Mutual Funds and Other Investment Companies

A regulated investment company (more often referred to simply as an investment company) is an SEC-regulated public corporation or other legal entity, whose only activity is to invest in securities of other entities. There are several types of investment companies, the most important being the open-end investment company, or mutual fund.

Investment companies, usually organized as corporations, sell shares to the public and use the cash to build a portfolio of investment securities that is managed by professional money managers who charge a fee for their services. Thus, purchasers of the mutual fund shares are investing in a diversified pool of assets (shares of different companies) with the objective of generating profit through interest, dividends and capital growth. These investment companies offer the opportunity for even the smallest of investors to achieve a broad diversification of investment securities— diversification which would not otherwise be feasible with the limited amount of funds that are available to this class of investors.

# Open-End Investment Companies (Mutual Funds)

An open-end investment company, commonly known as a mutual fund, continuously offers new shares to the public, and stands ready to redeem outstanding shares, usually immediately upon demand of the shareholder. Thus, the number of outstanding shares will fluctuate each day, as new shares are sold, and previously-issued shares are redeemed.

When a mutual fund is first established, its shares are offered at a set price, for example, $10 per share. As soon as the proceeds from this initial offering are invested in traded securities, the value of the fund's net assets will fluctuate continuously, based upon fluctuations in the values of the fund's investments. Shares of the fund are then sold and redeemed at a price equal to the fund's then-current net asset value per share, computed daily, based upon the closing market price of each security held. After the close of the market each day, the fund calculates the closing value of its entire holdings, including cash, net of operating expenses, and divides the net total by the then total number of fund shares outstanding. This is the net asset value per share. Thus, when an investor purchases shares, the amount going into the fund is measured essentially by the underlying current portfolio value attributable to each share.

Mutual Funds and Other Investment Companies

The price paid for each share by the investor may be higher than the net asset value of the share if the fund imposes a sales charge. The added-on sales charge does not go into the fund, but is used to pay commissions to financial advisors who refer the investors to the fund and to defray marketing costs of the fund's sponsoring organization. This sales charge is often referred to as the "load" or "front-end load." There may also be a “back-end load” where the sales charge is assessed when the investor sells their shares. Many mutual funds are offered without any sales charge, and these are known as "no-load" funds.

Load mutual funds are widely available through stock brokerages, banks, financial planners, and other licensed securities dealers or representatives. No-load funds, in general, are purchased by direct dealings with the funds, through their contracted marketing/administrative services agents. Several so-called discount stock brokerage firms maintain no-load fund marketplaces, through which clients can buy and redeem shares, or have their shares held in brokerage accounts. A transaction fee is imposed by the broker for share purchases. However, several of these brokers have established arrangements with no-load fund sponsors, under which they are compensated by the sponsors for fund share sales, and thus, they are able to offer a large number of no-load funds without transaction fees. Some of the mutual fund market place brokers impose a transaction fee upon redemption of the no-load fund shares if they have not been held by the investor for at least a minimum period (e.g., 30 days 90 days, or 120 days).

After an investor purchases shares in a mutual fund, their net asset value will fluctuate daily, based upon the daily changes in the value of the assets in the portfolio. Net asset values for many mutual funds are widely published in newspapers and on the internet. An investor desiring to sell (redeem) their shares may do so upon demand, and the shares will be redeemed at the net asset value determined after receipt of the redemption request. Some funds impose a redemption fee; for shares redeemed within a short period after purchase (e.g., 30, 60 or 90 days). The main purpose of these fees are intended to discourage short-term trading in the fund's shares, which can be disruptive to effective portfolio management and increase fund costs, and are retained by the fund to offset such costs.

Income earned by the fund from its portfolio securities (primarily interest, dividends and capital gains) is distributed to shareholders at least annually; although some funds make distributions monthly, quarterly or intermittently. In most funds investors are given the option to have their distributions automatically reinvested in additional fund shares, at the net asset value per share determined immediately after the distribution becomes effective. (Distributions will reduce the fund's net asset value per share, but a shareholder's simultaneous reinvestment of her distribution in additional shares will

Mutual Funds and Other Investment Companies

result in no change in the overall value of their investment. Typically, no is no charge on reinvestment of distributions.)Mutual funds enter into contractual arrangements with professional money management firms to manage their investment portfolios and to perform administrative and marketing services. The funds pay fees for these services, which reduce the fund's net asset value. Fees and administrative cost structures vary from fund to fund, and investors evaluate the efficiency of fund managers by comparing their "expense ratios," which is the ratio of total expenses to net assets. Funds with lower expense ratios relative to their peers are considered more attractive investments. However, in the end, however, a fund's investment performance, reflecting the success or failure of its management team in increasing the fund's net asset value is the most widely used measure of comparison among competing funds.

