

Auction Rate Securities are municipal bonds whose yield and liquidity depend on a Dutch auction. While many investors consider ARS as substitutes for money market funds, they tend to be less liquid.

The markets for auction rate securities (ARS) have undergone some significant gyrations in recent weeks. Tax-exempt ARS, as the name would imply, are a type of municipal bond with intermediate to long maturities whose yield resets periodically according to the results of an auction. The period of reset is most commonly weekly, although monthly and daily reset ARS are also readily available. Because of their short duration profile, ARS are often considered a substitute for money market funds, **although the liquidity of ARS is by no means guaranteed.** Auction rates can usually only be purchased or sold at these scheduled auctions, which follow a "Dutch" format and are conducted by the "bulge bracket" banks, such as Goldman Sachs, Merrill Lynch, and Bear Stearns, for example. All of the sellers of a given bond place sell orders ahead of the auction and all potential buyers place bids expressed as yields at which the buyers are willing to purchase the securities. Sellers receive par for the ARS and the bonds' coupon resets to the highest yield required for all bonds to be sold (i.e., via a Dutch auction process).

It is possible, however, that not all sell orders will be filled at these auctions if there are an insufficient number of bids to cover all sell orders. In that sense, while the ARS do have a periodic auction, liquidity is by no means guaranteed. In other cases, some of the bids may be at almost comically-high yields, often 50 - 100 basis points higher than a liquid market would support. These low-ball bids are frequently the result of hedge funds and other investment pools looking to "pick off" an illiquid security. If, in an auction with low-ball bids the number of sellers exceed the number of buyers, the low-balls will be accepted and the entire deal will reset to an above-market coupon. Since the municipalities that issued the bonds pay the coupon, this is naturally an unattractive prospect for issuers. One way that the issuers avoid the risks of these yield spikes is to depend on brokerage firms to support ARS deals. ARS auctions are usually managed by the same firm that underwrote the deal when it was first issued. Many times, if the number of sellers exceeds the number of buyers at a given auction, the dealer managing the auction will step in with its own capital to provide additional liquidity to a given ARS deal. While this liquidity backstop is not guaranteed, it can certainly provide benefits to holders of ARS who may need to turn their holding into cash in a short timeframe. In addition, many dealers will use their own capital to ensure that low-ball bids need not be accepted. By entering a bid at, say 3.75%, a dealer can prevent a low-ball bid of 4.25% from being accepted and the issuer being forced to pay higher interest costs. The below table compares the results of three example auctions in which liquidity is largely absent, in which liquidity is provided by a low-ball bid, and in which a dealer steps in to provide additional liquidity.

Sample ARS Auctions: Liquidity and Rate

Sellers Exceed Buyers (Unlikely)			Low-Ball Hedge Fund Bid			Dealer Support		
	Amount	Price		Amount	Price		Amount	Price
Sellers:	\$100 MM	Par	Sellers:	\$100 MM	Par	Sellers:	\$100 MM	Par
Bids:			Bids:			Bids:		
Investor A	\$10 MM	3.25%	Investor A	\$10 MM	3.25%	Investor A	\$10 MM	3.25%
Investor B	\$1 MM	3.50%	Investor B	\$1 MM	3.50%	Investor B	\$1 MM	3.50%
Investor C	\$5 MM	3.50%	Investor C	\$5 MM	3.50%	Investor C	\$5 MM	3.50%
Investor D	\$50 MM	3.54%	Investor D	\$50 MM	3.54%	Investor D	\$50 MM	3.54%
Investor E	\$10 MM	3.55%	Investor E	\$50 MM	3.54%	Investor E	\$50 MM	3.54%
Total	\$76 MM	3.55%	Hedge Fund	\$100 MM	4.05%	Dealer	\$30 MM	3.70%
Unsold:	\$24 MM		Total	\$216 MM	4.05%	Hedge Fund	\$100 MM	4.05%
			Unsold:	\$0 MM		Total	\$246 MM	3.70%
						Unsold:	\$0 MM	

Source: Janney FI Strategy;

