Chapter 1

Definition and Structure of a Mutual Fund

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The concept underlying a *mutual fund* has probably existed since securities were created. In its simplest form, it works as follows. A group of individuals, with a similar *investment objective* or goal, place their investment monies into a common pool. These funds are then used to buy and sell securities. By pooling their money, the participants reap two primary benefits. The first benefit is diversification. The collective buying power of the group's pooled resources enable it to purchase shares or bonds in a broader range of industries or business sectors than any individual in the pool could do on his or her own. The second benefit is lower transaction costs per participant. Because the commissions and other trading fees are spread over more shares and more investors, the cost per person is usually much lower than it would be if each individual had bought the same shares directly through a brokerage firm.

Originally, one person, usually a contributor to the pool, was designated by power of attorney or other legal means to select which securities to buy and sell. Each

> **mutual fund**
> commonly used name for an open-end management company that establishes a portfolio of securities and then continually issues new shares and redeems already outstanding shares representing ownership in the portfolio.

investment objective the strategy by which an investor wishes to increase the value of his or her assets.

bull market a period during which the overall prices of securities are rising.

investment company generic name for one of the many companies, like a mutual fund, whose primary business is investing and reinvesting in securities.

person in the pool shared in the gains and losses on the investments. Their percentage of gains and losses was equal to their percentage of the participation in the pool.

These loosely run and unregulated pools were especially popular in the United States during the *bull market* of the 1920s. In March 1924, Massachusetts Financial Services created the first true mutual fund in the United States. It was called the Massachusetts Investors Trust. Following the market crash of 1929, Congress passed legislation designed to give clearer structure to and better regulate the various type of investment pools (also called *investment companies*). The *Investment Company Act of 1940* was the first U.S. law to define the different types of pools.

One of the types of investment companies defined in the Act is a management company. It is a corporation or trust whose primary business purpose is to invest and reinvest in securities in accordance with a stated investment objective. The securities that a management company's professional advisor buys and sells are held in an investment portfolio. When an individual buys shares of a management company, he or she is, in reality, buying an undivided interest in the portfolio of securities created by the company.

When a management company is formed, it will have either a closed-end structure or an open-end structure. (See Figure 1.1.) The basic difference between the two forms is how frequently new shares are issued to the investing public. A closed-end management company creates an investment portfolio and then issues shares backed by that portfolio to the public *only one time.* Therefore, the number of shares outstanding, called the company's capitalization, remains relatively fixed. (This is discussed in more detail at the end of this chapter.)

An *open-end management company* also creates an investment portfolio and then issues shares to the public backed by that portfolio. In contrast, however, this company, continually issues new shares and buys back already outstanding shares each business day in direct response to investors' orders to put more of their money into or pull money out of the underlying portfolio. The number of shares outstanding—its capitalization—changes continually. An open-end management company is the legal name for what is widely called a mutual fund.

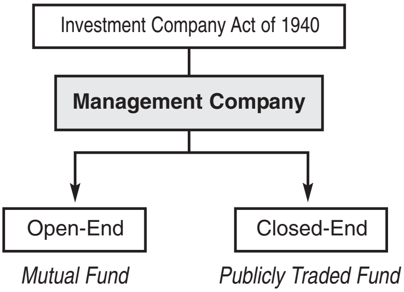

FIGURE 1.1 Types of management companies.

Open-End Management Company (aka, Mutual Fund)

Each mutual fund is legally registered as a separate management company or trust with the Securities and Exchange Commission (SEC). The financial services company that creates a fund is called the *sponsor*. It invests its own money to start the fund's portfolio. (The minimum dollar amount that the sponsor is required to invest is specified in the provisions of the Investment Company Act of 1940.) It also initially selects the fund's portfolio manager. The sponsor then seeks to bring additional money into the portfolio by marketing it to the public. The more shares it sells, the more money it has to invest in *stocks* and/or *bonds*.

A mutual fund is called an "open-end" management company because it stands ready to issue new shares and redeem outstanding shares every business day. As individuals buy (i.e., invest more money in) a fund, it issues more shares to the purchasers. The fund's portfolio manager then uses that money to purchase additional stocks and/or bonds into the portfolio. When investors sell (i.e., redeem or pull money out of) a fund, the total shares outstanding declines. If the number of redemptions is very high, then the fund's portfolio manager may have to sell some of the stock and/or bonds out of the portfolio in order to pay the investors who have sold (i.e., redeemed) their mutual fund shares. Thus, the number of a mutual fund's shares outstanding changes daily depending on the number of purchases or *redemptions*. Even when a mutual fund closes to new investors, those people who already have money invested in the fund can continue to buy and redeem that fund's shares.

Investment Company Act of 1940
the federal legislation that defines the types of organizations that qualify as investment companies and requires them to register with the SEC.

open-end management company
legal name for a mutual fund under the Investment Company Act of 1940.

sponsor
the corporation or trust that creates a mutual fund or a family of mutual funds.

stock
a negotiable security representing ownership of a company and entitling its owner to the right to receive dividends.

bond
a long-term debt security or IOU issued by a corporation, municipality, or government that promises to pay interest periodically and to repay the bond's principal at maturity.

Mutual fund shares do not trade on stock exchanges or in the over-the-counter market. In fact, the Financial Industry Regulatory Authority (FINRA) expressly prohibits trading these shares in these *secondary markets*. It is, therefore, inaccurate to describe mutual fund shares as tradable securities. Investors cannot buy and sell shares among themselves. Instead, mutual funds are redeemable securities. An investor can only buy shares from or redeem them with the fund itself or one of the fund's authorized sales agents. Redeeming mutual fund shares is widely described as selling fund shares.

