

Financial Markets +
Institutions

fifth edition



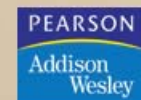
Frederic S. Mishkin

Stanley G. Eakins

Class 6

Mutual funds and
other investment
management
companies

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Money Managers

- Investing money into a portfolio of assets on behalf of their clients
- Main types
 - Mutual funds
 - Hedge funds
 - Pension funds
 - Insurance companies

History of Mutual Funds in the US

- 1824: the first mutual fund in Boston
- 1929: the stock market crash damaged the mutual fund industry
 - Small investors avoided stocks and distrusted mutual funds
- 1940: the Investment Company Act reinvigorated the industry
 - Requiring better disclosure of fees, etc.
- 1990s-2000s: on average, assets growing by 17% p.a.

TABLE 1 *Total Industry Net Assets, Number of Funds, and Number of Shareholder Accounts*

Year	Net Assets (millions)	Number of Funds	Number of Accounts (thousands)
1986	715,667	1,835	46,012
1987	769,171	2,312	54,421
1988	809,370	2,708	54,676
1989	980,671	2,900	58,135
1990	1,065,194	3,081	61,948
1991	1,393,189	3,405	68,334
1992	1,642,543	3,826	79,932
1993	2,070,023	4,538	93,217
1994	2,155,396	5,330	114,388
1995	2,811,484	5,728	131,231
1996	3,526,270	6,254	150,176
1997	4,468,200	6,684	170,521
1998	5,525,209	7,314	193,854
1999	6,846,339	7,791	226,872
2000	6,965,249	8,171	243,518
2001	6,974,950	8,305	248,809
2002	6,390,360	8,244	251,224
2003	7,414,080	8,126	260,650

Source: Investment Company Institute, *2004 Mutual Fund Fact Book*, 44th ed. (Washington, DC: ICI), p. 105.

Current Position of Mutual Funds

- Largest financial intermediary in the US:
 - Controlling over \$8 trln, 16% of assets held by intermediaries
 - Over \$16 trln assets in the world
- There are over 8,000 funds in the US alone
 - Over 55,000 in the world
- Broad ownership
 - Half of households hold MF shares
 - MF account for \$2.7 trln (22%) of the retirement market

TOTAL INVESTMENT COMPANY ASSETS, 1995–2004

(billions of dollars)

Year	Mutual Funds ¹	Closed-End Funds	ETFs ²	UITs	Total ³
1995	2,811	143	1	73	3,028
1996	3,526	147	2	72	3,747
1997	4,468	152	7	85	4,712
1998	5,525	156	16	94	5,791
1999	6,846	147	34	92	7,119
2000	6,965	143	66	74	7,248
2001	6,975	141	83	49	7,248
2002	6,390	159	102	36	6,687
2003	7,414	214	151	36	7,815
2004	8,107	254	226	37	8,624

¹Mutual fund data exclude mutual funds that primarily invest in other mutual funds.

²ETF data prior to 2001 were provided by Strategic Insight.

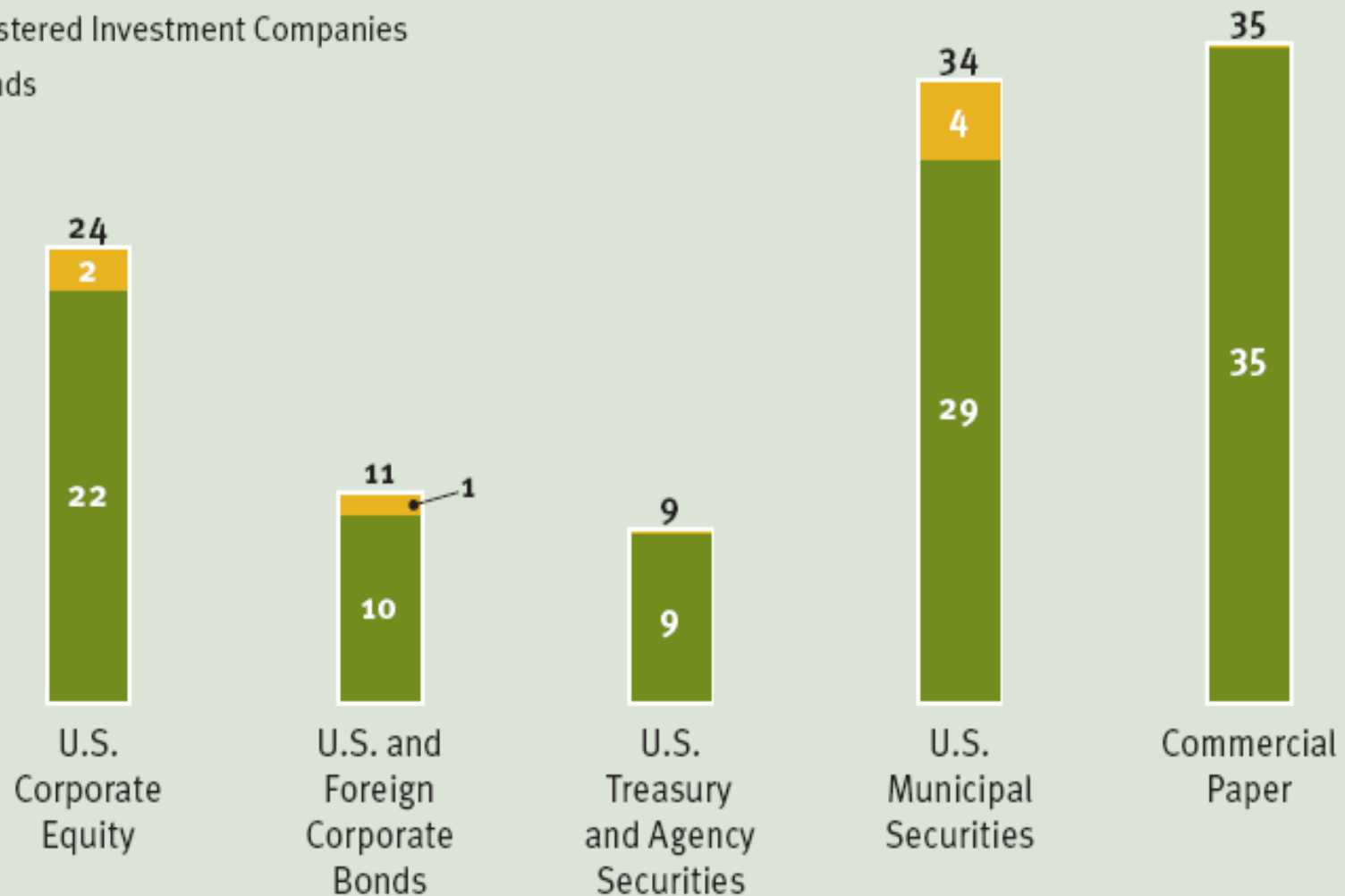
³Total investment company assets include mutual fund holdings of closed-end funds and ETFs.

