Investment Companies 
(Mutual Funds)

- Some Basic Characteristics
- Publicly-traded Mutual Funds
- “Regular” (open-end) Mutual Funds
- WEBs
- Performance

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Basic Characteristics

- Investment Companies are pooled funds from many investors. The money is used to purchase a portfolio of securities. The IC issues shares to represent the percentage amount of the portfolio an investor owns.
- If the portfolio is worth $1.2 billion, and there is $200 million in borrowings for leveraging, and 100 million shares issued, The net asset value (NAV) is $1billion or $10/share. Note: NAV is usually short for NAV per share.

Basic Characteristics

- The main benefit to the fund investor is access to an affordable diversified portfolio.
- Another major benefit is access to investment classes otherwise very difficult for the smaller investor to acquire: Money market instruments, junk bonds, international securities, especially emerging markets stocks and bonds.
- Questionable benefits: Professional Management - little evidence to show that the Pros outperform the market - at least after fees are deducted.

Publicly-traded Funds

- The oldest form, are mostly known as Closed-end funds. Adams Express was started in 1926.
- These Investment Companies publicly trade on a stock exchange like any operating company (almost always on the NYSE).
- Like other listed companies, CEFs have issued a specific number of shares. While there can be a an offering of additional shares, or a repurchase of outstanding shares, such changes are fairly infrequent.

Publicly-traded Funds

- Example: Country Funds like Mexico Fund benefit from the closed-end format as the portfolio can be in less marketable (liquid) securities. Many stocks in foreign countries do not trade often and have very wide bid-ask spreads.
- Closed-end bond funds can use leverage - up to 50% of equity (a leveraging of 1.5).
- Basically, these funds can follow “long-term” strategies as the fund does not redeem shares.
Publicly-traded Funds

• The Price of a CEF is set by the market.
• This market price may differ dramatically from the NAV. Usually the CEF trades at a discount to NAV (NAV is posted weekly in the WSJ).
• Example: Mexico Fund trades at $14 a share. Its NAV is $20 (really!). The discount is computed as: \((P - NAV)/NAV = (14 - 20)/20 = -0.30 = -30\%\).
• Why do most funds trade at discounts? (some trade at premiums). Supply and Demand

Publicly-traded Funds

• Many funds are sold when the “concept is hot”. The broker, like for any IPO, gets a sizable commission when the CEF first comes to the primary market. Often a fund sells for $10, but only $9.30 actually is put in the mutual fund after commissions: thus the fund begins at a premium.
• In 1994 Emerging Markets were “hot”, in 1990 Europe was “hot” (why in 1990?) When the “concept” eventually cools down, the demand may fizzle out too. Since the supply is fixed, the only equilibrium adjustment is the discount.

Publicly-traded Funds

• Prices of CEFs are listed everyday, just as they are for IBM and GM. The underlying NAV, however, is often listed only for the weekly close and published in the Monday WSJ.
• Any changes in the NAV number may be good to know, but it still may not affect the CEF’s price.
• The CEF does not redeem the shares: perhaps the NAV value is more theoretical than practical.
• The value of GM’s net plant/equipment may also be interesting but may not impact GM’s shares.

Open-end Mutual Funds

• When folks talk about investing in mutual funds, they are usually talking about open-end funds.
• These funds are the ones listed in the local newspaper and the WSJ under the heading mutual funds. Closed-ends, as we mentioned, are mostly listed on the NYSE.
• OEFs are like CEFs in that they are Investment Companies (run by operating companies) and are pools of investor money invested in a portfolio.
• The difference is that OEFs investors can (1) redeem shares and (2) buy new shares daily.

Open-end Mutual Funds

• CEFs are like regular stocks, they trade once on the primary market and then “forever” on the secondary market. You trade a fixed number of shares with other investors. CEF’s are closed to new investor money.
• OEFs almost always trade on the primary market. Management stands ready to buy back shares at NAV on a daily basis (try that with B’ham Steel). They issue news shares the same way. Thus the number of outstanding shares varies (usually daily). OEF’s are open to new investor money.

World Equity Baskets WEBs

• WEBs are like CEFs without the problem of the discount.
• Publicly trade on the American Stock Exchange.
• Can be redeemed at NAV; but only in 100,000 share bundles known as creation units.
• Tend to hold stocks of one country, based on a Morgan Stanley index. EWW, EWL, EWQ, EWA, EWO, etc.
Open-end Mutual Funds

- OEFs usually base the share price on an estimate of the NAV as of the 4:00 p.m. EST market close. No-load OEFs would redeem or issue shares at the same NAV price.
- A load is a sales charge or commission. You always pay some variation of a commission if you buy through a stock broker. You have to deal directly with the fund companies to get no-load funds. Note, some fund companies charge a commission even if you do not use a broker.

Open-end Mutual Funds

- The main disadvantage of mutual funds is paying fees. Besides the annual fees (all funds) and the load (some OEFs), there is the more recent 12b-1 fee (for some OEFs, also an annual fee). This last fee is supposedly for “fund marketing”. Paying brokers to promote it is considered a form of marketing.
- The fee is also paid to discount brokers who run “fund supermarkets”. Schwab, Fidelity, and Waterhouse all run these.

Fund Performance

- Experts consider fund fees to be the main reason that mutual funds tend to underperform “the market”.
- The answer may be to invest in funds with low fees - like index funds.

Fund Performance

- There are several studies that show CEFs outperform “twin” OEFs.
- Example: Templeton’s Emerging Markets Funds run by Mark Mobius). His CEF beats his OEF almost every year - by two or three percent!
- CEFs are better here because they do not have to meet redemptions. This means 1) Don’t have to hold some assets in cash to meet potential redemptions. 2) Don’t have to sell shares in bad markets to meet redemptions 3) don’t have to spent fees on processing.

Information on Funds

- Morningstar is the best known source.
- Ranks based on historical results using “stars” - within investment objective categories. Stars (five is best) are based on risk-adjusted returns.
- Print version is updated on a 13-week cycle, one of the 13 sections updated each week.
- Online version also (which I have)