FINANCIAL PLANNING
PERSPECTIVES

DIVERSIFYING COMPANY STOCK WITH EXCHANGE FUNDS

It's axiomatic that a portfolio should be well diversified. Yet in this era of stock options and a booming stock market, many business owners and corporate executives find that their portfolio is riding on the fortunes of a single stock—their company. What's an investor to do?

One easy answer, of course, is to sell some of the stock and diversify the proceeds. This presents two problems: (1) the sale of low-basis stock is going to get hit with capital gains taxes and (2) it may not be politically acceptable from the company's viewpoint to sell its stock.

An alternative that's becoming increasingly popular is to use exchange funds. Basically, an exchange fund, or swap fund, is a limited partnership whose limited partners are all investors with a single problem: too much of a single stock. By pooling their stocks, they can diversify their holdings without incurring immediate capital gains taxes or donating the stock to charity.

As you might guess, exchange funds are not for the average investor. Generally, you must have a personal net worth of $1 million or more, and at least $500,000 in stock to invest.

The next trick is to have the right kind of stock for the right exchange fund. Several exchange funds are being formed at any given time. Investment banks and brokerage firms typically put the deals together. Each fund assembles what it thinks is a good mix of stocks provided by 50 to 499 investors. Most funds pool only large-company stocks, though you might find some with an emphasis on mid-cap stocks. If you're sitting on a block of small-company stock, you probably need not apply.

Let's say the broker assembling the fund accepts your stock. You're then sent a list of other stocks that have been accepted into the fund. Everyone who joins has five business days to decide to stay in or bail out. One piece of advice from experts is that if certain stocks in the pool particularly attract you, be sure the broker informs you if they pull out.

At the end of five days, the fund closes to additional investors for the duration of the partnership's life. You receive shares in the fund in proportion to the value of the stock you contributed and taxes on your investment (also on a proportionate allocation) are deferred. In short, you've

exchanged your over-concentration of single-issue stock for a diversified basket of presumably high-quality stock, and you haven't had to pay any immediate capital gains taxes for the privilege. Distributions, such as from dividends, are taxable along the way. When the partnership later
dissolves, you receive a portion of all the shares held in the fund, including the stock you originally invested. You've thus traded one stock for dozens of stocks, and in a way that can prompt less attention within your company than an outright sale.

This diversification strategy does not come without risks and drawbacks. First, to take full advantage of the deal the shares must remain in the exchange fund for at least seven years, and some partnerships keep the funds together for as many as ten years. Thus, exchanges can be a very illiquid investment (though valuation discounts for such illiquidity may help in estate planning).

Second, annual management fees run around one to two percent, along with upfront fees of another one to two percent. If you leave the fund before it dissolves, you may be assessed exit fees and you end up only with the stock you put in, thus losing the diversification benefits for which you first invested.

Third, exchange funds, in order to preserve their preferential tax treatment, must by law have 20 percent of their capital in nonfinancial assets, such as real estate. If the fund borrows to buy these assets, borrowing costs will reduce the fund's profits.

Proponents of exchange funds say the tax deferral aspect of the funds—versus the strategy of selling shares and then buying a variety of stocks—more than makes up for any drawbacks. However, other strategies may be more appropriate, so you'll want to talk to your financial advisor to decide what's best for you.

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