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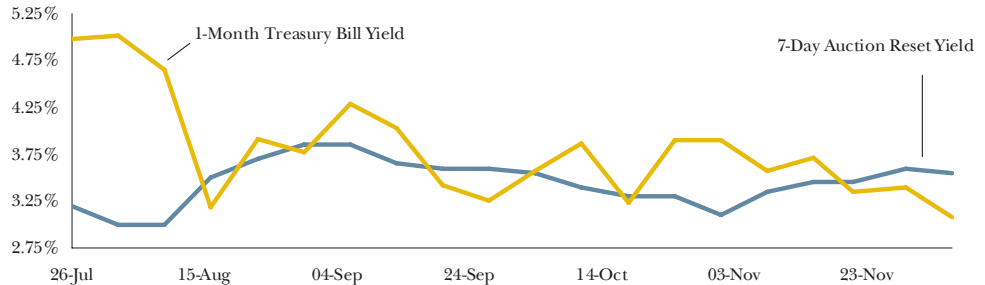
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The yields on many auction rate securities have accelerated upward as much as 70 basis points in the last four weeks, despite the fact that short-term Treasury yields have fallen significantly. As a result, a number of municipalities who planned the issuance of new ARS deals pulled those deals prior to sale. Since these auction rate deals have accounted for approximately 8.3% of 2007's total issuance volume (\$32.8 billion through October), any sizeable drop in ARS issuance represents a significant blow to muni market supply as a whole. There are three primary causes for the spike in ARS yields and the declines in issuance. First of all, liquidity in the broader markets is drying up. This phenomenon appears to be driven by a round of growing risk aversion that, while more gradual than the August increase, has proven more severe. Many investors, including many of the municipal bond hedge funds, are sitting on the sidelines and aren't willing to buy at current levels.

The second cause of the spike in ARS yields has been a lack of balance sheet room at a number of major dealers and banks. While the global decline in liquidity certainly factors in to the lack of balance sheet room, year-end reporting plays a very significant role. Not only is this lack of balance sheet space pushing up ARS yields, it's also booting LIBOR rates, which are the benchmarks for short-term bank loans. Many dealers had their fiscal year end on November 30 (Goldman Sachs, Bear Stearns, Lehman, and Morgan Stanley) and wanted to show shareholders a rosy picture. Part of this picture is a less-risky balance sheet with a smaller allocation to trading assets. As a result, these brokers have been hesitant to step into auctions with their own capital and provide the liquidity and rate backstop we discussed earlier. What's intriguing about brokers eschewing ARS purchases is that certain firms are more willing than others to support auctions with their own capital. At firms like Goldman, which has plenty of balance sheet room, yields on ARS are lower and liquidity much greater, but at firms that are more under the microscope such as Bear Stearns, ARS yields are higher and liquidity poorer. The difference in yields at the two firms, which is running as high as 35 basis points for similar securities, exemplifies how key liquidity is in determining value in today's markets.

>Auction rate securities' yields are increasing, but in some cases, this increase comes at the expense of poorer liquidity.

ARS versus 1-Month Treasury Yields



Source: Janney FI Strategy; Bloomberg; Goldman Sachs

Finally, concerns about the credit quality of the major muni insurers are pushing yields on auction rate securities higher. Although hard numbers are tricky to come by, experience suggests that the majority of ARS are insured to Aaa/AAA ratings with the major municipal bond insurers. Over the past six weeks or so, the credit quality of these insurers has come into question from investors and from ratings bureaus Moody's and Fitch. Both agencies are completing a top-to-bottom review of the insurers' exposure to the subprime mortgage markets, and early indications suggest that several insurers have a serious possibility of being put on negative credit watch. These questions have led investors to demand higher yields for purchasing insured munis. While we're on the topic of insurance, there's one misconception about insured ARS that should be cleared up. **The insurers only guarantee the timely interest and principal payments on a security, they do not guarantee the auction itself**—that is, the insurers provide no promises that an investor can sell an ARS at an auction. That liquidity is a function of the depth of bidders and the willingness of a broker to support an issue.

Ultimately, recent weeks' turmoil in the market for auction rate securities is likely to be a short-lived occurrence that could remedy itself as early as January of 2008. For the immediate term, it's best to be cautious with ARS. While the higher yields on some securities look attractive, those yields many times come at the expense of liquidity. For investors in what's considered a substitute to money market securities, the tradeoff between yield and liquidity deserves careful consideration.