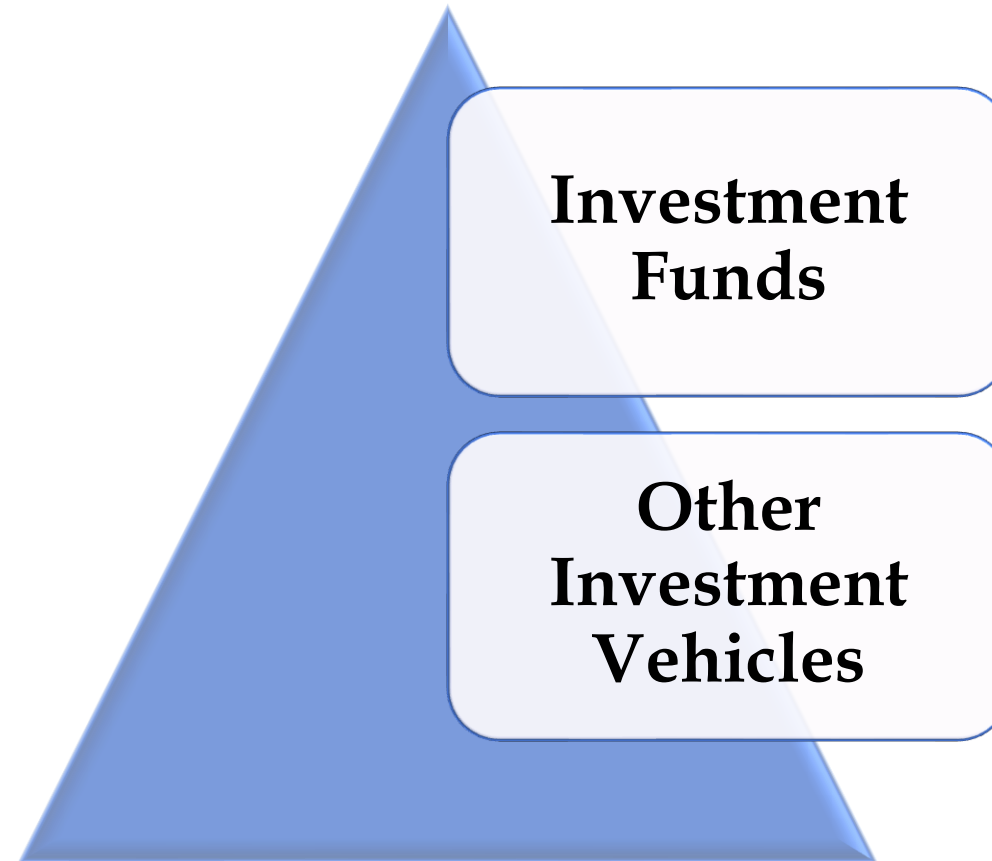




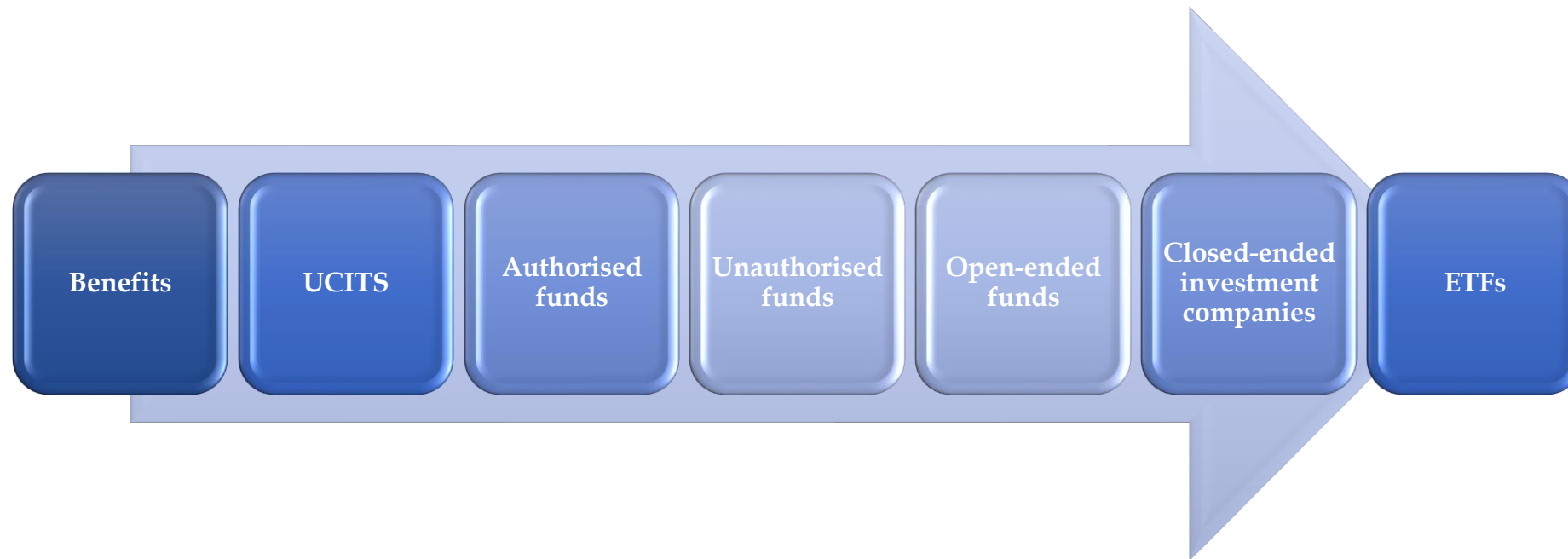
## Chapter 4 – Collective Investments

7 Questions

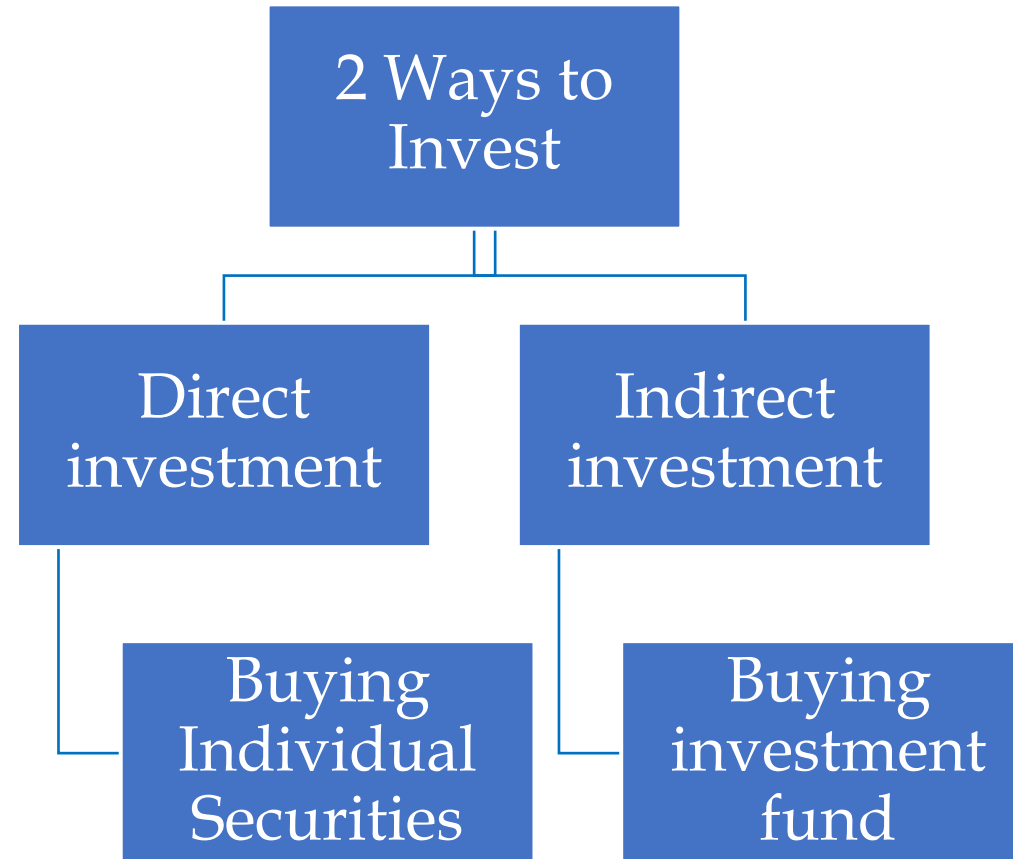




# Investment Funds



# Overview of Investment Funds



These investment or pooled funds are known as collective investment schemes (CISs). Also very well-known by other names, such as mutual funds,

unit trusts or open-ended investment companies (OEICs)

Funds can be:

- Open-ended funds can create new shares in response to investor demand or cancel them when sold so that their capital can expand or contract e.g. mutual fund.
- Closed-ended fund has a fixed capital base so if an investor wants to buy shares they will do so on the stock exchange and buy them from another investor who wants to sell.



