Indirect Investing

Chapter 3
Charles P. Jones, Investments: Analysis and Management,
Ninth Edition, John Wiley & Sons
Indirect Investing

• Alternative to direct investment in or ownership of securities
• Refers to buying and selling the shares of intermediaries that hold securities in portfolio
  – Shares are ownership interest in portfolio entitled to portfolio income
  – Shareholders also pay expenses
Investment Companies

- Financial firm that sells shares to the public and uses the proceeds to invest in marketable securities
  - Acts as conduit for distribution of dividends, interest, and realized gains
  - Can elect to pay no federal taxes on distributions
  - Offers professional management
Company Types

• Unit investment trusts: Typically holds an unmanaged, fixed-income portfolio
  – Assets not actively traded once purchased
  – Trust ceases to exist when securities mature
  – Passive investment
Company Types

• Closed-end investment companies: No additional shares sold after initial public offering
  – Share prices determined and trade in a secondary market
  – Price may not equal Net Asset Value of the shares
    • Net Asset Value: Total market value of the security portfolio divided by total shares
Company Types

• Open-end investment companies: Shares continue to be sold to the public at NAV after initial sale that capitalizes the company
  – Shares may be sold back to company at NAV
  – Company size constantly changes
  – Popularly called mutual funds
Mutual Fund Categories

- Money market mutual funds invest in portfolio of money market securities
  - Taxable or tax-exempt
  - Commercial paper important investment
  - Average maturity limit: 90 days
  - Investors pay a management fee but not a sales or redemption charge (load)
  - Not insured by the federal government
Mutual Fund Categories

• Equity, bond, and income mutual funds invest in portfolio of securities consistent with the objectives of the fund
  – Objectives set by the company’s board
  – Disclosure of objectives to investors
  – 18 major categories of investment objectives
Equity Funds

• Most assets in equity funds rather than bond or income funds

• Most equity funds are either:
  – Value funds, which invest in undervalued stocks as determined by fundamental financial analysis
  – Growth funds, which invest in stocks of firms expected to show future rapid earnings growth
Cost Considerations

• Closed-end fund prices may be at a discount or premium to NAV
  – Liquidation value different than price
• “Load” funds charge a front-end fee to cover the costs of selling the fund to investors
  – May also be a redemption (back-end) fee or distribution fee (called 12b-1 fee)
Cost Considerations

• All fees must be stated in the mutual fund prospectus
• No-load funds are purchased at NAV directly from the investment company
  – No sales force expense to cover
  – Investors must seek out funds
  – Still an annual operating expense paid out of fund income
Performance

• Reported on a regular basis in the popular press

• Measured over a given time period as a percent of initial investment
  – Total returns include reinvested dividends and capital gains
  – Average annual return reflects the mean compound growth rate of investment over a given time period
International Funds

• Some mutual funds specialize in international securities
  – US investors can participate in emerging market economies
  – International funds or global funds emphasize international stocks
  – Single-country funds concentrate assets
    • Actively or passively managed
Exchange-Traded Funds

- Basket of stocks that tracks the value of a sector, investment style, or market as a whole
  - Characteristics of index mutual funds and closed-end funds
    - Trades throughout the day on an exchange
    - Bond and equity indexes traded
- Tax efficient: control over capital gains distributions
New Directions in Funds

• Mutual fund “supermarkets”
  – Various mutual fund families can be purchased through a single source
  – Brokerage account may provide access
  – “Supermarket” managers earn fee

• On-line investment services
  – Internet used to provide mutual fund information and make transactions
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End Chapter 3