Investment Companies
Relationship Among a Firm Issuing Securities, the Underwriters and the Public

**Figure 3.1** Relationship among a firm issuing securities, the underwriters, and the public
Four Phase of IPO

- **Pre-IPO**
  - Preparation of the IPO

- **IPO**

- **Post-IPO ("aftermarket")**
  - First earnings announcement
  - First annual general meeting of shareholders

- **Stabilization**

- **Phase 1**
- **Phase 2**
- **Phase 3**
- **Phase 4**
The objectives of the chapter are to provide an understanding of:

- The market for investment management.
- Mutual fund operations.
- The structure and strategies of hedge funds.
- The features and strategies of venture capital funds.
- The market for buyout funds.
- Opportunities in real estate investment trusts.
Market Overview

• Indirect investing
  - Investment management companies pool money from investors and invest in a portfolio of financial assets.

• Direct investing
  - Investors invest directly in individual securities.

• Indirect investing advantages
  - Managerial expertise
  - Diversification
  - Administrative costs
  - Convenience
Growth in Investment Management

• Increased popularity of defined contribution pension funds
• Concerns about Social Security and future financial obligations
• Desire for more aggressive investment growth
• Emergence of new investment distribution channels
• Effect of the Internet on investment knowledge and access
Investment Management Operations

- Unit investment trusts
- Closed-end investment companies
- Mutual funds
- Hedge funds
- Venture capital funds
- Buy out funds
- Real estate investment trusts
Types of Investment Companies

• Unit investment trust (UIT)
  ➢ Purchases and holds a relatively fixed portfolio of securities.
  ➢ Investors who buy units in the trust will receive a pro rata share of principal and interest or dividends.
  ➢ UITs generally have a stated date for termination. After the dissolution of the trusts, the unit-holders receive all proceeds.
Types of Investment Companies (cont’d)

• Closed-end investment company
  ➢ Issues a fixed number of shares listed on a stock exchange or traded over the counter.
    ❖ After the issuance of the shares, investors buying or selling these shares do not deal with the fund company, but instead, trade with other investors.
  ➢ Four main types of closed-end funds:
    ❖ International and global bond funds
    ❖ International and global equity funds
    ❖ Domestic bond funds
    ❖ Domestic equity funds
Types of Investment Companies (cont’d)

• Mutual fund

➢ Pools money from a number of investors who share similar investment objectives, such as obtaining current income, maximizing long-term capital growth, or a combination of the two.

❖ A professional manager manages the fund to achieve its objective.

❖ Each share represents a proportional ownership in all of the fund’s invested assets.

❖ The net asset value (NAV) of a mutual fund determines its share prices. NAV is the value of the fund’s assets, less its liabilities, divided by the number of outstanding shares.
Types of Investment Companies (cont’d)

• Hedge fund
  - An unregistered, private investment pool bound by the investment agreement investors have signed with the sponsors of the fund.

• Venture capital (VC) funds
  - Make equity investments in entrepreneurial companies.
    - The financiers recoup their investments when the company they have invested in (called the portfolio company) either goes public or sells out to another corporation.
Types of Investment Companies (cont’d)

• Real estate investment trust (REIT)
  ➢ Pools capital from investors to acquire or to provide financing for real estate.
  ➢ Like a closed-end fund for real estate in that retail investors can trade shares on a stock exchange.
  ➢ Investing in REITs gives an investor a practical and efficient way to include professionally managed real estate in an investment portfolio.
Mutual Fund

• An investment company that makes investments in a portfolio of securities on behalf of fund shareholders who share common investment objectives.

➤ The value of a mutual fund portfolio fluctuates as investors invest in or redeem shares and as the value of the securities held by the fund rises or falls.

➤ Each investor owns an undivided interest in the portfolio and shares mutually with other investors in gains and distributions derived from the fund’s investments.
Advantages of Mutual Funds

• Diversification of investment reduces risk
  ➢ Buying mutual fund shares creates an ownership interest in all of the securities the fund owns.

• Professional money management
  ➢ Provides a way for the individual investor to obtain the same professional money management available to large institutions and wealthy investors.

• Variety of mutual funds
  ➢ A wide variety of funds are available to meet individual investor’s investment objectives
Advantages of Mutual Funds (cont’d)

• Ease of investment
  ➢ It is easy to invest in mutual funds.