# Benefits of Collective Investment

## Rationale:

- Pool the resources of a large number of investors, with the aim of pursuing a common investment objective

## Benefits:

- Economies of scale
- Diversification
- Access to professional investment management
- Access to geographical markets, asset classes or investment strategies which might otherwise be inaccessible to the individual investor
- In some cases, benefit of regulatory oversight
- In some cases, tax deferral

What are the drawbacks?



## UCITS

- European Directive
- Intended to enable free marketing of funds across Europe
- Product Directive - simplified prospectus; wider range of instruments
- Management Directive - single passport
- Allows approval in one country and cross border marketing subject to notification

## Distribution

- UCITS increasingly accepted as global standard
- Luxembourg funds distributed in over 90 countries



# Fund Characteristics

## Onshore versus Offshore

- When a fund is created it will be incorporate in a financial centre
- Offshore refers to the range of offshore financial centres who specialise in investment services and who offer attractive legal and tax regimes for funds

## Authorisation

- Funds can be classified as authorised or unauthorised
- Regulatory authorisation enables marketing to retail investors

## Tax Treatment

- Funds - tax treatment will vary depending upon whether onshore or offshore
- Investors - offshore funds may not be taxed in the same way as onshore





- Share capital can expand or contract in line with investor demand

|        |   |
|--------|---|
| US     | <ul style="list-style-type: none"><li>▪ Mutual funds</li></ul>                |
| UK     | <ul style="list-style-type: none"><li>▪ Unit Trusts</li><li>▪ OEICs</li></ul> |
| Europe | <ul style="list-style-type: none"><li>▪ SICAV</li><li>▪ FCP</li></ul>         |

- Segregation of management and safeguarding of assets

- Net Asset Value



# US Open Ended Funds

|                 |  |
|-----------------|--|
| Legal Structure | <ul style="list-style-type: none"><li>▪ Company</li></ul>  |
| Share Capital   | <ul style="list-style-type: none"><li>▪ Open ended</li></ul>   |
| Management      | <ul style="list-style-type: none"><li>▪ Investment management – investment advisers</li><li>▪ Custody – custodian bank</li></ul>   |
| Pricing         | <ul style="list-style-type: none"><li>▪ Based on NAV</li><li>▪ Purchases – NAV + charges</li><li>▪ Sales – NAV – charges</li></ul>   |
| Dealing         | <ul style="list-style-type: none"><li>▪ Direct with Fund Group</li><li>▪ Settlement – 7 days</li></ul>   |
| Charges         | <ul style="list-style-type: none"><li>▪ Operating expenses – management fees; distribution fees; other costs – custody, legal, accounting, administration</li><li>▪ Disclose operating expense ratio</li><li>▪ Charges for purchases – front end load; back end load; no load</li><li>▪ Charges for sales – exit fee</li></ul> |
| Share classes   | <ul style="list-style-type: none"><li>▪ Class A shares – front end charge; lower operating expenses</li><li>▪ Class B shares – no front end charge; possible back end load</li><li>▪ Class C shares – either front end or back end charges; higher operating expenses</li></ul>  |



# European Open-ended Funds

## SICAV

- Societe D'Investissement Capital a Variable
- ICVC - Investment Company with Variable Capital
- Corporate structure and open ended fund
- Requires appointment of depositary to exercise oversight on the fund
- Major fund type used in Luxembourg for cross-border marketing
- Single Priced
- Linked to NAV

## FCP

- Alternative legal structure for European funds
- Fonds Commun de Placement
- Contract structure between scheme manager and investors
- No legal personality - administered by a management company.
- Administration similar to SICAV

## Unit Trust

- Structured using a Trust Deed
- Trustee is the legal owner of assets
- Unit holders are the beneficial owners
- Unit Trust Manager is responsible for marketing and management of the fund
- Trustee safeguards assets and undertakes checks on manager for investor protection
- Dual-priced basis - bid and offer price

## OEIC

- Requires appointment of an Authorised Corporate Director to manage the company
- Fund investments are held by an independent depositary - who is the legal owner
- OEIC is beneficial owner
- Can be single or dual priced



# Fund of funds and Manager of managers fund

A **fund of funds** seek to harness what is considered the best investment management talent available within a diversified portfolio.