Sources: Investment Company Institute and Strategic Insight Mutual Fund Research and Consulting, LLC

INVESTMENT COMPANY HOLDINGS OF SELECTED SECURITIES, 2004

(share of total market securities held by investment companies)

- Other Registered Investment Companies
- Mutual Funds



Note: Components may not add to totals because of rounding.

Sources: Investment Company Institute, Federal Reserve Board, and World Federation of Exchanges



Benefits of Mutual Funds

- Low transaction costs
 - Easy way to buy a diversified portfolio
- Customer services
 - Liquidity insurance
 - Easy transfer across funds within the family
- Professional management
 - Selecting right stocks at right time?

The Organization of Mutual Funds

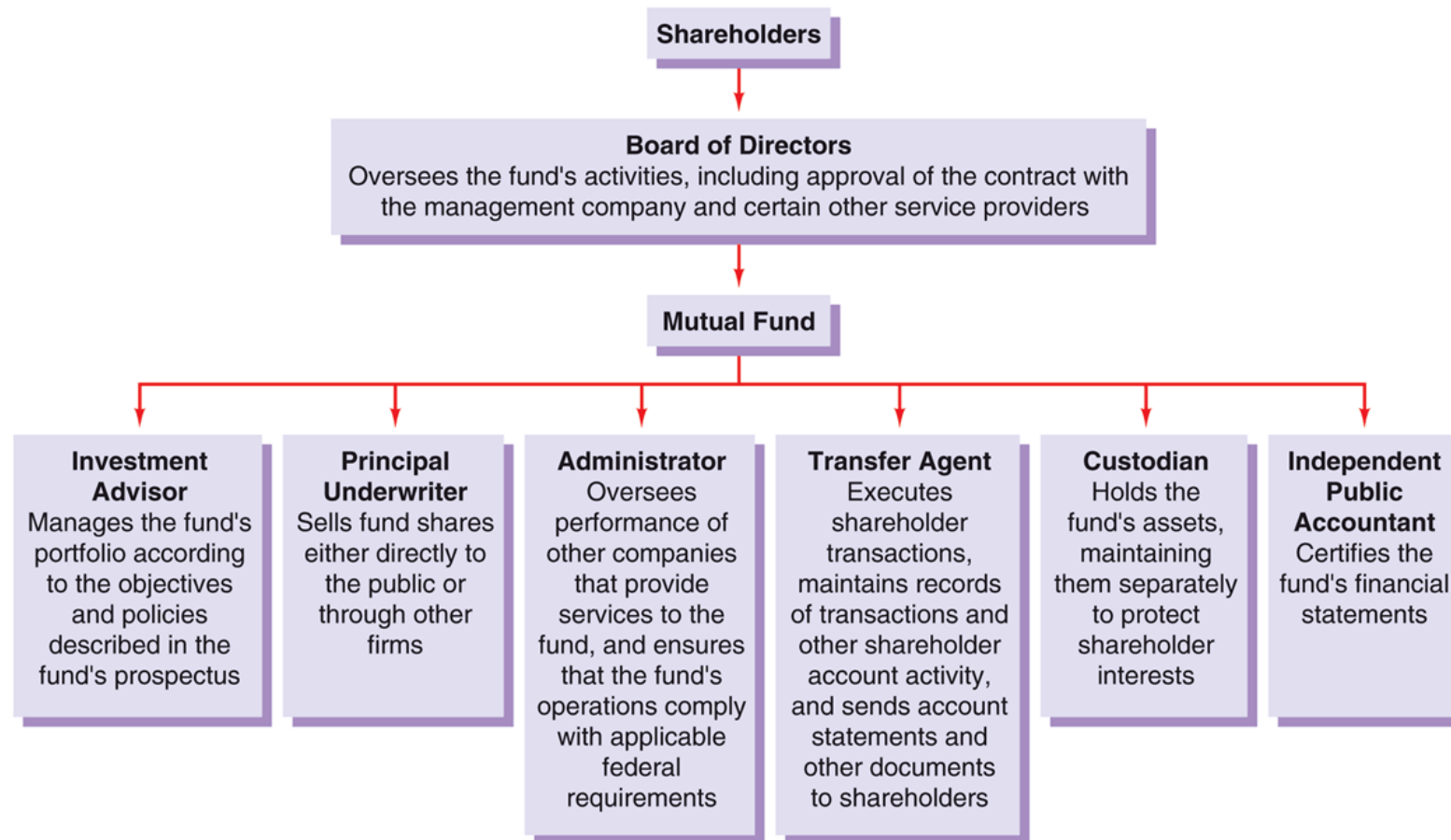


Figure 21.3 The Organizational Structure of a Mutual Fund

The Organization of Mutual Funds

- MF have limited internal resources
 - Specific services are provided by affiliated organizations and independent contractors
- Investment advisor (management company) manages the assets for a fee
 - The fee is usually proportional to fund's TNA
 - The management company offers a family of funds with different investment objectives

The Organization of Mutual Funds

- In theory, the board can fire the fund manager
 - In practice, most funds are created by the management company
 - Fidelity Magellan Fund would probably lose its name and reputation if it fired Fidelity
- 2001 SEC rules: independent directors must constitute a majority of the board

Main Types of Mutual Funds

- Open-end mutual funds
 - Shares are “marked to market” daily
 - Net Asset Value = Total Net Assets (TNA) per share
 - Obligated to buy/sell shares at NAV



Main Types of Mutual Funds

- Closed-end mutual funds
 - The fund issues a fixed number of shares that are traded at the secondary market
 - The share price is usually lower than the market value of the fund's portfolio
 - Usually created for illiquid assets or when open fund becomes too big

