



## Aronstein Skirts Tax 'Nightmare' as Commodities Bet Returns 50%

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By Miles Weiss



Jan. 21 (Bloomberg) -- **Michael Aronstein** made too much money betting on commodities last year.

The 56-year-old manager of the \$102.4 million **Marketfield Fund** predicted the collapse of commodity prices in 2008, then reversed course in the first quarter of last year, putting one-fourth of the fund's assets in commodities such as palladium and zinc. By the end of the year, the metals had returned more than 50 percent, running afoul of an Internal Revenue Service rule that mutual funds must get at least 90 percent of their income from securities to avoid being taxed, regulatory filings show.

"It's the nightmare of all nightmares for mutual funds," said **Vincent Calcagno**, a principal at the Roseland, New Jersey, accounting firm **Rothstein Kass & Co.** who supervises audit and tax preparation for hedge, private-equity and mutual funds. "A fund would get whacked just like a corporation that has to pay taxes on any gains."

Marketfield's mishap highlights the dilemma mutual funds face as they seek to profit from rising demand for commodities and diversify into assets that aren't directly linked to equity markets. Managers including Pacific Investment Management Co. and BlackRock Inc. have limited commodities investments or made them through instruments such as commodity-linked notes. Now the industry is backing legislation that would give managers greater leeway to fend off competition from other funds.

Mutual funds that specialize in commodities have failed to keep pace with the growth of exchange-traded funds that aren't limited by the IRS rule. Assets in commodity ETFs more than doubled to \$73 billion during the past two years, while assets in comparable mutual funds grew just 50 percent to \$23.2 billion, according to Chicago-based Morningstar Inc.

'Good Income'

IRS rules say mutual funds must get at least 90 percent of their income and realized gains from securities and related sources, or "good income." Funds that get more than 10 percent of their returns from sources other than securities, including futures and forward contracts on commodities, must pay taxes before distributing profits to shareholders.

"It's a direct hit to your total return," said **Thomas Winmill**, a portfolio manager for the \$116 million **Midas Fund Inc.**, which had an 83 percent gain last year, including dividends. The New York-based fund invests in gold, silver, assets denominated in Swiss francs, and companies dealing in real estate and natural resources.

Aronstein responded to the threat of a large tax bill by changing Marketfield's fiscal year, allowing it to offset gains with investment losses under the corporate tax laws. While it lost its tax-free status, the fund avoided making a taxable distribution to shareholders of 20 cents a share.

## Capping Investments

U.S. Representative **Charles Rangel**, the Democrat from New York who chairs the House Ways and Means Committee, is co-sponsoring "The Regulated Investment Company Modernization Act of 2009," a bill introduced last month that would allow funds to count commodities profits as "good income."

**Steven Lehman**, portfolio manager for the Federated Market Opportunity Fund, said the tax issue led him to cap investments in gold bullion at 5 percent of net assets. Other funds hold shares of mining or energy companies, a method that lessens benefits of diversifying because the stocks can track equity markets more closely than commodities do.

Pacific Investment Management Co., based in Newport Beach, California, and BlackRock Inc. of New York, have worked around the IRS limits by buying debt securities from brokerages and banks whose value is tied to a commodity or commodities index. These commodity-linked notes count as securities when funds are computing good and bad income, according to the IRS rule.

## Credit Quality

The commodity-linked notes expose investors to the credit quality of the brokerage that issued the security. The firms that sold such notes included **Lehman Brothers Holdings Corp.**, the brokerage that filed for bankruptcy protection in September 2008, and American International Group Inc., which received a government bailout the same month.

"I was very hesitant to have a long-term note with the name of a big broker-dealer on it" during last year's first quarter, said Aronstein, who is also chief investment strategist at Oscar Gruss & Son Inc. "Plenty of people had those contracts with Lehman and wound up with zero."

Aronstein instead invested in forward and futures contracts on industrial metals such as lead, zinc, palladium and nickel. Lead rose 131 percent last year, the second-best performer in the Standard & Poor's GSCI Commodity Index after copper, which rose 138 percent. Zinc was the fourth-best performing commodity, with a 104 percent gain, and nickel ranked sixth after rising about 56 percent.

## 'Perverse Regulation'

While the investments proved to be "very successful," the profits didn't qualify as "good income" for tax purposes, Marketfield said in a Dec. 29 filing with the U.S. Securities and Exchange Commission. As a result, it became "virtually certain" that Marketfield would lose its status as a registered investment company, according to the filing.

"We could have manufactured enough good income to obviate the whole thing," said Aronstein, who also runs a \$231 million offshore **fund** using the same strategy that's not subject to the IRS rule. "It's a very perverse regulation."

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*Last Updated: January 21, 2010 00:00 EST*