The emergence of *mutual fund supermarkets*, like those established by Charles Schwab & Co., OneSource, Fidelity Fund Network, E*Trade Mutual Funds Network. and others, has for some unknown reason caused some people to presume that they are actually trading mutual fund shares with other investors who have accounts at these companies. This belief is wrong. The supermarkets are authorized sales agents for many different mutual fund companies, in addition to selling their own. What many investors misconstrue as "trading" in the supermarket is nothing more than a purchase and a redemption, with the firm that runs the supermarket acting as an *agent*, directing the order to the specific mutual fund company. Again, there is no secondary market trading of mutual funds.

Structure of a Mutual Fund

Understanding the organization of a mutual fund and the responsibilities of each of its components makes clear two important features (See Figure 1.2):

1. The safeguards and separation of responsibilities designed to empower certain entities and individuals to act as watch dogs for the shareholders and thus protect their interests.
2. The various costs associated with its day-to-day operation, which are passed along to investors as fees and expenses.

The first feature does not imply that investors' shares are protected from market price fluctuations. Instead, it means that the fund's assets are protected from potentially inappropriate and fraudulent activities by the sponsor or portfolio manager. The diagram below illustrates the various participants or entities involved in a mutual fund. Their specific responsibilities and duties are detailed afterward.

redemption the sale of mutual fund shares back to the fund or its selling agents at the fund's NAV.

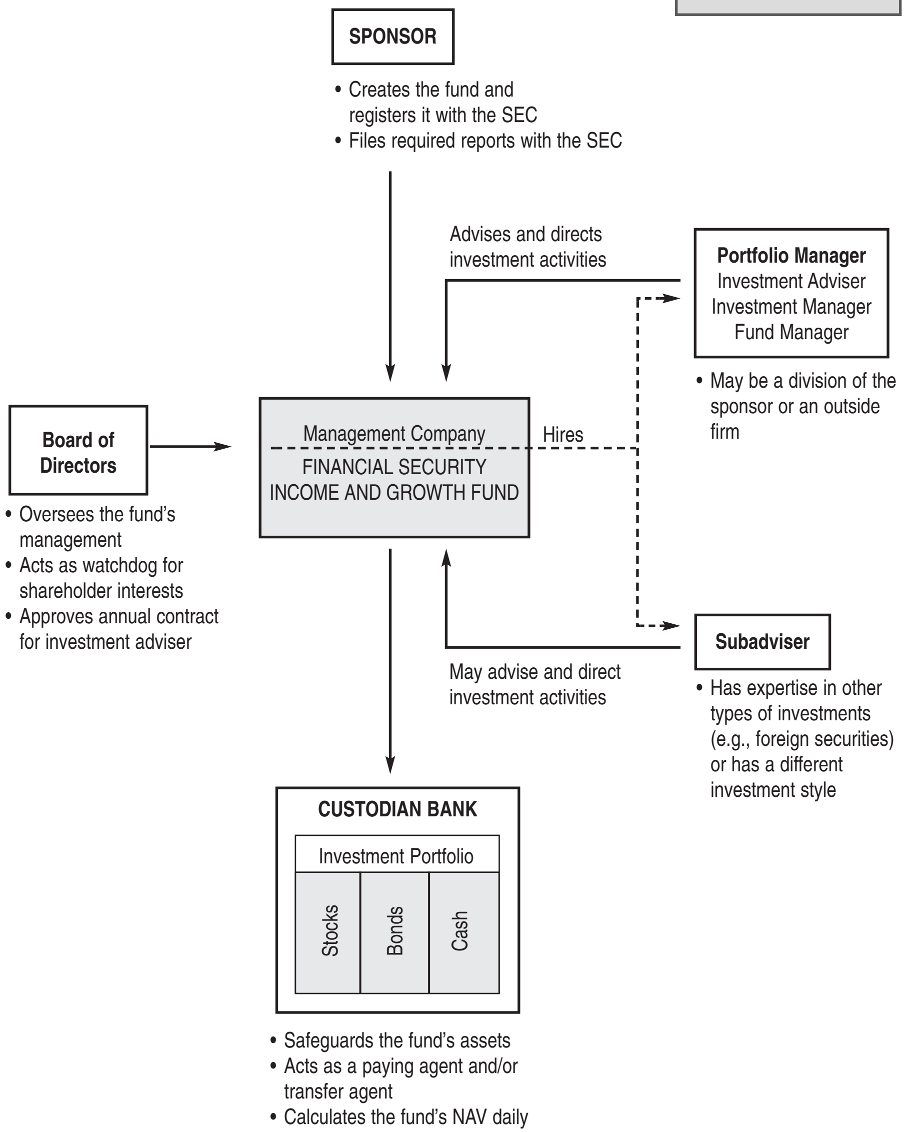

FIGURE 1.2 Structure of a typical mutual fund and the basic responsibilities of the various parties.

secondary market
also called the aftermarket market, a collective term for the markets—exchange and OTC—in which securities trade after they are issued to the public.

mutual fund supermarket
a select group of mutual funds from many different sponsors that can be bought and sold through one brokerage at nominal transaction fees.

agent
a registered person or business organization that acts as the intermediary in the purchase or sale of a security.