Main Types of Mutual Funds

- Active funds vs. index funds
 - Index fund mimicks the selected index for a low fee
 - Active fund uses a specific strategy and charges a higher fee
- Load funds vs. no-load funds
 - Sales loads: front, deferred, and annual 12b-1 fee
 - Correspond to class A/B/C shares of the same fund

Investment Objective Classes

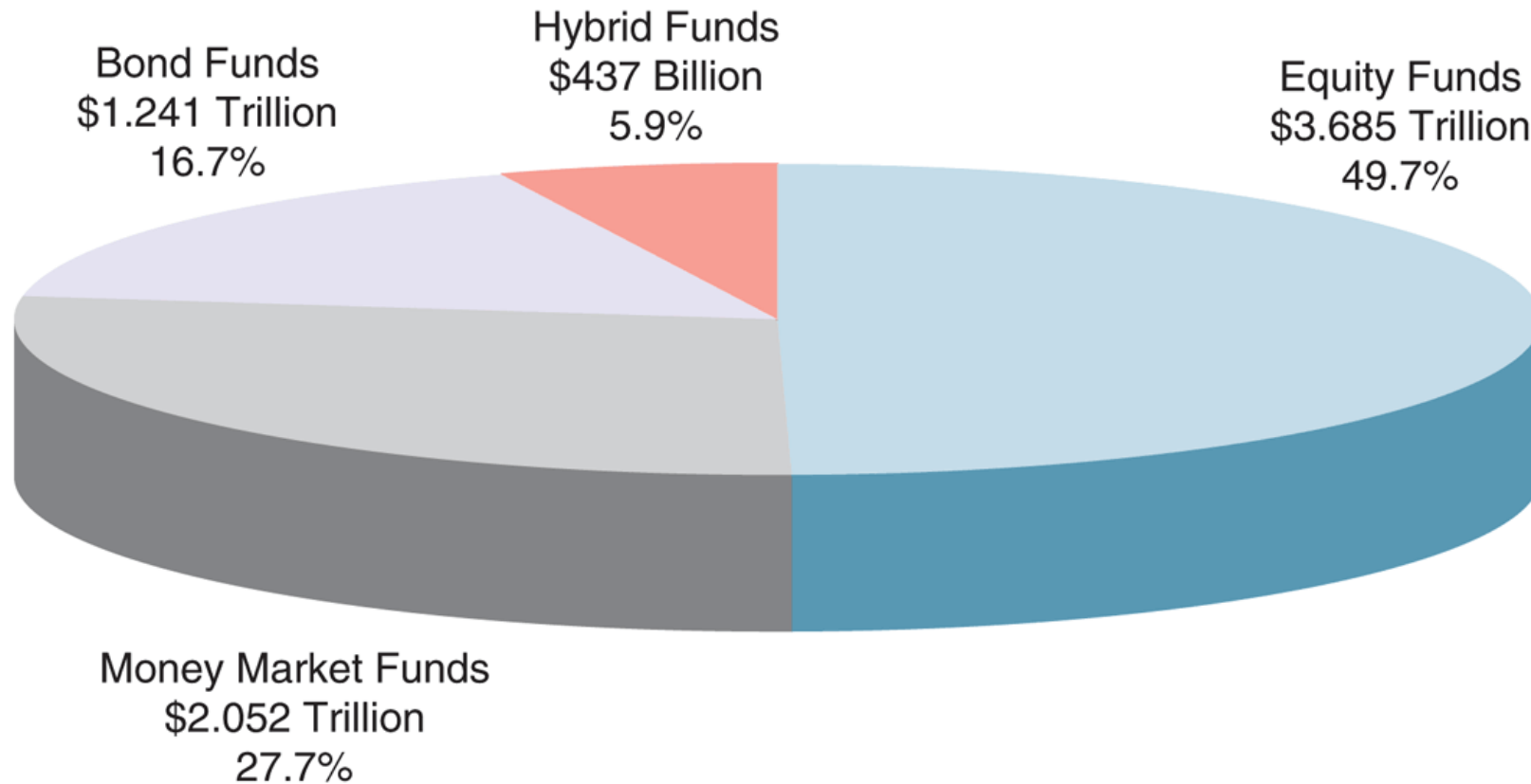


Figure 21.4 Distribution of Assets Among Types of Mutual Fund, 2004

Investment Objective Classes

- Stock (equity) funds
 - Capital Appreciation Funds seek rapid increase in share price, no dividends
 - Total Return Funds seek a balance of current income and capital appreciation
 - World Equity Funds invest primarily in foreign firms

Investment Objective Classes

- Bond funds
 - Strategic Income Funds invest primarily in U.S. corporate bonds, seeking a high level of current income
 - Government Bond Funds invest in U.S. Treasury, state and local government bonds.

