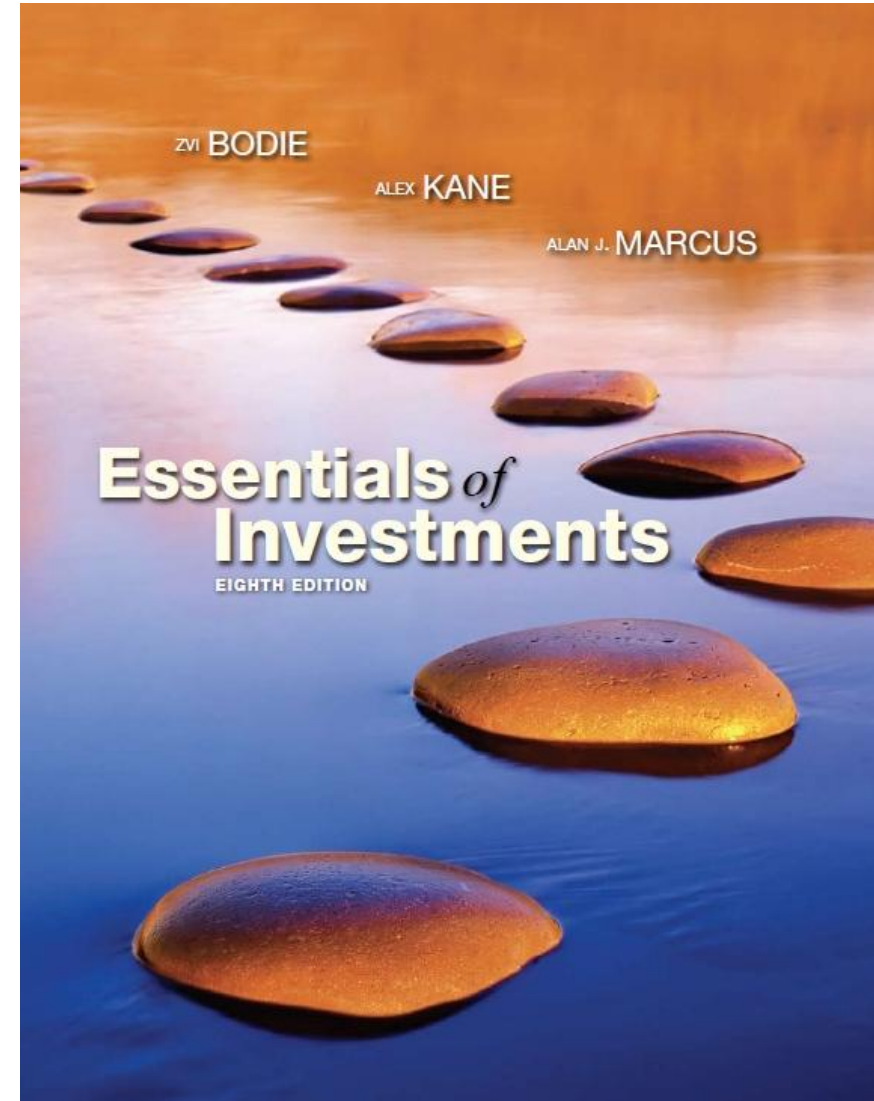


Chapter 4

Mutual Funds and Other Investment Companies



4.1 Investment Companies



Services of Investment Companies

a. Administration & record keeping

- ❖ Tax purposes
- ❖ Low cost reinvestment
- ❖ Low cost additional investment, DCA
- ❖ Low cost switching between fund families
- ❖ Some funds may allow check writing privileges



Services of Investment Companies

b. Diversification

- Low cost, instant diversification

c. Professional management

- Lower research costs
- Portfolio managed according to specific objectives
- Professionals to find undervalued securities and/or engage in asset allocation strategies

d. Reduced transaction costs

e. Investing for retirement:

Most funds can be set up as an IRA



4.2 Types of Investment Companies



Organizational Forms

Unit Investment Trusts (UITs): unmanaged, fixed composition portfolios

- ❖ Any interest and/or dividends are distributed immediately to trust certificate holders.
- ❖ Provide diversification within one sector or area and low cost entry.
- ❖ Often levered, rates of return can be extreme.



Organizational Forms

Managed Investment Companies: Managed, usually changing composition portfolio.