Sponsor

A sponsor is a company—typically a financial services organization such as a brokerage firm, bank, insurance company, or mutual fund company—that creates and makes the first investment in a particular mutual fund or series of mutual funds. For each new fund, the sponsor must file a registration statement with the Securities and Exchange Commission (SEC) and with the appropriate authority in any state in which it plans to offer or sell the fund to the public. This registration document, which becomes the *prospectus* for the mutual fund, must contain full and fair disclosure about the fund's sponsor, Board of Directors, investment objectives, types of investments permitted, expenses, fees, and risks.

Registration does not mean or imply in any way that the SEC or a state authority has approved or endorsed the mutual fund. In fact, all mutual fund prospectuses must contain the following statement in:

> *Like all mutual fund shares, these securities have not been approved or disapproved by the Securities and Exchange Commission or any state securities commission, nor has the Securities and Exchange Commission or any state securities commission passed upon the accuracy or adequacy of this prospectus. Any representation to the contrary is a criminal offense.*

Management Company

Each mutual fund is a separate open-end management company that the sponsor must register with the SEC when it is created. Janus Balanced Fund is an open-end management company. Vanguard's Long Term Bond Index Fund is an open-end management company. And Fidelity Select Gold Fund is a management company.

When a sponsor creates several mutual funds, it may choose to place them all under one umbrella or under different brand names. Such a grouping is called a *family of funds*. A family of funds may consist only of as few as three mutual funds—a stock fund, a bond fund, and a money market fund. Other companies (Fidelity, for example) create large fund families that include mutual funds that have different brand names (e.g., Fidelity Advisors, Fidelity Selects, Fidelity Spartan); invest in specific industries, specific countries, and specific combinations of securities; or have different investment approaches and different risk-to-reward characteristics.

Usually the shareholder services and benefits provided by one fund are also provided by all funds in the same family. Mutual fund companies view this grouping of different management companies as a way of being able to capture a larger percentage of each customer's investment dollars as, over time, individuals seek to diversify their holdings, or as their investment objects or economic circumstances change.

prospectus
a printed summary of the SEC-filed registration statement that discloses the details of a particular mutual fund's objective, historical performance, portfolio composition, and other information an investor can use to judge the merits of investing in the fund.

Board of Directors

The Board of Directors of a mutual fund is responsible for overseeing the day-to-day management of that fund as well as the trading activities of its portfolio manager or managers. Some of its specific responsibilities are: (1) deciding whether or not to renew the investment advisor's annual contract, (2) voting on any changes in the fees the manager charges the fund, (3) monitoring the specific investments within the portfolio to avoid undue concentration in any one sector or company, (4) making sure the advisor's investments comply with (and do not stray from) the fund's stated investment objectives, and (5) monitoring the fees charged by the fund to ensure that they are fair and reasonable to the shareholders. The primary purpose of all of the Board's responsibilities is to protect the interests of the fund's shareholders.

family of funds
a group of mutual funds created by the same sponsor with different investment objectives or with portfolios of different securities.

The members of the Board are initially appointed by the fund's sponsor. Afterwards, they are elected by the fund's shareholders. *Proxies* are distributed annually and are used by shareholders to vote. To prevent the sponsor, who may have large amounts of money invested in the fund, from having undue influence

proxy
a form on which an investor votes. Shareholders can also vote via the Internet or phone.

over the Board, the Investment Company Act of 1940 mandates that although 60 percent of the Board can come from the sponsor, at least 40 percent must be independent directors (also unaffiliated or disinterested persons) that receive no compensation for either working for the fund or rendering services to the fund. These independent directors must also be individuals with no affiliation with the sponsor. In reality, the current percentages still give the sponsor a strong sway over the management. In many cases, the chairman of the Board of Directors is typically the same person who is the Chief Executive Officer (CEO) of the sponsor. Other Board members typically include individuals from the fund's law firm, its accounting firm, and the trading firm that executes its buy and sell orders, and important business associates of the sponsor.

Board members are paid fees for their services. (Importantly, this is not considered to be compensation.) The amounts are disclosed in the prospectus. It has become a widespread practice for individuals to serve on the boards of several funds, especially if those funds are sponsored by the same company. For example, if you compare the prospectuses for some of the large mutual fund groups, you will discover that many names appear again and again on the Boards of different funds.

Due to this overlap of directors, some shareholder activists and industry regulators have sought to make some changes in the board's composition. They argue that the large percentage of non-independent directors results in their merely rubber stamping the portfolio manager's activities, offering little oversight or expertise, failing to monitor expenses, and devoting less time than their fee warrants. Also activists (and regulators) question whether the non-independent board members, who already earn compensation working for a mutual fund or mutual fund company should also "double dip" by earning additional fees to serve as board members. Two important changes to a fund's Board of Directors have been proposed. First, the required number of independent board members (currently set at 40 percent) should be increased. Since these members are appointed specifically to watch out for the interests of the fund's shareholders, then the more of them on the board the greater the possibility that the shareholder's point of view would have greater representation during any conflicts with the fund's manager or sponsor. And second, there should be a review of member's compensation to see if it is excessive, perhaps resulting in less careful oversight of the fees charged by the portfolio manager.

Many mutual funds already appoint a number of independent board members in excess of the percentage required under the Investment Company Act of 1940.