• Issuance of both full and fractional shares.
  ➢ Investors can purchase shares based on an even dollar investment.
  ➢ Each full or fractional share represents ownership of the fund’s overall portfolio and not a specific interest in any one investment in a portfolio.

• Mutual funds are liquid.
  ➢ Investors can redeem shares any business day without penalty.
Types of Mutual Funds

• Equity Funds
  ➢ Aggressive growth
  ➢ Growth Sector
  ➢ Growth and income
  ➢ Income equity
  ➢ Emerging markets
  ➢ Global equity
  ➢ International equity
  ➢ Regional equity

• Hybrid Funds
  ➢ Asset allocation
  ➢ Balanced
  ➢ Flexible portfolio
  ➢ Income-mixed

• Taxable Bond Funds
  ➢ Corporate bond
  ➢ High yield Global bond
  ➢ Government bond
  ➢ Mortgage-backed
  ➢ Strategic income

Types of Mutual Funds (cont’d)

• Tax-free Bond Funds
  ➢ State municipal bond
  ➢ National municipal bond

• Money Market Funds
  ➢ Taxable money market
  ➢ Tax-exempt money market-
    national
  ➢ Tax-exempt money market-
    state

Mutual Fund Share Pricing and Performance

• Mutual funds determine the price of their shares each business day.
  
  ➢ A fund’s **net asset value (NAV)** is the value of all the fund’s assets, minus liabilities, divided by the total number of shares outstanding.
  
  ➢ A fund’s **offering price** is its NAV plus (if any) the applicable sales charge.
  
  ➢ The **redemption price** is its NAV minus (if any) the applicable redemption fee, or back-end load.
Mutual Fund Share Pricing and Performance

• Determining the price of a fund’s shares
  ➢ A fund’s net asset value (NAV) is the value of all the fund’s assets, minus liabilities, divided by the total number of shares outstanding.
  ➢ A fund’s offering price is its NAV plus (if any) the applicable sales charge.
  ➢ The redemption price is its NAV minus (if any) the applicable redemption fee, or back-end load.
A mutual fund owns a portfolio of stocks worth $10 million at the end of the business day; its liabilities are $1 million; and it has 800,000 shares of the fund outstanding. Net asset value (NAV) for the fund is calculated as follows:

\[
NAV = \frac{\$10,000,000 - \$1,000,000}{800,000} = \$11.25
\]
Types of Mutual Funds

• Exchange-Traded Funds (ETF)
  ➢ An index fund or trust listed on an exchange and traded like a listed stock during trading hours.
  ➢ Investors can trade shares in ETFs as a single security.
  ➢ ETFs cover a wide variety of broad stock market, industry sector, international stock, and U.S. bond indexes.
Technology and Mutual Funds

• Benefits of technological advances
  ➢ Enabled better customer service and introduced a broad array of new products at a reasonable cost.
  ➢ Made it possible for mutual fund companies to manage the records of their shareholders.
  ➢ Allowed the use of 800 numbers and routing of incoming calls to provide information and take orders over the phone.
  ➢ Internet access helps investors gain access to Wall Street research and real-time data from investment companies’ web sites.
Factors Causing Growth in Mutual Fund Assets Worldwide

• Favorable economic conditions in developed countries in recent years
• Popularity of mutual fund investing for retirement and an improved living standard
• Private savings as a substitute/supplement for government retirement programs
• Growth of the middle class worldwide
Mutual Fund Selection: Fund Strategies

• Capital preservation strategy
  ➢ Appropriate for investors who want income, a fair amount of stability, and some increase in the value of the investment.

• Moderate growth strategy
  ➢ Suitable for investors who primarily want a balance of moderate growth and moderate income with a fair amount of stability.
Mutual Fund Selection: Fund Strategies

• Wealth-building strategy
  ➢ Suitable for investors who want the potential for growth and capital appreciation, but also want some protection from stock market volatility.

