MUTUAL FUNDS AND THE INSTITUTIONAL ENVIRONMENT

The previous chapter introduced you to the mechanics of trading securities and the structure of the markets in which securities trade. Increasingly, however, individual investors are choosing not to trade securities directly for their own accounts, as this requires personal attention that many investors feel they have neither time nor expertise to give; rather, they entrust investment decisions to institutional management.

The investment decision hinges on the individual's needs for funds throughout the earning period and after retirement. Investment choices are also affected by the tax regime and how it affects the individual; in particular, tax rates on investment income are expected to be higher during earning years than during retirement years. Insurance companies and pension funds are institutions that participate in the investment process to help meet individual needs; indirectly, they are managing individual assets.

The most important institution to manage individual assets is the mutual fund industry, and this chapter focuses on this branch of professional investment management. We begin by giving a broad overview of institutional management, relating different types of institutions to individual needs, and how these needs impose constraints on institutional actions. We then turn to a classification of the variety of investment companies available to investors, before describing the particular form known as mutual funds. We categorize them according to their policies

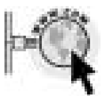
and styles, discuss how these affect the taxation of their results in investors' hands, and note where information may be obtained. Following this, we examine the expenses associated with management and how costs and fees affect the returns. This leads to the final topic of just how good is the performance of professional managers in directing mutual funds.

In Appendix 4A, we present a summary of the tax system, as it affects investing; this detail is essential for determining what investment promises to provide the highest risk-adjusted, after-tax returns. In Appendix 4B is a general overview of the pension fund industry with a focus on the defined benefit and defined contribution dichotomy.

4.1 MANAGEMENT BY INSTITUTIONS

Investors can be differentiated as individuals and institutions. A frequent lament is that individuals appear to be abandoning the markets to the institutions. As small investors, individuals are thought to provide liquidity to the market, which institutional portfolios are too large to do. Nevertheless, individuals provide the funds to the institutions to invest; although individuals have no immediate control over pension funds, mutual funds must respond by buying and selling as their investors add or withdraw cash. This process should still channel funds to the best investment opportunities.

Institutions must attempt to interpret and serve the requirements of households in making their investment decisions. Generally, the household sector equates to individuals, but occasionally there will be **personal trusts**.[1] The institutions that respond to household needs by investing in stock and bond markets include mutual funds, pension funds, endowment funds, and life insurance companies. Casualty insurance companies, like banks and trust companies, tend to have more conservative investments, with shorter maturities, due to the nature of their cash payouts. Each of the institutions must tailor its policies to the needs of its clients and the regulations or circumstances guiding it. We shall examine how these respond accordingly, with particular attention to mutual funds and pension funds.



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A formal process for making investment decisions has been established by the Association for Investment Management and Research (AIMR), established by the merger of the Financial Analysts Federation (FAF) with the Institute of Chartered Financial Analysts (ICFA). The idea is to subdivide the major steps (objectives, constraints, and policies) into concrete considerations of the various aspects, making the process more tractable. The standard format appears in Table 4.1, and we shall discuss the three parts of the process in turn.

Institutions and Their Objectives

Portfolio objectives centre on the risk-return tradeoff between the expected return the investors want (*return requirements* in the first column of Table 4.1) and how much risk they are willing to assume (*risk tolerance*). Investment managers must know the level of risk that can be tolerated in

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[1]These are established when an individual confers legal title to another person or institution (the trustee) to manage that property for one or more beneficiaries. The beneficiaries are of two types, essentially, those entitled to a life income and those entitled to the remaining principal upon death of the former. By definition of the objective of the trust, the options of the trustee are limited; the requirements have been made much clearer for the trustee than for individuals.