ATLANTIC ADVISORS, LLC
ASSET MANAGEMENT

February 21, 2008

The Shoe Drops – The Ugly Side of an ARS

About a month ago, I wrote a piece entitled ‘the Next Shoe to Drop’, which highlighted the asset class I thought was in the most danger—municipal bonds and in particular, the municipal bond closed end fund space. As luck would have it, the Auction Rate Security (ARS) market has frozen up since then. The municipal bond market itself has frozen up as a result of insurers like MBIA, AMBAC and FGIC’s business models being brought into question. Add to the mix a slowing economy and falling tax receipts as a result of the real estate debacle (which is now spreading to commercial real estate) and you have a recipe for disaster. Yes, I know disaster is a powerful word, but I truly see it on the horizon for the municipal bond market, particularly as it relates the ARS of closed end, levered, municipal bond funds. For my thesis, read on.

Bifurcation Develops in ARS

There are two distinct parts of the ARS market. On one hand, you have individual issuers like municipalities, hospitals and school systems. Generally speaking, the individual issuers have ‘maximum rates’ for their issues, typically in the 10-15% range. We really haven’t seen too many ‘failed auctions’ in this arena, simply a lack of short-term liquidity that forces the rates up for the issuers. To be sure, there is a bit of short-term pain that develops for the issuers, but to the extent that the underlying credit ratings are sound, buyers for this paper are slowly surfacing. I have heard many stories that hedge funds and large institutions are buyers of this paper as it is clearly mis-priced. The end game is that the rates will likely settle into a more realistic range over the intermediate term, and that these institutions will roll their ARS into fixed rate bonds or possibly into letters of credit, if they have the facility available to them. This excess issuance will of course put pressure on the municipal market as supply overtakes demand and hurt prices across the board. If you are a lower rated underlying credit, say BBB rated, you could face huge hurdles as your insurer is toast, you have spent loads of money on insurance premiums to downgraded and possibly defaulted insurers and you will have to refinance at higher rates. This is a bit of a self fulfilling prophecy and I can imagine a temporary dislocation in the municipal bond market.

Higher credit costs for leveraged enterprises are not pretty. But those with solid credit ratings, sound finances and good reputations will likely suffer some short-term pain but be just fine in the long run. This is a good news/bad news proposition for the individual issuers. The bad news is that they are forced to pay high rates for a short period of time, but the good news is that the owners of the paper can get out of the paper if they wish. Imagine that you are an opportunistic hedge fund and that you knew that the ‘maximum rate’ for an issuer was 15%. Wouldn’t you step into the auction and bid 14.95%? Rhetorical question, no? Of course you would. The issuer would surely be irritated and quickly wish to refinance into a fixed rate deal, but setting up these deals takes six to eight weeks. And there will be LOADS of issuance. So there will be quite a rush to the market to rid you of this potential outcome again in the future. This is why I expect a flood of fixed rate issuance, led by the highest quality issuers. Once that market develops, others will be able to offer new issues.