[Note: The government had proposed changing the composition of the Board of a mutual fund, increasing the number of disinterested members to 55 percent. This change was proposed in response to scandals that occurred in the late 1990s and early 2000s. However, one of the largest mutual fund companies in the United States was able to challenge the proposed rule change and effectively stop it from being enacted. Given the current climate for financial reform that's focused on banks and brokerage firms, it seems unlikely that this rule change will be adopted for mutual funds. There are more important issues given the state of the U.S. economy. Nonetheless, increasing the number of unaffiliated, disinterested, or independent persons on a fund's board is thought to be a reasonable way of providing greater oversight on behalf of the investing public.]

Investment Advisor/Investment Manager/ Portfolio Manager/Fund Manager

When most people hear the term *investment advisor* or *portfolio manager*, they think of an individual who works directly for the sponsor or the fund itself. In reality, an advisor is generally a corporation that is a wholly owned subsidiary of the sponsor. Fidelity Funds, for example, is managed by Fidelity Management and Research (FMRCo), a subsidiary of Fidelity. Other mutual funds contract an outside investment advisory company, called an *asset-management firm* or a *sub-investment advisor*, to be the portfolio manager. Vanguard's Windsor Fund, for example, outsources portfolio management responsibility to the U.S. Value Equities at AllianceBernstein and Wellington Management Company. The person or persons listed as the portfolio manager is therefore an employee of an investment advisory firm. In the case of the Dreyfus Appreciation Fund, the Houston-based Fayez Sarofim & Company (where Mr. Sarofim is president, chairman of the board, and a director), has been the fund's sub-investment advisor since 1990. Fayez Sarofim & Company also serves as an advisor to several other Dreyfus funds.

An investment advisor is responsible for implementing the mutual fund's investment strategy by researching and selecting the specific securities that will be bought into and sold out of the portfolio. This individual or team manages the fund in accordance with the investment objective stated in the fund's registration statement and prospectus. He or she must also abide by any restrictions regarding the types of investment products (stocks, bonds, options, and futures) that can and cannot be traded in the portfolio, as well as the percentage of the fund's assets that the manager can, at his or her discretion, hold as cash in a money market account. These restrictions are detailed in the fund's prospectus.

The organization of the people within the investment advisory firm varies. At some firms, a portfolio manager works autonomously handling only one fund. At others, an individual portfolio manager will be responsible for several funds within the same sector or related sectors (e.g., consumer staples and pharmaceuticals) or with complementary investment objectives. When a team of managers is responsible for a mutual fund, usually one or two are designated as *team leader* or *lead managers.* These leaders are usually senior persons who supervise the activities of junior managers (relatively recent business school graduates) and sometimes researchers or analysts. (Research is sometimes a separate department.) The manager and/or the analysts may visit many of the companies that they are evaluating for possible investment. Then, using computer technology and proprietary analytical approaches, they use their findings and other factors about the company or business entity to create models of the security's potential performance. This arrangement is common throughout the mutual fund industry. At companies with formal training and development programs, like Fidelity, recently graduated professionals work with experienced managers in order to learn the business. This arrangement also enables the company to assess the individual's potential skill as a portfolio manager before assigning a fund to him or her.

As noted in the previously sited example of the Dreyfus Appreciation Fund, sponsors also hire outside investment advisory companies called *subadvisors.* These asset management firms typically provide skills in areas where the sponsor lacks expertise, such as emerging markets, international bonds, or certain industry sectors (e.g., precious metals, biotechnology, etc.). They may also employ a different or complimentary investment style to the one already being implemented in the fund. Asset management firms also provide research and information, which the managers can use in their other investment decisions. Outside asset management firms may have sub-advisory agreement with many different mutual funds or mutual fund companies. When a sub-advisor is used, each portfolio manager is usually an employee of the sub-advisor.

actively managed mutual fund
a fund that has a portfolio manager who decides which securities should be bought into and sold out of the fund's portfolio.

Each investment manager's professional experience must be disclosed in the prospectus in a section describing the fund's management. Here, an investor is told how long the sole manager or each member of the investment team has been in charge of that fund, any funds each manager has previously run, each manager's education, and other professional licenses that person has attained. This is important information to read, particularly if you are investing in an *actively managed mutual fund.* First, it gives you the ability to determine what period of the fund's performance has been under the direction of that specific individual or team. Second, if the advisor has managed another mutual fund previously, it enables you to research the performance of that fund under that manager's tenure. Finally, and perhaps most important, it enables you to determine the manager's depth of experience in the investment markets. Has he or she experienced both bull and *bear markets*? What returns did he or she produce during these periods relative to the overall stock or bond market? All of this information will help you to judge the expertise and talent of the manager or management team before you invest.

The longer a manager or investment team has been in charge of a mutual fund, the better. When a new or young manager takes charge of a fund, or there are management changes due to a merger or acquisition between mutual fund companies, future performance becomes even more uncertain. You should look for an experienced advisor with a proven track record of producing consistent results in good times and bad. The value of experience, tenure, and consistency should not be underestimated.

Mutual fund companies have become aware of the trust that these attributes can garner for the specific fund and the sponsor. In reaction, funds sometimes publicize successful portfolio managers in their promotional materials, advertisements, and *annual reports*. This "star system" is a double-edged sword. While it increases trust and cash inflows to the fund, it can backfire if the star portfolio manager leaves. Investors might redeem their shares and follow the manager to his or her new fund. While the old childhood rhyme, "hitch your wagon to a star and it will take you very far," might seem applicable, it is prudent for mutual fund investors to keep in mind that few portfolio managers make all investment decisions completely alone. There are analysts and researchers at the management company supporting these trading activities. For example, it is usually the analysts or even the fund's senior management who determine the fund's *asset allocation*—i.e., how much of it assets should be held in stocks, bonds, and cash. When a "star" leaves, it does not necessarily mean that the performance of a mutual fund will decline. There may be a great understudy trained and waiting to step into the role.

bear market
a period during which the overall prices of securities are declining.

annual report
a document containing audited financial statements as well as other information about the fund's performance that each fund must distribute to shareholders annually.

asset allocation
the systematic and thoughtful placement of investment dollars into stocks, bonds, and cash equivalents.

