

A LOOK AT HOLDRS: STOCK BUNDLES OFFERING UNIQUE CHARACTERISTICS

By Albert J. Fredman

Currently, most HOLDRS represent an individual's undivided beneficial ownership in a basket of 20 of the largest, most liquid companies in an industry. And unlike mutual funds, you have much more personal control because you actually own each stock.

Many individuals recently have turned to exchange-traded index funds for low-cost access to a broad market benchmark such as the S&P 500 or an index tracking a sector such as financial or healthcare companies. [See my July 2000 *AJII Journal* article, "Exchange-Traded Funds: A New Twist on Index Investing," for details on exchange-traded funds.]

The recent proliferation of such funds has attracted considerable interest, along with some misunderstanding. This column examines HOLDRS (HOLDing Company Depositary Receipts), an entirely different kind of exchange-traded portfolio that should not be confused with a typical exchange-traded fund. However, these two distinct vehicles can play a similar role within an individual's portfolio.

HOLDRS present another option for today's more sophisticated, tax-conscious, and frugal investor. Developed by Merrill Lynch, most HOLDRS represent an individual's undivided beneficial ownership in a basket of no more than 20 of the largest, most liquid companies that are in an industry—for instance, the Internet, or its sub-sector (for example, Internet architecture). As we'll see, an investor can have the ultimate in personal control over a predefined bundle of stocks because you actually own each stock.

As of this writing, 12 HOLDRS are traded on the American Stock Exchange.

Merrill Lynch recently launched a more diversified basket containing more stocks and spanning a wide range of industries. Called Market 2000+ HOLDRS, this global portfolio contains 50 of the world's largest stocks, including Cisco Systems, General Electric, Glaxo Wellcome, Intel, Royal Dutch Petroleum, Sony, and Wal-Mart. Those companies based outside the U.S. trade in New York via ADRs (or American depositary receipts). Because it contains giant companies, the total market cap of all securities contained in Market 2000+ HOLDRS exceeds \$8 trillion.

AN UNMANAGED BASKET

In contrast to exchange-traded funds, HOLDRS do not replicate a market benchmark. HOLDRS retain fixed baskets of stock, whereas exchange-traded funds are reconstituted from time to time to reflect any changes in their underlying indexes. HOLDRS almost never experience turnover and result in taxable events only under special circumstances. Like unit investment trusts, HOLDRS are unmanaged baskets of securities held in a trust.

Low cost is a major plus. To start with, instead of paying 20 separate commissions to buy 20 stocks, you pay only a single commission for the 20-stock basket. Investors incur a \$2 quarterly fee per 100 shares (or eight cents per share yearly), offset by the dividends earned on the holdings. However, individuals won't pay any portion of the fee not covered by dividends. In any case, the ultra-low expense ratios of the trusts range from zero to less than

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TABLE 1. HOLDERS AT A GLANCE

HOLDERS	Trading Began	HOLDER Symbol	Index Symbol	Cos. Held	Market Cap.* (\$ Mil)	Average Daily Volume** (# Shs)
Biotech	11/23/99	BBH	IBH	20	1,916.5	645,330
Broadband	4/6/00	BDH	XDH	20	584.4	134,161
B2B Internet	2/24/00	BHH	BUX	17	655.1	486,587
Internet	9/23/99	HHH	HHI	19	771.2	525,209
Internet Architecture	2/25/00	IAH	XAH	20	284.3	34,743
Internet Infrastructure	2/25/00	IIH	YIH	19	501.7	233,704
Market 2000+	8/30/00	MKH	XKH	50	501.4	—
Pharmaceutical	2/1/00	PPH	IPH	18	743.0	102,022
Regional Bank	6/23/00	RKH	XRH	20	130.1	30,250
Semiconductor	5/5/00	SMH	XSH	20	167.7	217,048
Telecom	2/1/00	TTH	ITH	18	629.4	68,296
Utilities	6/23/00	UTH	XUH	20	88.4	21,700

*As of June 30, 2000; Market 2000+ as of August 31, 2000.

