



MARKET COMMENTARY

Variable Rate Demand Bonds: An Alternative to Low-Yielding Money Market Funds

July 20, 2009

In the interest of caution, many investors currently hold a higher-than-normal percentage of cash or cash equivalents in their portfolios. Unfortunately, money market instruments and bank deposits offer meager yields, often resulting in a negative real rate of return once income taxes and inflation are factored in. Variable Rate Demand Bonds (“VRDBs”) offer a good alternative or complement to money market investments, preserving the liquidity and credit quality that investors demand.

VRDBs are bonds, often issued by municipalities, that have a long-dated final maturity and a floating interest rate. They are unique in that they have a “put” feature that allows an investor to return the bond to the selling broker or trustee with seven day’s notice. The bondholder then receives cash (par value) and accrued interest in return for the bonds. On rare occasions the bonds are called back by the issuer with thirty day’s notice, with the cash being received on the call date.

VRDBs have multiple layers of credit strength or cash sources, beginning with the underlying issuer. Many are insured and/or have letters of credit or other types of guarantees attached to them. Among other viable entities, those guarantees or supporting credits could include the Federal Home Loan Bank, Federal National Mortgage Association, bank letters of credit, or possibly the revenues from a well known university or municipal taxing authority.

The liquidity of these securities is derived from the “put” feature embedded in the bonds. This gives them an effective 7-day maturity at par and qualifies the securities as an approved money market instrument in which many money market funds participate. There are other variations of this security with a 1-day or monthly “put” feature back to the broker or trustee. The Dreyfus and Morgan Stanley funds we typically use as cash sweep vehicles hold these securities.

O u r a p p r o a c h t o t h e p u r c h a s e
o f a l l f i x e d i n c o m e s e c u r i t i e s ,
s h o r t - t e r m o r l o n g - t e r m , i s c o n s i s t e n t .

Our clients benefit from investing in VRDBs in a variety of ways. Most of these securities pay interest on a monthly basis, can be put back at par generally within seven days, have several layers of credit and liquidity, and can be purchased on a taxable or tax-free basis. Perhaps most importantly, VRDBs typically have significantly higher yields than money market funds. The minimum investment in a VRDB is \$100,000. We suggest diversifying a portfolio by substituting some or all cash reserve balances in money market funds with VRDBs. It is also possible to create a diversified portfolio consisting entirely of VRDBs for cash management purposes. At present, the average yields offered on VRDBs, which are reset on a weekly basis, are 75 to 150 basis points above money market rates.

In summary, our approach to the purchase of all fixed-income securities, short- or long-term, is consistent. We always look through to the quality of the underlying issuer and to the structure of all instruments which are considered for purchase in our clients’ portfolios. Most importantly, we tailor every security and portfolio to the specific goals, objectives and risk parameters of each client.

If you would like to discuss VRDBs in greater detail, please contact your portfolio manager or Mary Talbutt-Glassberg on our fixed income desk.