- Has one overall manager and it invests in a portfolio of other existing investment funds

Can be managed on:

- **Unfettered basis** - the component funds are run by a number of managers external to the fund management group marketing the fund of funds.
- **Fettered basis** - are obliged to invest solely in funds run by the same management group as the fund.

A **manager of managers fund** arranges segregated mandates and appoints fund managers who they believe are the best in their sector to manage each area.

- Initial investment required is usually substantially higher than required for a fund of funds or other CIS.
- It takes time to change from an underperforming fund manager



## US Closed End Funds

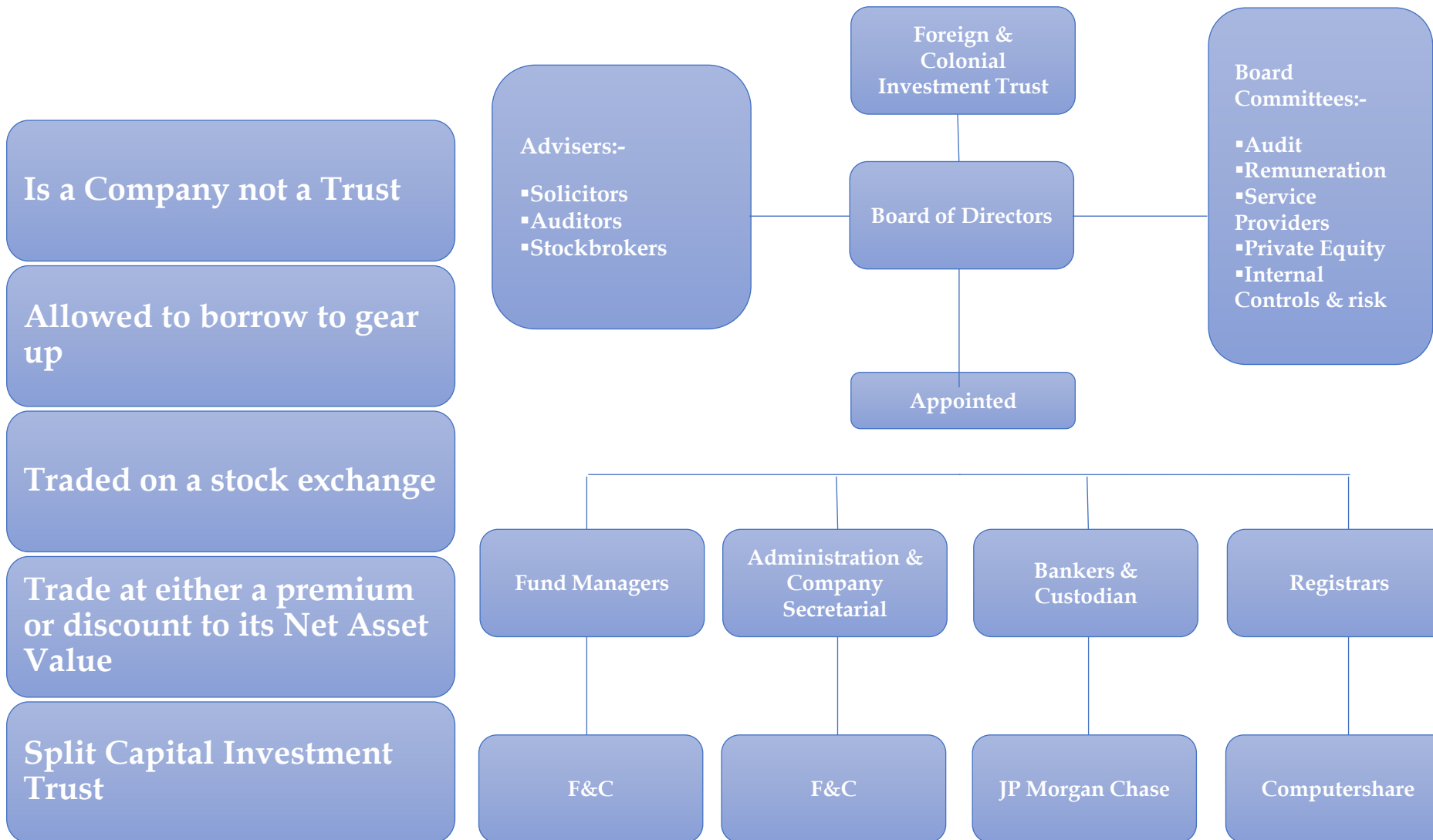
- Have fixed capital and traded on a stock exchange
- Can have different investment objectives, strategies, and investment portfolios
- Also can be subject to different risks, volatility, and charges
- Permitted to invest in a greater amount of "illiquid" securities than are mutual funds