• Aggressive growth
  ➢ For investors who want the potential for substantial growth and capital appreciation.
### Mutual Fund Investment Strategy Matrix

<table>
<thead>
<tr>
<th>Tolerance for Risk</th>
<th>Investment Horizon of 0 to 3 Years</th>
<th>Investment Horizon of 4 to 6 Years</th>
<th>Investment Horizon of 7+ Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>High</td>
<td>Moderate growth</td>
<td>Wealth-building</td>
<td>Aggressive growth</td>
</tr>
<tr>
<td>Moderate</td>
<td>Moderate growth</td>
<td>Moderate growth</td>
<td>Wealth-building</td>
</tr>
<tr>
<td>Low</td>
<td>Capital preservation</td>
<td>Capital preservation</td>
<td>Moderate growth</td>
</tr>
</tbody>
</table>

**Source:** Fidelity Focus: Fidelity Investments, Boston.
Mutual Fund Selection: Asset Allocation

• Asset allocation
  ➢ The process of strategically diversifying investments between stock, bond, and cash in order to achieve a return consistent with the investor’s financial goals, investment horizon, and risk tolerance.

• Developing an asset allocation program
  ➢ Determine financial goals and investment horizon.
  ➢ Evaluate level of risk tolerance
  ➢ Develop a detailed asset allocation strategy using assets that complement each other
  ➢ Implement the strategy
Asset Allocation Strategies

• Strategic asset allocation
  ➢ Is a value-oriented technique that seeks to increase exposure to the market when recent market performance is poor, and to reduce exposure when recent market performance is good.

• Dynamic asset allocation strategy
  ➢ Seeks to ensure that the value of the portfolio does not fall below a certain level (portfolio insurance) to avoid large losses and secure any favorable market move.
Composition of Mutual Funds in Indonesia

Source: Bapepam-LK
## Hedge Fund Investment Styles

<table>
<thead>
<tr>
<th>Style</th>
<th>Holding Period</th>
<th>Expected Volatility</th>
</tr>
</thead>
<tbody>
<tr>
<td>Emerging markets</td>
<td>Short/medium term</td>
<td>Very high</td>
</tr>
<tr>
<td>Short only</td>
<td>Medium</td>
<td>Very high</td>
</tr>
<tr>
<td>Macro</td>
<td>Medium</td>
<td>Very high</td>
</tr>
<tr>
<td>Sector play</td>
<td>Medium</td>
<td>High</td>
</tr>
<tr>
<td>Distressed</td>
<td>Medium/long</td>
<td>Moderate</td>
</tr>
<tr>
<td>Growth</td>
<td>Medium/long</td>
<td>Moderate</td>
</tr>
<tr>
<td>Risk arbitrage</td>
<td>Medium</td>
<td>Moderate</td>
</tr>
<tr>
<td>Convertible arbitrage</td>
<td>Medium</td>
<td>Low</td>
</tr>
<tr>
<td>High yield</td>
<td>Medium</td>
<td>Moderate</td>
</tr>
<tr>
<td>Event driven</td>
<td>Medium</td>
<td>Moderate</td>
</tr>
<tr>
<td>Value</td>
<td>Long</td>
<td>Low/moderate</td>
</tr>
<tr>
<td>Opportunistic</td>
<td>Short</td>
<td>Low/moderate</td>
</tr>
<tr>
<td>Market neutral</td>
<td>Short/medium</td>
<td>Low</td>
</tr>
<tr>
<td>Convergence</td>
<td>Short/medium</td>
<td>Low</td>
</tr>
</tbody>
</table>

**Sources:** *All About Hedge Funds*, Van Hedge Fund Advisors, 2001.
Venture Capital (VC) Funds

• VC firm
  - Operates several VC funds; pools funds from investors and invests in entrepreneurial companies.

• Unique features of VC
  - Are actively involved in searching for candidates, negotiating, and structuring the transaction, and monitoring the organization.
  - Investments tend to last for several years, typically three to seven
  - Securities purchased by VC funds are usually privately held.
A VC fund passes through four stages in its life:

- **Fundraising**: obtaining capital commitments.
- **Actual investment**: the company that becomes a portfolio company of the fund.
- **Portfolio growth**: the fund makes and manages the investment until the closing of the fund.
- **Closing**: the VC fund liquidates its portfolio of companies using one of three forms: an initial public offering (IPO), a sale of the company, or bankruptcy.
Venture Capital Terms

• Venture funds
  ➢ Provide such first-round financing for risky investments are often called VC angels.

• Restricted securities,
  ➢ Securities acquired directly or indirectly in a transaction not involving any public offering.
  ➢ Restricted securities can be sold via a subsequent private sale or a public offering registered with the SEC.
Buyout Funds

• Buyout funds defined
  ➢ Investment firms that invest in leveraged buyouts (LBOs) using borrowed money for the purchase price of the buyout company.
    ✷ The assets and future cash flows of the selling company typically are used to secure the debt.

