



Lecture 10

The Mutual Fund Industry

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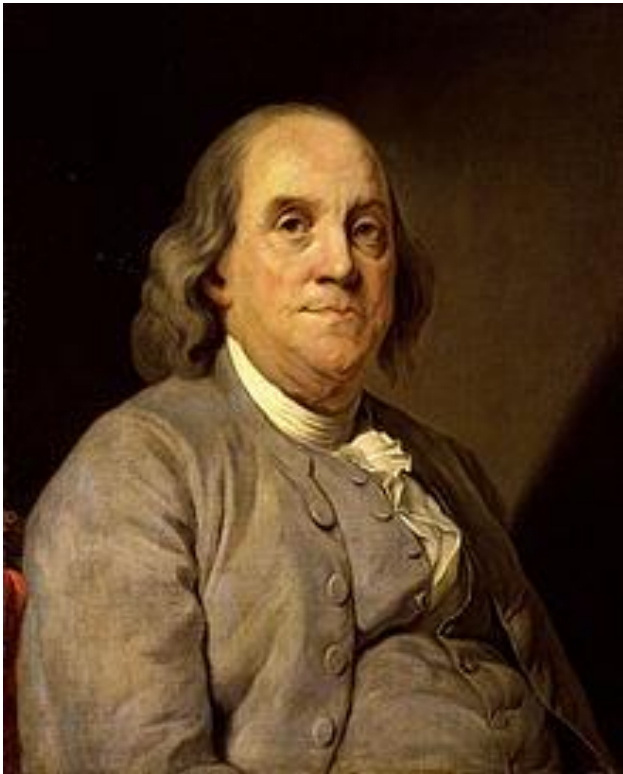
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Quote for today

“An Investment in Knowledge Pays the Best Interest!”



- Benjamin Franklin



Agenda

- What is a Mutual Fund?
- The Growth of Mutual Funds
- Investment Objectives of Mutual Funds
- Mutual Fund Categories
- Mutual Fund Structure
- Advantages and disadvantages of mutual funds



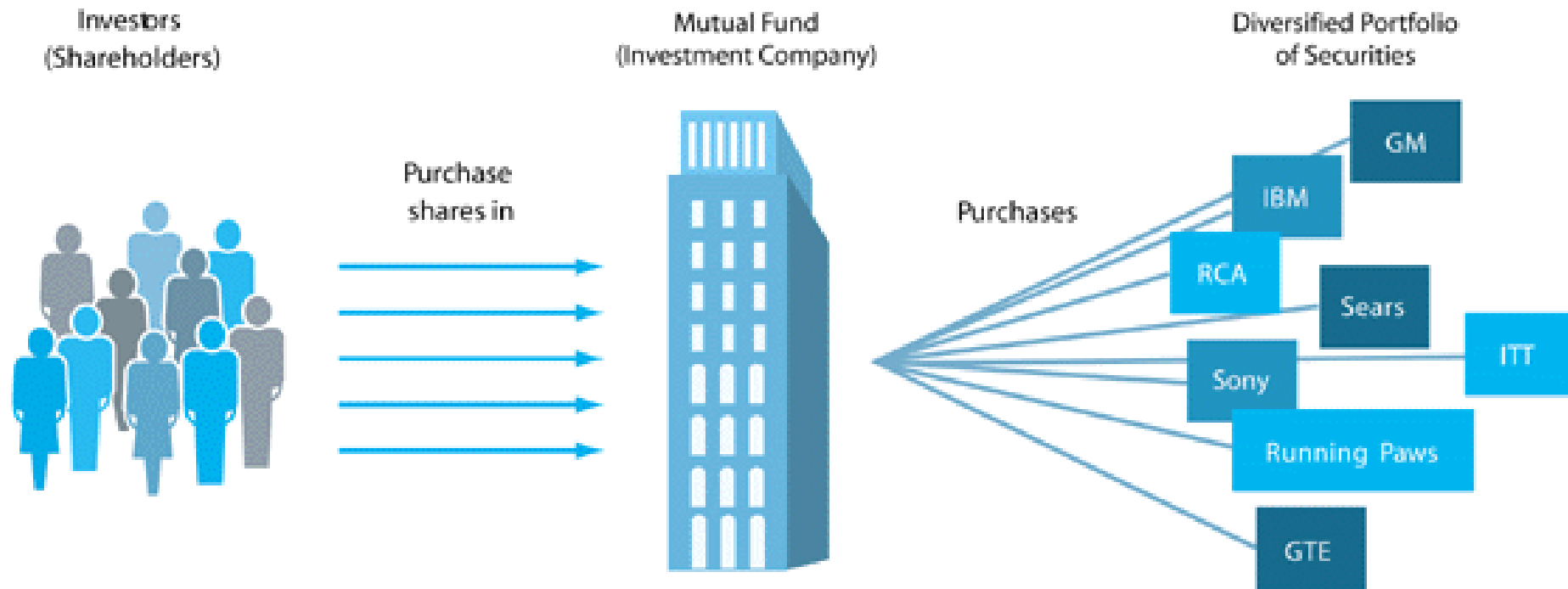
What is a Mutual Fund?



