

4. Mutual Funds

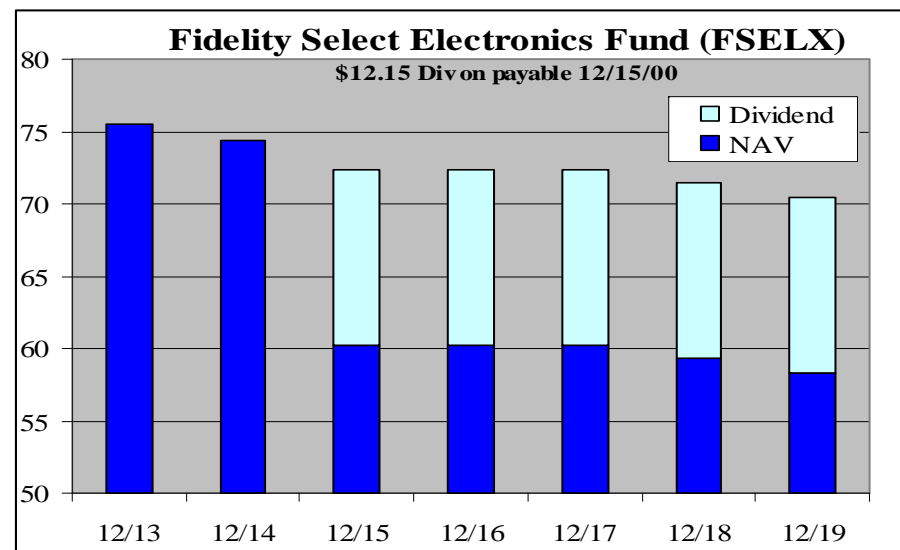
- Mutual Fund – sells shares and invests proceeds!
 - 50% of households hold mutual funds (~\$9 trillion)!
 - Organization and Operation
 - Investment Companies: UIT, Open-end (mutual), closed-end
 - Capital Gains
 - Costs and Fees

- Fund Types
 - Asset Class (money mkt, bond, stock)
 - Objectives.

- Exchange Traded Funds

- Mutual Fund Performance

- Hedge Fund Primer



MF: Organization and Operation

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- Mutual Fund – a corporation that pools funds from investors and invests.
 - Fund sponsor establishes fund; Board of Directors hires investment advisor.
 - Open-end funds
 - Closed End funds – less common.
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- Most funds are Regulated Investment Trusts (IRS code), to avoid paying taxes.
 - Must distribute realized investment income; Issue prospectus; etc..
 - Web (Morningstar) - Prospectus, objectives, manager; performance, holdings.

- Distributions (capital gains and income) are taxed at investor level.
 - 11/1/00 – You own 100 shares; NAV=\$10/share; Total =\$1000.
 - 10/30/01 – NAV increases to \$11, due to income and realized capital gains.
 - 10/31/01 – Fund distributes \$1/sh capital gains and income as dividend.
 - You own 100 shares

 - Implications
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MF: Costs and Fees

- Direct Costs: Operating Expenses (.25% - 2%) deducted from assets.
 - Mgt fees – paid to investment advisory firm.
 - Other fees – operations (legal, accounting, custodial, transfer agent).
- Direct Costs: Sales charges
 - 12b-1 fees (0-1%) – annual advertising / sales charges;
 - Loads – depend on share class. Lowest cost depends on holding period.
 - Class A – front end load (4-6%), small 12b-1 (0.25%). Break pts for large \$\$.
 - Class B – back end load (4-6%), large 12b-1 (1%) for ~8 yrs; then lower (converts to A). Aka “contingent deferred sales charge.”
 - Class C – higher 12b-1 (~1%), possible 1% redemption fee in first year.
- Trading Costs – commissions, soft dollars.
 - Turnover (lesser of purchases or sales)/(avg assets)
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- Why pay loads and fees?
 - Note: Class B best only for brief, interm horizons, or if horizon uncertain.
 - Scandal: Mkt timing with BoA, Putnam, Janus, Invesco, Schwab, Strong...

MF: Types of Mutual Funds

- **Money Market Funds** (least risk) - Seek to preserve principal. Invests in high quality short term debt.
- **Bond (Fixed-income) Funds** (more risk)
 - Objectives: Maturity (short vs long); Credit Quality (high vs low).
 - Other objectives: Country funds; Taxability (single state munis).
- **Balanced/Asset Allocation Funds** (more risk) - income from bonds. Balanced funds usually have fixed weightings.
 - Asset allocation (life-cycle) – Seek high total return with variable weightings.
- **Stock Funds** (most risk) - Wide variety of funds seeking capital gains/income.
 - Objectives: Value (vs Growth); and Size (Large vs small firms).
 - Value – firms (often large) with low share prices relative to earnings.
 - Aggressive Growth – firms (often small) with high potential for growth.
 - Other objectives:
- Examples – MF Map of Mkt; Morningstar;
 - Yahoo – Fidelity Group