**Based on June 2000 volume; RKH and UTH traded only 6 days in June.

Source: Merrill Lynch

paying a fee of \$10 per 100 shares of HOLDERS to The Bank of New York. Note, however, that you must take delivery of your entire basket. That way, a tax-conscious investor can sell some losers to lock in the losses, while retaining winners. Individuals also may elect to sell some stocks for investment-related reasons such as overvaluation or poor prospects. They also may choose to purchase a few promising new companies in the sector that were not part of the original package. Thus, indi-

viduals can have as much control as they would have if they had owned each company outright to begin with.

HOLDERS UNIVERSE

HOLDERS trace their origins to mid-1998 after the break-up into 12 separate companies of TeleBras, Brazil's state-owned telecommunications giant. To accommodate investors desiring broad exposure to the Brazilian telecommunications sector, Merrill Lynch took all the spun-off companies and rolled them up into a single stock called TeleBras HOLDERS (NYSE ticker: TBH). That stock recently had a market cap of about \$3.2 billion. In September 1999, Merrill expanded this concept when it introduced Internet HOLDERS, the first in its series of Amex-traded sector portfolios. (Recently, that trust owned 19 companies, with 46% of the assets in America Online and Yahoo!) Four additional Internet-oriented baskets subsequently came to market.

Table 1 lists the HOLDERS presently available. The first nine baskets to come to market track high-growth sectors such as business-

0.1%.

If dividends remain after fees are netted out, the residual is paid to the investor; they are not reinvested. The dividend payment patterns of HOLDERS may appear puzzling to new investors. You might see four dividend payments concentrated within a month or two and then none for several months. That's because a HOLDERS passes along the net dividend whenever a stock makes its payment. Thus, the dividend payments of HOLDERS depend on the payment cycles of the individual stocks in the basket.

Although HOLDERS offer diversification like a fund, they simply allow an individual to own a group of stocks. They are not registered investment companies under the Investment Company Act of 1940. Technically, they are structured like ADRs. For years, ADRs have offered stateside investors easy access to foreign companies through certificates traded in U.S. markets. The actual shares of stock remain with a bank in the issuer's country. Whereas each ADR represents shares of a single company, a HOLDERS trust represents a basket of stocks. The Bank of New York holds the

underlying stocks as a trustee.

At the outset, companies are selected for inclusion in each basket by Merrill's research department based upon their market capitalization, liquidity, and prominence in the sector. At inception, most HOLDERS have been weighted on a modified market-cap basis and most have placed a maximum 20% weight on any stock. (Newer HOLDERS focusing on utilities and regional banks use a 10% initial limit on market cap weight. Each of the 50 stocks in the Market 2000+ HOLDERS recently represented from 1.4% to 2.8% of the trust.) Weightings change as prices fluctuate, and a stock's weighting can surge. For example, Yahoo! represented 20% of Internet HOLDERS at the trust's inception but subsequently rose as high as 33%.

A HOLDERS essentially takes a group of stocks and puts a rope around them. However, owners have the ability to remove that rope. By taking the stocks from a HOLDERS, individuals can manage them to suit their personal tax situations. Because they own the individual stocks, investors can take delivery of all of them (a non-taxable event) by

to-business (B2B) Internet stocks and biotech firms. Biotech is the largest, most actively traded basket of the group. The number of shares of biotech HOLDRS has actually doubled since its initial offering in November 1999 due to strong investor demand. When demand increases, more HOLDRS are created as professional investors such as Amex specialists buy the underlying stocks and deposit them into new HOLDRS.

With the exception of Market 2000+, the highly defined focus of the baskets in Table 1 is apparent. Rather than a HOLDRS that is simply healthcare, for instance, you find separate biotech and pharmaceutical portfolios. Many baskets came out as the technology sector was peaking in March and consequently fell sharply in price when the Nasdaq careened. On June 23, HOLDRS focusing on the less volatile regional bank and utility sectors began trading. At this writing, Software HOLDRS were scheduled to be launched.