- A pool of money
- Managed by a professional investor
- Manager works for an investment firm
- Each fund has a specific objective
- Over 6,000 funds to choose from
- Each shareholder in the mutual fund participates proportionally (based upon the number of shares owned) in the gain or loss of the fund.



What is a Mutual Fund?



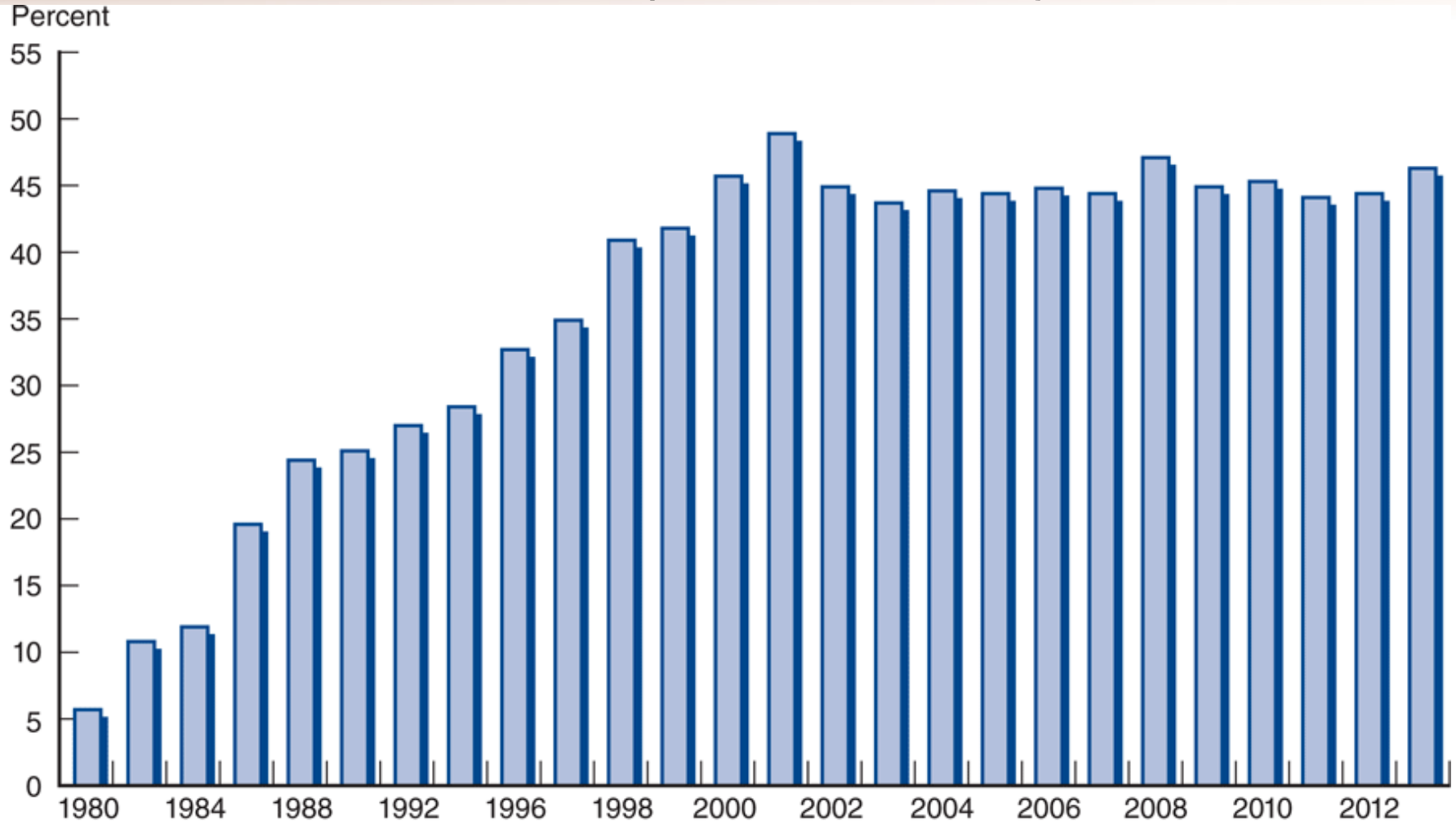


The Growth of Mutual Funds

- The first mutual fund similar to the funds of today was introduced in Boston in 1824.
- The stock market crash of 1929 set the mutual fund industry back because small investors avoid stocks and distrusted mutual funds.
- The Investment Company Act of 1940 reinvigorated the industry by requiring better disclosure of fees, etc.



Household Ownership of Mutual Funds (1980-2012)



Data Source: Investment Company Institute, *2012 Investment Company Fact Book*, 53rd ed. (Washington, DC: ICI), www.icifactbook.org.
Source for additional (2010–2012) data: Table 6.1 in section 6 ICI fact book.



Benefits of Mutual Funds

There are five principal benefits of mutual funds:

1. Liquidity intermediation: investors can quickly convert investments into cash while still allowing the fund to invest for the long term.
2. Denomination intermediation: investors can participate in equity and debt offerings that, individually, require more capital than they possess.
3. Diversification: investors immediately realize the benefits of diversification even for small investments.



Benefits of Mutual Funds (Con't)

4. Cost advantages: the mutual fund can negotiate lower transaction fees than would be available to the individual investor.
5. Managerial expertise: many investors prefer to rely on professional money managers to select their investments.



The Mutual Fund Prospectus

- This is a legal document which describes the investment objective of the fund, the manner in which the fund is administered and operated, the fees and other pertinent information.
- The prospectus should be read thoroughly before making an investment decision.

