

AUCTION RATE SECURITIES

APRIL 12, 2005

This is an update to a prior research note on Auction Rate Securities (ARS) in which we expressed some concerns over a weakening liquidity dynamic in this \$210 billion market. Following that analysis, we abandoned this security type and currently *do not* hold any bonds in any client accounts. Our concerns were centered on increasing broker inventory and falling bid-to-cover ratios in the auction process. The subsequent U.S. Securities and Exchange Commission's (SEC) investigation only cemented our view that these security types carried too much risk for accounts that had "preservation of capital and provision of liquidity" as prime directives in their investment policies.

Recently, PricewaterhouseCoopers (PWC) issued a *DataLine* advisory that focused on the accounting treatment for ARS. Their conclusion is that these securities are not cash equivalents under FAS 95. Further, PWC asserts that the "other three major accounting firms all presently hold a similar view."

PWC'S REASONING

- Generally, FAS 95 permits the accounting of a security as a cash equivalent "only if the investment has an original maturity of three months or less" as assessed from the perspective of the investor. Thus, any security purchased with a final maturity less than three months away can be considered a cash equivalent — no matter what the original issued maturity might have been. Since the auction process does not grant a put to the investor, the auction period cannot be used as a final maturity. Most ARS have final maturities well in excess of ten years, which excludes them from the cash equivalent category.
- Once the cash equivalent classification under FAS 95 is not available, ARS must be analyzed as investments under FAS 115. FAS 115 clearly focuses on the final maturity of the bond, not the auction periodicity. As a result, the classification falls out of the short-term category and must drop to long-term. Arguably, under the "available-for-sale" criteria, some investors may be able to assert that ARS are short-term if they will be liquidated for working capital purposes.
- PWC also believes that any auction rate security that was sold at an auction date cannot be classified as held-to-maturity if, in fact, the true maturity is still some years away.

The most ominous part of PWC's *DataLine* note was its characterization of the misclassification of ARS as cash equivalents in prior periods as "material error" requiring a restatement of historical financial statements to conform to current statements.

INVESTMENT POLICY IMPLICATIONS

Virtually all investment policies contain some provision to limit the final maturity of any bond and the weighted average maturity of the portfolio. If the policy permits ARS, typically there will be some safe harbor language that "the final maturity of auction rate type securities is deemed to be equal to the auction period." It is our view that this language is no longer appropriate. Retaining this language in an investment policy would leave corporate officers in the uncomfortable position of maintaining one perspective of the bonds for public reporting purposes

and keeping a completely different perspective for internal management purposes. In the post-Enron, Sarbanes-Oxley world, this lack of alignment will draw certain scrutiny. Holding ARS may be a violation of investment policies with final maturity constraints.

LIQUIDITY IMPLICATIONS

It is not obvious how the market will react to this news from the accounting profession. We have heard that some clients are liquidating their ARS portfolios at the request of their auditors and replacing them with Agency discount notes or commercial paper. Clearly, if enough demand moves to the sidelines, the yield on ARS will rise. Unfortunately, the liquidity will decline as well — possibly in a dramatic fashion. Once liquidity thins and broker inventories rise to unacceptable levels, auction failures may become commonplace. The only recent failed auction is a Zurich Pass Thru CTFS 4A issue that failed due to a credit downgrade in 2002. Note that there has been essentially *no bid in the market* for that bond since it failed.

CONCLUSION

For the reasons cited above SVB Asset Management believes that Auction Rate Securities are inconsistent with the investment priorities of risk-averse investors that have liquidity as a prime directive.

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