An investment advisor earns a management fee for its services. The specific individuals who manage the fund usually receive a base salary plus a bonus based on the return of the fund. The management fee is an annual fee based on the total amount of assets under management, and is deducted from the fund a little each day. It is therefore in the investment advisor's interest to make the fund's assets grow as well as attract new money to the fund because the amount of money they earn from fees increases. (Management fees are discussed in more detail in Chapter 3 on Fees and Expenses.)

Additionally, the advisory company or the individual portfolio manager may have its own money invested in the fund, and will profit if it makes the fund perform well. The amount of a manager's holdings in a specific fund is usually not disclosed to the public. Some analysts argue that this information is just as important as the manager's professional experience and education. If the manager doesn't invest his own money in the fund, the debate goes, then does he have a real incentive to make the fund grow? Will the manager "feel the shareholders' pain" during a period when the portfolio is significantly underperforming in the market, or will he be content to simply earn its fees, albeit lesser of them?

Many factors must be considered when evaluating the past and potential performance of an individual fund manager or team of managers. Unfortunately, there are no perfect models or formulas. Length of experience and consistency of returns are probably two of the best criteria for all investors to use.

Custodian Bank

The Investment Company Act of 1940 requires every mutual fund to appoint a qualified *custodian bank*. Its primary responsibility is to safeguard the fund's assets. It holds the securities and cash resulting from the portfolio manager's trading activities. This is one of the important protective features built into a mutual fund's structure. The portfolio manager does not and cannot have possession of the fund's assets. Therefore, he or she cannot abscond with the assets, as has happened in the past. Even if the management company were to be dissolved, the fund's assets would be at the bank where they could be distributed to the shareholders on a pro-rate basis or liquidated and the proceeds distributed to the shareholders. Further protection comes from the requirement that the bank must segregate the funds assets from other bank assets. This safeguards the mutual funds assets should the custodian go bankrupt.

custodian bank
the bank or trust company whose primary responsibility is safeguarding the fund's assets and calculating their value daily.

A key responsibility of the bank is to calculate the fund's net asset value (NAV) every business day and distribute this information to the public. The custodian bank may have other functions. It can be the fund's *transfer agent*, keeping track of how many shares each shareholder owns. It can also serve as *registrar*, maintaining a current and accurate list of the shareholders of the fund. This record is used for sending distributions (*dividends* and *capital gains*) as well as mailing reports, proxies, and other communications to shareholders. The custodian bank earns a custodial fee. The amount is disclosed in the prospectus.

The custodian bank may be an outside bank or trust company. However, it may also be a division of the mutual fund's sponsor. For example, either Merrill Lynch Bank USA or Merrill Lynch Bank and Trust acts as the custodian bank for Merrill Lynch funds.

transfer agent
usually a commercial bank or trust company appointed by a mutual fund to keep track of daily purchases and sales of fund shares.

Transfer Agent

While many mutual funds' custodian banks also act as transfer agent, other funds hire an outside organization to handle this function. A transfer agent is the primary record keeper and information distributor for a fund. It keeps detailed records of shareholders accounts, including calculating, distributing, and reinvesting dividends. The agent sends transaction *confirmations* to the customer and, at the end of each year, is responsible for mailing federal income tax information. A transfer agent prepares and mails shareholders monthly or quarterly account *statements*. It may also run the mutual funds customer service department, providing account information and answering shareholder questions.

registrar
usually a commercial bank or trust company responsible for maintaining an accurate list of the names and addresses of a mutual fund's shareholders.

Distributor/Underwriter

The *distributor* or *underwriter* is responsible for selling the mutual fund shares to the public. To accomplish this, the distributor prepares sales literature, brochures, advertising, and may even hold contests and promotions to give brokers an incentive to sell fund's shares. A mutual fund distributor can also act as a *retailer*, selling its shares directly to the public itself. Most of the major brokerage firms sponsor their own mutual funds. These are called *proprietary funds*. They are sold directly to the public by the brokerage firm. Merrill Lynch, Fidelity, and Charles Schwab,

dividend
that portion of the company's after-tax earnings that its board of directors decides to distribute to the shareholders.

capital gain
the profit that results when the proceeds from the sale of a security are higher than the price at which the security was purchased.

confirmation
a notice sent from the broker to the customer that discloses the details of the execution of an order, including the execution price, number of shares, and settlement date.

for example, all act as their own retailers (Figure 1.3). Merrill Lynch funds can only be bought through Merrill Lynch or Blackrock, a company that it partly owns. Today, some of these proprietary funds (especially those created by brokerage firms) are available through other sources, such mutual fund supermarkets. For example, Morgan Stanley Special Value Fund can be bought through Charles Schwab One Source. The reason for the change is the supermarkets' larger client base. The propriety funds can be marketed to a broader range of investors and their investment dollars. If successful, the result is an increase in assets under management and therefore more fee income for the investment advisor and sponsor.

