Chapter 4

Mutual Funds

Mutual Funds: Overview

- Our goal in this chapter is to understand the different types of mutual funds, their risks, and their returns.
- Around 1980, 5 million Americans owned mutual funds.
- However, by 2007, 96 million Americans in 55 million households owned mutual funds.
- In 2006 investors added $474 billion in net new funds to mutual funds.
- In 2006, mutual fund assets totaled $10.4 trillion.

Mutual Funds: Overview, Cont.

- Mutual funds are simply a means of combining or pooling the funds of a large group of investors.
- The buy and sell decisions for the resulting pool are then made by a fund manager, who is compensated for the service provided.
- Like commercial banks and life insurance companies, mutual funds are a form of financial intermediary.

Investment Companies and Fund Types, I.

- An investment company is a business that specializes in pooling funds from individual investors and making investments.
- An open-end fund is an investment company that stands ready to buy and sell shares in itself to investors, at any time.
- A closed-end fund is an investment company with a fixed number of shares that are bought and sold by investors, only in the open market.

Investment Companies and Fund Types, II.

- Net asset value (NAV) is the value of the assets held by a mutual fund, divided by the number of shares.
- Shares in an open-end fund are worth their NAV, because the fund stands ready to redeem their shares at any time.
- In contrast, share value of closed-end funds may differ from their NAV.

Investment Companies and Fund Types, III.
Mutual Fund Operations
Organization and Creation

- A mutual fund is simply a corporation. It is owned by shareholders, who elect a board of directors.

- Most mutual funds are created by investment advisory firms (say Fidelity Investments), or brokerage firms with investment advisory operations (say Merrill Lynch).

- Investment advisory firms earn fees for managing mutual funds.

Mutual Fund Operations
Taxation of Investment Companies

- A “regulated investment company” does not have to pay taxes on its investment income.

- To qualify, an investment company must:
  - Hold almost all its assets as investments in stocks, bonds, and other securities,
  - Use no more than 5% of its assets when acquiring a particular security, and
  - Pass through all realized investment income to fund shareholders.

Mutual Fund Operations
The Fund Prospectus and Annual Report

- Mutual funds are required by law to supply a prospectus to any investor who wishes to purchase shares.

- Mutual funds must also provide an annual report to their shareholders.

Mutual Fund Costs and Fees
Types of Expenses and Fees

- Sales charges or “loads”
  - Front-end loads are charges levied on purchases.
  - Back-end loads are charges levied on redemptions.

- 12b-1 fees. SEC Rule 12b-1 allows funds to spend up to 1% of fund assets annually to cover distribution and marketing costs.

- Management fees
  - Usually range from 0.25% to 1.00% of the fund’s total assets each year.
  - Are usually based on fund size and/or performance.

- Trading costs
  - Not reported directly
  - Funds must report “turnover,” which is related to the amount of trading.
  - The higher the turnover, the more trading has occurred in the fund.
  - The more trading, the higher the trading costs.

Mutual Fund Costs and Fees
Expense Reporting

- Mutual funds are required to report expenses in a fairly standardized way in their prospectus.
  - Shareholder transaction expenses - loads and deferred sales charges.
  - Fund operating expenses - management and 12b-1 fees, legal, accounting, and reporting costs, director fees.
  - Hypothetical example showing the total expenses paid by investors through time per $10,000 invested.

Example: Fee Table

Fidelity®
Low-Priced Stock Fund
(Fund number 316, trading symbol FLPDX)

Prospectus
September 29, 2006
Mutual Fund Costs and Fees
Why Pay Loads and Fees?

• After all, many good no-load funds exist.
• But, you may want a fund run by a particular manager. All such funds are load funds.
• Or, you may want a specialized type of fund.
  – Perhaps one that specialized in Italian companies
  – Loads and fees for specialized funds tend to be higher, because there is little competition among them.

Short-Term Funds, I.

• Short-term funds are collectively known as money market mutual funds.
• Money market mutual funds (MMMFs) are mutual funds specializing in money market instruments.
  – MMMFs maintain a $1.00 net asset value to make them resemble bank accounts.
  – Depending on the type of securities purchased, MMMFs can be either taxable or tax-exempt.

Short-Term Funds, II.

• Most banks offer what are called "money market" deposit accounts, or MMDAs, which are much like MMMFs.
• The distinction is that a bank money market account is a bank deposit and offers FDIC protection.