On the other hand, what about the ARS that help finance the levered closed end municipal bond funds? In my last piece, I wrote that the funds were nothing more than a ‘margin account in drag’. And indeed they are. The basic structure of these funds is one to benefit issuers, brokers and investment banks. Imagine that you go to the market and buy $100 million of municipals and then borrow $50 million at a lower rate that raises the yield of the fund. Except for the fact that the average fund charges over 1 percent per year in management fees which drags the yield back down to what you could earn if you just bought the bonds for yourself. I am not trying to beat up anyone here, just pointing out how ‘Mom and Pop Retail’ get stuck holding the bag.
So here comes the REAL SHOE TO DROP. What happens to you if you are the holder of an auction rate security issued by a close end municipal bond fund? As I stated previously, the ‘maximum rate’ on many of the individual issuers is 10-15%. I suppose those rates were set arbitrarily as no one ever imagined the market could seize up like this. But I truly believe that will be a temporary phenomenon. The case for closed end ARS issued by closed end Funds is MUCH WORSE, perhaps catastrophic. Most closed end funds have a stated maximum rate of 110% of the 60 day commercial paper index. And let’s say that index is at 3% which results in a maximum rate of a whopping 3.3%. Not so great, right? Now here comes the bad part.
Let’s say that the Fed keeps cutting rates, as we expect, as the economy worsens. And let’s say that 60 day commercial paper drops to 2% and the maximum rate falls to 2.2%. This is NOT a great proposition for the holder. You are now left holding a long term piece of paper that you can’t get out of (who would want to buy your bonds on a 2.2% yield?). One of the issues with ARS in closed end funds is that they have ‘workout dates’ that are quite far into the future, as much as 40 to 50 YEARS. Yes, years. Going one step further, the bond now becomes a 40 year 2.2% coupon — in a world where 40 year municipal bonds trade at say, 5%, due to the aforementioned heavy amount of issuance. What would that security be worth? I can tell you that our firm has toyed with the idea of buying ARS of solid municipal credits north of 10% but if anything, I would consider selling short these

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ARS of closed end funds at par. The reason is that a 2.2% bond with a 2049 maturity and a 5% yield trades at 51.387 cents on the dollar. And a 2.2% bond that trades on a 6% yield (I could imagine that this sort of issue would trade at a discount to high quality individual issuers) would trade at 42.271 cents on the dollar. I have created a custom bond to show these calculations below. The only thing I can say is, if you can get out of these ARS with minimal pain, get out while you can. I imagine a market will develop over time for them, but most people bought these securities as 'cash equivalents' to pay income taxes and such. Instead, Wall Street once again created the worst of all securities that we like to call the 'Roach Motel'—where you can get in but can never get out.

One Final Thought—Should You Trust Your Brokerage Statement???

One last thought, and this one may really be the biggest issue of all. Most municipal bonds are 'marked to matrix'. In other words, most AAA insured bonds are all lumped together and priced similarly. But therein lays the problem! Even if MBIA and AMBAC were to retain their AAA ratings, which I find highly doubtful over the longer term, would any prudent investor actually trade the bonds based on the insurer? Doubtful. Instead, as many of us have been doing for years, you price the bonds based on the underlying fundamentals of the issuer. It is why many investment policy statements insist on underlying ratings of 'A or better'. There is a gaping hole in the credit research world in municipal bond research. There are approximately 50,000 municipal issuers with a total market value of nearly $3.5 trillion. Brokerage firms and the like do tons of research on corporate bonds, but not much emphasis is placed on municipal bonds. But with the bifurcation developing in both the ARS market and in the long term municipal market, one can imagine that a lot more research needs to be done. But the huge problem is the following; if you own a bond that has a BBB underlying rating and it is insured by AMBAC or MBIA, it still is priced as if it is an AAA rated security, say on a 4.3% yield. But what if the bonds actually have to trade on its own merits (this is already starting to happen as investors look past the insurer's guaranty)? The bond might trade on a 5.5% yield which could be a difference of 12-15% of market value. I believe that in coming months, brokerage firms will begin marking down the prices of municipal securities based on where they really can trade, not on a questionable matrix. If I owned a bunch of municipal bonds, I would want to know what the underlying rating was on every bond I owned, whether it was pre-refunded and whether or not it was on a credit downgrade list. The other problem is the NAV (net asset value) of both open end and closed end municipal bond funds. I have a sneaking suspicion that the NAV's are grossly overstated and that a re-pricing will develop, only to be made worse by the large amount of issuance I foresee. So as this shoe drops, it may drop hard, and on a lot of people. I guess when Nuveen went private in early 2007, they saw this mess coming.

Consider the following exercise. Take a look at your brokerage statement online if you own a bunch of insured munis. Then ask for a bid. You may be surprised at the answer.