The distributor can also act as a wholesaler (Figure 1.4). In this case, the fund signs up *selling groups* through which it sells its funds. Janus Funds and Dreyfus Funds are good examples of this. In addition to buying shares directly from Janus or Dreyfus, you can buy them through just about every bank, insurance company, brokerage firm, or mutual fund supermarket. These financial institutions act as a selling group. They receive a selling concession when their customers purchase one of the Janus or Dreyfus funds. In serving as its own retailer and wholesaler, a fund distributor is able to offer its shares to the broadest range of investors.

The members of the selling group are prohibited from "warehousing" mutual fund shares. This means the firm cannot hold an inventory of shares in anticipation of its customers placing orders. When you place an order to

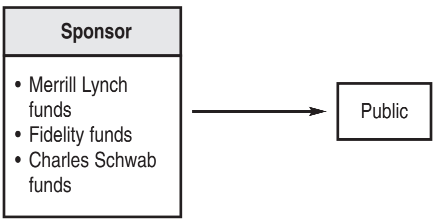

FIGURE 1.3 Retail distribution mechanism of mutual fund shares. The sponsor acts as a retailer, selling its own mutual fund shares directly to the public. Until recently, proprietary funds created by brokerage firms could only be bought and redeemed directly with the sponsor. Today, some firms now sell their funds through other sales agents such as mutual fund supermarkets.

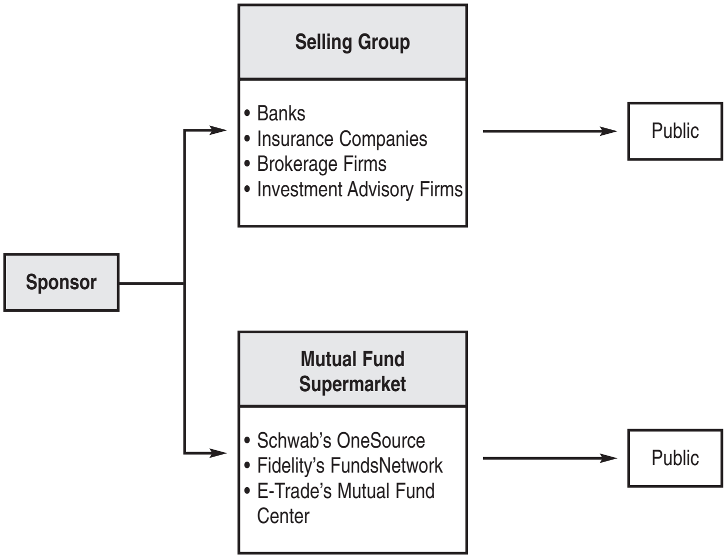

FIGURE 1.4 Wholesale distribution mechanism of mutual fund shares. Sponsor acts as a wholesaler, offering its funds' shares through individual selling groups or mutual fund supermarkets. This distribution method has become the most popular because the fund sponsor gains access to a broader customer base to which its funds can be sold. The same sponsor that sells its funds through selling groups can (and does) sell shares of the same fund directly to the public.

buy Janus fund shares through Charles Schwab OneSource or Fidelity FundsNetwork, for example, the supermarket forwards your order to Janus who executes the order to buy fund shares or redeem fund shares. Hence, a selling group member can only place an order to fill an existing customer order or for the firm's own proprietary investment account.

Closed-End Management Company (aka publicly traded fund)

Also called a publicly traded fund, a *closed-end fund* establishes a portfolio of securities, then issues shares to the public backed by the underlying portfolio. Like a mutual fund, each share represents an undivided interest in the portfolio of securities. However, a closed-end management company typically issues shares to the public only once. It does *not* continually issue new shares

statement
a summary of all transactions in an investor's account as well as the current value of all securities positions being held in the account.

distributor
the financial institution through which a mutual fund sells its shares to the public.

underwriter
the division of the sponsor responsible for creating the fund's prospectus and marketing the fund directly to the public or wholesalers.

proprietary funds
a mutual fund company's own funds that it creates and sells itself.

or redeem already outstanding shares each business day. Therefore, unlike a mutual fund, the number of a closed-end fund's shares outstanding remains relatively fixed.

Just like the common shares issued by a publicly held corporation (e.g., JNJ, MSFT, GOOG), closed-end fund shares can be bought and sold on stock exchanges or in the over-the-counter market; hence the name *publicly* traded fund. These shares are correctly described as being *tradable*. [Remember: Mutual fund shares (i.e., share of an open-end management company) are redeemable securities and cannot trade in the secondary markets.]

Historically, most closed-end funds have invested in the equity or debt securities of foreign countries or of specialized sectors (e.g., municipal securities, utilities). Today, closed-end funds invested in bonds make up the largest segment of this type of investment. The closed-end fund structure was originally chosen by the management company because the securities in the portfolio tended to lack the *liquidity* of those traded on major stock exchanges. If investors bought the securities directly in those local markets, they would have difficulty liquidating their holdings during market downturns. Because a closed-end fund shares trade on the highly liquid U.S. securities markets, it is easier for U.S. investors to buy and sell them.