## Unit Investment Trust

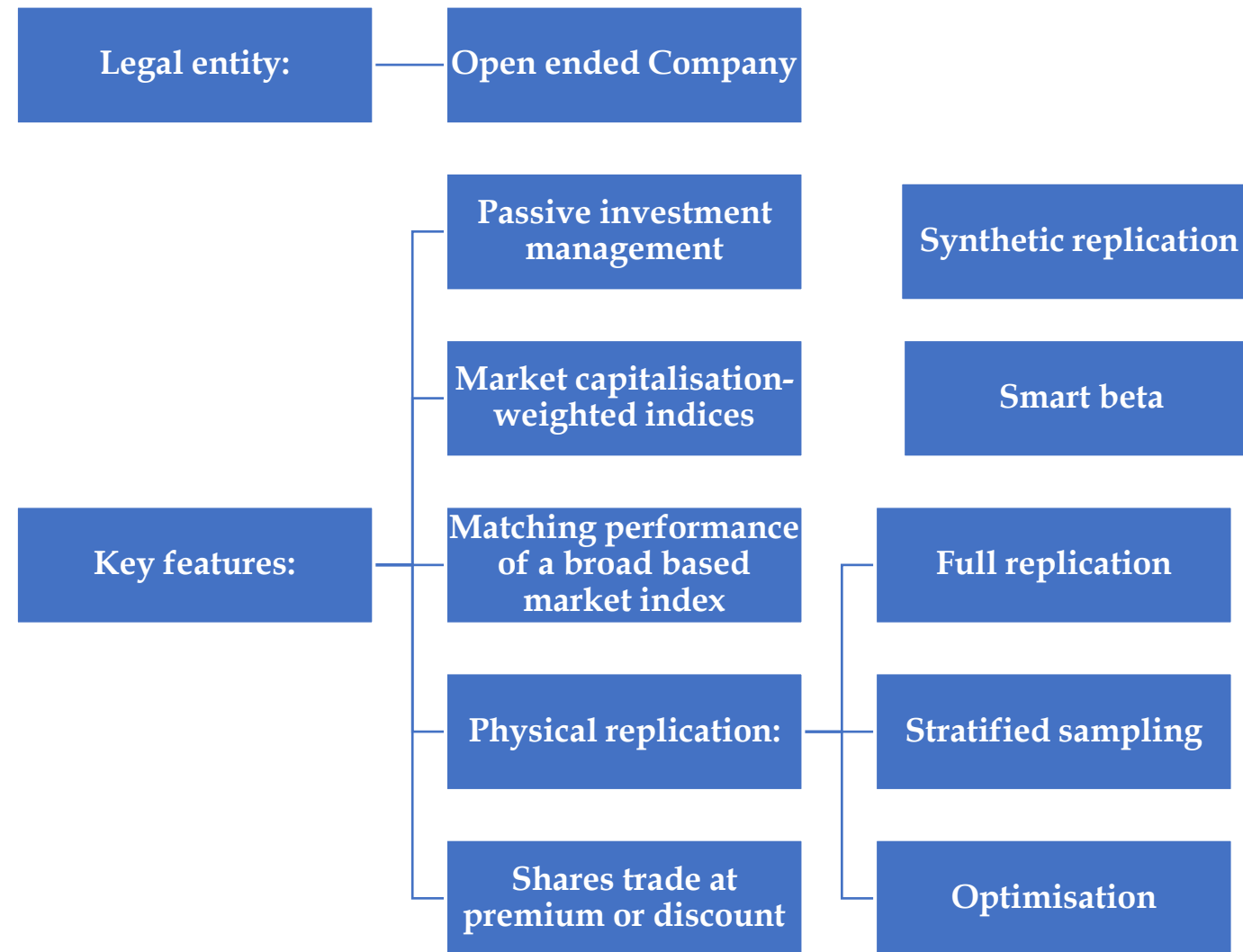
- Buys and holds a relatively fixed portfolio of securities for life of the fund
- Does not actively trade its investment portfolio
- It will usually make an initial public offering of its shares (or units) like a closed-end fund
- But the sponsors of the fund will maintain a secondary market
- Allows owners of UIT units to sell them back to the sponsors and allows other investors to buy UIT units from the sponsors