2.2% 40 year bond at 5% yield

MUNICIPAL BOND PRICE/YIELD CALCULATOR

SETTLEMENT DATE	2/26/08	ISSUE DATE	2/ 1/08
COUPON	2.2	1st COUPON DATE	9/ 1/08
MATURITY DATE	3/ 1/49	ISSUE PRICE	100.00000

CONCESSION ---expressed in points (X) OR percent ( )---	TO MATURITY YIELD % TRSY	TO CUSTOM 3/ 1/49 100.000 % TRSY
PRICE 51.387		
YIELD---no Concession	5.000 (108.5)	5.000 (108.5)
PRICE less concession = 51.387		
YIELD-with Concession	5.000 (108.5)	5.000 (108.5)
DOLLAR VALUE OF A 0.01 % CHANGE IN YIELD	0.106	0.106
ADJUSTED DURATION	20.557	20.557
EFFECTIVE YIELD: @ reinvestment rate of 5.000	5.000 (108.5)	5.000 (108.5)
AFT TAX YLD: ORDINARY INCOME 35.00 CAPITAL GAINS 15.00 OID & CPN INCOME 0.00	4.776* (103.6)	4.776* (103.6)
AFTER TAX - TAXABLE EQUIVALENT YIELD: @ 35.00	7.348 (159.4)	7.348 (159.4)
TRUE YIELD	4.999 (108.5)	4.999 (108.5)

ISSUE PRC = 100.000(2.200). NON OID BOND WITH MKT DISCOUNT.

PAYMENT FACE AMOUNT(1M) 1000		INCOME to 3/ 1/49	
PRINCIPAL	513870.00	REDEMPTION VALUE	1000000.00
less CONCESSION		COUPON PAYMENTS	903833.33
25 ACCRUED DAYS	1527.78	INTEREST ON INTEREST	2002517.61
TOTAL PAYMENT	515397.78	TOTAL INCOME	3906350.94

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2.2% 40 year bond at 6% yield

MUNICIPAL BOND PRICE/YIELD CALCULATOR

SETTLEMENT DATE	2/26/08	ISSUE DATE	2/ 1/08
COUPON	2.2	1st COUPON DATE	9/ 1/08
MATURITY DATE	3/ 1/49	ISSUE PRICE	100.00000

CONCESSION
---expressed in points (X) OR percent ( )---

	TO MATURITY YIELD % TRSY		TO CUSTOM 3/ 1/49 100.000 % TRSY	
PRICE 42.271				
YIELD---no Concession	6.000	(130.1)	6.000	(130.1)
PRICE less concession = 42.271				
YIELD-with Concession	6.000	(130.1)	6.000	(130.1)
DOLLAR VALUE OF A 0.01 % CHANGE IN YIELD	0.078		0.078	
ADJUSTED DURATION	18.391		18.391	
EFFECTIVE YIELD: @ reinvestment rate of 5.000	5.487	(119.0)	5.487	(119.0)
AFT TAX YLD: ORDINARY INCOME 35.00 CAPITAL GAINS 15.00 OID & CPN INCOME 0.00	5.756*	(124.8)	5.756*	(124.8)
AFTER TAX - TAXABLE EQUIVALENT YIELD: @ 35.00	8.855	(192.1)	8.855	(192.1)
TRUE YIELD	5.999	(130.1)	5.999	(130.1)

ISSUE PRC = 100.000(2.200). NON OID BOND WITH MKT DISCOUNT.

PAYMENT FACE AMOUNT(1M) 1000 **INCOME** to 3/ 1/49

PRINCIPAL	422710.00	REDEMPTION VALUE	1000000.00
less CONCESSION		COUPON PAYMENTS	903833.33
25 ACCRUED DAYS	1527.78	INTEREST ON INTEREST	2002517.61
TOTAL PAYMENT	424237.78	TOTAL INCOME	3906350.94

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Bennet Sedacca
President

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