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COMMON SENSE by James B. Stewart

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The Troubles of Auction Rate Preferred Shares

THEY WERE SOLD as a liquid, safe, slightly higher-yielding, tax-exempt alternative to money-market funds. I should know, since I bought some.

For several years I've been parking a good part of my cash in Auction Rate Preferred Shares (ARPS). These are typically shares of a closed-end fund that used the proceeds to buy triple-A-rated securities. (In my case, municipal bonds.) There was virtually no interest rate risk since the rate was set at frequent auctions of the shares. My shares were issued by **BlackRock** (*BLK*¹), the asset-management firm almost half-owned by **Merrill Lynch** (*MER*²); many other firms also sold the securities. When I needed cash, I simply redeemed shares, as I did last month when I took advantage of the market downturn to buy stocks.

Last week, when I read that some tax-exempt entities, even the Metropolitan Museum of Art, were suddenly paying exorbitant rates because of "failed" auctions for municipal bonds, I didn't immediately suspect this would have any immediate impact on me. I heard nothing from Merrill Lynch, which sold me the ARPS. My account statement continues to show the shares at full face value.

I became more concerned as news reports of "failed" auctions continued last week. Finally, I called a broker to ask about the status of my ARPS. I learned that recent auctions of these preferred shares have indeed failed, which means there were no buyers at rates acceptable to the sellers. The market has virtually collapsed. There is no guarantee the shares can be sold. Indeed, it's highly unlikely they can be. What was a ready source of cash is now essentially frozen.

Last year, when some money-market funds turned out to hold some mortgage-backed securities and faced a liquidity crisis, their sponsors stepped in and redeemed the shares at face value. This seemed the only decent course, not to mention a good long-term investment in customer loyalty.

But when I asked a broker at Merrill Lynch if it would do the same for owners of these money-market equivalents, the answer was "no" — not after the multibillion-dollar write-offs Merrill has already taken on illiquid assets. Merrill Lynch and the other big banks which sold these shares have stopped making a market in them, which is a major reason the auctions have failed.

Merrill Lynch, when asked for comment, told me: "We are offering our clients loans which can give them liquidity." It wasn't yet clear whether these would be interest-free loans, which they certainly should be, in my opinion.

BlackRock commented on its web site that, "We do not see any issues with the financial health or fundamentals of these funds as a result of the failed auctions." The firm also stated online that it "continues to closely monitor developments in the ARPS market."

The amount of auction rate preferred shares outstanding is massive — an estimated \$330 billion. Many firms besides Merrill Lynch sold the shares. I suspect that many investors own these and still don't realize the predicament they're in. Fortunately, I have no immediate need for the cash. But given that these securities were marketed as money-market alternatives, I'm sure that there are plenty of people who do, and will be in for a rude shock when they try to redeem them.

I hope that this will be a temporary paralysis and the market will come to its senses. The auctions have been going on for 20 years without incident. These securities still carry a triple-A rating. None of the underlying bonds have defaulted. Interest is still being paid, at a slightly higher rate than before.

In my view, any failure of the big banks to honor what is at least a moral commitment to the people to whom they sold these shares, as well as any failure to notify them, keep them informed, and work out solutions for people facing hardship, is appalling. At least two states are investigating and I would expect them to be joined by the Securities and Exchange Commission.

So the credit crisis has struck again, this time in what I thought was the safest corner of my portfolio. Is any fixed-income security short of U.S. Treasuries and the biggest, most liquid money-market funds safe at this point? I'd like to think so, but this experience has left me shaken. I don't want to contribute to the irrational panic that seems to have swept the debt markets. But if you own any securities that depend on investor confidence or raise any liquidity issues, be aware of the risks.

¹<http://www.smartmoney.com/quote/BLK/>

²<http://www.smartmoney.com/quote/MER/>

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