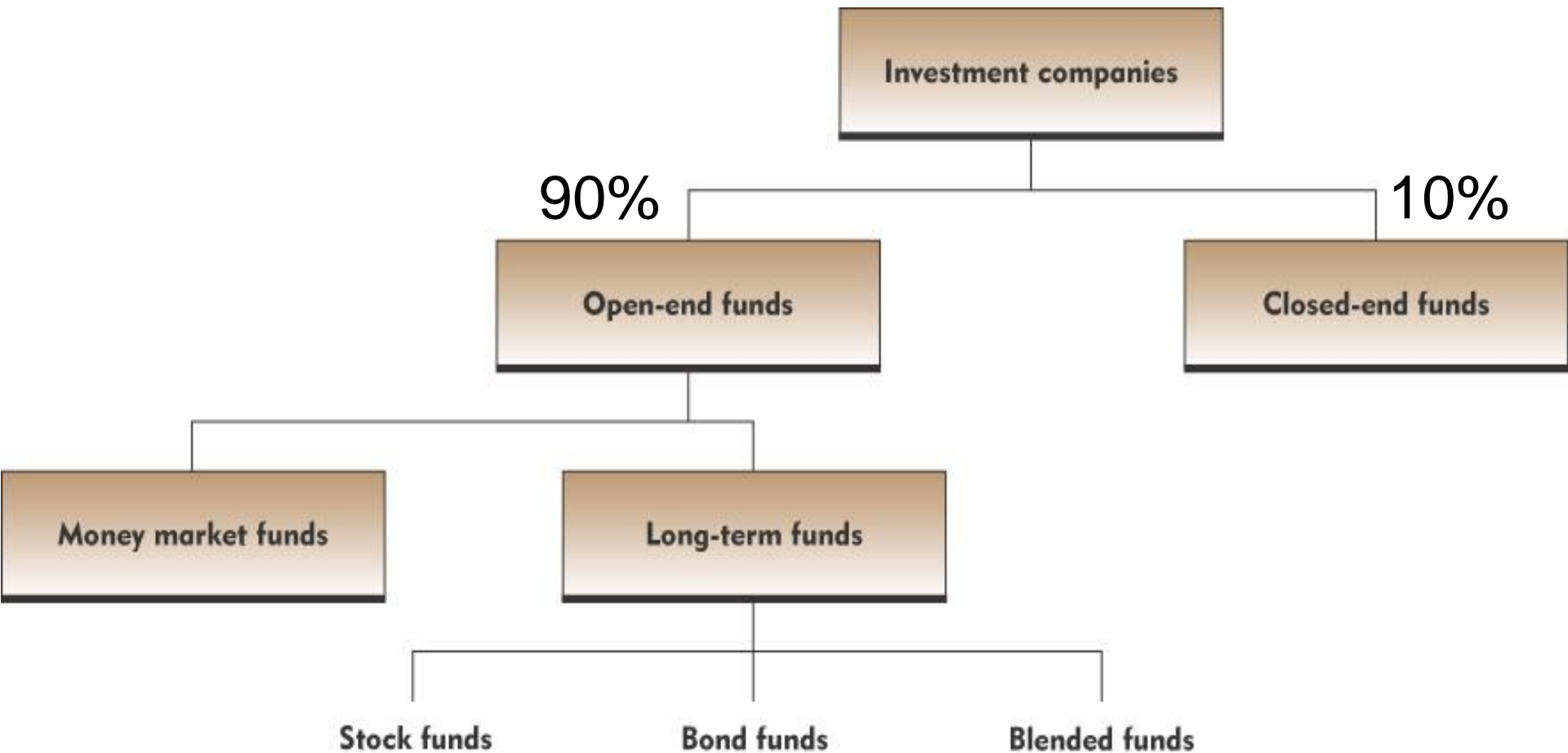


Objectives of Mutual Funds

- Current income
- Long-term growth
- Growth and income
- Balanced



Basic Mutual Fund Categories





Basic Mutual Fund Categories

1. Money Market Mutual Funds
2. Stock Mutual Funds
3. Index Funds
4. Bond Mutual Funds
5. Blended/Hybrid Mutual Funds



Money Market Mutual Funds

- This is the most conservative type of mutual fund.
- The goal is to maintain the \$1 value of its shares while providing income.
- Invests in high-quality, short-term securities such as certificates of deposit, U.S. Treasury Bills, and U.S. Treasury Notes.
- MMMF's are an appropriate place for savings.
- These funds have typically offered higher interest rates than bank savings accounts.
- Money market mutual funds are not insured by the FDIC.



Stock Mutual Funds

- Type of fund that invests in stocks.
- These funds are also known as equity funds.
- There are many different types of stock mutual funds.
- Some of the most common include:
Large-cap funds, mid-cap funds, small-cap funds, income funds, growth funds, value funds, blend funds, international funds, and sector funds.



Index Funds

- These are mutual funds whose holdings aim to track the performance of a specific stock market index.
- The most common index fund tracks the S&P 500. These index funds invest in the exact stocks (and in the same percentages) as those found in the S&P 500.
- Index funds also track bonds, real estate, and other types of assets.
- These funds are lower cost than other types of funds.