The mutual fund industry is huge, and there are thousands of different funds available for investment. Different funds have different investment objectives and thus invest in different types of securities. For example, there are funds that specialize investing only in certain types of securities, such as investment grade corporate bonds, high yield (junk) bonds, convertible bonds,  municipal bonds,  bonds with short-term maturities, or intermediate-term maturities. There are funds investing only in U.S. Treasury securities, or, U.S. agency securities, or, real estate related securities, or, gold-related securities, or, foreign securities, or, securities in companies in specific foreign countries or regions. There are funds that speculate with options, short sales and buying on margin. The list goes on and on; virtually any conceivable area of concentration is available from one fund company or another. Investment in foreign country securities through mutual funds is discussed above under the heading "Foreign Stocks."

Diversified stock portfolios are often categorized by certain investment objectives, concentrations or styles. These include "income," "growth," "value," "balanced"; "large cap," "medium cap," and "small cap." Numerous investment advisory and media firms do extensive categorization, and statistical and performance analysis of mutual funds.

# Closed-End Investment Companies

A closed-end investment company, like a mutual fund, is created solely to acquire and manage a portfolio of investment securities. However, unlike a mutual fund, which continuously issues new shares and redeems outstanding shares, a closed-end investment company has a fixed number of outstanding shares, which does not increase or decrease, once the initial share offering is completed (except for possible secondary offerings, in which an additional block of shares is sold through an underwriting at a fixed price all at one time). Thus, the term "closed-end" mutual fund, or "closed-end fund."

Mutual Funds and Other Investment Companies

The outstanding shares of a closed-end fund trade in the open market, through regular brokerage channels, and many are listed on stock exchanges. Although the fund holds a portfolio of securities, and a net asset value per share can be calculated, the net asset value per share has no direct relationship with the price at which the fund's shares are bought or sold. Share prices, as with all other market-traded securities, are determined strictly by supply and demand. Although the inherent value of the shares is obviously keyed to the underlying portfolio net asset value per share, the price at which the fund shares will trade may be higher or lower.

Historically, the price at which closed-end funds trade is lower— often considerably lower— than the underlying net asset value. This so-called "discount" from net asset value makes closed-end funds relatively unattractive to most mutual fund investors. Among other factors, if the fund's portfolio experiences good growth, and an investor wants to take profit by selling his shares, he cannot be assured that his fund shares will have increased, or increased as much as the fund's portfolio value.

# Unit Investment Trusts

Another form of investment in a pool of diversified equity or debt securities is through a unit investment trust (UIT). In contrast to a mutual fund, which continuously buys and sells stocks and bonds in a managed portfolio, a unit investment trust acquires stocks and bonds and holds them to maturity. Investments in UITs normally charge an up-front sales charge, but because they are not actively managed, their annual operating expenses are generally lower than in the case of a stock and or bond mutual funds. Investors receive monthly distributions of interest income, in fixed amounts because the UIT's income flow is fixed. If the UIT is a bond UIT it will have a defined life, typically 20 years, keyed to the maturity of the underlying bonds. As with bond mutual funds, UITs tend to be concentrated in a particular sector of the bond market, such as municipal bonds or corporate.

Unit investment trusts have certain disadvantages, compared with bond mutual funds. If a portfolio bond is redeemed early (called), the UIT's interest income, and its monthly distributions, will thereafter be reduced. Unlike a bond mutual fund, it cannot reinvest the redemption proceeds, but must distribute them to the unit holders. This is disadvantageous to those investors who were counting on a certain amount of monthly income when they made their investments. Reinvestment of the redemption proceeds by the investor to achieve a comparable rate of return will likely be difficult since the amount will be relatively small; the reinvestment may well be diluted by commissions or sales charges; and the prevailing market interest rates may have declined, declining market interest rates being the major cause for

Mutual Funds and Other Investment Companies

early redemption of the UIT's bonds, which can be refinanced by the issuers at lower rates. Thus, potential investors should investigate whether, and to what extent, the UIT's bond portfolio has call protection.

If a bond defaults the monthly UIT distribution will not only be reduced, but it will result in a permanent loss of a portion of the capital invested in the UIT. In the case of a mutual bond fund, a default will also result in a loss of capital, through a reduction in the fund's net asset value per share, but since mutual bond funds tend to be larger than UITs, the loss may be spread over a greater number of investor units, and can potentially be offset by portfolio trading profits.

