CHAPTER 20

Investment Companies

Investment Funds

- Purchase direct, long term, capital market securities and issue indirect, liquid, small denomination securities, called shares.
- (IF) offer the financial investor the following:
  - Provide risk intermediation by investing in a diversified portfolio of assets.
  - Provide denomination intermediation by issuing shares in smaller denominations than the direct securities purchased.
  - Provide marketability for IF shares.
  - Offer economies of scale in investment management and transaction costs.

Closed-end Investment Companies

- Have a fixed number of shares outstanding like any publicly traded corporation.
- Shares are traded and priced in the market.
- The net asset value (NAV) is often above the market value/share.

Open-end Investment Companies or Mutual Funds

- Most common and dominates asset holdings.
- Mutual funds stand ready to buy (redeem) or sell their shares at the current market price of assets--net asset value.
- No limit to the number of shares issued.

Exchange-Traded Funds (ETF)

- First introduced in 1989 at Toronto Stock Exchange
- Shares traded on organized exchanges like closed-end funds
- Created with deposit of portfolio of stock
- Redemptions in form of stock portfolio
- Most track stock index--SPDRs

Investment Trust or Unit Trust.

- Assets are not actively managed.
- Provide small denomination share claims against a diversified, fixed portfolio of securities.
- Trust sponsors usually will repurchase shares at net asset value, less a commission.

Importance of Investment Companies

- Investments in mutual funds exploded in the 1990s because
  - Many new funds were developed.
  - Individual Retirement Accounts (IRAs) were developed.
  - The shift of many pension plans from defined benefit to defined contribution plans (401k).
  - Increased investment by baby boomers.
  - The high rates of return available on common stocks.

EXHIBIT 20.5
Assets Held by Equity, Hybrid, and Bond Mutual Funds

		Percentage Distribution of Key Assets						
Year	Total Assets ($ billions)	Cash and Equivalent	Corporate Bonds	Preferred Stock	Common Stock	Municipal Bonds	Government Securities Long Term	Other
1945	$1.3							
1950	2.5							
1955	7.8	5.6	6.0	6.3	82.1	NA	NA	NA
1960	17.0	5.7	7.3	4.2	82.8	NA	NA	NA
1965	35.2	5.1	7.3	1.7	85.9	NA	NA	NA
1970	47.6	6.6	9.0	2.4	80.9	NA	NA	1.1
1975	42.2	7.6	11.3	1.2	78.6	NA	NA	1.3
1980	58.4	9.1	11.3	0.9	71.2	4.9	2.4	0.2
1985	251.6	8.2	9.9	1.5	47.6	15.2	17.3	0.3
1990	566.8	8.5	7.8	0.5	38.1	20.9	22.6	1.6
1995	2,058.3	6.9	9.3	0.8	58.2	11.9	12.6	0.3
1996	2,624.0	5.8	9.1	0.8	64.7	9.3	10.1	0.2
1997	3,409.3	5.8	8.6	0.9	68.3	7.8	8.3	0.3
1998	4,173.5	4.6	9.3	0.6	71.4	7.0	6.9	0.2
1999	5,233.2	4.2	7.4	0.6	77.0	5.1	5.6	0.1
2000	5,119.4	5.4	6.8	0.5	75.9	5.3	6.0	0.1
2001	4,689.6	4.7	8.0	0.5	72.6	6.2	8.0	0.0

Over time, mutual funds' stock and bond holdings have varied widely in relative importance. In the 1990 recession, mutual funds owned more bonds than stocks.

Source: Investment Company Institute, *Mutual Fund Fact Book*, May 2002.

Types of Investment Funds

- Growth and income funds
- Growth funds
- Aggressive growth funds
- Balanced funds
- Global equity funds
- Income-equity funds
- Bond funds
- Specialty funds.

Mutual Fund Families

- Mutual fund managing companies market a variety of types of mutual funds to investors, called families of funds.
- The intent is to provide an opportunity to change risk, asset, term and other investment profiles without changing mutual fund companies or retirement account manager.
- Funds may be switched from fund to fund at nominal charges.

Mutual Fund Families (concluded)

- Other services may include:
  - discount brokerage service--purchase/sale of individual direct securities, such as stocks and bonds.
  - Transaction Accounts--check writing and/or debit card relationship to mutual fund.
  - Pension fund management for businesses

Mutual Fund Fee Structures

- Load funds--investor pays a sales commission when shares are purchased from brokers.
- No-load funds--no initial sales fees, but other charges (Bank-end load, contingent deferred sales charge, or redemption fees) may be levied for services provided.
- 12b-1 fees - an annual fee levied against fund assets by some funds.
- Management or advisory fees
- Exchange fees and account maintenance fees.

Hedge Funds

- Hedge funds comprise investment pools that use a combination of market philosophies and analytical techniques.
- Hedge funds seek to develop financial models to identify, evaluate, and execute trading decisions.
- Hedge funds typically are organized as limited partnerships.
- The goal of a hedge fund is providing consistent, above-market returns while reducing the risk of loss.

How do Hedge Funds Differ from Mutual Funds

- Hedge funds are private, unregistered investment pools open to a limited number of accredited investors.
- Hedge fund managers receive a fee that is based on their performance.
- Mutual funds are heavily regulated investment pools registered with the SEC that are open to all investors.
- Mutual fund managers receive a fee that is percentage of the assets under management.

Traditional Hedge Fund Investment Strategies

Traditional hedge fund strategies include:

- domestic hedge strategies.
- global hedge strategies.
- global macro strategies.
- market neutral strategies.
- sector strategies.
- short strategies.

Arbitrage Hedge Fund Investment Strategies

- Arbitrage hedge fund strategies include:
  - Fixed income arbitrage.
  - Index arbitrage.
  - Closed-end fund arbitrage.
  - Convertible arbitrage.

Event-driven Hedge Fund Investment Strategies

- Event-driven hedge fund strategies include:
  - Risk arbitrage.
  - Distressed securities.
  - Special situation.

Money Market Mutual Funds (MMMF)

- Short-term money market investments.
- Provide excellent liquidity for investors.
- High quality and high yield when yield curve is inverse.
- Compete with bank deposits.

Initial growth of MMMFs affected by bank Regulation Q.

- When market rates were above Regulation Q maximum deposit rates, MMMFs grew rapidly.
- Banks were able to compete after the 1982 Depository Institutions Act when they were permitted to offer insured, Money Market Deposit Accounts (MMDA).

MMMFs' Role in the Economy

- At year end 2001, MMMFs had over $2 trillion worth of shares outstanding.
- MMMFs offer transactional conveniences that make them very competitive with bank deposits.
  - Check writing privileges, debit cards, wire transfers, sweep features.
- MMMFs that invest in tax-exempt securities can pass through interest payments that are exempt from federal (and possibly state) income taxes.
- Interest earned on bank deposits is fully taxable.

Real Estate Investment Trust (REIT)

- Is a type of closed-end investment company that invests in real estate related assets
  - Own income property.
  - Acquire mortgages.
  - Finance real estate development and construction.
  - Acquire and lease property.