MUNI UPDATE: AUCTION RATE SECURITIES

JANNEY FIXED INCOME STRATEGY FEB 6 2008

While general market pressures have eased, recent insurer troubles have brought a new round of stress to Auction Rate Securities. This publication is a follow up to the* Muni Update *on ARS dated December 10.

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After a brief easing of pressures post-year end, credit stresses have again begun to build in the Auction Rate Securities markets in the last two weeks or so. As investors become increasingly concerned about the credit quality of insurers that back the principal and interest payments on a number of ARS deals, potential buyers are backing away from many auctions through with ARS can be bought and sold. Since these auctions provide liquidity to current ARS holders, many such holders are naturally concerned that buyer hesitancy could cause a number of auctions to "fail," thereby preventing ARS investors from selling their securities. Unfortunately, the current situation is one where perception can quickly become reality–as ARS holders grow increasingly concerned about liquidity risk and attempt to sell their holdings into auctions with fewer buyers, some auctions are likely to fail. For that reason, even more so than in previous periods, we believe that **auction rate securities should not be considered a substitute for money market funds**, but rather as a long-term floating rate investment with limited credit risk and significant liquidity risk. In making this assessment, we're necessarily disassociating the two components of risk inherent in owning ARS: credit risk and liquidity risk. While all tax-exempt securities have some of each risk, auction rates are unique in that they're bought and sold though periodic auctions. The ability of a holder to sell securities is dependent on the success of these auctions, not directly on the credit quality of the issuer.

While there is certainly a heightened degree of liquidity risk in ARS, to this point, relatively few auctions have "failed." An auction fail occurs when there are more sellers than buyers present at a periodic ARS auction. In a failure scenario, current investors would be forced to continue holding their position and the coupon rate on the ARS would automatically set to the maximum allowable rate under the prospectus (usually a multiple of a common benchmark rate, such as LIBOR). This elevated coupon serves as compensation to holders that were unable to sell their securities. Broker-dealers that manage auctions will typically bid on their own behalf in order to prevent such failures, but since many firms remain balance-sheet constrained even after year-end pressures have lifted, they simply cannot be counted on to provide the same level of support that they were able to offer just 3 - 6 months ago. You can see investors' perception of higher risk on ARS in the average yield at which auctions are clearing. The MMD's weekly average ARS coupon increased from 3.63% in mid January to 3.92% as of the last week of the month, a 29 basis point increase. This increase effectively compensates ARS investors for poorer liquidity in the current environment. Particularly as comments about the potential

Example Investor "Run" on ARS Auction

Typical Auction			"Panic" Auction		
	Amount	**Price**		**Amount**	**Price**
Sellers:	$100 MM	Par	**Sellers:**	$250 MM	Par
Bids:			**Bids:**		
Investor A	$10 MM	3.25%	Investor A	$10 MM	4.05%
Investor B	$1 MM	3.50%	Investor B	$1 MM	4.10%
Investor C	$5 MM	3.50%	Investor C	$5 MM	6.00%
Investor D	$50 MM	3.54%	Investor D	$50 MM	7.15%
Investor E	$50 MM	3.54%	Investor E	$10 MM	12.00%
Dealer	$30 MM	3.70%	Dealer	$0 MM	
Hedge Fund	$100 MM	4.05%	Hedge Fund	$0 MM	
Total	**$246 MM**	**3.70%**	**Total**	**$76 MM**	**Max Rate**
Unsold:	$0 MM		**Unsold:**	$174 MM	

Source: Janney FI Strategy

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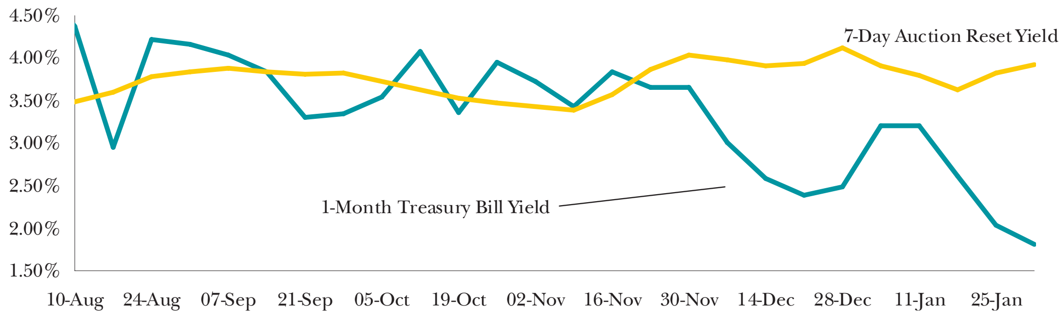
illiquidity of ARS investments begin to work through the mainstream press, it's likely that yields could push significantly higher. For that reason, for investors willing to accept the heightened liquidity risk, there is some value in owning auction rates, but, again, these structures should not be considered as money market substitutes, particularly in the current environment.

7-Day ARS versus 1-Month Treasury Yields



Source: Janney FI Strategy; Bloomberg; MMD

In the past two weeks, at least six known auctions of ARS have failed. While six auctions is still small in comparison to the entire $270 billion auction rate securities market, they're nonetheless significant in that these failures were the first since 1991, when the ARS issued by Tuscon Electric Power Co. and Pima County IDA (both in Arizona) ended a 16-month string of failed auctions. The six fails realized over the past several weeks included a $100 million deal issued by Georgetown University and insured by MBIA and $115 million deal issued by Nevada Power and insured by Ambac. Both deals had Lehman Brothers as their auction agent. In addition to these two deals, four other auctions of insured issues with underlying credit ratings in the A range whose auctions were managed by Piper Jaffray also failed. While Piper has not confirmed these failures, both Dow Jones newswires and independent sources attested to their existence. Janney does not manage ARS auctions, only participates in auctions with major ARS firms, and has not, to this point, been involved in any failed auctions.

> The liquidity risk in action rate securities is on the rise in the current risk-averse environment and investors who use the instruments as cash substitutes may be safer in alternate investments.

Recent ARS Auction Failures

Issuer	Insurer	Deal Size	Penalty Rate	Auction Manager	Notes
Georgetown Univ. (A3)	MBIA (Aaa*/AAA*/AAA*)	$100 MM	6.60%	Lehman	"Subsequently cleared"
Nevada Power (NR)	Ambac (Aaa*/AAA*/AA*)	$115 MM	6.76%	Lehman	Auctioned successfully on Jan 29
Health Care	Insured			Piper Jaffray	
Health Care	Insured			Piper Jaffray	
Health Care	Insured			Piper Jaffray	
Education	Insured			Piper Jaffray	

*Indicates negative creditwatch

Source: Janney FI Strategy

As you can see from the above examples, data on ARS auctions are often hard to come by, which is one reason that the SEC is considering requiring disclosure of failed auctions of corporate auction rate preferreds (the SEC has no authority to regulate municipal securities). Realistically, however, true transparency will take longer to implement than current illiquidity concerns are likely to last. For current ARS investors, there are a few straightforward steps that can help limit liquidity risk. First of all, diversify holdings into several different securities, preferably ones that are covered by different insurers. Diversity will prevent the impact of events specific to one issuer or insurer from putting an entire portfolio at risk. Second, focus purchases on larger deals backed by states, state authorities, and other large-scale issuers. These deals are likely to have the most stable, consistent auction bidders. Finally, for the near future, it's prudent to consider ARS as a floating rate investment and not a higher yielding money market substitute for placing excess cash. As recent auction failures and higher yields indicate, liquidity in these instruments is by no means guaranteed.

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