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Capital Management

The Trouble in the Auction Rate Preferred Securities Market

February 25, 2008

What is an Auction Rate Preferred Security?

An Auction Rate Preferred (ARP) security is a hybrid security. Like a preferred stock, ARP securities pay a dividend. However the dividend resets on a regular basis, typically 7 to 30 days, which gives the security some elements of a money market instrument. The dividend is reset through a "dutch auction" process. Because ARP securities do not have maturity dates with one year, they are not recognized as money market instruments and are not eligible for investment in money market mutual funds. Because the holder has the ability to opt out of (or sell) the security at par based on the rate they submit at the auction, these securities are often confused with money market instruments.

Why do Auction Rate Preferred Securities exist?

The issuers of ARP securities can be either a taxable or a tax-exempt entity. Issuers include municipal bond closed-end funds, municipal finance authorities, and special purpose entities. Generally, the ARP security has an AAA rating as a result of the purchase of bond insurance. However, some programs are AAA on their own merits and other programs carry only an AA rating. Issuers utilize ARP securities in their capital structure as a way to keep their financing costs lower than other financing alternatives. Also, once issued, the preferred stock remains outstanding unless it is called or redeemed in the market. Thus, it is a more permanent form of capital than if the issuer was issuing commercial paper or a short maturity note. Brokers help to place ARP securities with investors and typically earn a commission on each placement.

What is a "failed auction"?

Major money center banks and brokerage firms support the ARP security market as the placement agent, for which they earn a fee. When shares are placed up for sale, the broker-dealer assists in the auction by finding buyers on the other side at the auction rate. When there are more sellers than buyers for an ARP security, the broker-dealer may assist in the auction process by purchasing shares with its own capital. However, they are not obligated to do so. An ARP auction fails when there are more shares offered for sale than the number of shares being sought by buyers. As a result of a failed auction, the seller is left holding the security. The indenture of the ARP will describe how the rate resets when an auction fails. It is important to note that a failed auction is NOT a default. Preferred shareholders continue to receive dividends (at the "maximum rate" defined in the indenture), and their "liquidation preference" is unaffected by the auction failure. If a particular auction fails to attract sufficient demand, all investors in that auction's shares will receive the maximum rate dividend. This rate is intended to be attractively above comparable rates for successful auctions of closed-end fund preferred shares, although the maximum rates have been only slightly higher than the reset rates for recent successful auctions.

What happened with auction rate preferred shares in February?

The market for ARP securities is estimated to be in excess of $300 billion. During the third week of February, the vast majority of auctions scheduled for those ARP securities failed. This is an unprecedented event in our capital markets and underscores the concern that exists in the marketplace. The broad scope of the failed auctions suggests that this is a substantially a market liquidity issue, and not a credit issue targeted at a specific entity or any asset category.

Auctions have failed before, however, it is an extremely rare occurrence. There has never been a time when auctions failed at the frequency of last week.

What should I do if I hold ARP?

In the event that an auction fails, the dividend rate is set to a penalty rate (which is defined in the initial offering memorandum). This penalty rate is designed to compensate holders during the period that they are stuck holding the shares. Existing ARP shareholders must continue to hold their shares, and will receive the maximum applicable rate, until there is a successful auction or the shares are withdrawn by the issuer. A secondary market for individual ARP shares may exist; however, there is no guaranty.

We cannot predict what will happen with upcoming auctions. Current indications are that liquidity pressure and auction market displacements will continue for at least the near term. We would expect that many municipalities, closed end funds and other issuers will review their ARP programs and determine if they are serving their intended purpose. If investors do not have confidence in AAA rated issuers and it is a poor reflection on the issuing entity, their borrowing costs will rise. As a result, the program may not serve its intended purpose and the issuer may redeem or retire the securities. Closed end bond funds in particular, because of their regulated nature may face pressure from independent directors to utilize other financing means in order to finance their leverage.

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