Forecasting a Perfect Storm:

New developments aggravate the potential fall of the auction rate securities market

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March 1, 2005

Executive Summary

The auction rate securities (ARS) market may be on the verge of a systemic meltdown after the recent PriceWaterhouseCoopers' FAS 95 & 115 interpretations of ARS as long-term investments.

- Corporate cash managers may exit the ARS market. At a minimum, firms will likely scramble to comply with the new interpretation, experience technical defaults of bank loan covenants, delay 10-K filings, and have to restate financial results prior to March 31st, 2005.
- The SEC's ongoing probe into the ARS market should discourage dealers from "rigging" auctions at this critical juncture, making auctions more likely to fail.
- Auction rate securities' esoteric and option-like nature provides for the possibility of a classic "bank run" situation. Market contagion may set in, causing a chain of failed auctions that could continue for weeks or months.
- Significant credit deterioration of asset collateral and/or discovery of fraud by ARS issuers/servicers may be made public as the result of failed auctions, leading to more bad press and contagion.
- Investors with near-term cash needs may be gravely impacted as they are forced to sell at steep discounts. Those without cash needs may also incur credit losses as some issuers may become insolvent after successive failed auctions.

In a game of poker, as the old adage goes, if you don't see a fool around you, you are probably the fool. Ever since our May 2003 publication of "Seven Facts… and Fiction about Auction Rate Securities", we have been beating the drums on the risks of ARS investments in cash portfolios. Liquidity risk, credit risk, and market-making irregularity were some of the factors that led us to shy away from these seemingly "yield rich" and innocent looking "cash" instruments.

Recent developments on the accounting and regulatory fronts have led us to believe that a market-wide failure is possible and that investors, particularly corporate cash investors with near-term cash needs, should rid themselves of ARS immediately to avoid a potential "run" on the fragile auctions market.

The Straw that Could Break the Camel's Back

Recently, PriceWaterhouseCoopers (PwC) issued an accounting opinion that we suspect could be the straw to break the camel's back. In an unequivocally straightforward fashion, PwC said in its February 2005 DataLine bulletin that ARS should not be classified as "cash equivalents" (FAS 95) in most cases. Instead, they should be treated as "investments" in order to comply with FAS 115: Accounting for Certain Investment in Debt and Equity Securities.

The bulletin went on to say that "the other three major accounting firms all presently hold a similar view." Moreover, PwC believes that the staffs at the Financial Accounting Standards Board (FASB), the SEC, and the Public Company Accounting Oversight Board all share the same opinion.

Treating ARS as investments instead of cash equivalents, in and of itself, may not seem like anything other than an accounting nuisance. However, we believe the cash equivalent classification is precisely the hook that lured most corporate cash investors into the ARS market. The reclassification may have the following immediate impacts:

- Public companies that used to handle ARS as "hold to maturity" will have to treat them as "trading securities" or "available for sale", which may violate their existing accounting policies regarding investments.
- If firms have debt covenants that prohibit or limit investments in non-cash instruments, the possession of ARS may be viewed as a violation, possibly resulting in revoked bank loan commitments and/or negative impacts on corporate credit ratings.
- If reclassification of an existing holding represents a "material" error (consult SEC Staff Accounting Bulletin No. 99), the firms will have to restate their financial results from prior periods. Announcements of restatement, as well as missed 10-K filings, may create headline risk for stock prices.

Despite clear and steadfast rulings by the SEC prohibiting money market funds from investing in ARS, corporate investors who purchase directly from Wall Street repeatedly hear whispers that the bonds' long-dated maturities are merely "notional"; i.e. not to be taken literally or seriously. In fact, one can easily find scores of online broker brochures that promote ARS as cash equivalents or money market alternatives.

SEC Intervention May Contribute to the Fall

Ironically, the SEC's probe into alleged broker-dealer manipulation of the auction rate market may contribute to a quicker fall of the market. The 25 brokerage houses involved in the probe appear eager to settle with the regulators and are not likely to support failing auctions through continued "auction rigging".

Unlike the large and liquid U.S. Treasuries auctions market, which has 22 primary dealers and wide participation of bond investors, the ARS market traditionally involves a single dealer who submits all bids on its customers' behalf. The dealer is also allowed to bid on its own behalf while knowing its customers' bids. According to press reports, after having had a peek at its customers' bids and for fear of a failed auction, certain brokers would have their best institutional clients put in a clearing bid to avert the negative publicity of a failed auc-

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tion. In other words, these auctions were sometimes auctions in name only and allowed dealers and/or their preferred customers to earn the best interest rates.