Long-Term Funds

• There are many different types of long-term funds, i.e., funds that invest in long-term securities.
• Historically, mutual funds were classified as stock funds, bond funds, or income funds.
• Today, the investment objective of the fund is the major determinant of the fund type.

Stock Funds, I.

• Some stock funds trade off capital appreciation and dividend income.
  – Capital appreciation
  – Growth
  – Growth and Income
  – Equity income
• Some stock funds focus on companies in a particular size range.
  – Small company
  – Mid-cap
  – Large-cap
• Some stock funds invest in different parts of the world.
  – Global
  – International
  – Regional
  – Country
  – Emerging markets

Stock Funds, II.

• Sector funds specialize in specific sectors of the economy, such as:
  – Biotechnology
  – Internet
  – Energy
• Other fund types include:
  – Index funds
  – Social conscience, or "green," funds
  – "Sin" funds (i.e., tobacco, liquor, gaming)
  – Tax-managed funds
Bond Funds

- Bond funds may be distinguished by their:
  - Maturity range
  - Credit quality
  - Taxability
  - Bond type
  - Issuing country
- Bond fund types include:
  - Short-term and intermediate-term funds
  - General funds
  - High-yield funds
  - Mortgage funds
  - World funds
  - Insured funds
  - Single-state municipal funds

Stock and Bond Funds

- Funds that do not invest exclusively in either stocks or bonds are often called “blended” or “hybrid” funds.
- Examples include:
  - Balanced funds
  - Asset allocation funds
  - Convertible funds
  - Income funds

Mutual Fund Performance

- Mutual fund performance is very closely tracked by a number of organizations.
- Financial publications of all types periodically provide mutual fund data.
- The Wall Street Journal is particularly timely print source.
- www.morningstar.com has a “Fund Selector” that provides performance information

Mutual Fund Performance: Cautions

- While looking at historical returns, the riskiness of the various fund categories should also be considered.
- Whether historical performance is useful in predicting future performance is a subject of ongoing debate.
- Some of the poorest-performing funds are those with very high costs.

Closed Funds

- Sometimes a fund will choose to close.
- This means that the fund will no longer sell shares to new investors.
- The use of the word “close” here should not be confused with “closed-end.”
- The number of shares in a closed fund can still fluctuate as existing owners buy and sell.
- Why would a fund choose to close?
  - When a fund grows rapidly, the fund manager may feel that the incoming cash is more than the fund can invest profitably.
  - Funds that close often reopen at a later date.

Closed-End Funds

- A closed-end fund has a fixed number of shares.
- These shares are traded on stock exchanges.
  - There are about 600 closed-end funds that have their shares listed on U.S. Stock Exchanges.
  - There are about 8,000 long-term open-end mutual funds.
The Closed-End Funds Discount

- Most closed-end funds sell at a discount relative to their net asset values.
  - The discount is sometimes substantial.
  - The typical discount fluctuates over time.
- Despite a great deal of academic research, the closed-end fund discount phenomenon remains largely unexplained.

Exchange Traded Funds, ETFs

- An exchange traded fund, or ETF,
  - Is basically an index fund.
  - Tracks like a closed-end fund (without the discount phenomenon).
- An area where ETFs seem to have an edge over the more traditional index funds is the more specialized indexes.
- A well-known ETF is the "Standard and Poor’s Depositary Receipt" or SPDR.
  - This ETF mimics the S&P 500 index.
  - It is commonly called “spider.”
- Another well-known ETF mimics the Dow Jones—it is called "Diamond."
- A list of ETFs can be found at www.amex.com.

Exchange Traded Notes, ETNs

- Introduced in mid-2006 by Barclays Bank.
- To investors, ETNs look like ETFs.
- However, ETNs are unsecured debt—so, unlike holders of ETFs, holders of ETNs do have default risk.
- ETNs provide investors with exposure to commodities, but without the leveraged risk of futures contracts.
- Handy web source: www.ipathetn.com

Hedge Funds

- Like mutual funds, hedge funds collect pools of money from investors.
- Like mutual funds, hedge funds are generally required to register with the SEC. But:
  - Hedge funds are not required to maintain any particular degree of diversification or liquidity.
  - Hedge fund managers have considerably more freedom to follow various investment strategies, or styles.
- Hedge fund fees:
  - General management fee of 1-2% of fund assets
  - Performance fee of 20-40% of profits