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The Investment Case for Exchange Funds

Atlantic Trust Private Wealth Management is a leading provider of innovative, strategic and customized wealth management services to high-net-worth individuals, families and select institutions who seek dedication, continuity, complete privacy and accountability in the management of their wealth.

One of the primary lessons in managing one's investments is that diversifying your asset base is paramount in order to decrease the risk inherent in individual securities. However, despite all the warning signs, including corporate collapses such as Enron and Worldcom, and corporate malfeasance such as Tyco, Adelphia Communications and Qwest Communications, investors continue to hold large sums of their net worth in the equity of a single firm. This phenomenon has been amplified over the recent past as a large percentage of executive compensation is now issued in stock or options to purchase low-cost basis stock. Investment advisory firms are charged with the responsibility of advising their clients relating to their stock holding(s).

Determine a Suitable Strategy

Strategies exist to eliminate or reduce the effects of a concentrated stock holding on an investor's overall portfolio. These include routine selling, tactical selling based on indicators, derivative-based strategies, charitable giving, and what have come to be known as exchange funds. In the routine selling of a

concentrated stock position, the investor's advisor will liquidate a portion of the concentrated position on a regular basis (e.g. the 15th and 30th of each month). While this serves the ultimate purpose, capital gains are incurred immediately and the value added is difficult to measure as the planning, timing and execution is typically simplistic. More complex are tactical sales based on indicators such as stock volatility. When the security outperforms the market by an unusual amount, a sell indication is triggered. This method is measurable and typically adds value, but incurs an immediate capital gain and largely depends on what investment vehicle the proceeds are being invested in. Derivative strategies such as "cashless collars" are effective at taking advantage of a steady or declining stock price; however, this approach only defers the sale of the security while limiting the risk. The concentrated stock will still need to be liquidated in the future and diversified into a broad-based portfolio. A forward sale is another type of derivative strategy in which the investor can sell the

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security, receive cash and defer the capital gain tax for the contract period. The investor also has the ability to donate all or a part of the concentrated stock to charity to reduce taxable income. The last option is to contribute the security into an exchange fund in which investors with similar concentrated stock problems are aggregated and a diversified portfolio is created. This vehicle offers many estate and tax-planning benefits in addition to effectively diversifying the investor's assets.

What Are Exchange Funds?

Exchange funds or "swap funds" are vehicles structured as partnerships in which investors with the same problem, a concentrated single stock position, are aggregated and their individual holdings form a diversified portfolio. Stock positions are exchanged for fund shares and the contributions are not taxable under current federal tax law. Thus, assets are immediately diversified without triggering a capital gain. If the stock is restricted due to being held by a company insider, it is generally accepted to the fund subject to the review of the company's counsel.

Current tax laws allow for these exchange funds to exist and operate. Tax-free, "like kind" exchanges are prohibited by the IRS; however, the vehicle is permissible if it holds a minimum of 20% of its assets in "qualified investments." Exchange funds invest in these qualified investments, which are non-publicly traded assets such as illiquid real estate holdings or commodities. An exchange fund may use leverage in the purchase of these real estate entities or require cash deposits

along with the contributed stock position. They are held to satisfy the tax law treatment and not to augment performance of the fund.

An exchange fund has the discretion to accept an investor's concentrated stock position and manages the fund to a particular style. For instance, a fund will typically not accept shares of a \$500 million "small-cap" company if the fund seeks to operate as a large-cap core strategy that will perform in line with the S&P 500 Index. Investment criteria the fund will screen may include a company's market capitalization, volatility, industry/sector membership, trading volume and operating history.

When a security is accepted, the investment firm sponsoring and managing the fund will issue all participants a list of the securities within the fund. At this point the investor has an opportunity to review the list of accepted securities over several business days and has the ability to withdraw from the fund. After this decision period, the fund manager re-examines the holdings list to determine if the holdings are suitable for the investment objective of the fund. Once this determination has been made, the partnership is formed.

Many large investment firms offer exchange funds. These firms include Merrill Lynch, J.P. Morgan, Goldman Sachs, Solomon Smith Barney, Fidelity and Eaton Vance. The differences between each offering are due to the way the fund is structured, what securities are accepted and overall fee structure. These firms typically require the investors submitting

securities to be "qualified purchasers" as stated in Rule 3(c)7 with net investable assets of at least \$5 million.

After the partnership is formed, the investor is required to keep the stock in the fund for a period of seven years to receive back a diversified basket of securities. Thus, the original cost basis on the single stock is prorated across the diversified basket of securities. A sale of these securities would trigger a capital gain. Should the investor wish to redeem his or her shares prior to the seven years, the investor receives his or her shares back on a pro rata basis and may be assigned a small penalty.

Benefits of Utilizing an Exchange Fund as a Vehicle for Diversification

Immediate, low-cost diversification: Contributing a concentrated position to an exchange fund offers immediate diversification among the stocks in the fund without incurring a capital gain. After seven years the investor receives back a diversified basket of stocks. Costs associated with the exchange fund are primarily ongoing management fees, which are generally less expensive than the average actively managed mutual fund product.

Estate-planning opportunities: Exchange funds may offer the potential to gift or transfer units of the partnership to relatives. Due to their illiquid characteristic (discussed below), these gifts can remain unreachable by the intended recipients for several years. This lack of liquidity would also dictate assessing a discount to the valuation of the gift (typically 15% to 40% on gifts made in the

first year of the partnership).

Risks Associated with Exchange Funds

Investment risk: There is risk that the concentrated stock contributed will outperform the exchange fund and the diversified basket received after seven years will be worth less than what the original stock would be worth. In fact, many of the constituents will perform better than the fund as a whole. These vehicles, however, are most effective at tax deferral and diversification. If the investor feels his/her company stock will outperform the fund, he/she may decline to participate or remove the shares prior to the required seven-year lockup period. The majority of exchange funds tend to perform and act like index-type strategies.

Liquidity risk: Despite having the ability to withdraw the contributed shares at any time, the shares are not accessible before seven years in order to reap the full benefits of the exchange fund. Should the fund sell all or a portion of an investor's contributed shares prior to the seven years and create a taxable gain, the fund will generally pay the investor's tax burden. In addition to this lack of liquidity, the investor will cease to vote proxies and receive the dividend stream of the contributed stock. Therefore, the investor should not count on the income stream from the dividends paid on the stock, rather the dividend yield of the Fund minus expenses and any borrowing costs.

Legislative risk: Exchange funds currently operate due to a window in the tax laws allowing for such a product holding a minimum of 20% of fund assets in "qualified

investments." Tax laws which are subject to legislative acts can be modified to erase this loophole. Such a change could be retroactive, although fund providers believe that would be highly unlikely.

Conclusion

Exchange funds offer one strategy to diversify an investor's concentrated stock position. Each solution should be weighed against the investor's specific situation, including investment objectives, liquidity/cash flow needs, and time horizon. Despite today's low 15% long-term capital gains tax rate and other diversification strategies, a long-term investor seeking immediate, low-cost diversification with estate and financial-planning attributes should seriously consider this vehicle for diversification of a concentrated stock position. Once a decision to utilize an exchange fund within a client's overall portfolio has been made, strong attention must be paid to the Fund's issuer and structure as not all exchange funds are created equal. ■

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