing basis to achieve maximum investment returns.

7. ***"ARS provide better yields than other high-quality investments"***
FACT: Though ARS offer some yield advantage to short-term assets that coincide with their rate-reset schedules (usually 28 or 35 days), they almost always under yield securities of similar credit quality maturing between three and 12 months in a normal (positively-sloping) yield curve environment.

The rate-reset feature essentially limits yield potential to very short maturities. Other than trying to sell it back to the dealer, investors have little or no choice to extend out the curve to pick up additional yield.

IN CONCLUSION:
Claims made by broker-dealers that ARS are liquid, high-quality short-term investments are often incomplete, inaccurate, and misleading. The securities are appropriate only as a small (10% to 20%) and illiquid part of an actively managed short-term portfolio. Ongoing monitoring of dealer support, secondary market liquidity, collateral quality, as well as bidding mechanism at each auction, are imperative for holders of these assets.

APPENDIX A: ABCS OF ARS:
Auction rate securities (ARS) are adjustable rate long-term debt or preferred stocks whose dividend rates are reset periodically through a "Dutch Auction" process by an auction agent or a broker-dealer.

Originally seen only in tax-exempt bonds, municipal issuers also come to the taxable market with ARS backed by high quality collateral such as guaranteed student loans.

Theoretically at a Dutch auction, existing and potential investors enter a competitive bidding process for all outstanding par amounts until a bid level is reached that the entire block can be bought by bidders with yields at or below this level. All winning bidders will be paid at this yield level until the next auction.

In reality, many investors forego the competitive process and agree to buy bonds at the clearing bid yield through "hold", or noncompetitive orders. The dealer supports the auction by providing a clearing bid that clears all outstanding issues. It means when there are not enough competitive bidders, the dealer sometimes buys for its own account and resells it later to prevent a failed auction.

The number of participants for an auction range from a few to a few dozen with par value bids ranging from $500,000 to $5 million. There are approximately 20 dealers that trade auction rate securities.

APPENDIX B: QUESTIONS TO ASK YOUR AUCTION DEALER:

- Is there more than one auction dealer for a specific issue?
- What are the collateral assets backing up the note?
- How much am I paid for not having a put option such as with a taxable VRDN?
- What is the structural risk I am taking?
- How much will I be paid if and when an auction does fail?
- What's the proportion of hold vs. sell orders at each auction?
- How do I know if the clearing bid represents true market demand and not the act of the auction dealer trying to avoid the negative publicity of a failed auction?