

LEAPS On ETFs Measure
Holding Period Risks Among Industries

We have written before about how LEAPS put options provide guidelines for discounts for lack of marketability of closely-held stocks, and we have described that discount or cost as the cost of price protection or a measurement of holding period risk.¹ During the study of all LEAPS in late November 2008, we analyzed the costs of 2010 and 2011 LEAPS put options for 39 ETFs, Exchange Traded Funds.

ETFs are similar in makeup to mutual funds and are traded on several exchanges. Generally, ETFs hold stocks or other assets with a common theme, 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 theme enables an investor to invest in an industry or an asset class and achieve some diversification at the same time.

In November 2008, LEAPS were sold and traded on 39 ETFs. A study of the costs of LEAPS put options on these 39 ETFs provides an interesting view of the costs of price protection by industry and a view of the extent to which risk is reduced by diversification within a specific industry or investment theme.²

Analysis of the 39 funds listed in Exhibit I (page 4 and 5) shows some interesting facts:

- 1) The costs of price protection in November 2008 are significant, even on diversified investments like ETFs, often from 20% to 30%.
- 2) The nature of the industry is a significant factor in the cost of price protection.
- 3) Within an industry category, specific company factors such as size and risk are even more important factors in the cost of price protection.
- 4) An ETF generally, but not always, reduces the cost of price protection below the costs of owning the same stocks individually.
- 5) The specific cost of price protection for an ETF is a function of the companies included, their individual risk profiles, and the sizes of the ETF's holdings. This is clear when comparing two ETFs whose interests are in the same industry.

Do the ETF discounts have any applicability for determining discounts for lack of marketability on FLPs? Maybe

¹ See "Minimum Discounts For Lack of Marketability," 2009 Study at www.dlom-info.com.

² By "theme" we mean a common group other than an industry; for example, gold or petroleum futures, or the stocks of countries like China or Brazil.

. I have appraised interests in FLPs that hold publicly traded stocks similar to the “Diamonds Trust, Series 1” (ticker symbol DIA) shown in the following chart, although none of the FLPs had as many as 10 or more holdings like the ETFs. Because fewer holdings increases holding period risk, a FLP of this nature (i.e., holding a few large public company common stocks) likely would have warranted a discount for lack of marketability in November 2008 larger than “Diamonds” discount of 22.8%. Moreover, the anticipated holding period for many FLP interests is longer than 26 months (the 2011 LEAPS), thus arguing for a higher discount..

DIA - Diamonds Trust, Series 1
Top 10 Holdings = 59.7% of total assets
Total Holdings = ?

		% of Tot. Assets	2010 Option	2011 Option
IBM	Intl. Business	9.11%	22.1%	25.9%
SOM	Exxon Mobil	7.61%	18.9%	23.7%
CVX	Chevron Corp.	7.01%	20.4%	26.6%
MCD	McDonalds	5.77%	20.1%	24.7%
JNJ	Johnson & John	5.74%	16.3%	19.8%
PG	Procter Gamble	5.42%	18.5%	23.3%
MMM	3M Co.	5.35%	19.6%	25.5%
UTX	United Technol.	4.77%	21.3%	26.8%
WMT	WalMart Stores	4.69%	20.3%	25.1%
KO	Coca-Cola	4.25%	17.9%	22.7%
Individual Companies:				
	Median Discount		19.9%	24.9%
	Mean Discount		19.5%	24.4%
	Fund Discount: DIA		17.8%	22.8%

As Exhibit I shows, the median discount for all 39 ETFs at the end of November 2008 was 28.5% for the 2011 LEAPS. The range of the lowest to highest discount was from 12.9% to 49.4%.

The “Financial Sector SPDR” fund (symbol XLF) illustrates the differences in discounts within an industry. This fund (shown below) is in the highest quartile of holding period discounts at 37.5%. Its top ten holdings, individually, have a median discount of 41.0%; so, collectively within the ETF, the saving or reduction in holding period discount due to diversification is relatively small.

XLF - Financial Sector SPDR
 Top 10 Holdings = 51.2% of total assets
 Total Holdings = ?

