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SAMSON CAPITAL ADVISORS

Update: Municipal Auction Rate Securities Market and the Broad Market

Over the past few weeks, issuers and investors have been grappling with the volatility of the Municipal Auction Rate Securities (ARS) market. Many issuers have had to deal with failed auctions and higher interest rates on debt that had previously provided them with an attractive cost of capital. Investors have been rewarded with higher yields while taking on liquidity risk. Most recently, the trials and tribulations of the auction market have impacted the Variable Demand Rate Note (VRDNs) market and the municipal market in general. In this piece, we will update you on the ARS market and give some insights on its impact on the VRDNs market and the general municipal market.

The recent important changes that are positive for the ARS market are as follows:

- The Treasury Department has stated that in some cases municipal issuers of auction rate bonds can convert to another interest rate mode or remove bond insurance without being viewed as reissuing bonds.
- Although rates are still high, they have declined from the mid-double digit rates of mid-February.
- Many issuers are making plans to change the nature of their debt from an auction to a VRDNs or to change the interest rate mode from variable to fixed, or some form of both. It is this latter factor that has put pressure on the general municipal market that is now discounting new supply of longer fixed rate municipal bonds.

Prospects for the Auction Rate Market

It is difficult to conceive of a scenario where the auction rate market returns to its historical behavioral patterns. The issuers were using the auction rate market for their on-going capital needs while many investors were seeking a money market instrument. For this reason the auction market must now be redefined, both in terms of relative pricing (we'll venture that yields would be higher than in the past) and the investment objectives of its holders. We present some answers to questions that are important in the present market environment.

1. How long does it take to redefine a $300+ billion market?

Nearly two thirds of the auction market is in the tax free category, which is comprised of municipal issues, student loan issues and closed-end fund preferred shares. Secondary market trading is beginning to develop and although there are still failed auctions, many auction issues are now clearing. The present levels, although not at the double digit level for some noteworthy issuers, remain in the mid to high single digit level. Secondary market trading is not likely to restore previous low yield levels, but it will likely narrow the significant disparities that currently exist among similar quality issuers. There is also tremendous disparity of yields in the market for auction rate securities. The most predominant factor is related to the calculation of the maximum yield. Many ARS that are issued by closed-end funds are yielding below 4% because they are tied to Libor or other short dated securities. Other factors impacting the yield include the size of the issuer, the insurer, the balance sheet capacity of the broker-dealer, and the credit quality and sector. As to the latter, many hospitals and health care issues are trading at higher yields than tax backed bonds.

In addition to closed-end preferred shares, most student loan ARS and many municipal issuer ARS also contain formulaic maximum yields and, as a result, are also systematically failing. The idiosyncrasies of these securities also include low average rates over a period of time, so they are susceptible to wide swings in their allowable rates in order to maintain those averages. The liquidity in both asset classes at present has not been restored; however, banks are using the securities as collateral and providing attractively priced loans to investors requiring liquidity.

2. Who will be the new participants?

Tactical participants, including hedge funds, institutions, and individual investors have entered the market in a more meaningful way, opportunistically purchasing higher yielding primary market auctions and actively bidding secondary market auctions. This pressure has narrowed yield differentials among similar quality issuers, but yields are likely to remain at relatively prohibitive levels (from an issuer's perspective) despite this new demand. This marginal demand is unlikely to be large enough to replace the demand of the previous holders and the tactical participants will only participate as long as the yield advantage is significant relative to other investment alternatives.

3. Will the pricing levels set by the new participants still provide an attractive financing alternative to issuers?

Issuers will restructure auction rate debt as quickly as possible, based on their access to the market and liquidity enhancement (in the case of variable rate debt), as well as the issue-specific technical considerations discussed earlier. A key dilemma presented by the restructuring option is that the highest quality issuers with the largest market presence will have the ability to move more quickly than the weaker issuers with more limited market presence. That is, the strongest issuers will be able to reduce their debt service costs relatively quickly, whereas the weaker issuers may face a more prolonged period of pain. It is too early to tell whether this tiering could result in a significant weakening of credit quality in certain sub-AA issuers (i.e. historically those issuers that were more dependent on bond insurance), but it is an important issue to watch as the situation evolves. As we are writing this commentary, several prominent issuers have planned refundings or structural changes into VRDNs for March. A variable rate demand note is a bond whose interest rate will typically vary at specified 1 or 7 day intervals. The VRDNs, however has a put option which allows the investor to put the bond back to the bank when a new rate is set.

4. What opportunities/risks will be present as the Auction Rate Market is restructured?

As issuers re-finance, we expect to see a greater supply of VRDNs and fixed rate bonds.

Given that several issuers are likely to move to VRDNs, we would expect yields in these securities to increase modestly. VRDNs have a mandatory put feature and can be purchased by money market funds unless there are provisions in the bond documents that would jeopardize the liquidity of a specific VRDNs. Over the past several weeks, VRDNs yields have increased for various reasons ranging from downgrades of specific monoline insurers to the large dealer inventories of VRDNs. We believe that this increase in yield will be transitory as the regular buyers in the market will once again surface as auction securities are retired (freeing up broker/dealer balance sheets to some extent) and credit facilities are restructured. The higher debt costs for smaller issuers may possibly weaken the credit fundamentals and lead to credit downgrades. Stabilizing their debt service costs is a powerful incentive for smaller issuers to refinance or restructure their debt.