# Europe Close-ended Funds - Investment Trusts



# Exchange Traded Funds



# Commodity Funds

Commodity funds offer alternative way of accessing commodities rather than through holdings of direct equities involved in commodity extraction or manufacture



ETC - exchange traded commodity fund -

Open ended collective investment vehicles

Exchange traded

Can give exposure to single commodity such as gold or a basket of commodities





# Exchange Traded Products – ETP

Are a type of security that is derivatively priced

- Derived from other investment instruments, such as a commodity, a currency, a share price or an interest rate.

Generally benchmarked to stocks, commodities or indices.

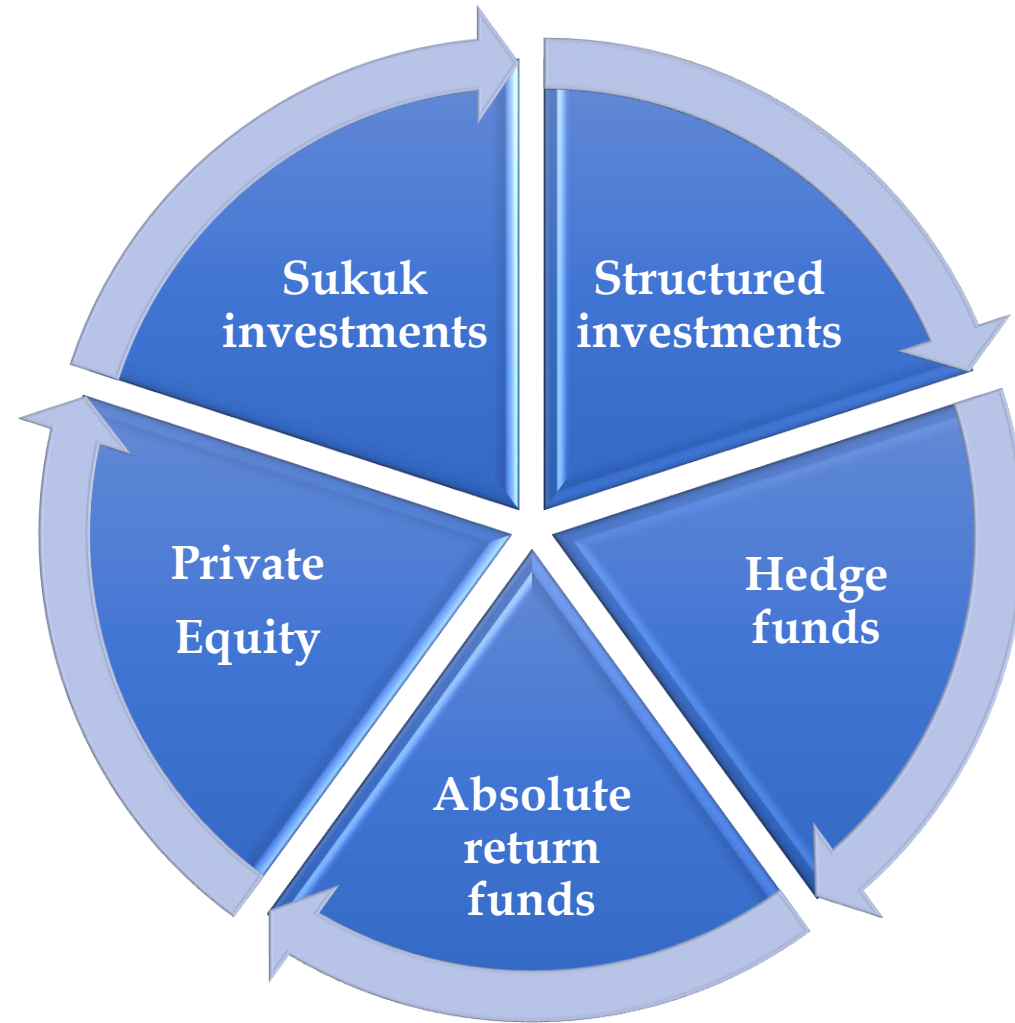
Can also be actively managed funds.