Through each focused basket, an individual owns leading stocks in the target sector. For example, Table 2 lists the initial portfolio of Regional Bank HOLDRS. Thus, for each 100 shares of Regional Bank, you have 24 shares of Wells Fargo, 25 shares of FleetBoston Financial, and so on. Observe that the top six stocks comprise half of Regional Bank's assets. The Merrill Lynch HOLDRS Web site (www.holdrs.com) lists the composition of each HOLDRS, including the specific share amounts for each round lot (100 shares) of that basket.

Table 1 contains an "index" symbol as well as a "HOLDRS" symbol for each trust. The latter is the Amex stock symbol for the basket, while the former provides an up-to-the-minute price index of the stocks weighted as they are in the trust. The index is updated every 15 seconds during the trading day and can help investors determine how efficiently a HOLDRS is priced. If a

trust were correctly priced, the index value would lie about midway between the bid and the asked of the stock. If the bid rises above the index, the trust trades at a premium; if the asked price drops below the index, it sells at a discount. An investor must be aware of the danger of buying at a premium and subsequently selling at a discount.

However, because of the potential for arbitrage, you could normally expect any premium or discount to be short-lived. For instance, if a HOLDRS trades at a discount, professional investors would buy its shares and simultaneously sell the underlying stocks, thereby earning an arbitrage profit. The more liquid the holdings, the less likely a premium or discount would exist. And if a discount should develop during a time of extreme market stress, the investor could always elect to take delivery of the stocks. This is something individuals could not do with exchange-traded funds.

Through HOLDRS, you receive proxy statements and annual reports from each stock in the portfolio. You also have full voting rights in each company. If there is a trading halt for a single company in the bundle, the entire basket stops trading. Companies can leave a basket due to a merger or an acquisition, but new ones normally are not added; no manager stands ready to replace a stock. For instance, the Internet Infrastructure trust lost a stock following VeriSign's acquisition of Network Solutions. Five of the 11 sector baskets listed in Table 1 have fewer than their 20 original stocks.

Ordinarily, shareholders receive no capital-gains distributions from HOLDRS; however, a taxable distribution would be made if a component stock was acquired for cash. If a stock is acquired in your sector-specific HOLDRS, you will receive the appropriate amount of cash or stock in your regular brokerage account (not in your

HOLDRS) to replace the stocks that left. If one of the holdings spins off a division, the spun-off stock will appear in your brokerage account. For example, Hewlett-Packard, a stock in the Internet Architecture portfolio, spun off Agilent Technologies. For every 100 shares of Internet Architecture that you owned, you would have received 2.67 shares of Agilent. The spun-off stock may remain in the HOLDRS if it fits with the others in the basket.

In contrast to other baskets, Market 2000+ is not expected to lose companies due to corporate events. If a holding is acquired by a company that isn't contained in the basket and trades in the U.S. market, the acquiring company's stock can be added to the basket. Spin-offs also will be added back. The reasoning is that Market 2000+ is broad-based, in contrast to the highly defined sector HOLDRS, where new companies in different areas may not fit in.

CONCENTRATION PERILS

Although HOLDRS focusing on the Internet and its sub-sectors offer lower costs and greater tax-efficiency than the typical Internet fund, they provide less diversification. Company-specific risk can be extreme, since more than half of your assets may be in just a few stocks. And, because the ever-evolving Internet groups can change rapidly, a fixed, top-heavy 20-stock portfolio may not be the best way to invest long term. A good fund manager may be able to add value.

Sector HOLDRS are susceptible to wide price swings as their top-weighted stocks soar and plunge. This volatility is evident by tracking the price charts and 52-week and daily high-low price ranges of these stocks. For instance, on BigCharts (www.bigcharts.com) you can compare a HOLDRS chart with market indexes and other funds. Some of the baskets have declined