• Characteristics of LBO firms
  ➢ Use other people’s money to acquire companies
  ➢ Seek out distressed companies in out-of-fashion industries to avoid paying top dollar.
Buyout Funds (cont’d)

• Management buyout (LBO)
  ➢ An LBO in which the purchasers are the management of the company.
  ➢ Management usually invests in the equity of an LBO company together with an LBO fund, a corporate investor, or a group of institutional investors.
  ➢ The seller and subordinated lenders sometimes receive equity in the new company.
Buyout Financing Structure

• Senior loan
  ➢ Collateralized by a first lien on the assets of the company and includes:
    ✶ Revolving line of credit: a line of credit on which the company pays a commitment fee and can take and repay a loan at will.

• Senior term loan
  ➢ Loan based on a percentage of the fair market value of the land and buildings, as well as the liquidation value of the machinery and equipment.
Buyout Financing Structure (cont’d)

• Subordinated financing
  ➢ Funds raised from insurance companies or subordinated debt funds
  ➢ A public offering of high-yield or non–investment-grade bonds to insurance companies, pension funds, and other institutional investors provides the financing.
  ➢ Equity financing that makes up the difference between the financing required and the financing available in the form of debt.
Real Estate Investment Trusts (REIT)

- An investment company that pools funds from investors to invest in income-producing residential and commercial properties.
  - REITs differ from stocks only in that they are engaged exclusively in the real estate business.
  - They pay dividends and may be listed on an exchange.
  - As large blocks of real estate become equitized, investment opportunities in REITs will expand.
Types of REITS

• Equity REIT
  ➢ A corporation that purchases, owns, and manages real estate properties and draws its revenues come from rent.

• Mortgage REIT
  ➢ A corporation that purchases, owns, and manages real estate loans and draws its revenues from interest from the mortgage loans.

• Hybrid REITs
  ➢ Combine the investment strategies of both equity REITs and mortgage REITs.
Brokerage & Clearing Companies
The objectives of the chapter are to provide an understanding of:

- The various types of brokerage services securities firms offer.
- Interdealer brokers’ functions for non-exchange-traded securities.
- The trading mechanism in electronic communications networks.
- The importance of clearing and settlement.
- The services provided by various clearing firms.
Types of Brokers

• Full-service brokers
  - Provide a complete menu of financial services, including trade execution, research reports, financial advice, and financial planning.

• Discount brokers
  - Execute trades for customers for lower commissions but do not provide research or advice.

• Electronic brokers
  - Only offer their services online.
Types of Accounts

• Cash account
  - The customer pays the brokerage house the full transaction value for any securities and does not borrow funds from the brokerage firm.

• Margin account
  - Customers to borrow money from the brokerage firm to purchase securities.

  ✤ Margin account restrictions
    – Initial margin: a deposit of cash or eligible securities equal to 50% of trade values.
    – Maintenance margin: customer equity equal to 25% of the market value of securities held in the account.
Types of Accounts (cont’d)

• Asset management accounts
  ➢ Require a minimum balance to open and they charge an annual fee.
  ➢ Offer automatic reinvestment of the account’s cash balances in money market funds.
  ➢ Offer loans based on the marginable securities in the account.

• Wrapped accounts
  ➢ The customer pays the brokerage firm a flat annual fee to cover all services and trading commissions.
Types of Orders

• Market order
  ➢ Instructs the broker to buy or sell the securities immediately at the best price available at that time.
  ➢ Ensures that the transaction will be completed, but the price of the trade is unknown until executed.

• Limit orders
  ➢ Specifies a particular price for a trade (buy or sell).
  ➢ **Buy order:** customer specifies the maximum price that he is willing to pay for a security.
  ➢ **Sell order:** the customer specifies a minimum price that he is willing to accept to sell the security.
Types of Limit Orders

- Effective for one day or good until canceled
- All or none: fill the whole order or nothing
- Immediate or cancel: fill any part of the order immediately or cancel the order
- Fill or kill: fill the entire order or kill (cancel) the entire order
Types of Orders (cont’d)

• Stop orders
  ➢ Used to purchase or sell a security after its price reaches a certain level.
  ➢ **Buy stop order** is placed above the current market price to stop buying once a higher price level is reached.
  ➢ **Sell stop order** is placed below the current market price to stop selling once a lower price level is reached.
  ➢ A stop limit order becomes a limit order once the limit price is reached.
Types of Brokerages

