



Pricing at the FAS 157 Yard Sale

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How to avoid mark-to-market overpricing and underpricing on Auction Rate Securities

Do you remember the days, not so long ago, when you might have heard this? "Oh, I'm not moving. I just put my house on the market at a ridiculous price in case someone might want to actually pay it!" This could even have been one of your neighbors. Now, assume for a moment that your neighbor actually got that ridiculous price for his house and decided to accept it, move to an affordable condo, and bank the difference.

This pricing action is similar to the overstated prices that are occasionally being assigned to auction rate securities (ARS) these days (only without the "Greater Fool" buyer.)

Now imagine that this neighbor held a yard sale before moving to a far smaller condo because he needed to get rid of a lot of stuff. You wandered over to the sale and spotted his snow blower that you so coveted all those times when you were breaking your back shoveling snow. The snow blower, like all of the items on display, was priced to move and had a sticker taped to it that said "\$25." You, of course, bought it immediately and didn't even bother dickering because you didn't want to alert anyone else to this steal.

This kind of pricing illustrates what is happening on the other end of the ARS valuation spectrum today, and both pricings can lead not only to inaccurate balance sheet representations but can also foster a bit of accounting and disclosure risk. (The discussion that follows here does not pertain to auction rate preferred stock shares in closed-end funds — see ENDNOTE.)

On the snow blower end of things, some valuations will reflect private transactions that have been effected between buyers and sellers without the involvement of full-service brokerage firms. Absent from the transaction discussion are traditional market-role players, such as research analysts who have in-depth knowledge of ARS issues and their structure, and traders who commit their firm's capital to support their investor clients with price quotes that constitute offers to buy or sell. Private transactions are done at bid prices offered by opportunistic buyers (often hedge funds and other private investors), whose goal is largely to exploit unsettled market conditions and to pay prices that include substantial discounting for market uncertainty in the short run and the lack of easily obtainable information. Sellers are almost always distressed sellers who have no choice but to get what they can for their ARS, but such prices do not reflect the intrinsic value of ARS based on their known cash flows.

As an example, privately conducted secondary trades in student loan backed ARS have averaged about 55 cents on the dollar, while discounted cash flow modeling (DCF) produces valuations in the range of 70 to 80 cents on the dollar as of this writing.

Valuations based on opportunistic bidding are the kind of pricing that the FASB and the SEC stated are not determinative, in a joint release from September 30, 2008:

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"The results of disorderly transactions are not determinative when measuring fair value. The concept of a fair value measurement assumes an orderly transaction between market participants. An orderly transaction is one that involves market participants that are willing to transact and allows for adequate exposure to the market. Distressed or forced liquidation sales are not orderly transactions, and thus the fact that a transaction is distressed or forced should be considered when weighing the available evidence."

For a company that can afford to continue to hold its ARS to maturity, the risk here is that its balance sheet could suffer unnecessarily and, if it should choose (or be forced to choose) to deem its ARS' impairments as "other than temporary," its unrealized losses would then have to be deducted from earnings. Not only could this result in an exaggerated reduction of earnings, it could also lead to confusion further on if some or all of the ARS' value is restored, and the positive jump in earnings impact must be explained.

On the over-priced end of things, there are double-digit prices that start with a "9" being assigned to ARS. ARS prices in the nineties are the equivalent of your neighbor asking \$400,000 for his house in a \$300,000 market and pretending that it is reasonable. Many companies have explained, in the footnotes of their quarterly filings, that they hold student loan backed ARS whose underlying loans are 97% guaranteed by the Department of Education. Indeed, they are, but the Department of Education does not guarantee the market price for bonds, only the student loans that back them. This guarantee may be the basis for pricing ARS in the nineties, but based on DCF pricing, (expected interest payments, market yields for similar interest flows, and a maturity date), prices are empirically more likely to be in the seventies currently.

