

Mutual Funds and Other Investment Companies

Chapter 4

Investment Companies

- financial intermediaries that collect funds from individual investors and invest in a portfolio of assets
- shares = claims to portfolio
- services
 - administration and record keeping
 - diversification and divisibility
 - professional management
 - reduced transaction costs

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Net Asset Value

- used as a basis for the valuation of the shares issued by the investment company (the "value" of a share)
 - selling new shares
 - redeeming existing shares
- calculation

$$NAV = \frac{\text{Market value of assets} - \text{Liabilities}}{\text{Shares outstanding}}$$

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Types of Investment Organizations

- Unit Investment Trusts
 - portfolio is fixed for the entire life of the fund (*unmanaged* fund)
 - lower management fees
 - shares called *redeemable trust certificates*, usually sold at a premium

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Types of Investment Organizations (cont.)

- Managed Investment Companies
 - management company manages the portfolio for an annual fee
 - *open-end* = ready to redeem or issue shares
 - not traded on exchanges – investors buy or sell to the issuer → number of shares changes daily
 - shares price \geq NAV (if the fund carries a *load*)
 - *closed-end* = do not redeem or issue shares
 - traded on organized exchanges – investors trade with other investors
 - price \neq NAV (why? if price $<$ NAV, i.e. *selling at a discount to NAV*, higher dividend yield!)

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Types of Investment Organizations (cont.)

- Other investment organizations
 - *commingled funds* = partnerships of investors, similar to open-end funds
 - *real estate investment trusts (REITs)* = similar to closed-end funds investing in real estate, either directly (*equity trusts*) or indirectly (*mortgage trusts*)
 - *hedge funds* = “mutual funds” not registered with the SEC and open only to wealthy or institutional investors, speculating on valuation differences between assets

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Open-End and Closed-End Funds: Key Differences

- Shares outstanding
 - *closed-end*: no change unless new stock is offered
 - *open-end*: changes when new shares are sold or old shares are redeemed
- Pricing
 - *open-end*: NAV
 - *closed-end*: Premium or discount to NAV

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Mutual Funds

- open-end investment companies
- dominant for of investment company (around 90% of investment company assets)
- specific investment strategy outlined in its prospectus
- management companies usually manage a family of mutual funds (diversification)
- management companies: Vanguard, Fidelity, Putnam

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Investment Policies

- Money Market
- Equity
 - income funds = high dividend yields
 - growth funds = capital gains (riskier)
- Fixed Income (bond)
- International
- Balanced and Income
- Asset Allocation
- Index
- Specialized Sector

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Costs of Investing in Mutual Funds

■ Fee Structure

- *front-end load* = commission (sales charge) paid when buying the shares
- *back-end load* = exit fee when selling the shares
- *operating expenses* = costs incurred by the fund in operating the portfolio (expressed as percentage of total assets)
- *12b-1 charges* = distribution costs paid by the fund (advertising, annual reports, commissions paid to brokers)
- operating expenses and 12b-1 charges are deducted annually from the value of assets

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Costs of Investing in Mutual Funds (cont.)

■ Fees and Returns

- the value of an investment after n years is

$$Value_n = (1 - f) \cdot I \cdot (1 + r - e - b)^n \cdot (1 - s)$$

where:

- f = front-end load
- I = sum initially invested in fund
- r = (gross) rate of return on shares
- e = operating expenses ratio
- b = 12b-1 charges
- s = back-end load

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Costs of Investing in Mutual Funds (cont.)

■ Fees and Returns

- operating expenses and 12b-1 charges are deducted annually from the value of assets
- rate of return:

$$R = \frac{NAV_1 - NAV_0 + \text{Income and capital gain distributions}}{NAV_0}$$

- this measure does not take into account front- or back-end fees

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Exchange Traded Funds

- allow investors to trade funds based on indexes like they would trade stock
- examples
 - “spiders” (SPDR = Standard & Poor’s Depository Receipt, based on S&P 500)
 - “qubes” (based on Nasdaq 100)
 - WEBS
- advantages
 - traded continuously during the day
 - price cannot depart too much from NAV
 - cheaper than mutual funds

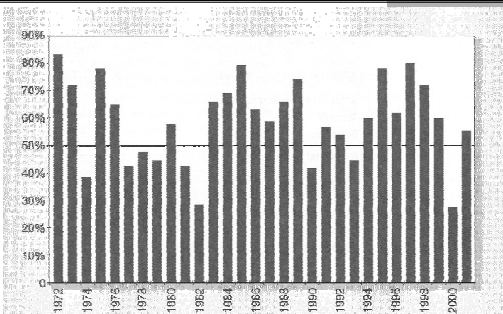
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A First Look at Fund Performance

- difficult comparison because of risk
- if benchmark is Wilshire 5000 Index (most comprehensive value-weighted index) – most funds underperform (even when adjusting for costs)
- do “good managers” continuously perform well (Goetzmann and Ibbotson, 1994)?
 - roughly 62% of “winners” tend to stay winners the following 2 years
 - seems to be a mix of luck and “skill”
 - changed over time (70s vs. 80s)
 - bad performance is more persistent

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Percentage of Funds Outperformed by the Index, 1972-2001



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