A second alternative for issuers is to re-finance their auction bonds with fixed rate bonds. This increase in the supply of municipal fixed rate bond new issuance is a technical factor which will cause rates to increase; we are already seeing evidence of such concerns in the municipal market in all maturities.

A final alternative is the retirement of debt; this is an option for only the cash rich issuers and although this may occur, we do not expect this to be a favored option for most issuers.

5. What will be the outcome for the monoline insurers and will it be a factor for the ARS market?

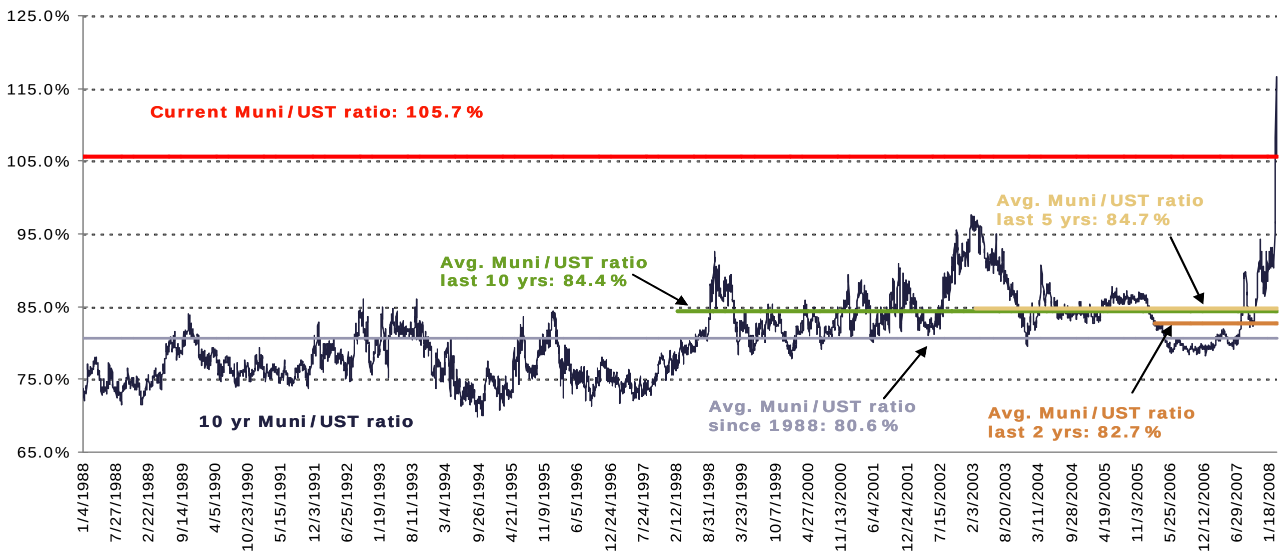
One of the triggers for the problems in the ARS market was the downgrading of the monoline insurers. We believe there will be a tiering of insurers, and bond insurance will eventually become important to some investors and issuers. This transition, if it does occur, will take a significant amount of time though. Many municipal issuers of ARS are paying several hundred basis points above market on their debt and will not wait for the insurance solution. As noted above, the issuers are working with their banks, rating agencies and insurers to move away from their auction rated securities. It is likely that by the end of the year, the ARS market will be dramatically smaller than it is now.

We are pleased to report that regulators and politicians have become more directly involved in the issues related to auction rate securities. Again, however, the solutions to the problem remain very issuer specific.

A Brief Update on the Rest of the Municipal Market

The strains in the auction market, along with concerns about the monolines and certain municipal funds unwinding and selling securities caused the yields on longer dated municipal bonds to rise, or cheapen, dramatically compared to historical measures. The chart below shows the twenty year history of the 10 year municipal to treasury ratio, a traditional way to evaluate municipals relative to taxable securities. The average ratio over the past 10 years has been 84.4%. On February 29, the ratio was 116.7%, meaning that municipals yielded 16.7% more than treasuries, something that has not happened in the past twenty years, and in our collective memories at Samson, has never happened to this extent. By March 5 that ratio had dropped to 105.7%, indicating that the municipal market has recovered somewhat, but is still cheap by any historical measure.

10 Year AAA GO Municipals/10 Year US Treasury Ratios as of March 5, 2008



Recommendations:

A tactical allocation is appropriate for clients who realize that the current dislocation has significantly impeded liquidity in this sector and additional exogenous shocks to the financial system may make these securities illiquid for a sustained period of time. However, the yields provide a tremendous opportunity and there are manageable risks related to liquidity, credit, structure and maturity. Only auction rate securities of the most creditworthy issuers are to be used. The best structures offer high maximum rates, solid credits, and bankers who are equipped to make a market in the securities. Every ARS will be analyzed carefully as to its creditworthiness and the details of the indenture.

We expect the high current interest rate opportunities in the short-term markets will be temporary though, and we are prepared to invest our clients in longer intermediate securities as they have become more attractively priced.

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Data Source: JP Morgan®

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