Over-pricing might also be the result of blind optimism or defensive pricing from a company's broker. Many brokerage firms report market values in the nineties on their client statements and in some cases are still assigning a value of par ("N.A." is an equally popular choice.) This may be because brokerage firms that have extended ARS-collateralized loans to their clients at market value don't want to risk reporting prices that would dramatically slash their loan availability. With overpriced valuations, brokers may also wish to avoid inviting hard questions or exposing themselves to liability arising from client action. (Some firms include lengthy caveats to their pricing information.) Whatever the motive, ARS holders should know that these prices are not the product of the most accurate method for pricing fixed-income securities, discounted cash flow (DCF) pricing.

Equally likely here, companies may themselves assign higher values, in an attempt to minimize the impact on their balance sheets or, perhaps more ominously, their income statements. But companies should consider that an informed auditor will not be supportive of these practices. If an organization's audit counsel should compel them to use the more scientific DCF methodology, the result will be more bad news for shareholders and some disclosure risk. So, how can a reporting company determine whether they are on the most defensible ground with their ARS pricing? Ask for clear and detailed substantiation of a source's price calculations, be they from your broker or a third-party-pricing source. Solid and rational pricing can best be drawn from the DCF exercise, so ask to see the detail of these calculations, including:

1. Assumed interest rate and source
2. Maturity or average life date or other effective maturity date and source
3. Calculation of average life or effective maturity date and source
4. Investment rating
5. Market yield and source
6. Any non-observable considerations (e.g., illiquidity discount, issuer developments, market developments) and their sources

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If prices seem low (a good current benchmark is, say, 50 or lower), and the reasoning relies at all upon reports of actual private transactions in ARS, you're getting snow-blower-at-a-yard-sale pricing, and reliance on opportunistic bids has been over-weighted. If prices are in the nineties or at par, you've got your neighbor's real estate paradigm at work, though unlike your neighbor, there are simply no buyers at such artificially inflated prices.

A bit about matrix pricing

Traditionally, most fixed-income securities have been priced on brokerage and bank statements using prices supplied by third-party services that utilize matrix pricing. Because of the enormous volume of securities that require regular pricing, an automated means is necessary for large-scale providers of this information, like banks and brokers. With matrix pricing, a security's basic parameters, including stated interest rate, maturity date, quality rating and other measurable items, are compared against the matching parameters in a matrix, and a price is produced based on the relevant market yield that the matrix assigns.

The difficulty in relying on matrix pricing in the current market environment is that for many securities, their parameters have changed. As an example, pricing auction rate securities now relies on the longer-term, stated final maturity of the issue or its average life, rather than its auction date, and volatile fail rates on ARS can confound a matrix approach. Similarly, the presumed average lives of many asset-backed security classes have been modified as their underlying cash flows slow and average lives lengthen.

For these kinds of changes, market yields must be adjusted, and the array of (and relationship among) longer-term market yields is greatly dispersed when compared with shorter-term securities. Moreover, market yields have become very difficult to triangulate, as many markets are either in disarray or have largely ceased functioning. These considerations have rendered matrix pricing unreliable for some securities and have fostered the need for manual or "hand" pricing, as opposed to an automated method. By this means, a knowledgeable individual examines the parameters that currently pertain to each security, researches all underlying credit source considerations and then selects the most appropriate market yield that can be discerned.

In either method (matrix or hand pricing), the last step is to perform a discounted cash flow analysis, and market yield is the critical factor in this calculation. The weakness in matrix pricing is that market yields now vary widely within the same security class, in addition to the wide dispersion of yields among differing security classes. As an example, within the class of student loan backed auction rate securities, some issues represent only loans made through the Federal Family Education Loan Program, while other issues involve privately originated student loans. The market, such as it is, now distinguishes between these two types, in contrast to the time when normally functioning auctions made no distinction. Matrix pricing often fails to comprehend such nuances and, in a disorderly market as now exists, this can foster over- or under-pricing.

ENDNOTE: It is important to know that the foregoing applies only to student loan backed ARS, municipal debt ARS and CDO-backed ARS and some other derivative-backed ARS. Auction rate preferred stock in closed-end funds (Nuveen, Black Rock, Eaton Vance, Van Kampen, etc.) and contingent capital ARS do not lend themselves well to DCF pricing because they do not have an identifiable effective maturity date.

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