Investment Objective Classes

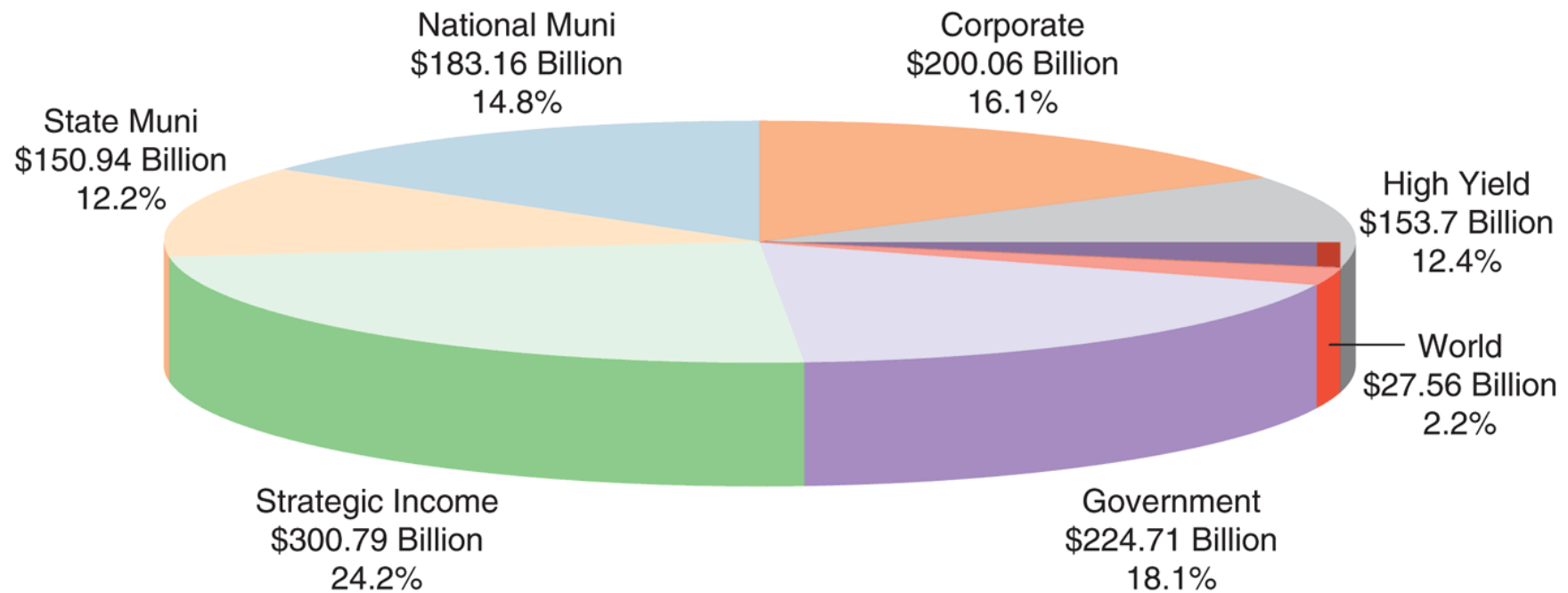


Figure 21.5 Assets Invested in Different Types of Bond Mutual Funds

Investment Objective Classes

- Hybrid funds
 - Combine stocks and bonds into a single fund.
 - Account for about 7% of all mutual fund accounts.
- Money market funds
 - Open-end funds that invest only in money market securities.
 - Offer check-writing privileges.

Investment Objective Classes

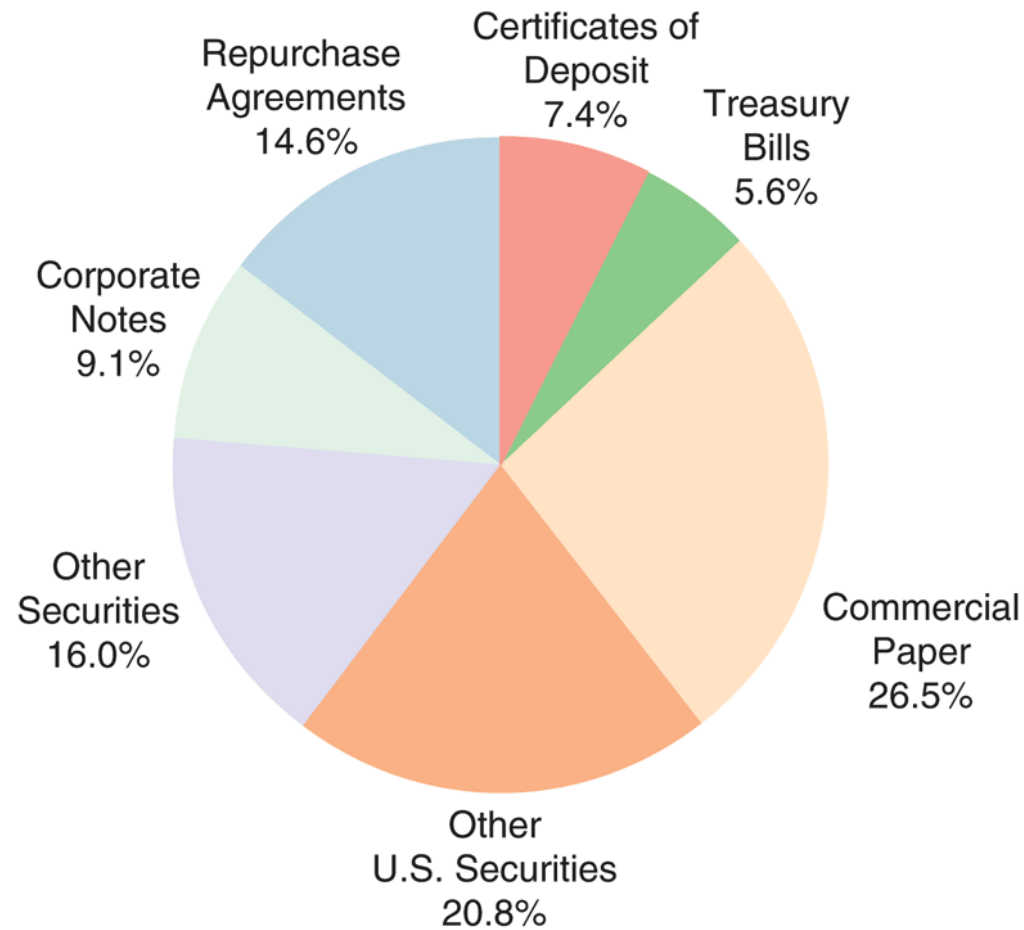


Figure 21.7 Average Distribution of Money Market Fund Assets, 2004

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Discussion topic

What is the main benefit of mutual funds for their investors?



Hedge Funds

- **Private** investment companies for wealthy individual investors and institutional investors
 - High minimum investment, averaging around \$1mln
 - Long-term commitment of funds is required
- Little regulation
 - 55% of funds are domiciled offshore
 - If onshore, not subject to direct SEC regulation



Hedge Funds

- Performance-based fees
 - E.g., 1% of assets + 20% of profits
 - High watermark provision
- More aggressive strategy
 - High leverage
 - Using complicated instruments
 - Usually, the income is market-neutral



Typical Strategies

- Long-short: buy undervalued, sell overvalued
 - E.g., long AAA bonds, short Treasury bonds
- Event-driven
 - E.g., buy stock before the merger
- Macro
 - E.g., bet on weakening of the dollar
- Lately, move to investment banking
 - Provide financing for M&A, private equity, etc.