Bond Mutual Funds

- Type of mutual fund that invests in bonds.
- Typically, bond mutual funds have the objective of providing stable income with minimal risk.
- There are different types of bond mutual funds.



Types of Bond Mutual Funds

- Short, Intermediate, and Long-Term Treasury Bond Funds
- Short, Intermediate, and Long-Term Corporate Bond Funds
- Municipal Bond Funds
- High-Yield (junk) Bond Funds



Blended/Balanced Mutual Funds

- These are also known as hybrid funds.
- These mutual funds invest in stocks, bonds, and money markets.
- These are very diversified mutual funds. The stock portion of the fund provides the potential for capital appreciation, while the bond and money market portion provide income.



Mutual Fund Structure

- Investment companies usually offer a number of different types of mutual funds.
- Investors can often move investments among these funds without penalty.
- The complexes often issue consolidated statements.



Mutual Fund Structure

- Closed-End Fund: a fixed number of non-redeemable shares are sold through an initial offering and are then traded in the OTC market. Price for the shares is determined by supply and demand forces.
- Open-End Fund: investors may buy or redeem shares at any point, where the price is determined by the **net asset value** of the fund.



Net asset Value



- NAV: per share value of a mutual fund's investment holding.

$$\text{NAV} = \frac{\text{Market Value of Assets} - \text{Portfolio Liabilities}}{\text{\# of Shares Outstanding}}$$

Example

A mutual fund has \$100 mil in assets and \$3 mil in short term liabilities. 10.765 mil shares outstanding. What is the NAV?

Solution

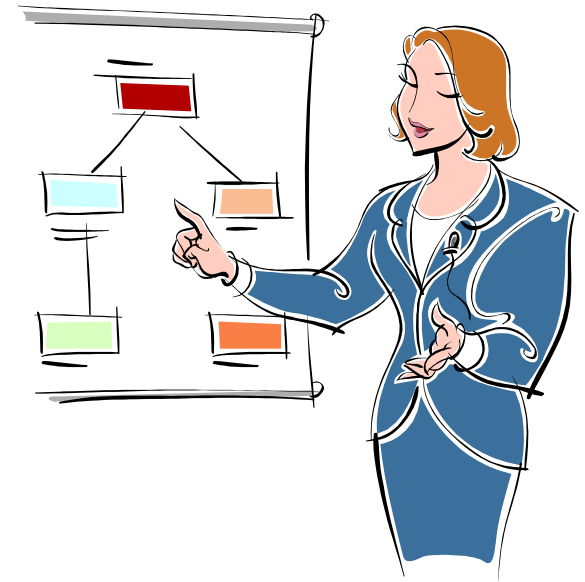
$(\$100 \text{ mil} - \$3 \text{ mil}) / 10.765 \text{ mil} = \9.0107 per share

