



MARKET COMMENTARY

Auction Rate Securities: What Are They?

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There have been several headlines recently regarding Auction Rate Securities (“ARS”). What exactly are these securities? They are a form of a floating rate investment vehicle, issued by a variety of both public and private entities. The rates generally reset monthly on the “auction date.” The auction is the key to the current headlines.

Let’s examine how the auction system works. First, a broker sells the security to an investor. The investor holds the security until the auction date arrives and then may notify the broker that he or she wants to sell the security in the auction. Other buyers or investors will “bid” on the ARS using an interest rate that they are willing to accept on the securities in order to purchase them. The securities are then sold to the bidder who has submitted the lowest interest rate.

The problem with this auction system is that there is no written guarantee that the securities will sell at auction. In essence, there is no guarantee that any buyer will even bid on them (hence, a “failed” auction) or that the issuing broker will take them back if the auction fails. The auction feature and the long final maturity date disqualifies these bonds as being a money market eligible security.

Many corporate investors incorrectly continue to view them as “short-term” instruments because of the auction feature. Over the past few weeks, these auctions have been very disappointing and several have actually failed. This means that there were no buyers to sell them to and the original investor was left holding them for now. Initially, dealers had been taking them back on good faith, when no buyers showed up at the auction. But that only lasted for a short period.

B e c a u s e t h e s e a u c t i o n s o f f e r n o
d e f i n i t e w a y o f d i s p o s i n g o f t h e s e b o n d s
w e d o n o t n o r h a v e w e e v e r p u r c h a s e d
t h e s e s e c u r i t i e s .

Because these auctions offer no definite way of disposing of these bonds we do not nor have we ever purchased these securities. Further, the money market funds into which our clients’ cash reserves sweep do not hold any Auction Rate Securities.

Securities that we sometimes purchase for our clients are Variable Rate Demand Bonds (“VRDB”). These securities do not have an auction feature. Although, like the ARS, they do have a long final maturity; the difference is that they have a 7-day PUT feature back to the selling broker. This means that the investor can contact the broker and tell them they are returning the bonds in 7 days.

These securities have multiple layers of credit strength beginning with the underlying issuer. Many are insured and/or have letters of credit or other types of guarantees attached to them. Unlike the ARS, there is extra liquidity in the securities because of the PUT feature. This gives them an effective 7-day maturity and thus, these securities qualify as an approved money market instrument in which many money market funds participate. There are other variations of this security which all maintain a PUT feature back to the broker.

In summary, our approach to the purchase of all fixed income securities, short-term or long-term, is consistent. We always look though to the quality of the underlying issuer and to the structure of all instruments which are considered for purchase in our clients’ portfolios. Most importantly, we tailor every security and portfolio to the specific goals, objectives and risk parameters of each client.