**TABLE 2. COMPOSITION PROFILE:
THE REGIONAL BANK HOLDERS**

Company (Ticker)	No. of Shares**	Weighting (%)
Wells Fargo (WFC: NYSE)	24	9.78
FleetBoston Financial (FBF: NYSE)	25	9.71
Bank One (ONE: NYSE)	33	9.67
First Union (FTU: NYSE)	29	8.75
Firststar (FSR: NYSE)	29	6.79
Fifth Third Bancorp (FITB: Nasdaq)	9	5.82
Mellon Financial (MEL: NYSE)	14	5.35
State Street (STT: NYSE)	5	5.32
PNC Financial Services (PNC: NYSE)	9	5.00
Northern Trust (NTRS: Nasdaq)	7	4.92
U.S. Bancorp (USB: NYSE)	22	4.71
Sun Trust Banks (STI: NYSE)	9	4.61
Wachovia (WB: NYSE)	6	3.53
National City (NCC: NYSE)	18	3.37
BB&T (BBT: NYSE)	10	2.72
KeyCorp. (KEY: NYSE)	13	2.53
Comerica (CMA: NYSE)	5	2.39
AmSouth (ASO: NYSE)	12	2.15
Synovus Financial (SNV: NYSE)	8	1.49
Marshall & Ilsley (MI: NYSE)	3	1.37

**Data as of June 21, 2000*
***Per 100 HOLDRS shares*
Source: Regional Bank HOLDRS prospectus

more than 50% in a matter of weeks. The B2B Internet and Internet Infrastructure HOLDRS were off 76% and 66%, respectively, between March 10 and their bottoms in late May. The broader Nasdaq 100 declined a more modest 35% over that period.

In addition, sector HOLDRS can become even more concentrated going forward. As certain stocks rise in price while others fall, the winners receive increasingly more weight. The typical mutual fund will pare back winners to keep concentration within bounds. Most traditional funds don't let concentration exceed 5% to 10% per issue. For instance, Barclays iShares Dow Jones U.S. Internet (ticker: IYV), which recently began trading on the Amex, limits any stock's weighting to 10%. Another way HOLDRS can become more concentrated is by shrinking if companies leave through

acquisitions.

Yet letting your winners ride can lead to astronomical returns if the high-flyers soar for an extended period. Unlike most other funds, HOLDRS allow their best stocks to grow without restraint. And, capital gains are realized and distributed when managed funds sell their winners, which may be disturbing to investors with taxable accounts.

COMPARING PRODUCTS

Individuals considering HOLDRS should examine ex-

change-traded funds as a potential alternative because the latter also offer exposure to narrowly defined sectors. Both HOLDRS and exchange-traded funds should normally trade very close to their net asset values because of the potential arbitrageurs have to profit from premiums or discounts. Like exchange-traded funds, HOLDRS can be traded intraday, allowing short-term traders to attempt to profit from near-term price swings. HOLDRS can also be sold short on a downtick and purchased on margin. In addition, HOLDRS have listed options for those who might be interested. With a few exceptions, such as the Nasdaq 100 Tracking Stock (ticker: QQQ), most exchange-traded funds do not have listed options.

Compare HOLDRS focusing on market sectors with State Street Global Advisors Select Sector SPDRs

and Barclays Global Investors iShares Dow Jones. The former (which were covered in my July *AII Journal* column) offer relatively broad sector groupings carved out from the S&P 500. You might find Barclays Dow Jones sector funds a bit narrower and more focused.

HOLDRS demand greater sophistication than exchange-traded funds. For starters, you must be prepared to confront the tax aspects of acquisitions and spin-offs. Further, HOLDRS become more complicated if you surrender your basket for its underlying stocks. You are now a stock investor and need to know each company individually. You also must determine the cost basis of each stock you own so you can report the correct gain or loss to the IRS when you ultimately sell a stock.

HOLDRS CHECKLIST

Sector HOLDRS probably are most suitable for relatively high net worth individuals, since the trusts only can be traded in round lots (100 shares), or multiples thereof. This translates into minimum investments ranging from several thousand to well above \$10,000, depending on the portfolio. For instance, if Biotech HOLDRS are quoted at \$200 a share, \$20,000 is your minimum entry fee.

Here's my checklist for potential investors:

- **Study the volatility.** Some of the higher-octane baskets can plunge 50% or more in a matter of weeks. Of course, portfolios such as the Market 2000+, Regional Bank and Utilities HOLDRS should exhibit greater stability. Make sure you understand the loss potential of a particular basket before investing. If a HOLDRS is relatively new, study the price charts of its biggest component stocks or an index of its industry to determine volatility.