The following example illustrates how a closed-end fund is established and how its shares trade. Suppose a brokerage firm determines that individuals are interested in investing in growth companies whose shares trade in India. It buys shares of companies traded on the local stock exchange or exchanges of India, creating a portfolio that it then registers with the SEC. Typically the portfolio or fund would be named after the country or region where the shares were purchased. Our theoretical fund will be called the India Growth Fund. Once the shares are issued, they then trade on the NYSE-Euronext. As with any publicly traded company, closed-end fund shares are issued at an initial public offering price. This initial price is based on the value of the equity or debt securities in the portfolio, plus any fees that the underwriter builds into the price. Once the shares are issued, their market value fluctuates daily based on expectations of the performance of the India-based companies whose stocks make up the underlying portfolio. The fund's shares on the NYSE-Euronext may trade at a price *equal to* the net asset value (NAV) of the shares in the portfolio, at a *discount* to the NAV, or at a *premium* to the NAV. Investors in the fund can place orders with their brokers to buy or sell their shares at their current market value or at specified prices during the trading day. A closed-end fund's shares are subject to the rules of the exchange where they are listed and traded. However, the companies' shares and/or bonds in the portfolio are regulated by the securities authorities of the markets in which those securities are listed and traded.

selling group a group of registered brokers/dealers responsible for offering and selling mutual funds created by other sponsors to the public.

Closed-end funds allow the investment manager to maintain the portfolio, while at the same time giving investors a way to buy or sell in the secondary markets the shares backed by that portfolio. If there were a huge downturn in that particular country, market, or sector, the manager will not be forced to liquidate the portfolio during unfavorable conditions. As investors sell the fund's shares, their market value on the U.S-based stock exchange would be driven down, perhaps trading at a deep discount to the actual NAV of the stocks and/or bonds in the portfolio. In contrast, the manager of a mutual fund might be forced to liquidate positions in the portfolio if the number of redemptions resulting from the market's downturn was high. This forced sale could drive the market price for the securities in the portfolio even lower.

closed-end fund a type of management company that creates a portfolio of securities and then issues a fixed or limited number of shares to the public backed by the portfolio. The shares trade on exchanges or OTC markets.

Today, closed-end funds are not limited to equity securities. Many of them are bond funds, particularly *municipal bonds*. Each Monday, *The Wall Street Journal* publishes a list of closed-end funds near the end of Section C. The excerpt from the online version of this column in Figure 1.5 shows that most of the funds trade at a discount to their NAV. This discount reflects, among other factors, the reality that many of closed-end fund portfolios consists of illiquid securities. If the fund had to sell them all at one time, it is virtually certain that such a large sale would cause the market value of the securities to decrease substantially. Hence the securities would be sold at low prices—well below their market value when the selling began.

The prevailing wisdom is that it is best to buy a closed-end fund when it is trading at a deep discount to the fund's NAV. The reasoning is that if you hold them over a long period of time, the price should eventually rise back to the fund's NAV. This price appreciation, combined with any dividends or interest, should provide the investor with a higher than

CLOSED-END FUNDS: World Equity Funds
Friday, September 3, 2010

Fund	NAV	Mkt Price	Weekly Statistics (as of 9/03/2010) Prem/Disc %	52 Week Market Return %
Aberdeen Chile (CH)	22.25	20.84	-6.34	50.90
Aberdeen Em Mkt Telecomm (ETF)	19.68	17.37	-11.74	6.94
Aberdeen Indonesia (IF)	13.40	12.59	-6.04	59.05
Aberdeen Israel Fund (ISL)	16.58	15.02	-9.41	11.84
Aberdeen Latin America (LAQ)	45.93	42.87	-6.66	38.60
AGIC Gl Eq & Conv Income (NGZ)	15.23	14.66	-3.74	18.39
Alpine Glbl Dynamic Div (AGD)	6.17	6.21	+0.65	-18.03
Alpine Tot Dynamic Div (AOD)	5.54	5.31	-4.15	-22.09
Asia Pacific Fund (APB)	11.17	10.19	-8.77	9.22
Asia Tigers Fund (GRR)	20.56	19.34	-5.93	14.19
BlackRock S&P Qual Gl Eq (BQY)	13.45	12.10	-10.04	15.08
Calamos Glbl Dyn Inc (CHW)	8.51	7.59	-10.81	10.44
Calamos Glbl Tot Rtn (CGO)	14.01	13.93	-0.57	13.84
Central Europe & Russia (CEE)	38.91	35.36	-9.12	26.85
China Fund (CHN)	32.40	30.16	-6.91	30.83
Clough Glbl Allocation (GLV)	15.55	14.40	-7.40	11.68
Clough Glbl Equity (GLQ)	14.88	13.53	-9.07	13.39
Clough Glbl Opptys (GLO)	13.39	12.08	-9.78	10.38
Delaware Enh Gl Div & In (DEX)	12.05	12.02	-0.25	22.82
Eaton Vance Tx-Ad Gl Div (ETG)	14.16	13.35	-5.72	18.07
Eaton Vance Tx-Ad Gl Opp (ETO)	20.43	18.70	-8.47	16.64
First TrActive Div Inc (FAV)	9.47	10.20	+7.71	9.54
First Tr/Abrdn Emerg Op (FEO)	21.78	20.99	-3.63	42.38
Gabelli Global Deal (GDL)	15.35	13.85	-9.77	4.96
Global Income & Currency (GCF)	16.10	14.55	-9.63	8.35
Greater China Fund (GCH)	12.99	11.78	-9.31	-1.38
Herzfeld Caribbean Basin (CUBA)	6.75	6.18	-8.44	-1.75
India Fund (IFN)	35.53	33.88	-4.64	25.20
ING Infr Indus & Matr (IDE)	19.01	17.37	-8.63	NS
J Hancock Tx-Ad Gl Sh Yd (HTY)	12.53	12.62	+0.72	18.05
JF China Region Fund (JFC)	15.02	13.49	-10.19	5.78
Korea Equity Fund (KEF)	11.14	10.29	-7.63	26.88
Korea Fund (KF)	42.90	39.16	-8.72	23.65
Latin American Discovery (LDF)	18.52	17.36	-6.26	27.53
Lazard Gl Tot Ret & Inc (LGI)	15.63	14.20	-9.15	13.21
Lazard Wld Div & Inc (LOR)	12.82	11.67	-8.97	28.02
Malaysia Fund (MAY)	11.36	10.25	-9.77	52.48
Mexico Equity & Income (MXE)	10.57	9.25	-12.49	38.89
Mexico Fund (MXF)	26.42	23.51	-11.01	27.52
Morg Stan China A (CAF)	29.07	28.61	-1.58	1.33
Morg Stan East Europe (RNE)	17.99	16.09	-10.56	23.67
Morg Stan Emerg Mkts (MSF)	15.62	14.43	-7.62	18.66
Morg Stan Frontier Em Mk (FFD)	13.88	12.84	-7.49	18.90
Morg Stan India Inv (IIF)	26.85	25.04	-6.74	26.27
Nuveen Glbl Val Opps (JGV)	18.93	18.40	-2.80	21.67
Taiwan Fund (TWN)	16.81	15.16	-9.82	18.29