Event-Driven Strategies

ПРАВИЛЬНОГО ПАРТНЕРА

помог выбрать компании Arcelor
портфельный менеджер Оппетит



СДУВАННИЕ «ПУЗЫРЯ»

на американском рынке
недвижимости может принести доход



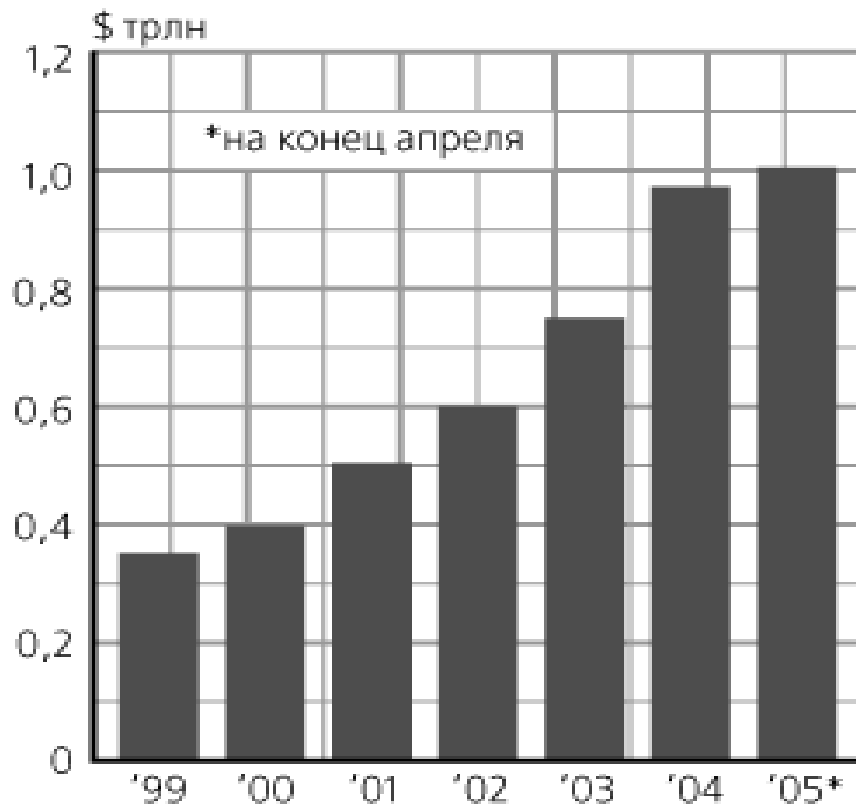


Hedge Funds

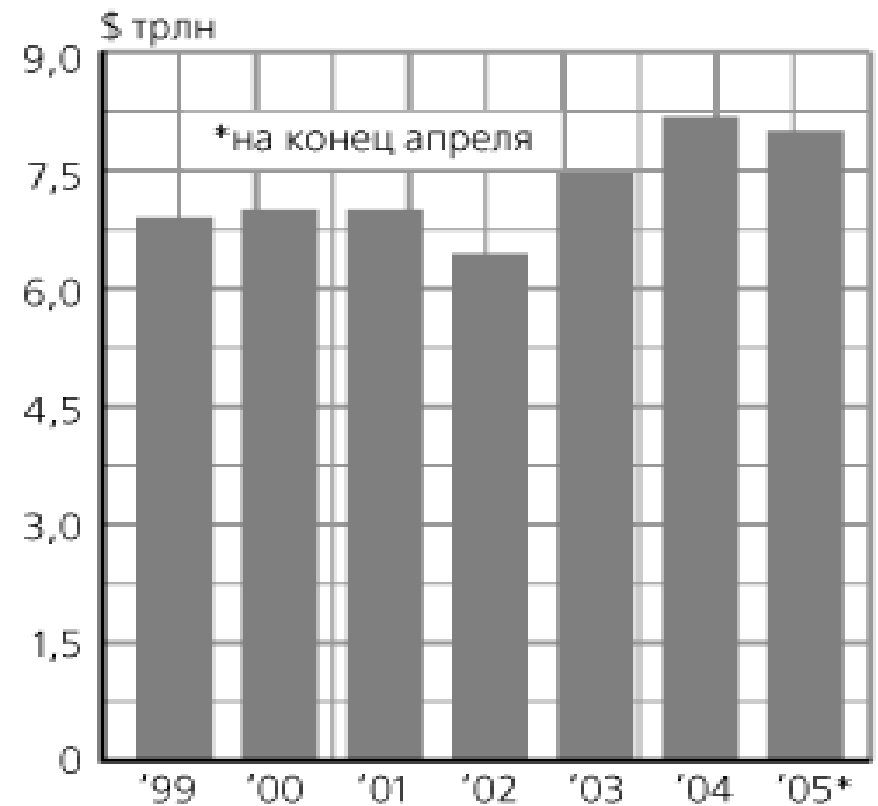
- Over 9,000 funds in the world
 - 1,000 funds of funds
- Assets over \$1,2 trln
 - Doubled over the last 5 years
 - 30% held by institutional investors

