Exchange Funds: A Primer

with Scott Fellmeth, CIPM® | *Partner and Senior Advisor*

A relatively obscure investment vehicle known as an “exchange fund” may be an attractive solution for ultra-high-net-worth individuals looking to diversify out of their overweighted stock positions, without triggering immediate capital gains consequences.

Simply defined, **exchange funds are structures that let subscribers defer gains by contributing their concentrated single stock holdings to a limited partnership structure, via a behind-closed-doors shares swap.** In return, participants gain instant diversification in the form of shares in the fund, providing them with up to 80% equity exposure to a broad market index.

But exchange funds (aka “swap funds”) carry unique baggage. For one thing, entrée requires complex execution measures and a rigorous vetting process. And then there's the seven-year lock-up period, where investors who redeem their positions ahead of schedule can incur significant fiscal penalties.

We spoke with Westmount partner and senior advisor **Scott Fellmeth, CIPM®**, to break down everything investors should know about this under-the-radar strategy, before they take the exchange fund leap.

Philosophically speaking, how do exchange funds benefit investors?

Exchange funds swap an investor's idiosyncratic risk with systemic risk. Idiosyncratic risk refers to the threat of a concentrated position tanking a portfolio if something goes south with a single stock. Amazon and Facebook are two recent examples of specific companies where singular events (in both cases, an earnings miss) depressed their share prices. But then you also have systemic risk, which is the system-wide risk of the entire market selling off. When COVID hit in March 2020, it didn't matter if you held positions in the best companies in the world because everything sold off at the same time. Consequently, if you're highly concentrated in a single stock, you carry both types of risk, but if you're exposed to the whole market, you can diversify out of the idiosyncratic risk segment, which is the main advantage of exchange funds.

How can wealthy investors utilize these vehicles?

Exchange funds tend to apply only to wealthy individuals, because you'd only need them if you were looking to defer a large unrealized capital gain with a concentrated position that you couldn't sell off for one reason or another. And generally speaking, people looking to diversify out of a single stock in this way tend to be on the wealthier end of the spectrum anyway. Additionally, exchange funds are classified under section 3(c)(7) of the Investment Company Act of 1940, which exempts them from registering as an investment company, so only qualified purchasers with a minimum $5 million net worth are eligible to participate. These funds would not be relevant to non-taxable investors like pensions or foundations, or non-taxable vehicles like IRAs.

We Dig Deeper

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We provide an institutional approach to portfolio construction, eschewing commissions and proprietary products to eliminate potential conflicts of interest.

Clients often come to Westmount for objective advice about their investments, or for guidance about major wealth events and other complex financial situations.

Let's Start a Conversation

To learn more about our firm, people, and capabilities, visit www.westmount.com, call us at 310-556-2502, or email info@westmount.com to speak with an advisor today.

Does Westmount manage these funds directly or does it refer investors to outside purveyors?

We have done due diligence on the best-run managers in this space and will recommend one or the other depending on a client's specific circumstances. The funds mimic either the S&P 500 or the S&P All Cap index because they rely on broad exposure to the US market for the exchange mechanism to work. This is a hard business to be in, because you really need to scale big to be profitable. And since the funds rarely sell anything off, they only generate cash through dividends.

Gaining acceptance into these funds involves multiple steps. Can you describe the process?

From a practical perspective, the way that it works is that we approach one of the funds—and we, honestly, go to all of them—and ask, "Can you guys take $3 million worth of Google stock right now?" And they'll either say they can, they can't, or they can only take some of the stock. And then we'll sit with our client to decide their exact contribution amount. At that point, there's paperwork to fill out and documents to file in order to transfer the shares to the exchange fund. Then you receive a proportional ownership in the fund itself, which is structured as a limited partnership where investors get a K-1 tax form at the end of each year. The whole process would be rather onerous for an investor to carry out independently, but we take steps to make it as seamless as possible for Westmount clients.

In addition to tracking the performance of a stock index, exchange funds fold real state exposure into the mix. Does this offer investors further diversification?

Yes, the funds have 20% direct exposure in illiquid assets like multi-family residential real estate—usually in the form of privately-held properties. This exposure is the result of an IRS rule requiring the fund to hold a percentage of qualified assets. The fund managers have a goal to match the return of their index, not outperform it, so they are not looking to hit home runs in real estate, it's just there to meet the requirement. In the end the exchange fund is looking to minimize tracking error to the index.

Finally, how can Westmount combine exchange funds with other risk mitigation strategies?

If your true goal is market risk reduction, we'd need to pair your exchange fund with something else--either a charitable remainder trust, an options overlay, or intermittent selling in order to gradually unload positions over different tax years. On the other hand, if someone is very comfortable with US market risk, since these are all domestic-oriented funds, you could employ this strategy exclusively. But the one thing I'd stress is that liquidity will always be an issue here, because you can't get your money out from an exchange fund in just a day or two. Then again, most people who hold onto a stock for an extended period of time aren't looking to sell it off for emergency expenses. Still, liquidity should always be considered when making this recommendation.

For more information, call us at 310-556-2502 to speak with an advisor, or email info@westmount.com.

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