In June 2004, the SEC asked 25 dealers to detail "any potentially deceptive, dishonest or unfair practices" related to auction rate securities. A settlement is in the works, but may be several weeks away. Against this backdrop, if auctions become crowded with sellers, buyers are scant, and the dealers stay on the sidelines, then systemic auction failures are more likely to occur.

Other Factors that Matter

Market dynamics have changed since ARS came to stardom in the late 1990s. The case for investing in them is no longer as compelling as it once was:

Higher yield than money market funds: Since the Federal Reserve started raising interest rates in June of 2004, the yield curve has become steeper, reducing the yield attractiveness of ARS. For example, on February 24th, the average 28-day student loan ARS yielded the same as 45-day commercial paper and 13 basis points less than 90-day commercial paper from AAA-rated financial issuers.

An attractive funding channel for bond issuers: Since the SEC probe of alleged "auction rigging" last June, several high profile municipal issuers, including Cook County, IL, have scrapped their bond sales in the auction market and gone back to the traditional variable-rate demand note market. "Issuers are rightfully concerned about the integrity of the interest rate setting process,'' the Chief Financial Officer of Minneapolis, MN, was quoted as saying in a June 2004 Bloomberg article.

A booming student loan market providing plenty of collateral assets: Students loans are the preferred asset collateral for ARS because many of them carry government guarantees. Since these loans are floating rate, higher interest rates will probably put a stop to the refinance boom. As issuers scramble for new types of asset collateral, credit quality of loans has deteriorated as seen in the recent Federal Reserve senior loan officers' survey.

Broker-dealers' willingness to support the market: The current $200 billion 28-day revolving market is too large for any dealer or group of dealers to support, especially considering the low potential returns on equity when compared to the firms' other profitable businesses. Plus, the phrase "the house always wins" aptly explains broker-dealers' motive in supporting a particular product. After all, ARS official statements do not assert that dealers are legally liable for failed auctions or making investors whole when one does occur.

Conclusion- Market Contagion Revisited

We discussed the risk of "market contagion" in our December 2004 issue of *The Capital Advisor*. We examined the phenomenon of negative events occurring in one security and triggering large movements in other securities in a domino effect.

We have always been concerned that the fragile liquidity and dependency on investor confidence of ARS may subject the securities to potentially violent market contagion that could lock up the entire market for days or weeks. The PwC accounting opinion and the SEC probe may create a powerful concoction that results in a potentially explosive chain of events in the not too distant future. **Investors may experience significant losses if they do not act quickly.**

1. Corporate cash managers may exit the ARS market. At a minimum, firms will likely scramble to comply with the new interpretation, experience technical defaults of bank loan covenants, delay 10-K filings, and have to restate financial results prior to March 31st, 2005.

2. The SEC's ongoing probe into the ARS market should discourage dealers from "rigging" auctions at this critical juncture, making them more likely to fail.

3. Auction rate securities' esoteric and option-like nature provides for the possibility of a classic "bank run" situation. Market contagion may set in, causing a chain of failed auctions that could continue for weeks or months.

4. Significant credit deterioration of asset collateral and/or discovery of fraud by ARS issuers/servicers may be made public as the result of failed auctions, leading to more bad press and contagion.

5. Investors with near-term cash needs may be gravely impacted as they are forced to sell at steep discounts. Those without cash needs may also incur credit losses as some issuers may become insolvent after successive failed auctions.

Appendix:

Why are ARS cash-like instruments with embedded short put options and asymmetrical return payoffs?

We view ARS as esoteric cash-like instruments with embedded short put options and asymmetrical return payoffs. In simple terms the maximum potential gains from the instruments are negligible when compared with their maximum potential losses.

A put option is an agreement that gives a buyer the right to sell a security at a set price on a future date. The seller, or the party who shorts the put option, is paid a premium for promising to pay the buyer at a later point in time. The buyer retains all the optionality, and the seller retains none.

At the time of the ARS purchase, the investor has in practice unknowingly sold a put option to the bond issuer. The option would legally require the investor to keep the underlying investment until its legal final maturity if the issuer decides to "put" the security when a failed auction occurs. The issuer would, of course, not exercise it as long as the auctions were successful. The option is embedded, as it is not explicitly stated in bond documents.

The return potential of an option seller is the premium, while the loss potential for the seller is the whole value of the security. In an auction rate transaction, the investor has essentially sold a put option on the value of the investment for as little as 0.05% to 0.20% in premium, the rate differential between money market funds and most ARS. On the other hand, the investor stands to lose the entire investment if the security becomes worthless before maturity.

We believe that the miserly incremental yield earned by ARS represents an immense risk relative to the potential reward. The best course of action is to tender the security back at the earliest possible time before anyone else does.

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