ETPs include exchange-traded funds (ETFs), exchange-traded vehicles (ETVs), exchanged traded notes (ETNs) and certificates.

Traded on many global stock exchanges



# Other Investment Vehicles - Characteristics & Application



# Structured Products



Are **packaged** products based on **derivatives** which generally feature **protection of capital** if held to maturity but with a **degree of participation** in the return from a higher-performing, but riskier, underlying asset.



Created by combining underlying assets such as shares, bonds, indices, currencies and commodities with derivatives.



## Benefits:

- Protection of initial capital investment
- Tax-efficient access to fully taxable investments
- Enhanced return
- Reduced risk.



## Their major disadvantage:

- Have to be held to maturity to secure any gains.



# Broad Categories of Structured Products

## Trackers

- Replicates the performance of an underlying asset or index
- No dividends are paid on the tracker - any income stream is built into the capital value of the tracker over its lifetime.
- Some are fully hedged for currency risk

## Accelerated Trackers

- Will participate in the growth of the underlying index or asset, providing that when it matures its value is greater than the initial value.
- If the value is less than its initial value, then the investor will lose the same amount.
- The investor will usually surrender any right to the underlying income stream from the asset in exchange for the right to participate in any performance.

## Reverse Trackers

- Should the underlying asset fall, then the value of the tracker will rise.
- Also referred to as bear certificates.

## Capital Protected Trackers

- allow investors to gain some exposure to the growth of an underlying asset or index while providing protection for the capital invested.
- E.g. track the performance of the FTSE 100 and provide participation of 140% of any growth but with 100% capital protection.

## Digitals

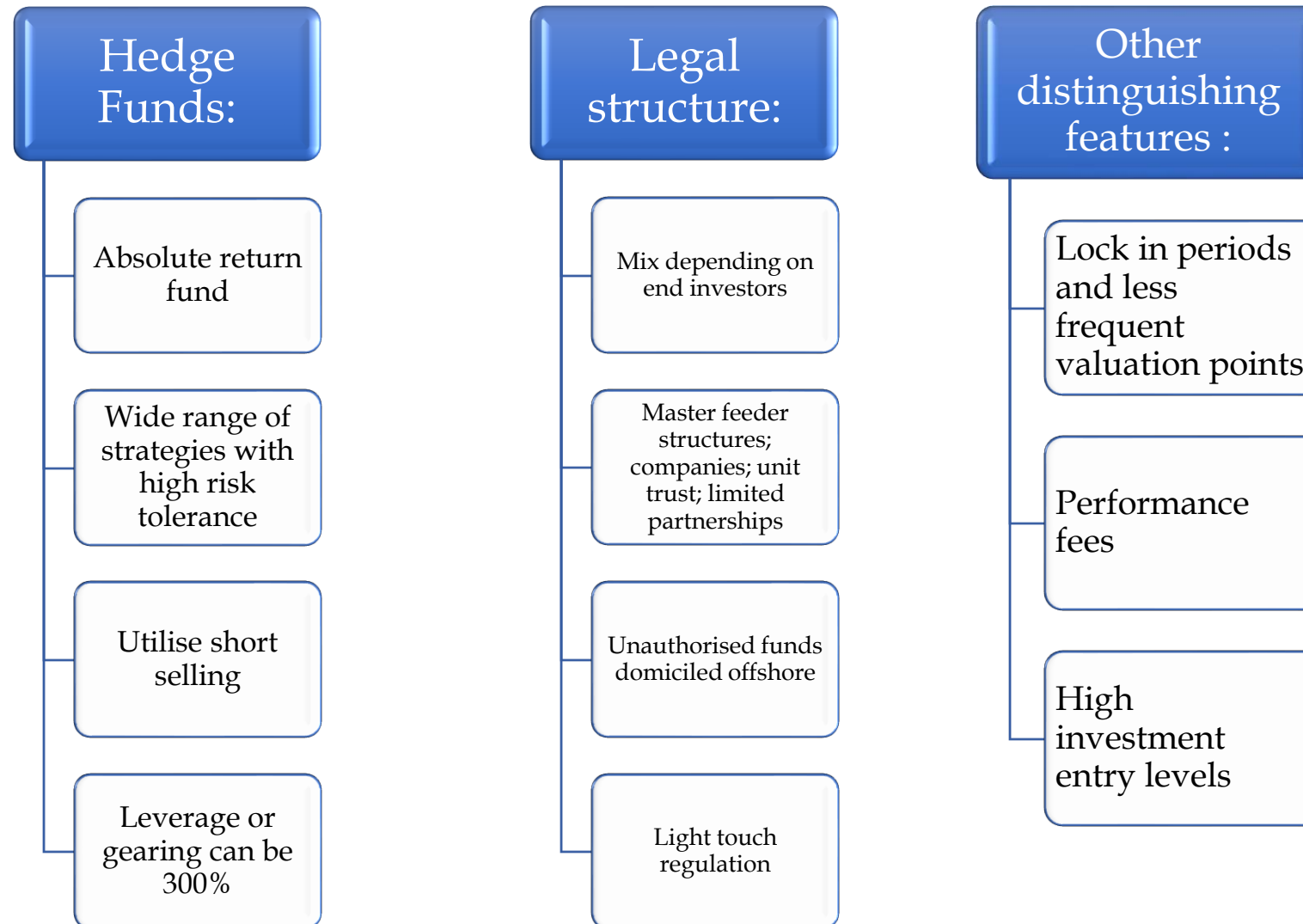
- Has two reference indices instead of just one as the basis for the pay-out.

