

AUCTION RATE SECURITIES JUNE 2006 UPDATE

In our advisory letter dated April, 2005 and titled Auction Rate Securities, we highlighted several factors that had prompted us to scrutinize the auction rate securities (ARS) market and its suitability for investors with liquidity and capital preservation as key elements of their investment objectives. We are providing this analysis as an update to our previous advisory.

FINDINGS FROM APRIL 2005 ANALYSIS

SEC's probe into fair practices in the ARS market:

- The Securities and Exchange Commission (SEC) launched an industry wide investigation into possible violations of fair dealing in the \$200 billion ARS market by broker-dealers.

Price Waterhouse Coopers' (PWC) DataLine notes on ARS:

- Due to the absence of an absolute put option granted to investors, the classification of this asset class as cash equivalents per FASB 95 is no longer permissible.
- The maturity of ARS will be determined by the final maturity of the underlying bond. The majority of issues have stated maturities well beyond 10 years.

RECENT DEVELOPMENTS

On May 31, 2006, the SEC settled with 15 broker-dealer firms for improper practices in the ARS market. In the settlement numerous firms were found improperly disclosing one or more of the following activities in their auction setting processes:

- Allowing customers to place open or market orders in auctions;
- Intervening in auctions by bidding for a firm's proprietary account or asking customers to make or change orders in order to prevent failed auctions, to set a "market" rate, or to prevent all-hold auctions;
- Submitting or changing orders, or allowing customers to submit or change orders, after auction deadlines;
- Not requiring certain customers to purchase partially-filled orders even though the orders were supposed to be irrevocable;
- Having an express or tacit understanding to provide certain customers with higher returns than the auction clearing rate; and
- Providing certain customers with information that gave them an advantage over other customers in determining what rate to bid.

Subsequently, the Bond Market Association (BMA) issued a draft of "best practices" for broker-dealers of ARS, which we feel is a step in the right direction for this asset class. The best practices provide investors with a thorough description of various types of ARS products and the brokers-dealers' obligations to investors, issuers, and the auction process. Specifically, the document delineates the following elements of the ARS market:

- Role of the broker-dealers to the issuers and investors
- Appropriate procedures in bidding by broker-dealers
- Proper handling of bids by investors

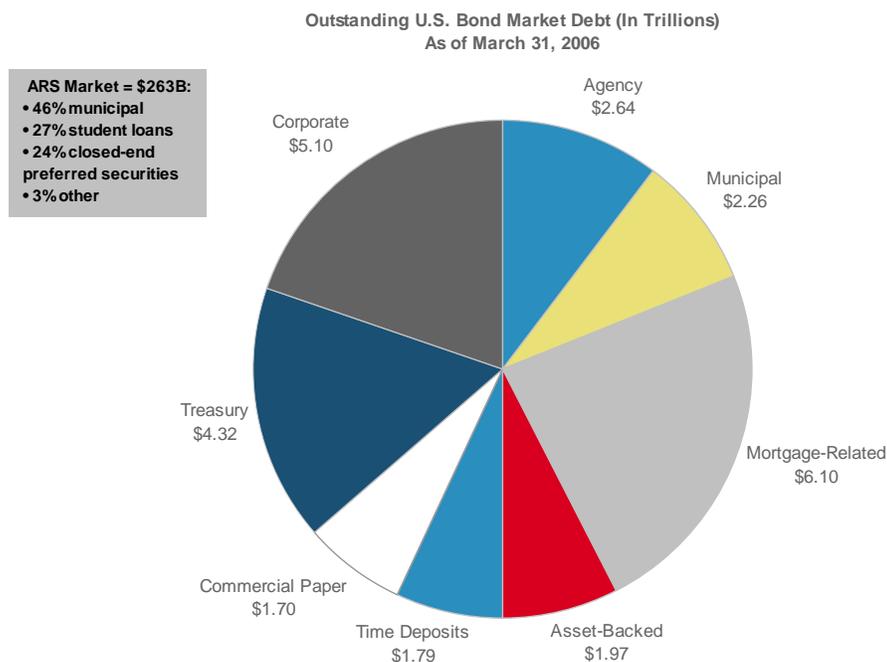
- ARS transactions outside of the Auction
- Program disclosure documents

OUR CURRENT RECOMMENDATIONS

At this time, we are not buyers of ARS for our client accounts. Despite our belief that the SEC settlement and the cooperation of the BMA with broker-dealers in developing acceptable practices are positives, existing concerns outweigh recent improvements.

The Big Four accounting firms continue to recommend that ARS be classified as investments, but there are examples of classification differences, with some auditors requiring their firms to classify them as long-term securities, and others as short-term. Although this does not affect a firm's cash flows, differential treatment of security classification per FAS 95 presents unnecessary uncertainty for investors in this asset class, exposing them to potential loan covenant violations in the process. Additionally, in an event of a failed auction, the holding period of that investment would invariably be extended beyond original intent.

From a risk and liquidity management perspective, other asset classes provide similar yields without compromising liquidity. The chart below illustrates the relatively small size of the ARS market compared to other asset classes in the debt market. Investments in short corporate bonds, commercial paper, certificate of deposits, and other money market instruments are excellent alternatives to ARS without sacrificing liquidity or subjecting firms to accounting risk.



Source: The Bond Market Association

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