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FUND TRACK

Equity UITs Gain As Alternatives To Mutual Funds

By IAN SALISBURY
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Unit investment trusts, for years a popular way to hold municipal bonds, are getting a second life in investors' portfolios as an alternative to mutual funds.

But equity UITs, which often hold a fixed roster of 10 to 40 stocks for one to five years, face stiff competition from similar and popular exchange-traded funds. They also face skepticism from some fee-only financial advisers who say the costs of UITs are too high.

Unit investment trusts resemble mutual funds except that their holdings are readily published and can't generally be altered.

Although investors can sell trusts back to the issuer at their net asset value, UITs also have a termination date, which is intended to dissolve investment strategies as they become obsolete.

"They have a maturity date, almost like a CD," says Christian Magoon, managing director of product development at Claymore Securities Inc., which packages UITs.

For decades, UITs were a way for individual investors to hold portfolios of municipal bonds that would have been expensive to buy and hard to sell if owned individually.


As recently as 1990, \$91.7 billion of the total \$105.4 billion invested in unit trusts was in tax-free debt trusts, according to the Investment Company Institute. That figure took a nose dive in the 1990s as interest rates fell and fixed-income mutual funds gained momentum. Municipal-bond trusts now hold a mere \$10 billion.

Meanwhile, equity unit investment trusts, which held just \$4.2 billion in 1990, have more than \$28.6 billion today. Assets in all UITs are about \$40.9 billion.

Often, UITs are designed to beat a particular index. "A lot of our products are quantitative strategies," says Alan Rooney, vice president of new products at money manager First Trust Portfolios LP. First Trust often builds UITs by taking a well-known index and "screening" for a few dozen stocks it expects to outperform the rest.

"They are intended to beat the underlying index. Our value proposition is that the returns are good," he says.

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One of the most famous of these strategies is "Dogs of the Dow," which caught on after Michael O'Higgins published "Beating the Dow" in 1991. The tactic involves buying the 10 highest-yielding stocks in the Dow Jones Industrial Average and holding them for one year, after which the process is repeated.

Because of their built-in termination date, unit investment trusts are well-suited to executing the "Dogs" strategy.

"There was a time in the late '90s when [the Dogs strategy] was practically all unit trusts were known for," says Rich Stewart, product manager for unit trusts at UBS AG.

UBS still launches a Value Select 10 unit trust, its proprietary "Dogs" product, every other month, so investors don't need to wait a year to buy in. Investors who get rolled over into a new fund get part of their fee waived, Mr. Stewart says.

UBS financial advisers also offer clients six other proprietary UIT strategies as well as products packaged by outside fund managers.

Firms such as Claymore, First Trust and Van Kampen Investments, a unit of **Morgan Stanley**, offer UITs covering dozens of exotic strategies ranging from companies identified as potential merger targets to renewable energy to preferred securities.

One example, the Van Kampen EAFE Select 20 Portfolio, includes 20 of the highest-dividend-yielding stocks from the popular EAFE emerging-markets index run by Morgan Stanley Capital International.

The UIT, which was formed in July and terminates October 2007, would have posted an average annual return of 16.5% over the past 30 years, compared to 11.9% for the MSCI EAFE index, according to the UIT's sales literature.

However, because the trust hasn't actually been around that long, the estimate of past performance relies on back tests, a frequent point of criticism for UITs (as well as newly launched mutual funds of all stripes).

Since back tests rely on historical data, critics argue that stock pickers who design new funds simply keep shifting the composition of the funds' proposed holdings until they find one that happens to have worked over the necessary range of dates.

The same pattern may not succeed in the future, especially over a gap of only a year, the duration of some UITs. In fact, in the 12 months ended Dec. 31, 2005, Van Kampen's EAFE Select 20 Portfolio's strategy underperformed the index by more than three percentage points.

"One of the big problems is that you cannot get historical information because they roll these things out all the time," says **Barry Kaplan**, a financial adviser at Cambridge Southern Financial Advisors.

Another frequent criticism of unit investment trusts is their costs. UITs, which historically have been sold through commission-based brokerages, often charge front-end and back-end loads, as well as lower continuing management fees for fund maintenance.

For instance, the same Van Kampen EAFE UIT comes with sales charges totaling 2.95%, plus another 0.26% in annual fund expenses. Sales charges for longer-term strategies can be close to 5%.

In comparison, the median load for a front-end-load emerging-markets mutual fund is 5.75%, according

to research firm Morningstar, and the annual expenses run about 1.9%. The funds can also charge additional 12b-1 marketing fees.

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