Offer price = NAV + sales commission



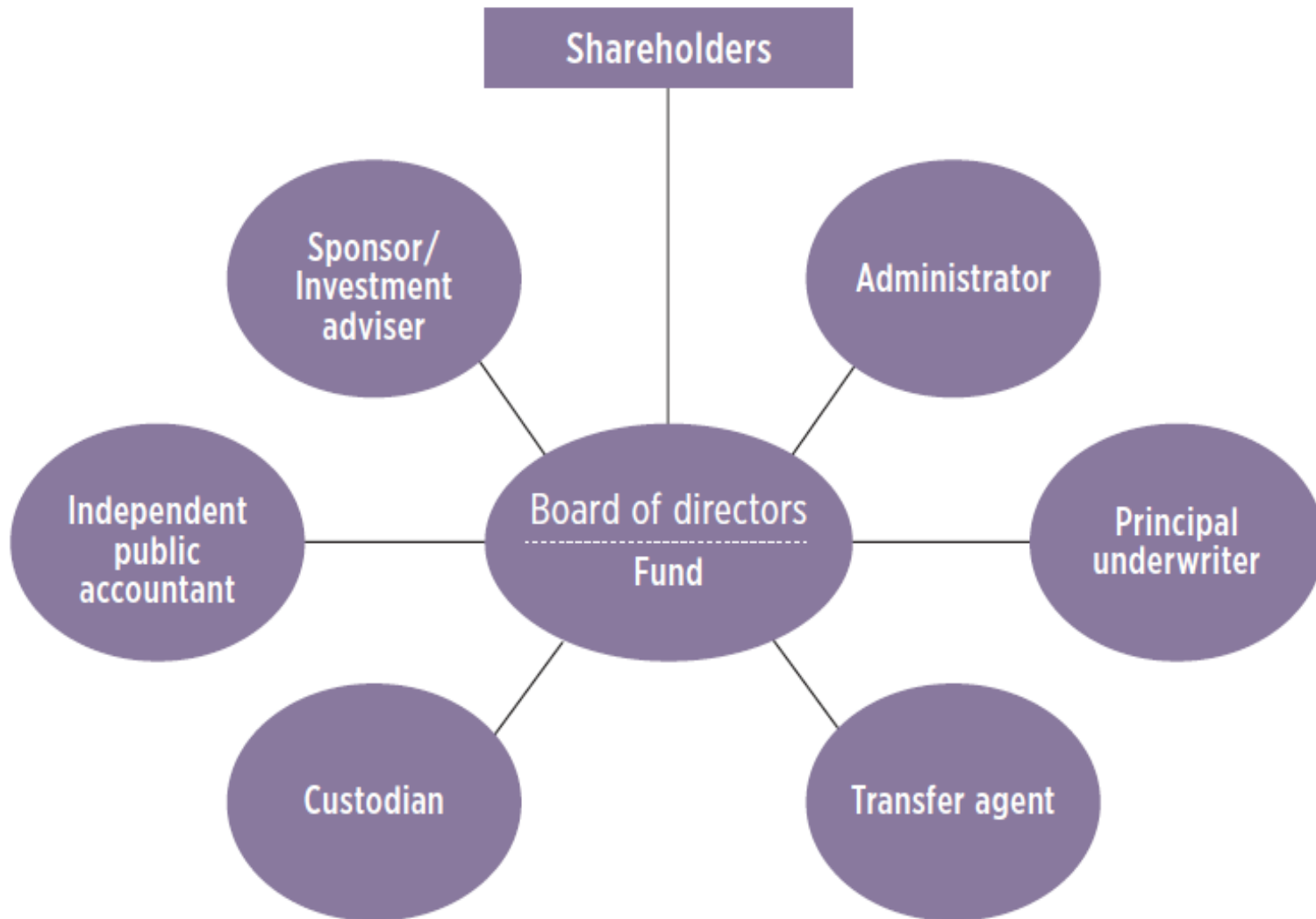
Mutual Fund Structure: the Organization

- The shareholders, or owners, of the mutual fund are the investors.
- The board of directors oversees the fund's activities, hires the investment advisor, an underwriter, etc., to manage the day to day operations of the fund.





Mutual Fund Structure: the Organization





Board of Directors of Mutual Funds

- Mutual funds are the only companies in the U.S. that are required by law to have independent directors, as follows (2001 SEC rules)
 - Independent directors must constitute a majority of the board
 - Independent directors select and nominate other independent directors
 - Legal counsel to the independent directors must also be independent



Mutual Fund Structure: the Organization

- In theory, the board can fire the fund manager and hire anyone they choose. For instance, the board for the Fidelity Magellan Fund can fire Fidelity. Of course, if the board hires a non-Fidelity management team, the fund will probably lose its name, and possibly its reputation along with it.



Hedge Funds

- A special type of mutual fund that received considerable attention following the collapse of Long Term Capital Management.
- Different from typical mutual funds, as follows:
 - High minimum investment, averaging around \$1 million
 - Long-term commitment of funds is required
 - High fees: typically 1% of assets plus 20% of profits
 - Highly levered
 - Little current regulation



Regulation of Hedge Funds

- The SEC passed regulation in 2006 requiring hedge fund advisors to register with the SEC. The SEC became concerned about fraud, and hedge funds became available to the average investor via “retailization”.