• Full-service brokerages
  ➢ Offer a full range of investment products, including stocks, bonds, mutual funds, certificates of deposits, insurance, and annuities.
  ➢ Offer services such as financial advice on retirement planning, asset allocation, portfolio management, college funding, estate planning, and trust services.
Types of Brokerages (cont’d)

• Discount brokerages
  ➢ Resulted from deregulation of the brokerage industry in 1975 when negotiated commissions became available to individual investors.
  ➢ Offer fast access and lower commissions for executing transactions for independent investors who telephone or use a computer online to request a trade.
  ➢ Do not offer investment advice to their clients, and they provide only limited services.
Types of Brokerages (cont’d)

• Electronic brokerage
  ➢ Developed when discount brokerages allowed their existing customers to trade online.
  ➢ Focused on first-time, self-directed individual investors.
  ➢ Offer one-stop shopping where investors can trade, research, and track stocks, and customize their online portfolio accounts for a low commission cost.
  ➢ Have expanded beyond stock brokering and now help to distribute shares of initial public offerings to retail customers.
Types of Brokerages (cont’d)

• Interdealer brokerage
  ➢ Display bids and offers of other dealers anonymously
  ➢ Enhance liquidity by providing a central mechanism to display the bids and offers of multiple dealers
  ➢ Allow dealers and investors to trade large volumes of securities anonymously and efficiently based on these bids and offers.
  ➢ Compile the anonymous bids and offers of other government securities dealers and traders and display the quotations on screens located in the dealers’ offices.
Types of Brokerages (cont’d)

• Electronic communications networks (ECNs)
  ➢ Computerized trading systems that match buyers and sellers of securities.
  ➢ Let buyers and sellers of stock meet without the use of intermediaries such as market makers and specialists.
Electronic Communications Networks

- **Advantages**
  - Extended trading hours
  - Lower costs
  - Fewer errors
  - Faster trades reduce *slippage*
  - Reduced opportunity for *front running*

- **Disadvantages**
  - Lack of liquidity during extended trading hours
  - Not widely available
  - Maintaining necessary trading volume
Clearing And Settlement

• Settlement

  ➢ The transfer of money and securities by a clearing bank between the parties to complete a transaction to receive and deliver money and securities.

  ➢ **Clearing account**: a firm’s money and securities accounts at its clearing bank.

• Clearing and settlement process:

  ➢ Completing the trade ticket and conveying its details to the back office.

  ➢ Matching the terms and configuration.

  ➢ Settlement and booking.
Mortgage-Backed Securities (MBS)

• Mortgage Backed Securities Clearing Corporation (MBSCC)
  ➢ Provides automated trade comparison/confirmation and net settlement services.
  ➢ Offers a real-time Electronic Pool Notification (EPN) system to transmit pool information quickly, efficiently, and reliably to reduce fail costs

• MBSCC settlement systems
  ➢ Trade-for-Trade
  ➢ Settlement Balance Order (SBO)
International Transactions

• Euroclear
  ➢ Is the largest clearance and settlement system for internationally traded securities.
  ➢ Is a delivery-versus-payment system with settlement in book-entry form.
  ➢ Offers a Securities Lending and Borrowing Program, which enables participants to avoid costly fails by borrowing securities automatically during the settlement process.
• Clearstream

- Is a major clearing and settlement system for international securities transactions that uses delivery-versus-payment to minimize risk..

- Offers settlement services for internationally traded securities:
  - Automatic securities lending, flexible financing, custody, and cash management.
  - New Issues Acceptance service to lead managers, issuing and paying agents, and their advisers to facilitate new issues of securities in the international markets.
International Transactions (cont’d)

• Emerging Market Clearing Corporation
  ➢ Engages in clearance, multilateral netting, and risk management of transactions involving emerging-market debt instruments.
  ➢ Employs a designated trade-matching system that:
    ❖ Compares emerging-market debt trades executed by major securities firms and transmits them to the EMCC.
    ❖ Evaluates trades to guarantee accepted transactions and reports to members on an accepted trade report.
    ❖ Calculates margin requirements daily, issues margin calls, and manages the resulting collateral.
    ❖ Transmits settlement instructions to Euroclear or Clearstream on behalf of EMCC member firms.