FIGURE 1.5 Closed-end fund listing from *The Wall Street Journal*. This separate listing of "Closed-End Funds" is published in *The Wall Street Journal* each Monday but the prices are updated daily online. During the rest of the week, a specific fund can be found in the listings of stock prices or at www.wsj.com. The listings above, labeled "World Equity Funds," are the type described in the example in the text. However, today's closed-end funds invest in a variety of securities: mortgage bonds, municipal bonds, high-yield bonds, government bonds, convertible securities, as well as domestic and international equities.

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market rate of return. While this strategy seems simple, investing in closed-end funds requires considerable knowledge of the securities within the portfolio and the economic factors that affect them, as well as knowledge of the factors that influence the markets in which they trade. This information may not be readily available, especially for world equity funds. There are no simple, foolproof strategies.

liquidity
the ease with which a security can be bought or sold.

Sometimes when a closed-end fund is selling at a deep discount to its net asset value (NAV), its Board of Directors and shareholders may vote to convert it to an open-end structure—i.e., a mutual fund. (It is rare for an open-end fund to covert to a closed-end fund.) At conversion, the fund's market price will be its net asset value. (Remember mutual funds are priced daily at their net asset value.) The difference between the discounted market price and the NAV will be a gain for holders of the once closed-end fund. Additionally, it also means that the fund can now begin to issue more shares, raising additional investment capital for the fund's portfolio.

Mutual Funds versus Closed-End Funds

Although mutual funds and closed-end funds are both management companies, they are quite different products. There is occasional mention in the financial media of a product called a *closed-end mutual fund*. The definitions of a closed-end fund and an open-end fund under the Investment Company Act of 1940 makes this term an oxymoron. When this term is used, it usually refers (1) to a mutual fund that is closed to new investors (this would be correctly called a closed mutual fund); or (2) to an actively managed closed-end fund. Many closed-end funds are not managed; therefore, the fund's investment portfolio of securities changes little. A closed-end fund that is actively managed might resemble a mutual fund to some people, but keep in mind that the number of outstanding shares remains relatively fixed, unlike a mutual fund. Given current legislation, however, a true closed-end mutual fund cannot exist.

municipal bond
a debt security issued by a city, town, state, political subdivision, or territory of the United States whose interest income is exempt from federal taxes.

Now that you understand the basic differences between the two types of funds, you probably wonder what caused mutual funds to become a more popular investment product than closed-end funds. There are four most-probable reasons for this development.

First, there are simply more mutual funds (over 8,600) than closed-end funds (around 630) available in the market. And they are more heavily marketed and advertised than closed-end funds. Hence, when people look at investment options, mutual funds show up and are recommended more often.

The second reason for their popularity is the certainty of pricing. At the end of each business day, a mutual fund (actually, its Custodian Bank) computes and publishes the value (minus applicable fees and expenses) of each share outstanding. In contrast, the "real" value of a closed-end fund is less certain. Market forces could drive the value of the fund's shares up, causing them to sell at a premium to their net asset value. Or the same forces could drive the price down, resulting in their selling at a discount. Price uncertainty is a concept that is emotionally (if not intellectually) anathema to most investors. They want to know exactly what their shares are worth.

The third reason is size. Mutual funds typically have more money to invest than do closed-end funds. Each time an investor buys a mutual fund share, the fund itself is getting new money that it can use to by more securities or can hold as cash in a money market account until it's ready to buy more shares into the portfolio. These additional dollars enables it to achieve greater diversity more easily than a closed end fund. It can purchase shares of more companies in different sectors. When a person buys a closed-end fund share on a stock exchange, the money goes to the person who sold the fund, not to the fund.

The final reason is for mutual funds' popularity is low initial investment cost. You can begin by investing as little as $25 a month in a fund. This makes the product available to a vast cross section of potential investors. These reasons, combined access to professional management, largely explain why mutual funds are the investment of choice of millions of people in the U.S. and abroad.

The remainder of this book focuses almost entirely on mutual funds. (Exchange-trade funds or ETFs will be occasionally mentioned.) Each chapter will examine particular features of a fund that you must evaluate to be able to select the mutual funds that are most suitable for your investment objectives, time horizon, and risk tolerance.