Exchange-Trade Funds (ETFs)

- Tradable shares in baskets of stocks that closely track broad market averages, market sectors, or major stock markets from around the world.
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- Standard and Poor's Depository Receipts (SPDR), "spiders": closely track S&P 500 Index
- Diamonds (DIA): track Dow Jones Industrial Average
- QQQQ: track Nasdaq 100 Index
- Select Sector SPDRs: unbundled S&P Index to give investors ownership in a particular market sector or group of industries.
- Barclays Global Investors: offer "iShares" – internationally indexed





Mutual Fund Advantages

- Broad diversification
 - Diversified stock funds hold large and small company stocks broadly spread across industries and economic sectors
 - Diversified bond funds hold bonds with different maturities, coupon, and credit quality
- Ability to retain professional investment management at a reasonable cost
- Investor convenience
 - Many offer “fund family”



Mutual Fund Disadvantages

- Volatility can be significant
 - Diversification doesn't protect investors from the risk of loss from an overall decline in financial markets
 - Mutual fund regulation doesn't eliminate the risk of an investment falling in value
- High management fees and sales commissions

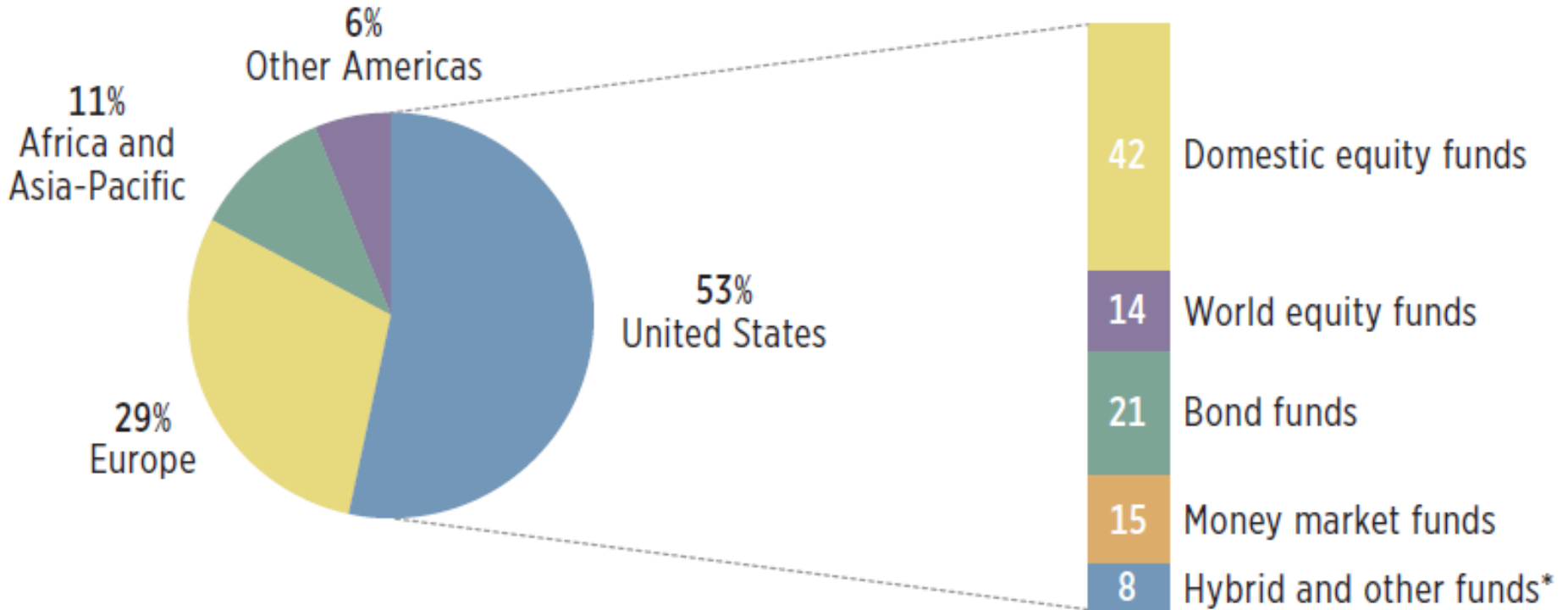


Major Mutual Fund Companies

- World's major mutual fund companies.
 - BlackRock Funds / iShares
 - Vanguard
 - State Street Global Advisors



