A Compelling Option

Mutual funds that employ hedge fund strategies offer better tax efficiency than regular funds.

By Robert N. Gordon

In the August 2004 column, we discussed hedge fund investors paying tax on “phantom income”—tax on profits that are never earned. This happens because K-1s from limited liability companies or partnership funds of funds break out gross profits and fees separately. And those fees are miscellaneous itemized deductions—unusable to most investors. The combination of the funds’ high fees and their flow-through nature creates a serious tax challenge.

Ironically, plain old mutual funds do not have this problem. Mutual funds are corporations that must distribute their net gains and income each year (or face being taxed at the corporate level).

There are now a good number of mutual funds that employ hedge fund strategies. Most of them are long/short mutual funds. But we’ve also found two merger arbitrage funds, one convertible arbitrage mutual fund, a covered call writing fund, distressed debt funds, and a fixed income arbitrage fund.

Besides offering better tax efficiency, these funds are compelling in other ways. First, they have no incentive or performances fees. Second, their management fees are low by hedge fund standards. True, they’re high by mutual fund standards, but part of the reason is that hedged mutual fund fees are inflated by having the short dividend expense considered as part of the expense calculation.

Like other mutual funds, hedged mutual funds offer daily liquidity—quite an advantage over regular hedge funds’ standard of quarterly liquidity. To offer this daily liquidity feature, mutual funds must limit their level of ownership in illiquid, hard-to-price securities. There is also a limit on leverage.

By SEC estimates, $13.7 billion is invested in these alternative investment mutual funds, with 61% of the total held by the five biggest funds.

A March 2004 study by the Center for International Securities and Derivatives Markets at the University of Massachusetts concluded that mutual funds employing alternative investment strategies were doing a good job of representing their respective investment “styles.”

The categorization of these mutual funds can prove difficult—especially for funds that employ the hedged equity investment style. If a fund is not required to always be balanced long and short, does it deserve to be in this group? According to SEC numbers for 2003, 3,900 mutual funds were permitted to short, but only 236 actually did so.

For investors who want to bet on long/short technology portfolios, the best alternative to hedge funds may well be a Merrill Lynch product called TRAKRs (www.trakrs.com). As discussed here in February 2004, TRAKRs (a loose acronym for Total Return Asset Contracts) are registered futures contracts designed to offer participation in a variety of financial instruments. Two TRAKRs currently offer exposure to long/short technology portfolios.

Their management fees might be high by mutual fund standards, but they’re low for hedge funds.

From a tax perspective, TRAKRs offer numerous advantages. Because these contracts don’t issue distributions, investors aren’t taxed until they actually sell—unlike hedge fund or mutual fund investors. And when non-institutional investors hold TRAKRs, the holding achieves long-term status after only six months and a day. In contrast, if institutions acquire TRAKRs, traditional futures margin rules apply and the contracts are marked to market at year-end, with a 23% blended rate. So while institutions may find TRAKRs less tax-efficient than individuals do, they should still find them more attractive than hybrid mutual funds, and vastly better than hedge funds.

All in all, hybrid mutual funds may offer hedge-fund-like returns—but without hedge fund liquidity issues, incentive fees, or taxable “phantom” profits. We believe these funds are worth a look. And TRAKRs take tax efficiency a step further. OWS

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