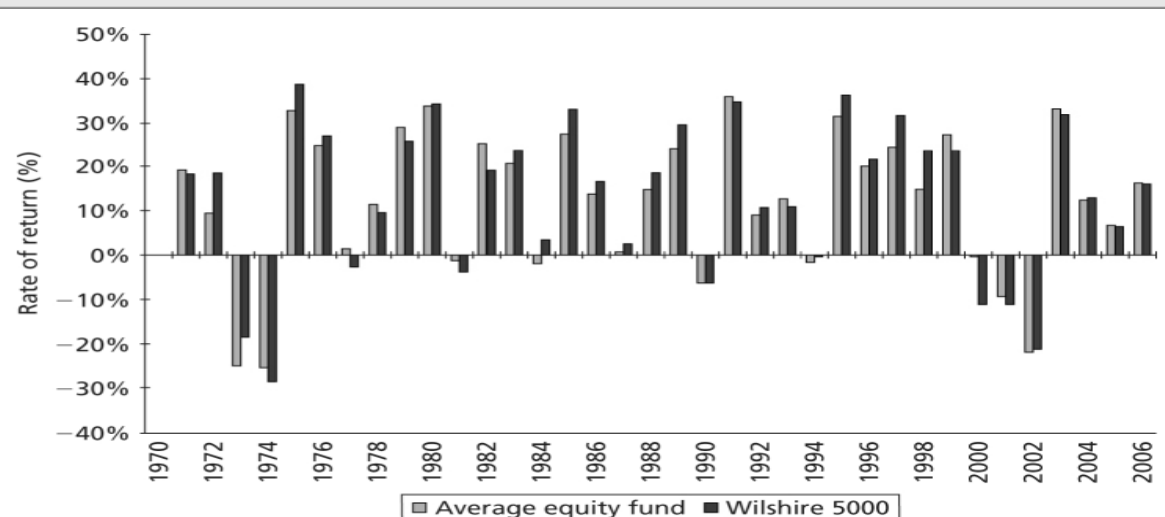
MF: Performance Issues

- Basic Mutual Fund Calculations
 - Q: NAV is \$10. Offer is \$10.50. What's the load?
 - A:
 - Total Return = $(P_1 - P_0 \pm \text{Inc}) / P_0$
- Morningstar Rankings (3 yrs) - 48 categories of funds.
 - 5 to 1 stars depending on rank – top 10%; 32.5%; 67.5%; 90%
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- Do managed funds outperform index funds? Does performance persist?

FIGURE 4.2

Diversified equity funds versus Dow Jones Wilshire 5000 IndexSM

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Exchange Traded Funds

- ETFs – Most are Unit Investment Trusts (fixed, unmanaged portfolio).
 - Trust may redeem/issue shares in 50k share blocks.
 - Examples: SPDR (SPY); Diamonds (DIA); Nasdaq 100 (QQQQ); Bonds;
 - Trade names: iShares (Barclay) HOLDERS (Merrill).
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- Advantages of ETF versus index Mutual Fund
 - ETF's trade continuously throughout day.
 - ETF can short sell and margin, some have options.
 - ETF's generally have lower operating expenses and do not have loads.
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- Disadvantages of ETFs
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- Assessment –
 - ETF's more costly for modest periodic investments.
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Hedge Fund Intro

- Hedge Fund – Loosely regulated investment vehicles that have limited registration with SEC. Investors must be limited (<100 or so) and accredited -- often pension funds, endowments, insurance co, private banks, high net worth indiv
 - \$400-\$500B industry with about 7000 funds.
 - Dozen common strategies (event driven, tactical, arbitrage);
- Macro (tactical) – Profit from changes in global economies, typically associated with shifting govt policy. May use currency, stock, and bond markets plus leverage and derivatives.
- Market Neutral (arbitrage-relative value) – Long and short offsetting positions, esp in different securities of same issuer. E.g, long convertible bonds (may hedge credit risk) and
- Market Neutral (tactical-securities hedging) – Long and short offsetting positions, esp in equities matched by sector. Little market risk.

Summary for Savy MF Investor

- Great for automatic equity/bond investing
 - Periodically rebalance -- otherwise “set and forget”
 - Choose fund with appropriate objectives
- Look for low expenses (e.g, Vanguard)
 - Do not pay a lot for sales or managerial compensation!
 - Index/sector funds have lowest expenses
 - International funds have highest expenses
- May be cheaper to manage own portfolio (>\$100k)
 - Can find top ten fund holdings in prospectus (on web)
- ETFs trade when markets are open, but have hidden costs
- Screener on finance.yahoo.com