## Structured Capital at Risk Products (SCaRPs)

- Have variable (or floating) floors rather than a fixed capital protection.



# Hedge Funds - Characteristics



**Fixed-income Arbitrage (FIA)** - Seeks to exploit inefficiencies in interest rate yield curves, corporate spreads and/or pricing of government bonds, swaps and other derivatives based upon interest rates.

**Non-Directional Strategies**- Expected returns are limited, but implemented with high leverage, which magnifies the returns (and losses). Low volatility and low correlations with traditional markets.

**Market Neutral**- Known as equity arbitrage. The strategy is to combine long and short positions, while balancing the beta exposure to ensure a zero or negligible market exposure.

- The emphasis is on stock-picking
- One favoured strategy is pairs trading, in which one takes converse positions in correlated securities e.g. going long - a major retailer such as Marks and Spencer and short another retailer, such as Morrisons.

**Convertible Arbitrage**- Focuses on those securities which have convertible features. The objective is to profit from mispricing of a convertible. Typically, the strategy will involve a combination of a long position in the convertible security and a short position in the underlying stock.



**Statistical Arbitrage (StatArb)** - Is bottom-up, beta-neutral in approach and uses statistical/economic techniques in order to provide signals for execution. Signals are often generated through a belief in the notion of **mean reversion**.

## Event-Driven

- **Special situations** - typically an attempt to profit from a change in valuation as a result of a corporate action or takeover.
- **Distressed securities** - such as when corporate bonds, bank debt and sometimes the common and preferred stock of companies are in some sort of distress i.e. its debt securities may be substantially reduced in value. Considered distressed when its YTM is more than 10% or if it is rated CCC or below.
- **Merger arbitrage** - seeks to profit from the spreads in announced mergers and acquisitions or takeovers. The approach is to buy the stock of the target company in a mergers and acquisitions (M&A) deal and sell the acquiring company's stock.



# Hedge Fund Directional Strategies

## Equity Hedge

### Long/short equities

- Will consist of securities that are on both the long and short sides of the market.
- Market exposures may be net long, net short, or neutral at any given time.
- Should outperform in bear markets by aiming to deliver absolute returns, but they will tend to underperform in sharply rising markets.

## Tactical Trading - 2 Approaches

### Global macro

Find large-scale themes in the global capital markets, identify trading opportunities and to take large positions on broad indices and currencies. E.g. George Soros

### Systematic strategies

Use mathematical models to evaluate markets, detect trading opportunities and generate signals and investment decisions.

- Classified as trend-following
- Also known as black-box methods because they contain proprietary indicators and analytical tools which the creators do not wish to disclose to investors





# Private Equity

Now a major  
asset class in its  
own right

Venture capital or  
complete buy  
outs

Provides medium  
to long term  
finance in return  
for an equity  
stake

Usually  
structured as a  
limited  
partnership



**Always linked to underlying assets, whether tangible or intangible assets.**

**Holding a Sukuk represents a partial ownership in assets**

- So Sukuk are neither shares nor bonds
- instead, they represent a little of each.

**This means that the return on a Sukuk bond is calculated according to the performance of the underlying assets or projects**

