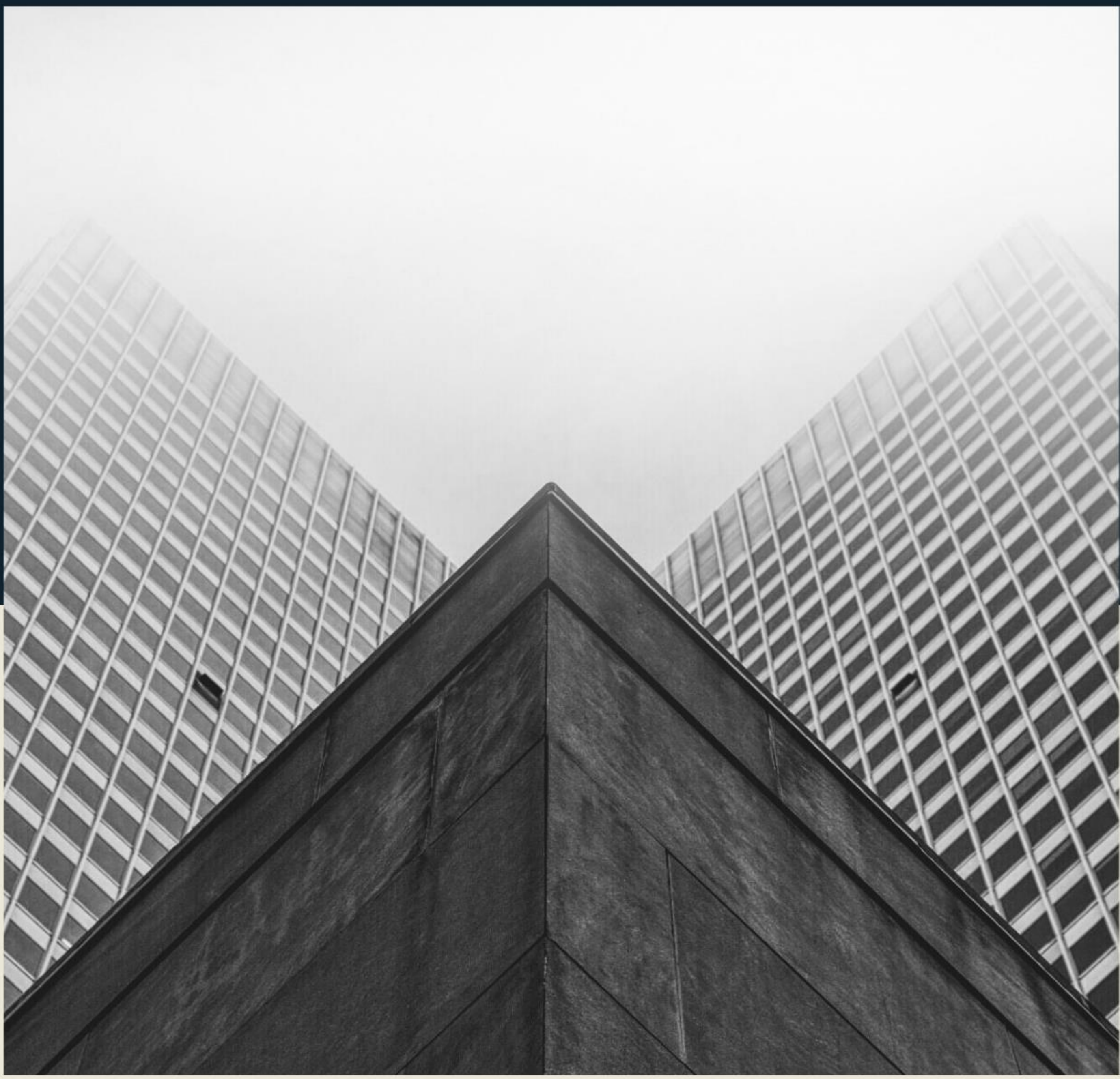
Mutual Funds

MARKET INSIGHTS DIVISION

MATTIA GASPARDIS - TEAM LEADER
MIKOLAJ BOROWIAK - ANALYST
TEODORA PAVLOVIC - ANALYST

BSAMC
Bocconi Students Asset Management Club



Introduction

A mutual fund is a corporation that pools money from several people and invests it in securities such as stocks, bonds, and short-term loans. The portfolio of the mutual fund is made up of all of the mutual fund's holdings and shares in mutual funds are purchased by investors, both individual and institutional. As it would be difficult to replicate those investments on your own, mutual funds create a great opportunity for effective allocation in the stock market.

The mutual fund's price, also known as its net asset value (NAV[1]), is computed by dividing the entire value of the securities in the portfolio by the number of outstanding shares. This price changes dependent on the value of the portfolio's securities at the conclusion of each business day. It is important to note that mutual fund investors do not own the assets in which the fund invests; instead, they hold shares in the fund itself.

The decisions to acquire and sell assets in actively managed mutual funds are made by one or more asset managers, who are assisted by teams of researchers. The fundamental purpose of a portfolio manager is to search for investment opportunities that would help the fund exceed its benchmark, which is often some well watched index, such as the S&P 500[2]. Looking at the fund's returns compared to this benchmark is one technique to determine how well a fund manager is performing. While it may be tempting to concentrate on short-term performance when analyzing a fund, most experts will advise that longer-term performance is more important.

All mutual funds allow to buy or sell shares of the fund at the fund's NAV once a day at market close. It is also possible to automatically reinvest the money from the distribution of dividends and capital gains or to make additional investments at any time; more precisely, there are two types of funds:

- distribution funds, whose return is composed of a periodic coupon flow and a capital income; in this case the investor in addition to the common advantages of a fund also benefits from the receipt of an income
- accumulation funds, which, on the other hand, do not distribute income that is subsequently reinvested automatically

