Chapter 2
Characteristics of Investment Companies

Abstract Chapter 2 provides a brief overview of five types of investment companies: open-end funds, closed-end funds, unit investment trusts, exchange-traded funds, and hedge funds. The primary topics introduced are how investment companies are formed, how they are operated, and how their shares are bought and sold. The chapter also includes a brief treatment of the legal environment in which they operate.

Keywords Open-end funds (mutual funds) · Closed-end funds (CEFs) · Unit investment trusts (UITs) · Exchange-traded funds (ETFs) · Hedge funds · Initial public offerings (IPOs) · Prospectus · Discounts · Creation units · Limited partnerships

2.1 Introduction

In this chapter we look at the basic structural characteristics of open-end investment companies (mutual funds), closed-end investment companies (referred to as either CEFs or CEICs), unit investment trusts (UITs), exchange-traded funds (ETFs), and hedge funds. Although the primary foci of the book are CEFs, ETFs, and hedge funds, a treatment of open-end funds is included as a source of comparison. UITs are described because that structure is frequently adopted by ETFs.

2.2 Open-End Investment Companies

Open-end investment companies (commonly referred to as *mutual funds*) continuously issue and redeem ownership shares. The shares of an open-end fund do not trade in a secondary market or on any organized exchange; instead, investors purchase shares from the company. Likewise, investors redeem shares by selling them back to the company, where they are retired. Thus, the equity

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capital and assets of a mutual fund are increased when shares are sold and are reduced when shares are repurchased.

Open-end fund company shares are marketed in a variety of ways. Investors may purchase shares directly from the fund or through a licensed broker. Security regulations require that a prospectus be made available to the potential investor prior to the actual sale. A prospectus details the investment philosophy of the fund, assesses the risks in an actual investment, and discloses management fee schedules, dividend re-investment policies, share redemption policies, past performance, etc. Any sales or redemption fees (i.e., "loads") must also be disclosed. Management fees for most mutual funds range from approximately 0.2% for some index funds to more than 2% for some actively managed funds. The prospectus is updated quarterly to provide current information to potential investors. Generally, there are minimum initial investment dollar amounts and minimum subsequent investment amounts; usually the latter is significantly smaller than the former.

2.3 Closed-End Investment Companies

Commonly referred to as *closed-end funds*, CEFs do not continuously issue or redeem ownership shares. Initially, there is a public offering of shares, which is preceded by the issuance of a prospectus as described above. Management expenses for most CEFs are in the 1–2% range annually. Like most other initial public offerings, the shares are generally offered to the public by licensed brokers. At this juncture, however, the similarity ends between closed-end and open-end funds.

After the shares of the new closed-end fund are offered to the public, the fund invests the proceeds from the initial public offering in accordance with the policy statement disclosed in the prospectus. CEFs, however, do not sell new shares to interested shareholders, nor do they stand willing to redeem shares from their investors. To obtain shares after a public offering is completed, an investor must purchase shares from other investors in the secondary market (one of the exchanges or the over-the-counter (OTC) market). There is no legal requirement that there be any formal relationship between the price of the shares and the fund's assets.

The total market value of the company's assets less its liabilities (i.e., net assets) divided by the number of shares outstanding is generally referred to as the net asset value (NAV) per share. A common measure of the relationship between the price of the shares and the net asset value of a closed-end fund is

$$D = \frac{\mathrm{NAV} - \mathrm{MV}}{\mathrm{NAV}},$$

where D is the percentage difference between the net asset value per share and the market value or price per share (MV). When NAV exceeds the MV, the D is called a *discount*. When MV exceeds NAV, the *D* is called a *premium*. Discounts, which are far more common than premiums, have puzzled the investment community since the 1920s. Why discounts or premiums exist and persist is one topic of interest in Chapter 4.

2.4 Unit Investment Trusts

Commonly referred to as *UITs*, these investment companies offer an unmanaged portfolio of securities. They are not management companies as are both open- and closed-ends and have no board of directors. Also, a UIT is created for a specific length of time and is a fixed portfolio. Thus, the UIT's securities will not be sold or new ones bought, except in certain limited situations such as bankruptcy of a holding. UITs are assembled by a sponsor and are sold through brokers to investors. They generally issue units (shares) as intended for a set period of time before the primary offering period closes.

Stock trusts are generally designed to provide capital appreciation and/or dividend income until their liquidation date. In contrast, bond trusts are designed to pay monthly income. When a bond in the trust is called or matures, the funds from the redemption are distributed to the clients via a return of principal. The trust continues paying the new monthly income amount until another bond is redeemed. This continues until all the bonds have been liquidated.

2.5 Exchange-Traded Funds

ETFs are investment companies registered under the Investment Company Act of 1940 as either open-end funds or UITs. Regardless of a fund's organizational structure, all existing ETFs issue shares only in large blocks (such as 50,000 ETF shares) called "creation units." An investor such as a brokerage house or large institutional investor purchases a creation unit with a "portfolio deposit" equal in value to the NAV of the ETF shares in the creation unit. After purchasing a creation unit, the investor can hold the ETF shares or sell a portion of the ETF shares to investors in the secondary market. Management fees for ETFs are generally similar to those of low-cost index mutual funds.

The ETF shares purchased in the secondary market are not redeemable from the ETF except in creation unit aggregations. Thus, an investor holding fewer ETF shares than comprising a creation unit can dispose of those ETF shares in the secondary market only. If the secondary market ETF shares begin trading at a discount (i.e., a price less than NAV), arbitrageurs can purchase these ETF shares and, after accumulating shares amounting to a creation unit, redeem them from the ETF at NAV, thereby acquiring the more valuable securities in the redemption basket. If ETF shares trade at a premium (i.e., a price exceeding

NAV), then transactions in the opposite direction can generate profits. Because of arbitrage, deviations between daily ETF prices and their NAVs are generally less than 2%.

2.6 Hedge Funds

Hedge funds are private limited partnerships that accept investors' money and invest it in a pool of securities. They employ trading strategies using financial instruments and may or may not use financial leverage.

A general partner and limited partners are the two types of partners in a hedge fund. The general partner is the individual or entity who starts the hedge fund and who also handles the trading activity and day-to-day operations of the fund. The limited partners supply most of the capital but do not participate in the trading or daily activities of the fund.

The general partner generally charges an administrative fee of 1% of the year's average net asset value. For the services provided, the general partner normally receives an incentive fee of 20% of the net profits of the partnership. How an investor redeems shares may vary from fund to fund, and there are no guarantees on the fair pricing of a fund's shares.

Thus, these funds are similar to mutual funds in some respects, but differ significantly from mutual funds because hedge funds are not required to register under the federal securities laws. They are not required to register because they usually accept only financially sophisticated investors and do not offer their securities to the general public. Nonetheless, hedge funds are subject to the antifraud provisions of federal securities laws. Some, but not all, types of hedge funds are limited to no more than 100 investors.

Now that we have looked at the basic characteristics of investment companies, we turn to a brief history of them.

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