MITTS: Stock Plays for Chickens

They give you upside potential with no downside

BY LEWIS BRAHAM

The stock market has no sure things, but Market Index Target-Term Securities, or MITTS, are about as close as you can get. Pioneered by Merrill Lynch, these securities are bonds linked to a market index such as the Standard & Poor's 500-stock index, the Nasdaq 100, or the Russell 2000. Investors are guaranteed to get their principal back plus appreciation based on the performance of the underlying index. "These are ideal vehicles to protect you when markets are treacherous," says Mark Skousen, editor of investment newsletter *Forecasts & Strategies*. Think of MITTS as stock market plays for chickens.

The trade-off for eliminating risk is less appreciation if the bull market comes roaring back. These days, that's a price investors may be happy to pay

Here's how they work: Consider an S&P 500 MITTS, MLF, which trades on the American Stock Exchange for $10.17 a share. It was originally issued in June, 1998, when the S&P was at 1119, and is scheduled to mature on July 1, 2005. On that date, the MITTS holder will get $10 a share, no matter where the S&P is, and if the index is below 1119, that'll be all. Should the S&P close above 1119 on that date, the MITTS will pay the appreciation above 1119, less an adjustment of about 1.3% a year for expenses. Suppose the S&P is at 1600 when this MITTS matures. After adjustment, it will pay about $3.04 per $10 share, for a 30.4% gain. It's a good deal shy of the S&P's 43% gain, but that's the trade-off for eliminating downside risk.

All-Weather MITTS

INDEX / MITTS SYMBOL	CURRENT PRICE*	INDEX MATURITY DATE	CURRENT VALUE AT INCEPTION	INDEX VALUE*
DOW JONES IND. AVG. / MDJ	$8.72	06/26/06	10,721	9688
NASDAQ 100 / MNM	8.25	08/2/07	3521	1677
RUSSELL 2000 / RUM	10.37	09/30/04	494	447
RUSSELL 2000 / RSM	9.44	07/21/06	465	447
S&P 500 / MLF	10.17	07/1/05	1119	1153
S&P 500 / FML	9.13	03/27/06	1262	1153

*Mar. 26, 2001 Data: American Stock Exchange

Since MITTS trade like stocks, their prices fluctuate above or below the guaranteed $10 a share. That can present some interesting opportunities. For instance, one S&P 500 MITTS, ticker symbol FML, currently trades at $9.13 a share on the Amex (table). When FML matures in 2006, it will be worth $10, plus some of the rise in the S&P index. That's a guaranteed return of 9.5%—the difference between the current price and redemption. RSM, a MITTS that tracks the Russell 2000 index, trades for $9.44 a share, a guaranteed 5.9% return, and MNM, which tracks the Nasdaq 100 index, trades for $8.25 a share, a guaranteed return of 21.2%.

The cheapest MITTS aren't necessarily the best plays. For instance, MNM, the Nasdaq 100 security, was issued when the Nasdaq was at 3521, so the index has to double by August, 2007, to return any more than $10 a share. In contrast, Russell 2000 securities are within 10% of their index-issue prices and have a better chance of maturing above them. Skousen recommends the Russell MITTS that mature in 2004 because unlike most, they have no adjustment factor.

These derivative securities have characteristics of both stocks and bonds, but for tax purposes, the Internal Revenue Service considers them bonds. Since the principal is backed by zero-coupon bonds, MITTS holders are liable each year on the accrued interest even though there is no cash payment. And the payoff from the index appreciation is considered income, taxed at ordinary rates, not as long-term capital gains. All things considered, MITTS should work better in tax-deferred retirement accounts. And they should be held till maturity to get the full benefit of their final payout.

Although MITTS have been around for nearly a decade, they're not well known or understood on Wall Street. And different MITTS built on the same index can vary in their payouts and adjustment rates, so investors need to pay scrupulous attention to details. A good place to get info is the "Index Notes" section of the Amex Web site: www.amex.com/structuredeq/sp_index_notes.stm. Also on that page, you can get info on "TIERS" and "PEEQS," similar products offered by other investment banks. There are several sector and foreign MITTS worth a look as well.

No MITTS or any of their cousins would perform as well as a plain-vanilla index fund if the bear market ended tomorrow. But that's probably a bet most investors wouldn't take. □

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