- ❖ **More commonly known as a 'mutual fund'**
- ❖ **The fund's board of directors typically hires an investment advisor to select and manage the fund assets according to some specific goal(s) set by the board and any regulatory requirements.**
- ❖ **The investment advisor usually creates the fund and selects the investments. Most funds are of this type.**



Organizational Forms

A managed investment company (mutual fund) may be

❖ *Open end*

- *shares are bought from the fund and redeemed by the fund or*

❖ *Closed end*

- *shares are bought and sold among investors in the marketplace (NASDAQ or an exchange) and the fund itself is not involved.*



Differences in Open & Closed End

Most funds are open end:

The advantage of the open end form is

- ❖ Liquidity for the investor
- ❖ Fund's ability to grow (advantage for the fund or sponsor)

The disadvantage of the open end form is

- ❖ The need to keep a cash reserve
- ❖ Vulnerable to panics



Other Investment Organizations

– Commingled funds

- **Partnerships of investors that pool their funds. Designed for trusts or larger retirement accounts to get professional management for a fee. Operates similar to a mutual fund.**

– REITs

- **Similar to closed end fund. Invest in real estate and real estate loans.**

Equity trusts purchase real estate.

Mortgage trusts invest in mortgage and construction loans.



Other Investment Organizations Cont.

– Hedge Funds

- **Similar to mutual funds, but *not registered and not subject to SEC regulations.***
- ***Available to institutional and high net worth investors***
- **Can pursue investment strategies that are not allowed for mutual funds.**

–

Grew from about \$50 billion in 1990 to about \$2 trillion in 2008.



4.3 Mutual Funds



Net Asset Value

Used as a basis for valuation of investment company shares

- Selling new shares
- Redeeming existing shares

Calculation

$$\text{NAV} = \frac{\text{Market Value of Fund Assets} - \text{Fund Liabilities}}{\text{Fund shares outstanding}}$$



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: Fund share price = Net Asset Value (NAV)
- ❖ Closed-end: Fund share price may trade at a premium or discount to NAV



NAV calculation

ABC Fund (\$Millions except NAV)

Market Value Securities	\$550.00
+ Cash & Receivables	75.00
<u>- Current Liabilities</u>	<u>(20.00)</u>
NAV Total	\$605.00
<u>÷ # Fund Shares</u>	<u>20.00</u>
NAV	\$ 30.25

Most Mutual Funds have little or no Long Term Debt



How Funds Are Sold

Directly marketed

- You find them
- May avoid front end load
 - Front end load is an up front cost (fee) to purchase a share of a mutual fund.

Sales force distributed

- Recommended by a broker or planner
- Usually will have a front end load
- May be revenue sharing on sales force distributed
 - Potential conflict of interest



How Funds Are Sold

Financial supermarkets

- E.G., Charles Schwab

- Avoid a direct load, but may cost you more in expenses

- Low cost switching even between fund families and easier to interpret record keeping



4.4 Costs of Investing in Mutual Funds



Costs of Investing in Mutual Funds

Fee Structure

- Front-end load
- Back-end load (contingent), (redemption fee)

Operating expenses

- Buying and selling commissions, administrative expenses and advisory fees for the managers

12 b-1 charges

- Marketing costs paid by the fundholders
- Alternative to a load, but assessed annually
- Maximum is 1% of assets



Costs of Investing in Mutual Funds

Fees, loads and performance

- **Gross performance of load funds is statistically identical to gross performance of no load funds**
- **Why pay a load charge?**
- **Funds with high expenses tend to be poorer performers.**
 - **12 b-1 charges should be added to expense ratios**
 - **Costs found in the fund prospectus and may be compared via Morningstar**



Costs of Investing in Mutual Funds

Expense ratios:

- ❖ Funds charge annual operating expenses and annual advisory or management fees against the NAV.
 - *Expense ratios* are calculated as *Annual Expenses / Average NAV*
 - A "well managed" fund probably should have an *expense ratio* of less than 2%.
- ❖ All costs and charges must be revealed *in the fund's prospectus.*



4.6 Exchange Traded Funds



Exchange Traded Funds

ETFs allow investors to trade index portfolios like shares of stock **SPDRs and Diamonds, Cubes, WEBS**

Examples:

Potential advantages

- **Trade continuously throughout the day**
- **Can be sold short or purchased on margin**
- **Potentially lower taxes**
 - **No fund redemptions**
 - **Large investors can exchange their ETF shares for shares in the underlying portfolio**
- **Lower costs (No marketing; lower fund expenses)**



Exchange Traded Funds

Potential disadvantages

- ❖ **Small deviations from NAV are possible**
- ❖ **Must pay a brokerage commission to buy an ETF but a no load index fund may be purchased online for no commission.**



4.7 Mutual Fund Investment Performance: A First Look



First Look at Mutual Fund Performance

- ❖ Evidence shows that average mutual fund performance is generally less than broad market performance
- ❖ Evidence suggests that over certain horizons some persistence in positive performance
 - Evidence is not conclusive
 - Some inconsistencies



4.8 Information on Mutual Funds



Sources of Information on Mutual Funds

- ❖ **Wiesenberger's Investment Companies**
- ❖ **Morningstar (www.morningstar.com)**
- ❖ **Fund prospectus (a must read)**
- ❖ **Yahoo**
- ❖ **Wall Street Journal**
- ❖ **Investment Company Institute (www.ici.org)**
- ❖ **AAll**
- ❖ **Brokers**

- ❖ **Background information: "A Random Walk Down Wall Street," by Burton Malkeil**



Figure 4.4 Morningstar Report

Data through July 31, 2005 Reprinted by permission of Morningstar.

