What is...
a mutual fund?

BANKTrack

Mutual funds (or "unit trusts") are funds operated by a bank or an investment company that invest their money in a portfolio of assets, including company shares, corporate and governmental bonds, options, futures, currencies, or money market securities. They then sell parts of this portfolio to investors by issuing shares much like any other company sells shares to the public. For individual investors, mutual funds can be more attractive than building ones' own portfolio because mutual funds are managed by professional asset managers, and they allow individuals to reduce risks through owning a very diversified portfolio. Most mutual funds are open to all kinds of investors, including households.

How it works

Banks and investment firms offer a variety of mutual funds to the public. They can be distinguished on the following grounds:

- **Investment objective or style**. Funds vary in their objective (e.g. to provide steady income now, to grow over time, to grow aggressively, etc.). For example, "fixed income funds" are designed to deliver a fixed return at a certain point of time. They are thus the most reliable, but their returns are limited compared to the possible returns on equity investments. The most common "fixed-income" investments are government and corporate bonds. "Equity investments" involve the purchase of assets which makes the holder a partial proprietor of the asset. Mutual funds' equity investments are mostly comprised of shares of public companies. "Balanced funds" offer a mix of bonds and equity.
- **Geographical coverage**. Investors can choose also funds that differ in geographical scope; they may invest in assets all over the world, in specific regions or countries, in industrialized countries or in emerging markets only.
- **Sector**. Some funds specialize in specific sectors, such as high technology.

Investors pay the fund manager a fixed fee for managing the portfolio. In addition, a portion of the returns may be paid as a fee to the fund manager. Each share of a mutual fund shares equally in the profits and losses generated by the fund, and investors are allowed to cash in profits or reinvest them into the fund.

Expansion of mutual funds

Mutual funds have dramatically expanded over the past decades. The table below shows the total assets of mutual funds.

Year	Assets (in US $ billion)
1985	495,4
1990	1 065,2
1995	2 811,5
2000	6 964,7
2001	6 975,0
2002	6 391,3
2003	7 414,1
2004 (July)	7 435,7

Source: Securities Industry Association: SIA research reports, September 20 2004, www.sia.com)

Trends & Critical Issues

- **Industry has grown enormously**. The mutual fund industry has grown enormously in the last decades. Especially in the 1990s, increasing stock prices attracted a lot of individual and institutional investors to buy mutual fund shares, providing banks and mutual funds with income from the management fees. (see box)
- **Losses after the stock market bubble**. Lower stock prices in 2002-2003 decreased the value of mutual funds substantially. In some cases, investors lost up to 50% of the value of their portfolios. Some mutual funds and banks providing those services subsequently lost a significant source of income, which resulted in some mutual funds closing down completely. In 2003-2004 the mutual fund industry started to grow again.
- **Enormous impact on local economies**. Because of their size, mutual funds' investment decisions have an enormous impact on local economies. In the mid 1990s, mutual funds bought heavily into securities of emerging markets. This dramatically affected the upturns and downfalls of those economies. In the quest for short-term gain, funds quickly bought and sold securities, regardless of the impact on the economies in which they invested, and or of the lost potential for "patient" capital to deliver long-term economic benefits to these countries.
  For example, the appetite for investments in emerging market countries (EMCs), was dramatically curtailed

by the Asian Crisis of 1997, the Russian default and subsequent near financial meltdown of 1998, the resulting problems in Brazil and other countries, and the collapse of the Argentine economy (2001-2003). When mutual funds and traders quickly wanted to sell securities from countries in financial crisis, their actions further decreased the value of all securities. This was the case in South East Asia, and it exacerbated the overall financial crisis.

- **Malpractices at funds**. The lack of transparency regarding the difference between the actual cost of managing a mutual fund and the management fee charged to clients has led to various pricing scandals. Fund managers are also increasingly under investigation for not abiding by trading rules, including executing trades after the cut-off time (late trading). These scandals have led to lawsuits and indictments, and have made some mutual funds more accountable to investors. (see box)

CSR Issues

Civil society groups and individual investors are increasingly paying attention to the environmental and social impacts of investments. As a result, 'Socially Responsible Investment' (SRI) funds (green funds/ 'ethical funds') have been popping up all around the world. These funds promise to pay more attention to the social and environmental performance of the companies they invest in. In the Netherlands, investors are exempt from interest and dividend income tax on green funds that fulfil environmental criteria laid down by the government. The success of this program indicates that citizens are interested in green funds if they have the choice, and that tax incentives can create a strong demand for such funds.

Civil society groups continue to be critical of some 'so called' ethical investment funds. There is often also no social or environmental regulation of these funds, and thus no guarantee that they are truly sustainable. In the absence of clear, standardized guidelines for SRI, fund managers, and sometimes governments, are setting their own terms of reference. Investor organizations and civil society groups have made proposals on how to improve the accountability of funds towards investors. For example, EuroSIF, the European Social Investment Forum, has stressed the need for more transparency on the exact definition of SRI used by these funds.

Yet the SRI funds are still a niche in the total mutual fund industry. Most mutual fund managers continue to focus only on the portfolio's or their companies' financial performance, rather than their contribution to environmental sustainability or commitment to human rights.

Scandals at mutual funds

The U.S. mutual fund scandals uncovered the following illegal activities and malpractices:

- **Late trading and market timing:** transactions took place after 4 p.m., the official closing time for trading mutual fund shares. This allowed late traders to take advantage of price differences between old share prices and new prices of the next day, or between different international stock exchanges in different time zones.
- **Rapid trading and market timing:** mutual funds have allowed big investors, mainly hedge funds, to rapidly trade shares of international mutual funds in a way that takes advantage of discrepancies in asset values across time zones. This siphons off profits at the expense of longer-term investors. Although these practices are not necessarily illegal, 22 US mutual funds were investigated by the U.S. Securities and Exchange Commission in 2003 and have changed staff. The highest fine, amounting to US $ 250 million, was paid by Alliance Capital.
- **Improper sales practices:** Morgan Stanley had to pay a US $ 2 million fine for giving improper incentives (such as exotic travel trips and tickets for Rolling Stones concerts) to its sales staff to push their own mutual funds to clients, at the expense of other mutual fund products (non-proprietary funds).
- **Excessive fees:** The costs for managing mutual funds are often not transparent and many mutual funds charged clients excessive fees.

All these practices are calculated to have cost individual U.S. investors (95% of the population) US $ 10 billion.

Glossary:

Bond: promissory note that obliges the issuer to pay back a certain amount of money within a certain time (with or without regular payments, or 'coupons').

Option: a contract between two parties that offers the buyer of the option the right to buy (or to sell) an asset (e.g. a financial security) from (to) the contracting party at a agreed upon price, within a certain period of time. In practice though, the selling/buying hardly takes place. Investors buy these options only because of changes in premiums of the option.

Future: a contract between two parties in which the buyer of the future is obliged to buy (or to sell) an asset (e.g. a financial security) from (to) the contracting party, at a agreed upon price, within a certain period of time.

Money market security: a very short-term debt instrument. Most of them are comparable with a bond, but the maturity is always for a period less than a year, and often less than a month. They are considered very safe, but offer limited returns.

More info

www.eurosif.org - www.socialinvest.org - www.socialfunds.com

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