The US Has the World's Largest Mutual Fund



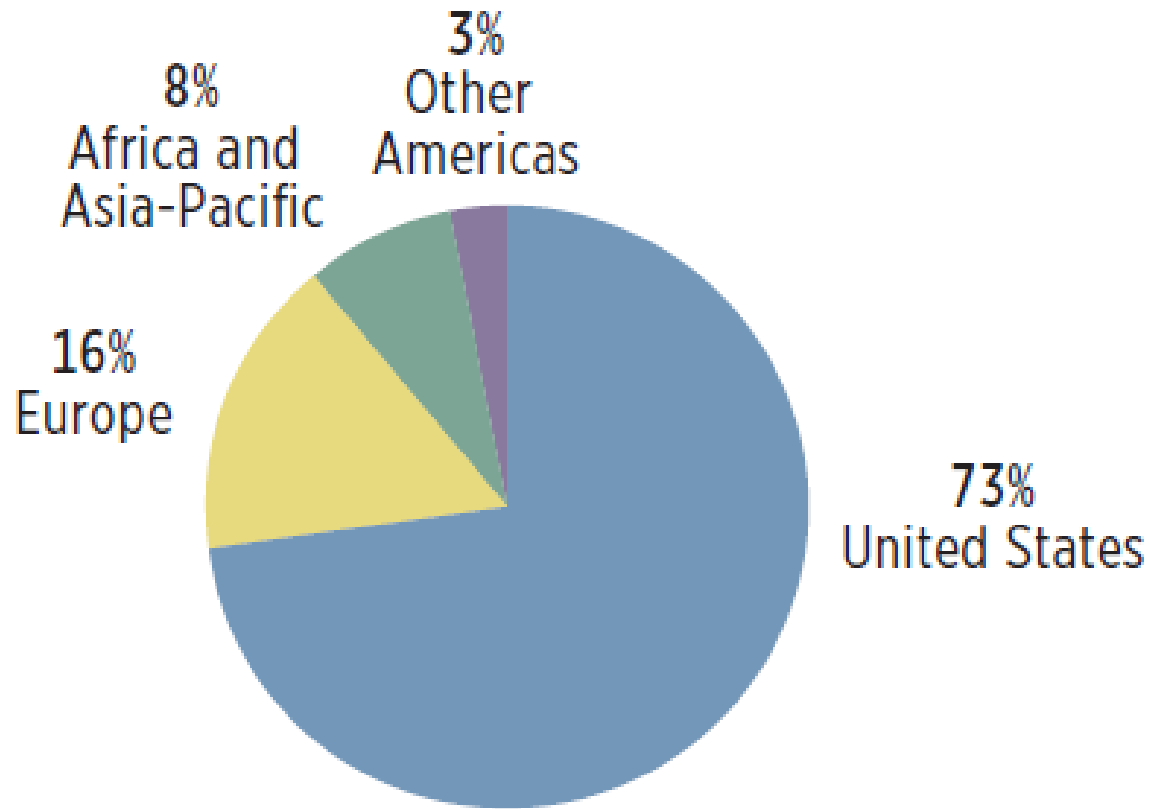
Total worldwide mutual fund and ETF assets:
\$33.4 trillion

Total U.S. mutual fund and ETF assets:
\$17.8 trillion

Percentage of total net assets, year-end 2014
Source: ICI Investment Company Fact 2015



The US Has the Largest ETF Market



Total worldwide ETF assets: \$2.7 trillion

Percentage of total net assets, year-end 2014

Source: ICI Investment Company Fact 2015