

February 21, 2008

Auction Rate Securities –

What to do now, from an independent perspective

WHAT HAS HAPPENED

What was pledged by supporters a few weeks ago as a situation that could “never” occur seems almost like old news today: Auction Rate Securities of all forms are failing at a daily rate between 70 to 80 percent or between \$15 to 25 billion. Ironically, the banks that actively marketed these securities as safe cash management vehicles have let some or all of their auctions fail because they won’t take the risk of holding them. All major issuers of ARS, including Deutsche Bank, UBS, Lehman, Merrill, Citigroup, Bear Stearns, JP Morgan, Morgan Stanley and Goldman Sachs have let auctions fail.

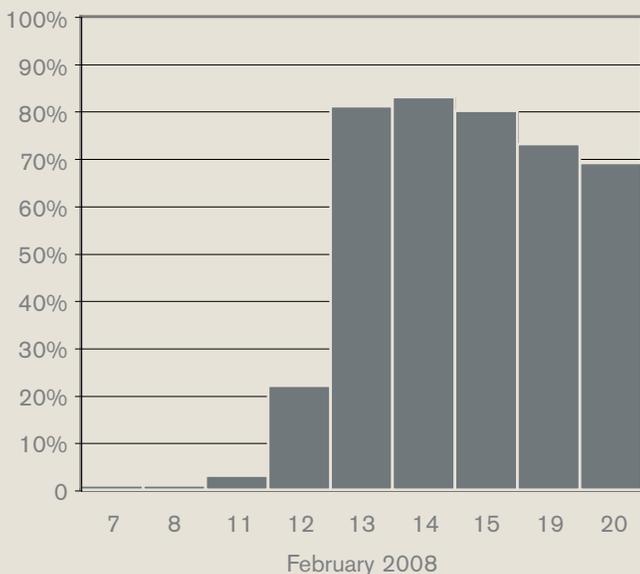
At face value, their decision to walk away from these auctions is remarkable. Auction Rates, as detailed in our [August 2007 advisory](#) are revenue drivers not only from an underwriting standpoint, but also for the fees they receive for being the auctioneer and sole conduit of liquidity. The decision to not support most auctions — they have no contractual obligation — virtually ensures a long road for the remaining auctions. In addition the brokers’ reputation, with investors holding suddenly illiquid, presumably long term debt, and with issuers paying “penalty” yields far beyond the market rate, will be hard to recover. As [the early spate of lawsuits implies](#), both sides feel they were given some form of assurance that what is happening now simply wouldn’t, couldn’t, happen.

WHERE IT BEGAN

What began 20 years ago [as a particularly esoteric debt structure](#) (long term debt that paid short term yields) grew into a \$300B+ asset class with thousands of auctions occurring daily. For corporations, the story of how auction rates found their way onto balance sheets is fairly straightforward. In a persistently low short-term interest rate environment, issuer demand to employ such a vehicle surged and brokers found it relatively easy to market a “money market-like” security that yielded a higher risk premium but usually carried a AAA-rating. Provided it was marketed as a FAS 95 cash equivalent that auctioned monthly, corporations were ideal buyers.

In the meantime, underwriting revenue was amplified by the fact that these brokers were the sole “book runners” and collected fees for that as well. All the brokers had to

Failed Auction Rate Security Auctions



Source: Bank of America, Reuters, and DJ Newswires

do was find enough buyers, and that was simply a function of hiring the right salespeople. If they convinced corporations to allow auction rate securities in their investment policy, and convinced them to classify them as cash, all that was left was to add ARS to client portfolios, which were almost invariably underwritten by the manager as well.

HOW IT ENDED

Early indications that auctions weren't as stable as advertised came with an [SEC reprimand of the 15 major auction runners](#) in the summer of 2006. They were essentially rigging bids to prop up demand for their auctions. While it got little national press, it was in our opinion an early sign that the markets were not as stable as advertised.

In the fall of 2007, the relatively few ARS that were directly tied to subprime CDOs, many of them private placements, began failing simply because of their creditworthiness. In the past fortnight, as total bank credit writedowns marched towards \$200B, the investment banks' shrinking risk appetites stopped them from stepping in on even the most creditworthy ARS.

Assurances of liquidity did not hold when they were most necessary — when things went wrong. The fundamental bias brokers had in marketing ARS were suddenly clear: they were the only source of liquidity on these revenue drivers, selling was driven by an absolute need to fill seats at the auction, and the risks inherent in the auction process had no relation to their AAA-credit rating.

One of the most telling facets of this story is the unending need brokers still have to find buyers. Although they themselves aren't buying them, a phrase commonly heard this week is that ARS presents a "buying opportunity."

WHAT YOU CAN DO NOW

Get Independent Insight

There is remarkably little transparency from brokers about the status of individual auctions and what auction runners intend to do for their impacted clients. While that may not change immediately there are still ways of finding information. SVB Asset Management is sharing market findings with clients on a daily basis and we encourage them to continue to press us for insight.

Know Your Options

Except for the special case of Auction Rate Preferred issues and ARS backed by subprime and CDO credit, the larger AAA municipal and student loan issuers and their collateral appears sound, even if their ARS funding vehicles have stalled and the AAA-rating was supported by bond insurance. The clear understanding is that few if any issuing firms have the will or desire to continue to pay penalty interest. While each situation is different it is a virtual certainty that refinancing is mandatory for each firm. What should also be clear is that making their debtholders whole plus interest is a mandatory aspect of their long term credit standing. Both investors and issuers have a strong motivation to unwind in whole and move on. Press your broker to keep you abreast of where these scenarios stand. While the process may not be terribly organized at first, we expect that in many cases issuer redemption or bank calls will eventually occur. Here we also encourage affected corporate investors to speak with us about the evolving market situation.

There is news of investors looking to benefit from failed auctions at attractive penalty rates by offering less than par (\$100). We believe that for many investors, taking this route may be premature unless the investor places a premium on unwinding their holdings relative to any risk of principal loss. If an investor wants to make that choice, we believe a secondary market is already alive and well.

Work with Issuers

AAA-rated auction rate issuers are generally solvent entities that can probably resort to other financing vehicles (and other underwriters) quickly. They generally have no interest in paying “penalty” rates simply because the auction dealer walked away. However, the creditworthiness of each issue may depend on their ability to refinance out of the current situation. Be proactive if you choose to investigate this route. Time is of the essence for both parties. Investors that reach out to issuers may very well [find someone looking to get out of the investment as much as you are](#).

Consider Speaking With Other Investors

Corroboration of what holders were told, how these were sold, and what they are hearing now, is hard fought information. We are happy to put interested parties in contact with one another on a confidential basis.

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Work Only With Registered Investment Advisors

SVB Asset Management has found that much of this situation for corporations stems from salespeople or “portfolio managers” who did not have an explicit fiduciary responsibility that registered investment advisors have to their clients. Broker conflicts of interest were disclosed in some fashion, but they did not prevent these securities from being marketed heavily to corporations. Ultimately, as auctions nationwide started experiencing pressure, it appears few if any auction salespeople called their clients to warn them about the growing risks of failure. Because they weren’t fiduciaries, they didn’t have to.

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