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Auction-Rate Notes Leave Individuals in Yield or Cash Purgatory

By Jeff Plungis

May 22 (Bloomberg) -- Susan Wilson trusted her broker, a friend of the family, to find a safe, liquid place to invest the money she'd inherited from her father. Unfortunately, he recommended auction-rate securities.

Wilson put $275,000 in four auction-rate funds from Jan. 14 to Jan. 24. A month later the auction-rate markets froze. Wilson needs the money to pay her kids' college tuition bills. For now, the Moorestown, New Jersey, resident is waiting to see what happens, declining the offer of a loan from her broker at **UBS AG** until the markets return to normal.

``It was pretty upsetting,'' said Wilson, 49. ``It's my money. Why should I have to pay to get it?''

That's the dilemma facing every buyer of auction-rate securities: wait for the market to shake itself out or look for ways to get money back now. The decision depends on the individual's financial circumstances.

For investors who are parking cash they don't need for awhile, there are benefits to staying put -- higher yields, for one thing. The **Sifma Auction Rate 7-Day Index** averaging 103 qualifying auctions for May 14 had an average yield of 3.61 percent, while the average 7-day annualized yield in the U.S. taxable money market was 1.95 percent as of May 13, according to **iMoneynet.com**, a Web site that tracks money-market mutual funds.

Eventually, the patient investors expect the banks and brokers that underwrote the investments to bail them out. Closed- end funds run by **Calamos Asset Management Inc.**, Claymore Securities and Nuveen Investments Inc. have secured financing to redeem some customers.

Merrill's Response

Bond issuers like the Southern California Public Power Authority are refinancing their debt, redeeming the auction-rate investments -- 38 percent of the securities have been replaced, data compiled by Bloomberg show. Merrill Lynch & Co Inc. Chief Executive Officer **John Thain** said May 8 the company has refinanced 23 percent of its auction-rate securities, and he expects all customers to have access to their cash within a year.

Problems arise for people like Wilson who thought they had a cash-like investment and need their money soon. They've woken up to a rude reality, because getting out now will come at a price, either interest on the brokerage's loans or allowing their adviser to buy the securities for less than the original value.

``We're trying to address our clients' immediate liquidity needs, given the unprecedented market-centered events that caused this breakdown,'' said UBS spokeswoman **Karina Byrne**. The Zurich- based bank is offering loans at the 30-day London Interbank Offered Rate plus 50 basis points, or 2.93 percent as of May 20.

Investors Get Stuck

Unlike regular bonds that pay a fixed yield until maturity, interest on auction-rate bonds reset based on auctions held every seven, 14, 28 or 35 days. Auctions fail when there aren't enough bidders, leaving investors stuck.

The auction-rate market performed well from 1984 to 2007, when there were only 44 auction-rate failures. The failure rate jumped to more than 80 percent in February and was more than 60 percent in April, according to Bloomberg data.

The type of security matters. Auction-rate debt backed by student loans is currently failing at a rate of almost 100 percent. Auction-rate securities issued by municipalities have a lower failure rate and are likely to be refinanced sooner.

Prior to 2008, it was common for banks underwriting the auctions to step in when there was a failure, even though they weren't obligated to do so. Strapped for cash after $379 billion of writedowns and credit losses from the subprime crisis, they aren't anymore.

Volatile Markets

Money that had been sitting in auction-rate securities, ultra-short bond funds and enhanced cash funds is flowing to **money-market** funds. More than $1 trillion poured into money markets during the past 52 weeks, as investors fled more volatile markets, said **Peter Crane** of Crane Data LLC, a mutual-fund tracking company in Westborough, Massachusetts.

``If you need money tomorrow, it's got to have `money market' in the title,'' Crane said, referring to both money- market funds and bank-backed money market deposit accounts.

Traditional money-market funds regulated by the U.S. Securities and Exchange Commission must put their assets in diversified, more conservative short-term investments, said **Connie Bugbee**, managing editor of iMoneynet.com in Ashland, Massachusetts. These funds try to maintain a constant $1 per share net asset value.

Other options for generating cash to replace the auction- rate bonds include a home equity loan, borrowing from a 401(k) retirement plan or a regular consumer bank loan. All will have fees, paperwork and interest costs, although home-equity loan interest is generally tax deductible. A secondary market exists for some auction-rate bonds.

Long Workouts

Long, slow workouts hardly help people who were counting on the ability to get their **cash** in a week.

A 72-year-old widow, who's about to retire as a school-bus attendant, invested $200,000 of the almost $500,000 she got from selling her home in auction-rate securities at the advice of a broker, said Maureen Whalen, her Briarcliff Manor, New York- based financial planner.

Whelan said the risks weren't explained to the woman, who she declined to identify citing client confidentiality. The woman made clear she'd need some of the money to pay for a move closer to her daughter. ``I'm not even sure the rep fully comprehended the risks,'' Whelan said in an e-mail.

There's some doubt that auction-rate securities will ever recover, given that many of the potential buyers are now aware there are no easy answers if things go bad, said Timothy Parker, an investment adviser in Ridgewood, New Jersey.

``The true smart money never bought these things,'' Parker said. ``They knew there was no out.''

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