

## TRAKRS – A TAX EFFICIENT SUBSTITUTE FOR HEDGE FUNDS AND OTHER INVESTMENTS

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Merrill Lynch's TRAKRS (a loose acronym for Total Return Asset Contracts) are registered futures contracts designed to offer participation in a variety of financial indices that are very favorably taxed. These contracts are long, unleveraged, and paid for in full. Since these contracts are cash settled, they do not have any delivery issues at expiration and therefore mark-to-market margin calls are non-existent. While the product is a futures contract, securities firms do not have to be licensed futures dealers to sell them. However, other than Merrill Lynch, the only brokerage firm willing to hold the TRAKRS product that we know of at this time is MAN Investments. Firms need only send a notice to the National Futures Association that they are buying TRAKRS for their customers, and the products may be held in securities accounts. It is somewhat puzzling as to why more firms do not offer this product.

Listed on the Chicago Mercantile Exchange where they began trading in July 2002, TRAKRS are non-traditional futures contracts designed to provide investors with a cost-effective way to invest in broad-based indices of stocks, bonds, currencies, and other financial instruments. TRAKRS currently offer exposure to the total return of the Dow Jones-AIG Commodity Index, the PIMCO Commodity Real Return Dow Jones-AIG Index (which is based upon the Dow Jones-AIG Commodity Index which is enhanced by PIMCO's Real Return Investment strategy), the Rogers International Commodity Index (35 exchange-traded physical commodities futures contracts, quoted in four currencies, listed on ten exchanges in five countries; the index is heavily weighted in energy and agricultural commodities because it is production based), a buy-write strategy (covered Calls) on the S&P 500, the spot price of Gold (this TRAKR will mature in late 2006 so it probably does not make sense to invest in it at this time due to the fact that an investor cannot obtain capital gains treatment), a lower-market capitalization stock strategy that focuses on an allocation between growth and value, and a Long/Short technology strategy (this TRAKR matures in early 2007 so it probably does not make sense to invest in it either at this time). The first TRAKRS – The Long/Short Technology TRAKRS – were designed to enable customers to track the Long/Short Technology TRAKRS Index, a total return index designed by Merrill Lynch and composed of long positions in individual technology stocks, short positions in technology sectors or sub-sectors, and a possible cash component.

What makes TRAKRS attractive is that they need be held only six months and a day to achieve long-term gain status. That compares to a twelve-month holding period for any other investment. The product's Web site ([www.trakrs.com](http://www.trakrs.com)) explains in great depth how the investments in these products are made through derivatives, not direct ownership, which offers the accompanying income tax advantages. Prospectuses can be found on the Web site as well.

While your typical investment portfolios realize taxable income as buys and sells of securities occur and the net asset value rises, a derivative tied to that value realizes no taxable income – just the unrealized increase in net asset value. This would include the PIMCO TRAKR, which would normally throw off interest income from its bond exposure (the real return feature). When the indexed derivative is sold, only then is the long-term profit or loss calculated. For individuals this would mean a maximum federal tax rate of 15 percent. These advantages make TRAKRS a very viable competitor to other, better-known investment vehicles. For example, consider the advantages of the Long/Short Tech TRAKR – with its tax efficiency – to a direct investment in a typical long/short hedge fund that carries huge fees and throws off highly taxed income (but no cash) each year. Also, management fees on a hedge fund in many cases cannot be offset against gains and instead must be taken as a miscellaneous deduction on an individual's income tax return. As a result, management fees will only be partially deductible, if at all.

Oddly, when institutional investors acquire TRAKRS, traditional futures margin rules apply. As a result, institutional investors receive IRC Section 1256 treatment, which means that the contracts are marked-to-market at year-end. Gains are treated as 60 percent long-term and 40 percent short-term (for a blended

rate of 23 percent). This is an odd case where the same contract is taxed in two different ways depending on the margin methodology applied. Of course if an institutional investor is a tax-exempt entity such as a retirement plan, endowment, or foundation, the gains may not be taxable at all.

Either way, for taxable investors, TRAKRS offer income tax efficiencies not available in any other tradable instrument.

A few important issues should also be mentioned. The first is that each newly issued TRAKR carries an effective load of approximately three percent for the first 40 days. As a result cannot we see any reason to purchase a TRAKR within the first 40 days. Second, ongoing fees will depend upon each product but seem to be reasonable as compared to similar in theme products. Third, TRAKRS have a limited life span. Many end in just three years, forcing an investor to recognize capital gain at that point in time. Fourth, on a positive note, these products do not require investors to be accredited.

TRAKRS appear to be interesting products with significant income tax benefits. While investors are limited in their ability to access these products, we nonetheless believe that these products are another viable investment option for the tax sensitive investor who wishes to invest in hedge strategies and other advanced products. Our only hope is that Merrill Lynch continues to develop new products based on the TRAKRS platform and they entice discount brokerage firms to offer them.