Hedge Funds vs. Mutual Funds

**РОСТ АКТИВОВ
В ХЕДЖ-ФОНДАХ**



**РОСТ АКТИВОВ
В ПАЕВЫХ ФОНДАХ**

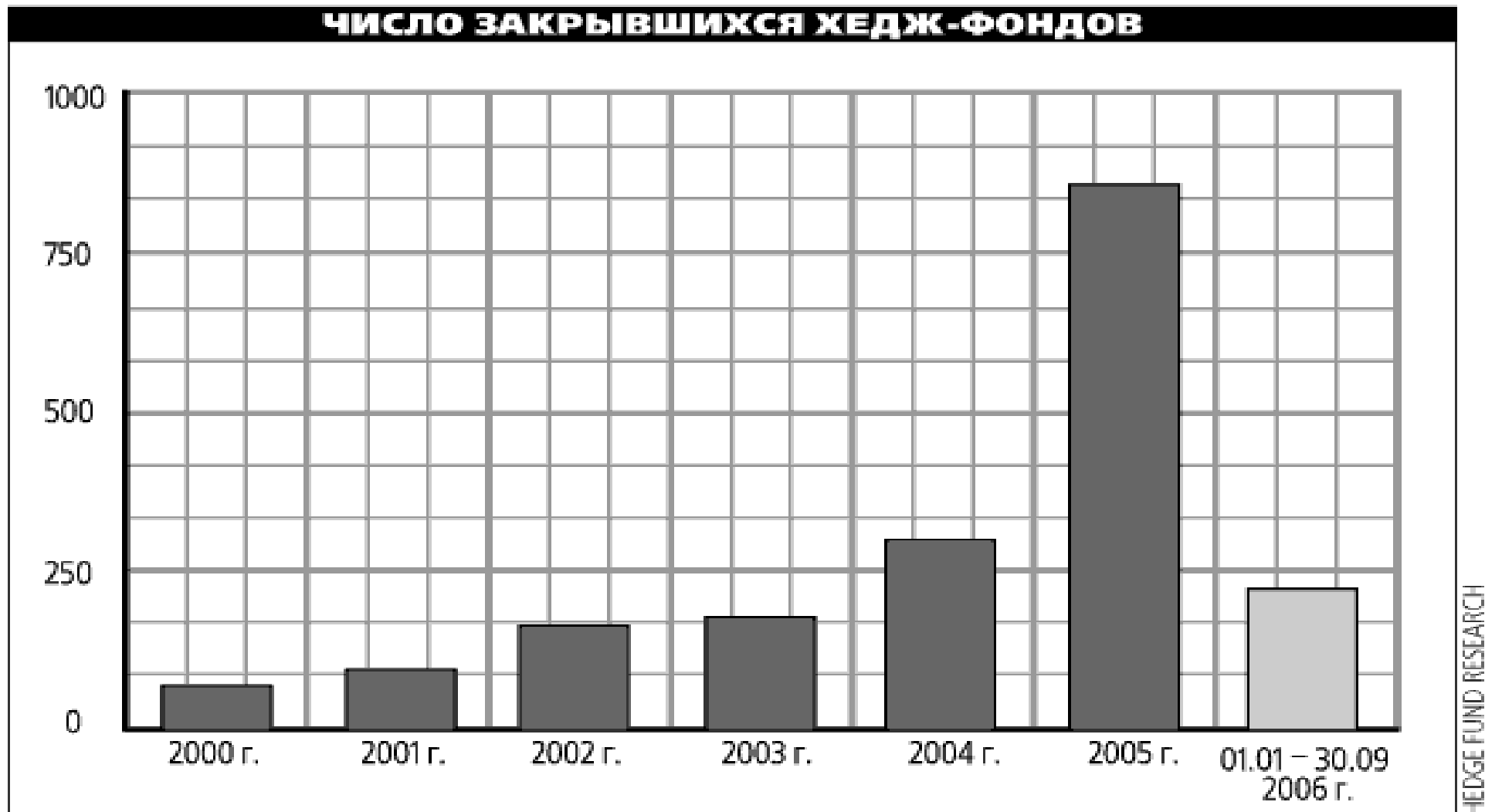




Hedge Funds

- High return...
 - On average, 11% p.a. during the last 10 year
- and high risks
 - 1998: LTCM lost \$4.6 bln on bonds and interest rate derivatives
 - 2006: Amaranth lost \$6.2 bln on energy derivatives
- The attrition rate is growing
 - 848 funds disappeared in 2006

The Attrition Rate is Growing





Insurance Companies

- Assume the risk of their clients in return for the **premium**
 - Life Insurance
 - Term Life: the insured is covered while the policy is in effect, usually 10–20 years.
 - Whole Life: when the term expires, the insured can get the cash value of the policy.
 - Health Insurance
 - Property and Casualty Insurance



Insurance Companies

- Two types of organization
 - **Stock company:** owned by shareholders, has a profit motive
 - **Mutual insurance company:** owned by the policyholders, attempts to provide the lowest cost insurance
- Reinsurance companies
 - Sell policies to other insurance companies, allowing them to reduce their risks

