

ETFs, DLOMs and FLPs:
Minimum Marketability Discounts

Summary

It is often said that limited partner interests in a family limited partnership (FLP) that holds publicly traded stocks warrant very small discounts for lack of marketability (DLOM). On the contrary, the prices of LEAPS put options on Exchange Traded Funds (ETFs) in July 2010 argue for significant DLOMs of 16% to 18% and above.

I have written before about how LEAPS put options provide minimum DLOMs for closely-held stocks. I argue that a major portion of any DLOM is the cost of price protection, the elimination of the risk of loss in value during the holding period.¹ A study of all LEAPS in late November 2008 analyzed the costs of 2010 and 2011 LEAPS put options for 39 ETFs.²

ETFs are similar in makeup to mutual funds and are traded on several exchanges. Generally, ETFs hold stocks or other assets with a common trait, such as the pharmaceutical industry or the semiconductor industry, a Standard and Poor's index or a Russell index, gold or petroleum, consumer staples or real estate. ETFs may hold as few as 10 or 12 stocks or as many as 75 or more. The common trait enables an investor to focus in an industry or an asset class and achieve some diversification at the same time.

In a study done on July 13, 2010 we analyzed 27 ETFs holding only U.S. assets, stocks, bonds or indices. Exhibit I describes the 27 ETFs. They range from a bond index fund, through a S & P 500 Index fund to specific industry ETFs like biotech or semiconductors. Exhibit II shows the costs of 2011 and 2012 put options expressed as percentages of the cost of the ETF units on that day; that is, the costs of price protection for a purchase of the underlying ETF units. It is very important to note the "Months To Expiration" on Exhibit II because the holding periods are short. The 2011 put option expires in January 2011. It provides only six months of price protection, an unusually short holding period for a comparable privately held stock. The 2012 put option expires in mid-January 2012, 18 months from July 13, 2010, still a much shorter holding period than the typical private investment. The point here is we know that discounts (and risk) increase as the holding period increases, so the discounts shown in this study are very likely the minimum reasonable discounts on this date.

Many of us have heard or read that discounts for lack of marketability for entities holding publicly traded assets (such as limited partner units in a partnership that holds publicly traded stocks) should be low, usually meaning single digits. My conclusion from this study of LEAPS on ETFs with only an 18 month holding period is that a reasonable DLOM should be double that, at a minimum. It seems irrational that, on this valuation date, July 13, 2010, a limited partner unit in a partnership holding publicly traded stocks would be assigned a 5% or 8% DLOM when

¹ See "Minimum Marketability Discounts – 5th Edition," March 2010, at www.dlom-info.com.

² See "LEAPS On ETFs Measure Holding Period Risks Among Industries," at www.dlom-info.com.

the cost of price protection on an S & P 500 Index ETF (trading symbol SPY) put option is 17.6%, or an oil services ETF (OIH) cost is 20.0%.

Exhibit I
ETF DATA
(as of July 2010) *

| <u>Symbol</u> | <u>Fund Name</u> | <u>Fund Nature</u> | <u>Tot. Net Assets (millions)</u> | <u>Yield (a)</u> | <u>10 Largest Holdings as % of Tot. Assets</u> |
|---------------|-------------------------------|---|-----------------------------------|------------------|--|
| TLT | IShares Barclays 20 | Tracks Barclays Capital U.S. 20+ Year Treasury Bond Index | \$2,240 | 3.95% | 94% |
| BBH | ML Biotech HLDR 12/39 | Holds stocks of 18 companies in biotech industry | \$826 | N/A | 99% |
| XLP | Consumer Staples SPDR | Common stocks of U.S. consumer goods and services companies. | \$2,060 | 2.77% | 66% |
| DIA | DIAMONDS Trust Series 1 | Tracks D-J Industrial Average | \$8,030 | 2.65% | 53% |
| DJX | Dow Jones Industrial Average | Tracks D-J Industrial Average (1/100) | | | |
| OEF | IShares S&P 100 Index | Tracks results of S&P 100 Index | \$2,500 | 2.25% | 30% |
| IWM | IShares Russell 2000 Index | Tracks results of Russell 2000 Index | \$11,780 | 1.20% | 3% |
| XLF | Financial Select Sector SPDR | Common stocks of fin'l companies, banks insurance, real estate, etc. | \$5,840 | 1.74% | 56% |
| XLE | Energy Select Sector SPDR | Common stocks of energy companies | \$5,340 | 1.90% | 63% |
| XLI | Industrial Select Sector SPDR | Common stocks of industrial companies | \$2,030 | 2.36% | 48% |
| IYR | IShares D-J US Real Estate | Tracks the performance of common stocks in D-J U.S.Real Estate Index | \$2,280 | 4.44% | 41% |
| IBB | IShares Nasdaq Biotech. Index | Tracks results of Nasdaq Biotech. Index | \$1,261 | N/A | 47% |
| XLB | Materials Select Sector SPDR | Common stocks of companies in industries like chemicals, packaging, mining, paper | \$1,650 | 1.92% | 68% |
| OIH | Oil Services HLDRS Trust | Common stocks of companies in the oil services industry. | \$2,200 | N/A | 85% |
| PPH | Pharmaceutical HLDRS Trust | Holds stocks of 21 companies in pharmaceutical industry. | \$1,630 | N/A | 95% |