The other principal disadvantage of UITs versus mutual bond funds is the inability to dispose of the investment at net asset value upon demand. Generally, the financial institution that sponsors the UIT will repurchase units from those desiring to sell, but this is likely to be at a discount from underlying net asset value. Thus, UITs are best suited for retirees and other investors who are in a position to leave their investments in place for a long period of time at a fixed rate of return.

# Index Funds

In general, a securities market index is a theoretical portfolio of securities, selected to be representative of a larger universe of securities having particular characteristics. Therefore, as the market value of the stock portfolio moves up or down, so will the value of the index.

The most widely followed indexes are the Dow Jones Industrial Average (DJIA, tracking 30 of the largest "blue chip" companies on the New York Stock Exchange); the Standard & Poors (S&P) 500 Index (based upon 500 selected large companies, including 60 transportation stocks and 40 financial companies); and the NASDAQ Composite Index (which tracks all stocks traded on the NASDAQ market, on a weighted basis, based on relative total market capitalization). In recent years market indexes have proliferated, and an index can be found for virtually any conceivable market segment. The bulk of this proliferation is attributable to the creation and proliferation of index mutual funds.

Index mutual funds were first conceived a number of years ago, partly in reaction to publicity that most actively managed stock mutual funds did not perform as well as the major indexes, such as the DJIA and the S&P 500. Therefore,, financial institutions began creating mutual funds that replicated the indexes. Such funds can be operated at

Mutual Funds and Other Investment Companies

a much lower cost than actively managed funds, since the portfolio make-up is fixed, and there is no need for continual professional investment research and management. Index funds caught on immediately with both large and small investors and thus, number of index funds proliferated. Funds were created for virtually every established index, including specialized indexes previously followed almost exclusively by financial services institutions. Where indexes did not previously exist, they were created, primarily to serve as the investment universe for a new index fund. This simply meant that the new fund would have a permanently fixed portfolio, and no active management. Thus, investors seeking a diversified portfolio within a given market segment (for example, European companies, or biotech companies) could find an index fund offering that market segment, and operating at lower cost than an actively managed fund focused on the same segment.

Most index funds are open-ended mutual funds, meaning that shares are continuously sold and redeemed at net asset value. In order to maintain the investment portfolio as an exact replication of the index upon which it is based, the flow of money in and out of the fund must be allocated to purchases and sales of all of the index's securities pro-rata in pre-determined proportions.

# Exchange-Traded Funds

The development of exchange traded funds (ETFs) was a logical extension of the index funds. An exchange traded fund is an index fund, shares of which are traded in the open market on an established securities exchange through stock brokerage firms. In this respect, they are traded in the same manner as closed-end investment companies (as described above), but unlike closed-end funds, which typically trade at a discount to underlying net asset value, ETFs trade at (or only fractionally divergent from) the net asset value per share, based upon the underlying current market value of the stocks that make up the index. Thus, an investor may place a regular brokerage order to buy or sell shares of an ETF, and the then current market trading price will very closely match the then current level of the index tracked.

Among the largest and best-known exchange traded funds is the SPDR Trust (tracking the Standard & Poors 500 Index, and nicknamed "Spiders"), the NASDAQ 100 Trust (tracking the 100 largest market capitalization companies traded on the NASDAQ exchange, and nicknamed "Cubes," after the stock ticker symbol QQQ) and the DOW Diamond Series Trust (tracking the Dow Jones Industrial Average, and nicknamed "Diamonds").

Mutual Funds and Other Investment Companies

How can ETFs trade at open-market prices through brokers without the discounts from the underlying net asset value per share that typifies trading in closed-end funds? The reason that this discount doesn't exist with ETFs is that large institutions eliminate the discount through arbitrage transactions; institutions swap "creation units" in block-multiples of 50,000 shares for in-kind securities and cash. In other words, if a discount were to develop, large institutions would acquire the discounted shares, and eventually be in a position to dispose of large blocks at the undiscounted net asset value. This potential arbitrage will always keep the market price extremely close to the net asset value.

Virtually all exchange-traded funds are index funds. Thus, investors seeking a diversified portfolio in either the broad market or in a specific segment are able to utilize a low-cost index fund, which can be bought and sold, just like an ordinary stock, through their regular brokerage account. Of course, these transactions involve brokerage commissions, just like regular stock transactions, on both the purchase and the subsequent sale of the index fund shares.

Index funds of various types, that are not exchange-traded, are offered by several fund sponsors. Typically they are subject to minimum holding periods imposed by the fund or the mutual fund marketplace broker through which they were acquired. Thus, for the price of normal brokerage commissions, ETFs represent an attractive alternative, based upon ease of purchase and resale with no holding period requirement.