Fidelity Magellan

Governance and Management

Stewardship Grade: B

Portfolio Manager(s)

Robert Stansky is an experienced manager who is backed by Fidelity's scores of analysts. Before taking over here, he ran Fidelity Growth Company from April 1987 to June 1996. Over that time Stansky produced an annualized return of 13.16%, compared with 10.00% for the average large-growth fund and 11.47% for the S&P 500. Stansky joined Fidelity in 1983 after earning an MBA from New York University.

Strategy

Robert Stansky likes to move into growth areas when they are temporarily depressed. Because the fund is so large, he cannot trade in and out of positions easily. He looks for stocks he can hold for several years. He favors stocks with above-average growth rates but marketlike prices. Stansky focuses on understanding the assumptions and expectations embedded in an analyst's estimates for a company to be certain that a company's growth engines will really work as expected. Because of the fund's size, it owns stocks across varied industries.

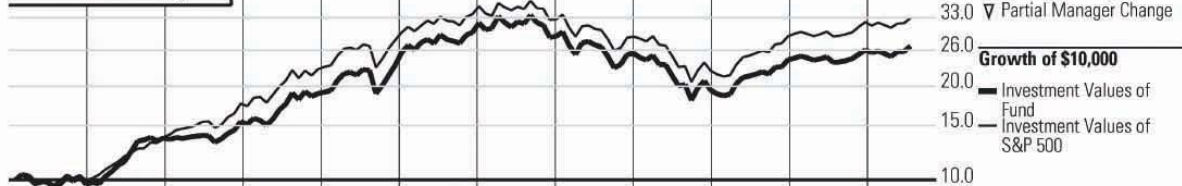
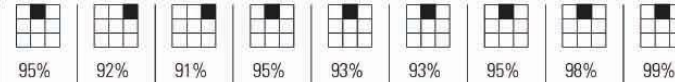
Performance 07-31-05

	1st Qtr	2nd Qtr	3rd Qtr	4th Qtr	Total
2001	-12.41	7.18	-15.36	11.18	-11.65
2002	-1.60	-13.72	-16.36	7.51	-23.66

Ticker FMAGX **Load** Closed **NAV** \$106.35 **Yield** 1.2% **Total Assets** \$55,956 mil **Mstar Category** Large Blend

Historical Profile

Return Below Avg
Risk Average
Rating ★★
Below Avg



	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	07-05	History
NAV	66.80	85.98	80.65	95.27	120.82	136.63	119.30	104.22	78.96	97.74	103.79	106.35	NAV
Total Return %	-1.81	36.82	11.69	26.59	33.63	24.05	-9.29	-11.65	-23.66	24.82	7.49	2.75	Total Return %
+/-S&P 500	-3.13	-0.71	-11.26	-6.76	5.05	3.01	-0.19	0.23	-1.57	-3.85	-3.38	-0.13	+/-S&P 500
+/-Russ 1000	-2.20	-0.95	-10.76	-6.26	6.61	3.14	-1.50	0.80	-2.01	-5.07	-3.91	-1.25	+/-Russ 1000
Income Return %	0.18	0.88	1.41	1.57	0.72	0.63	0.20	0.39	0.61	0.96	1.27	0.27	Income Return %
Capital Return %	-1.99	35.94	10.28	25.02	32.91	23.42	-9.49	-12.04	-24.27	23.86	6.22	2.48	Capital Return %
Total Rtn % Rank Cat	73	24	96	60	4	26	68	44	73	72	82	57	Total Rtn % Rank Cat
Income \$	0.13	0.59	1.10	1.25	0.67	0.73	0.27	0.46	0.64	0.76	1.24	0.28	Income \$
Capital Gains \$	2.64	4.69	12.85	5.21	5.15	11.39	4.69	0.80	0.00	0.00	0.00	0.00	Capital Gains \$
Expense Ratio %	0.99	0.96	0.92	0.64	0.61	0.60	0.74	0.88	0.88	0.76	0.70	0.62	Expense Ratio %
Income Ratio %	1.07	0.39	0.95	1.75	0.77	0.66	0.46	0.29	0.43	0.82	0.83	1.26	Income Ratio %
Turnover Rate %	132	120	155	67	34	37	28	17	5	21	13	6	Turnover Rate %
Net Assets \$mil	36,442	53,702	53,989	63,766	83,552	105,939	93,067	79,515	56,751	67,995	63,296	55,956	Net Assets \$mil