Growth of Insurance Companies

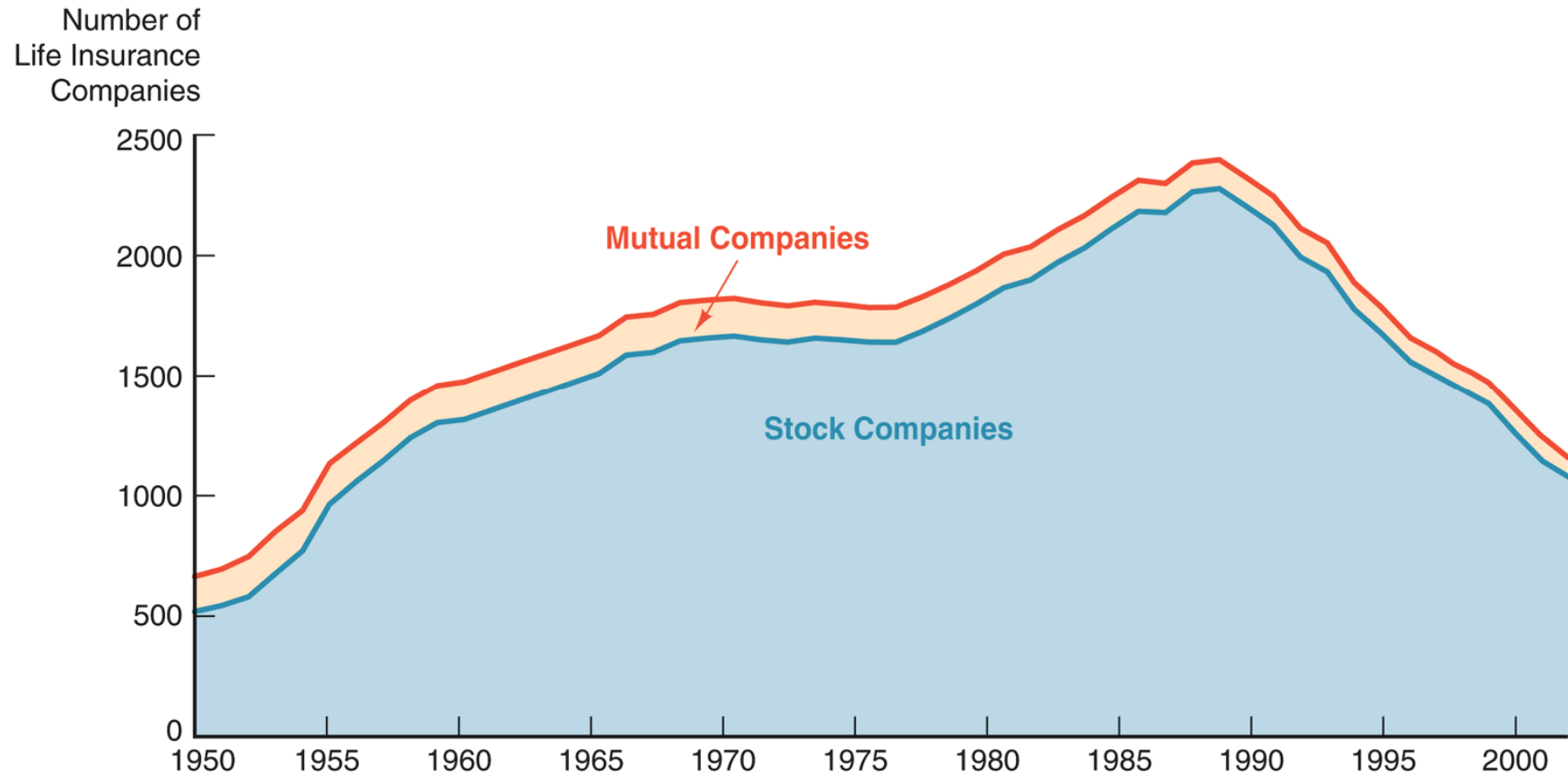


Figure 22.2 Number of Life Insurance Companies in the U.S., 1950-2002



Pension Funds

- Pension plan: asset pool that accumulates over working years and is paid out later
- **Defined-Benefit Pension Plan**
 - The sponsor promises the employees a specific benefit (annuity) when they retire
 - E.g., $2\% \times \text{average of final 3 years' income} \times \text{years of service}$
- **Defined-Contribution Pension Plan**
 - Certain amounts are contributed to the account is invested for retirement
 - The benefit payout is uncertain, based solely on the amount accumulated at the account



Pension Funds

- Private Pension Plan
 - A pension plan set up by employers, groups, or individuals
- Public Pension Plan
 - A pension plan set up by a government body for the general public (e.g., Social Security)
 - **Pay as you go** system: current funding is used to pay current benefits.
 - Aging of population may lead to the underfunding



Pension Funds

- 1978: Pension Reform Act in the US
 - Individual retirement accounts (**IRAs**)
 - **401(k)** plans: employer-sponsored retirement plans
 - Taxes are deferred if the funds are held until the retirement

