AUCTION-RATE BONDS
JULY 28, 2004

Following the launch of an SEC investigation into the $210 billion auction-rate bond market last month, SVB Asset Management and our clients have experienced a significant increase in the calls from dealers selling auction-rate bonds. According to news reports, the SEC is concerned about how pricing is established in the auction process. Issuers and investors may begin to withdraw from this market until the direction of SEC investigation is understood. Although the current run up in spreads and yield on auction-rate bonds can be enticing, we see this as another sign of weakness in the market for these securities. Our principal concern is the liquidity in the auction process. A lack of interest in this security type increases the risk of a failed auction, which could result in the accounting reclassification of the bonds as long-term rather the "cash-equivalent" status used by many investors today. At that point, investors would be left with a 20 to 30 year bond position with an unattractive coupon. We recommend that risk-averse investors avoid these securities at this time.

In May, the SEC sent a letter to 25 dealers requesting that they "voluntarily conduct an investigation" regarding activities in the auction-rate bond market and provide the SEC with "a written report detailing any potentially deceptive, dishonest or unfair practices"[1]. The SEC does not comment on regulatory reviews, but we believe any regulatory uncertainty is a significant concern for investors. Various sources have reported that the SEC's concerns range from dealers improperly trading for their firm's account to dealers providing clients with information on competing bids. One firm has already announced the suspension of an employee in connection with the review, and Cook County, Illinois cited the review as a key factor in their decision to withdraw plans to issue auction-rate bonds.

The following summary of the structure, market conditions, and risks of these securities is in response to a large volume of questions from our clients:

Auction-rate bonds are long term bonds (typically 20+ years) that reset their coupon rates in regularly scheduled Dutch auctions. The auction agent receives bids from brokers representing potential purchasers at each rate reset date. Once the bids are submitted, the auction agent sets the rate at the lowest yield that will sell the entire offering. The primary risk of these types of securities arises when not enough bids are submitted to sell the entire offering (a "failed auction"), at which point the securities would become long-term-holdings at a default interest rate with very limited liquidity.

Investing in auction-rate bonds can lead to a higher yield on the short end of the curve. As of the week of July 28, 2004, yields were in the 1.55-1.65 percent range for 28 to 35 day auction periods, compared to approximately 1.20-1.30 percent for 30-day Agency discount notes and commercial paper. These bonds have historically paid higher yields over like-maturity commercial paper, due to the inability of Money Market Mutual Funds, regulated under Rule 2a-7 of the Investment Company Act, to invest in securities whose final maturity exceeds their regulatory limit of 397 days.

While Moody's typically rates these securities "AAA", this rating reflects the likelihood of return of principal at maturity, and does not reflect the risk of a failed auction.

SVB Asset Management's position is that due to the SEC investigation, the current risk profile of these securities is inconsistent with the investment priorities of risk-averse investors.

You may contact SVB Asset Management for information about auction-rate bonds, this advisory, or our investment advisory services.

(1) Memo from Bond Market Association, Securities Industry Association and the American Bar Association, June 24, 2004

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