- **Know at least the top five or six holdings.** Because focused HOLDRS consist of fewer names than your typical sector fund, it's essential to be knowledgeable about the sector and its major companies. You may decide to take delivery of the stocks. At a minimum, investigate the top five or six. Your investment will be more secure if these companies are familiar household names.
 - **Gauge relative performance.** How has the HOLDRS performed relative to an index benchmark and other investments focusing on the same industry? For example, if you are considering the Regional Bank HOLDRS, see how it has performed relative to an index such as the Philadelphia Stock Exchange KBW Bank index (ticker: BKX) and funds that invest in the sector.
 - **Resist big sector bets.** Focused HOLDRS are most appropriate if you are looking for exposure to a certain sector when you already own a relatively large, diversified core portfolio. HOLDRS that target narrowly defined sectors should account for no more than a modest slice—say, 5% to 10%—of your total equity allocation.
 - **Be commission-conscious.** Yes, for the average retail investor, commissions are lower when you purchase a HOLDRS than the cost to take positions in each of the underlying stocks. However, if you take delivery of the underlying stocks, your commissions can add up if you sell a half dozen or so of the companies. (This is not an issue if your broker offers unlimited trades based on an annual account maintenance fee.) Finally, don't buy your HOLDRS on the initial public offering
- because you will incur a 2% underwriting fee.
- **Evaluate the bid, asked, and size.** Individuals who have invested primarily in mutual funds may not be familiar with the ins and outs of trading stocks. It's important to consider the bid-asked spread of each HOLDRS (the current price at which traders will buy shares and the current price at which traders will sell shares), along with the size in the quote. An indicator of demand and supply, the size represents the number of shares being bid for and offered. Since HOLDRS fluctuate from day to day and hour to hour, it makes sense to use limit orders to try and secure a better price—for example, buying at the bid or selling at the asked. Real-time quotes can help you set the price of your limit order.
 - **Beware of the short-term mindset.** You may find yourself doing more trading with HOLDRS than you would with a more diversified fund, such as an S&P 500 index portfolio. It's difficult to consistently buy and sell at the right time. Frequent trading often leads to poorer long-term results than a sensible buy-and-hold policy.
 - **Be prepared for the tax issues.** The IRS treats owners of HOLDRS as direct owners of each of the underlying stocks. Companies in your basket may be acquired or may spin off businesses. These are taxable events that you need to be able to handle. For instance, a spin-off will require you to recalculate the cost basis of your HOLDRS. If you unbundled a HOLDRS, you must determine the cost basis of each stock. You need this information to figure gains and losses

on eventual stock sales. Merrill Lynch's HOLDRS Web site (www.holdrs.com) has a helpful cost-basis calculator.

The tax issues normally are bypassed if you hold your basket in a tax-deferred account. However, because they allow individuals to control the timing of any gains or losses on the underlying stocks, HOLDRS frequently make most sense for taxable accounts.

CONCLUSIONS

A true buy-and-hold investment, HOLDRS straddle the gap between index funds and stocks. They are closer to the latter than the former. An investor begins by purchasing a basket of stocks but may eventually decide to take delivery of the companies. This provides a degree of control that mutual fund owners do not have.

But is this control necessary?

It depends. Because they allow you to gain control over the stocks and to realize losses to offset gains, HOLDRS probably make most sense in taxable accounts. However, their ultra-low expenses can make them attractive in retirement accounts.

Not all HOLDRS are created equal. Highly defined baskets are most suitable for more experienced investors with relatively large stock portfolios who desire exposure to a particular market sector and are comfortable analyzing and owning individual stocks. The highly diversified Market 2000+ is an ideal buy-and-hold portfolio. The fact that the world's 50 largest stocks may now be overpriced is the biggest risk investors face.

For further information, see the Amex Web site (www.amex.com) and the Merrill Lynch site (www.holdrs.com). ♦