		% of Tot. Assets	2010 Option	2011 Option
JPM	JP Morgan Cha.	12.34%	30.3%	37.2%
WFC	Wells Fargo	10.34%	37.1%	42.3%
BAC	Bank of America	5.45%	76.5%	42.5%
GS	Goldman Sachs	4.63%	31.6%	35.4%
BK	Bank of NY	3.83%	32.9%	40.2%
USB	US Bancorp	3.37%	27.3%	33.3%
MET	MetLife	2.96%	36.5%	41.8%
TRV	Travelers Corp	2.93%	27.3%	33.9%
MS	Morgan Stanley	2.78%	40.5%	49.2%
AXP	Amer Express	2.52%	38.8%	46.6%
Individual Companies:				
	Median Discount		34.7%	41.0%
	Mean Discount		37.9%	40.2%
	Fund Discount: XLF		29.4%	37.5%

Experience in valuing FLP interests tells me that only occasionally will my subject's holdings of publicly traded instruments be similar to the holdings of an ETF with LEAPS. However, if a similar ETF is available, it can provide excellent market substantiation of your discount conclusion on your particular valuation date.. Even without a similar ETF, an analysis of the discounts based on LEAPS of the FLP's individual holdings can provide market substantiation of your discount conclusion.

Exhibit I

Costs of LEAPS Put Options For Exchange Traded Funds

~ November 28, 2008

LEAPS expiration dates in January: Months to expiration:		Costs of LEAPS	
		2010 14 mos.	2011 26 mos.
Biotech Holdrs Trust	BBH	12.4%	17.7%
Consumer Staples SPDR	XLP	22.8%	25.5%
Currency Shares Euro	FXE	10.5%	12.9%
Diamonds Trust Series	DIA	17.8%	22.8%
Energy Sector SPDR	XLE	23.0%	29.6%
Financial Sector SPDR	XLF	29.4%	37.5%
Industrial Sector SPDR	XLI	21.9%	29.1%
IShares DJ Real Estate	IYR	35.8%	48.1%
IShares China 25 Index	FXI	27.3%	31.8%
IShares Brazil Index	EWZ	30.4%	35.8%
IShares Emerging Mkts.	EEM	26.7%	33.7%
IShares Japan Index	EWJ	20.0%	None
IShares Mexico Index	EWJ	24.1%	None
IShares Nasdaq Biotech	IBB	16.6%	21.1%
IShares Russell 2000 Index	IWM	19.7%	26.0%
IShares Rus. 2000 Value Ind.	IWN	25.7%	32.1%
IShares EAFE Index	EFA	21.3%	28.2%
IShares S. Korea Index	EWY	26.6%	30.6%
Mkt Vector Gold Miners	GDX	41.3%	49.4%
Mtls. Select Sector SPDR	XLB	26.8%	33.0%
Oil Services HOLDRs	OIH	26.3%	32.4%
Pharmaceutical HOLDRs	PPH	16.0%	20.5%
Powershares DB Agricult.	DBA	18.4%	24.4%
Powershares DB Base Met.	DBB	39.8%	None
Powershares DB Commod.	DBC	18.9%	24.0%
Powershares DB Gold	DGL	19.7%	None
PowerShares QQQ	QQQQ	19.3%	24.2%
Regional Bank HOLDRs	RKH	33.4%	40.9%
Retail HOLDRs	RTH	24.5%	29.1%
S & P MidCap SPDRs	MDY	20.9%	26.8%
Healthcare Sector SPDR	XLV	21.9%	25.9%
Consumer Sector SPDR	XLY	23.0%	28.8%
Semiconductor Hldrs.	SMH	23.8%	28.0%
SPDR Gold Trust	GLD	16.3%	22.6%
SPDR S&P Homebuilders	XHB	34.9%	None
SPDR Technology Sector	XLK	19.9%	NM
U.S. Oil Fund	USO	23.4%	30.9%

ML Utility Holders Trust	UTH	16.5%	None
SPDR Utilities Sector	XLU	19.8%	24.5%

Exhibit I (cont'd)

Costs of LEAPS Put Options For Exchange Traded Funds
~ November 28, 2008

LEAPS expiration dates in January: Months to expiration:	Costs of LEAPS	
	<u>2010</u>	<u>2011</u>
	14 mos.	26 mos.
Lowest Discount	10.5%	12.9%
25% Percentile	19.5%	24.4%
Median	22.8%	28.5%
Mean	23.5%	29.0%
75% Percentile	26.7%	32.2%
Highest Discount	41.3%	49.4%