Exhibit I (continued)
ETF DATA

| <u>Symbol</u> | <u>Fund Name</u> | <u>Fund Nature</u> | <u>Tot. Net Assets (millions)</u> | <u>Yield (a)</u> | <u>10 Largest Holdings as % of Tot. Assets</u> |
|---------------|-------------------------------|---|-----------------------------------|------------------|--|
| RTH | ML Retail HLDRS | Holds stocks of 20 U. S. retailers. | \$436 | N/A | 83% |
| QQQQ | Power Shares ETF | Tracks results of Nasdaq 100 Index | \$16,230 | 0.49% | 47% |
| SPY | S & P Depository Receipts | Tracks results of S & P 500 Index | \$66,710 | 2.03% | 19% |
| MDY | S & P MidCap 400 Dep. Rec. | Tracks results of S & P MidCap 400 Index | \$7,590 | 1.26% | 6% |
| XLV | Healthcare Select Sector SPDR | Common stocks of companies in healthcare pharmaceutical and related industries. | \$2,750 | 1.83% | 61% |
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| XLY | Consumer Discretionary SPDR | Includes common stocks of co.'s such as autos, household goods, restaurants, etc. | \$1,490 | 1.56% | 46% |
| SMH | Semiconductor HLDRS | Holds stocks of 20 semiconductor mfrs. | \$992 | N/A | 88% |
| XHB | SPDR S&P Homebuilder | Tracks S & P Sel. Homebuilders Index | \$675 | 0.98% | 45% |
| XRT | SPDR S&P Retail | Tracks 60 stocks in S & P Retail Index | \$322 | 1.38% | 18% |
| XLU | Utilities Select Sector SPDR | Common stocks of companies in the Utilities Select Sector Index. | \$3,330 | 4.31% | 56% |
| UNG | U. S. Natural Gas Industry | Holds futures of U.S. companies. | \$4,180 | N/A | 86% |
| XLK | SPDR Technology Select Sector | Common stocks of technology companies. | \$4,250 | 1.50% | 63% |

Exhibit II
Discounts On ETFs With LEAPS
 (As of July 13, 2010 - PM)

| <u>Symbol</u> | Fund <u>Type/Name</u> Months to Expiration | 2011 | 2012 |
|---------------|--|---|--|
| | | Option Cost <u>(% Stk. Price)</u> 6 | Option Cost <u>(% Stk. Price)</u> 18 |
| TLT | U.S.20+ Yr. T-Bond Index | 5.9% | 13.0% |
| BBH | ML Biotech HLDR | 8.0% | |
| XLP | Consumer Staples SPDR | 5.9% | 12.1% |
| DIA | Tracks D-J Industrial Average | 7.1% | 13.4% |
| DJX | Dow Jones Industrial Average | 8.5% | 15.1% |
| OEF | S&P 100 Index | 13.8% | 18.0% |
| IWM | Russell 2000 Index | 9.7% | 18.0% |
| XLF | Finl. Select Sector SPDR | 10.0% | 17.2% |
| XLE | Energy Select SPDR | 9.2% | 16.6% |
| XLI | Industrial Select Sector SPDR | 8.6% | 16.1% |
| IYR | D-J US Real Estate Index | 10.8% | 20.4% |
| IBB | Nasdaq Biotech Index | 7.5% | 13.4% |
| XLB | Materials Select Sector SPDR | 8.9% | 16.6% |
| OIH | Oil Services HLDRS Trust | 11.3% | 20.0% |
| PPH | Pharmaceutical HLDRS Trust | 3.9% | |
| RTH | ML Retail HLDRS | 7.5% | 13.8% |
| QQQQ | Nasdaq 100 Index | 8.0% | 14.4% |
| SPY | S & P 500 Index | 8.9% | 17.6% |
| MDY | S & P MidCap 400 Index | 11.1% | 16.5% |
| XLV | Healthcare Sector SPDR | 6.9% | 13.2% |
| XLY | Consumer Discretionary SPDR | 6.7% | 12.8% |
| SMH | Semiconductor HLDRS | 10.9% | 17.2% |
| XHB | S & P Homebuilders Index | 11.5% | 19.9% |
| XRT | S & P Retail Index | 9.5% | 17.0% |
| XLU | Utilities Select Sector SPDR | 6.6% | 13.2% |
| UNG | U.S. Natural Gas Industry | 14.3% | 22.9% |
| XLK | Technology Select Sector SPD | 7.8% | 14.9% |
| | Highest | 14.3% | 22.9% |
| | Lowest | 3.9% | 12.1% |
| | Median | 8.6% | 16.5% |
| | Mean | 8.8% | 16.1% |