The Retirement Money

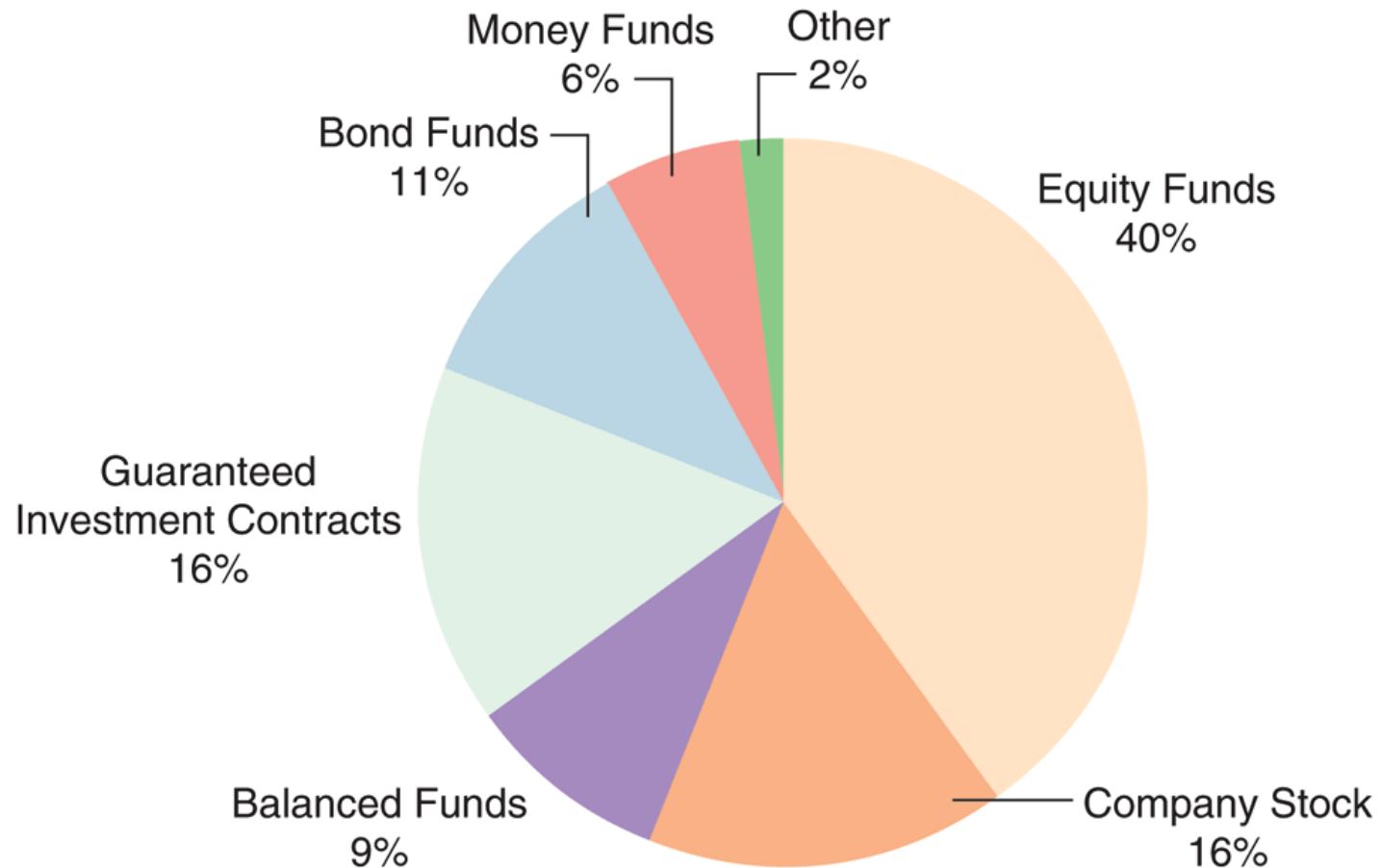


Figure 21.2 Average Asset Allocation for All 401(k) Plan Balances

Life Insurance Company Assets

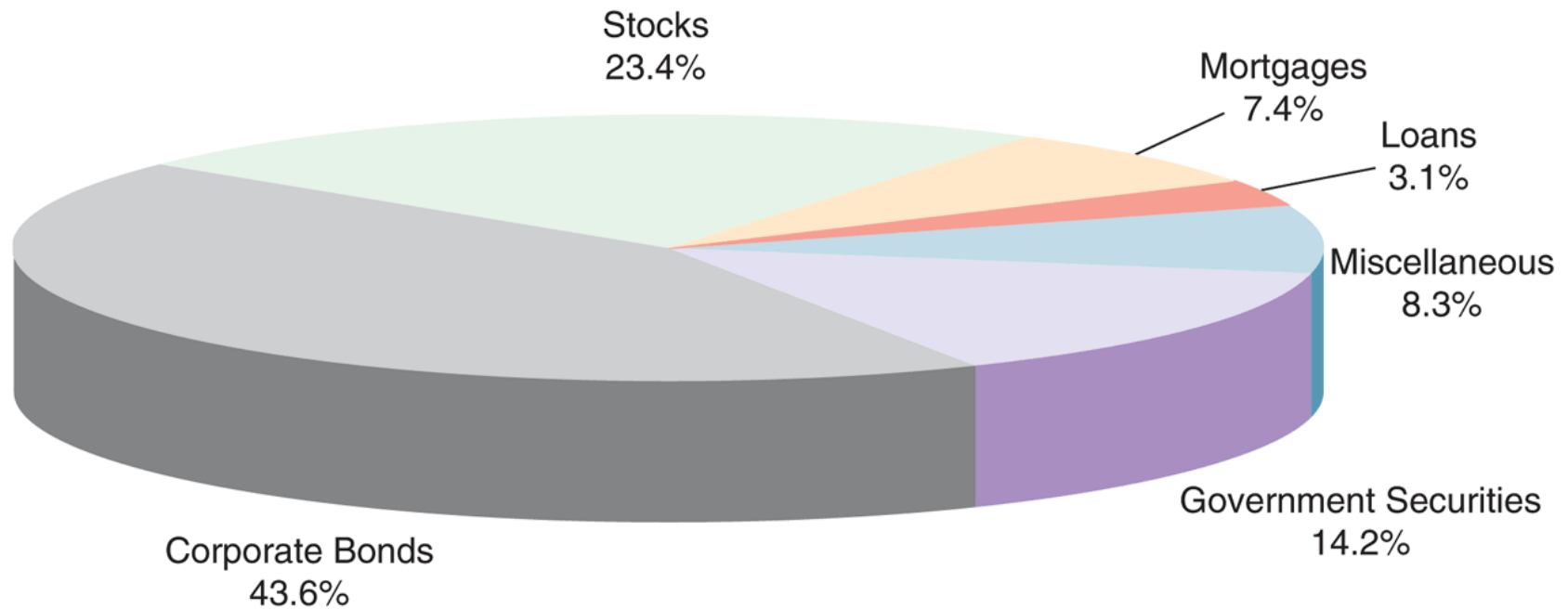


Figure 21.3 Distribution of Life Insurance Company Assets (beginning of 2003)

Private Pension Plan Assets

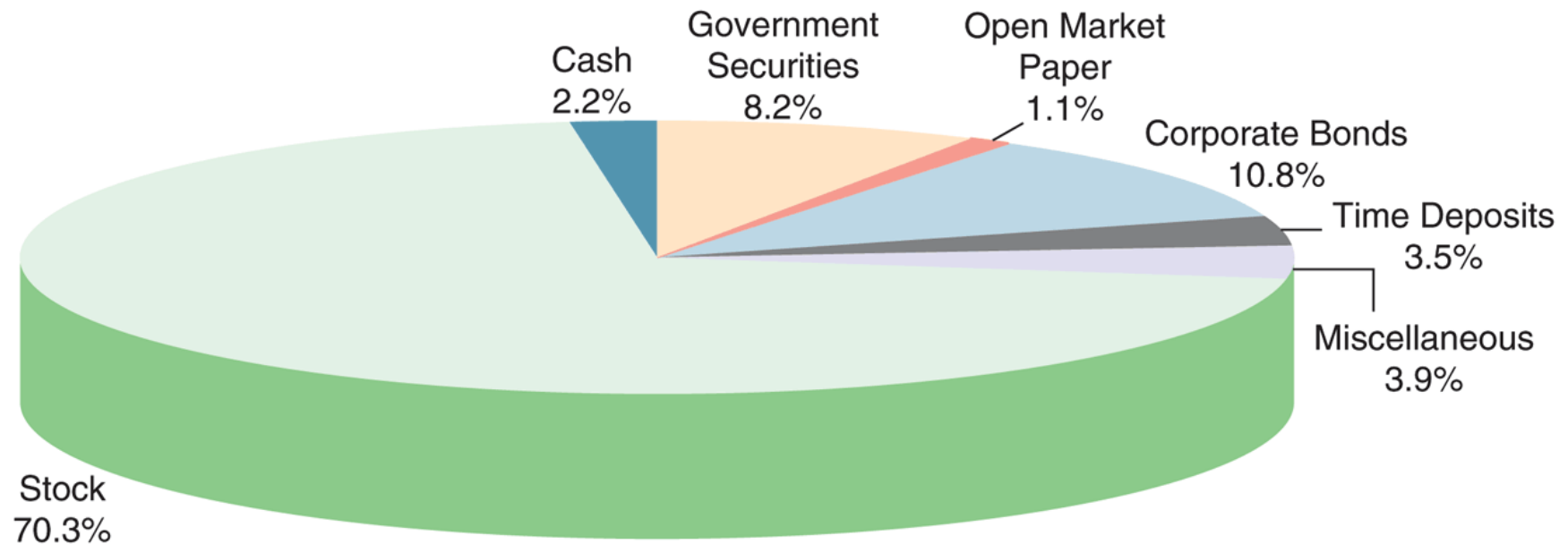


Figure 22.5 Distribution of Private Pension Plan Assets (end of 2003)

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Discussion topic

What hinders the growth of the pension fund industry in Russia?

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