Lastly, the minimum initial commitment required for most equity funds can be much less than you would have to pay to establish a diversified portfolio of individual stocks.

The securities in the portfolio frequently provide dividends or interest. The fund management can also sell securities that have increased in value. These sorts of occurrences can assist the fund earn revenue, which is required by law to be paid out to investors in the form of periodic distributions. The majority of the time, investors who possess shares in the mutual fund at the time these distributions are responsible for paying the taxes on that money.

Mutual funds may be subject to a range of fees. Some funds impose transaction fees for buys and sells, as well as commissions known as loads. There are other funds that impose a redemption fee if you sell shares you've only held for a brief period of time. Investors must

---

[1]: the value of a Fund’s underlying portfolio assets. The per-share NAV is calculated as follow “(Tot. value of securities in the fund’s portfolio - Liabilities)/N. of fund shares outstanding”.

[2]: abbreviation of Standard & Poor’s 500 Index; is a market-capitalization-weighted index of 500 leading publicly traded companies in the U.S. (it is not an exact list of the top 500 U.S. companies by market cap because there are other criteria that the index includes).

also pay continuing expenditures to support the fund's running costs, which include investing advising fees (paying the fund management and research staff) and transaction costs connected with purchasing and selling assets inside the fund.

Types of mutual funds

Index funds

These funds are composed by a portfolio of stocks or bond designed to mimic the composition and performance of a financial market index, such as the Standard & Poor's 500 Index (S&P 500). Theirs's value will rise or fall in tandem with the performance of the index; because of this and for the fact that the portfolio manager does not have to conduct as much research or make as many investment choices, index funds often have lower fees than actively managed mutual funds. In the end, this typology of funds is generally considered ideal core portfolio for retirements accounts, like Individual retirement account (IRAs)[3] and 401(k) accounts[4].

Balanced fund

As the name suggests, these funds invest in a mix of stocks and bonds. They attempt to strike a balance between the desire for better returns and the danger of losing money. Most of these funds use a formula to allocate money among several sorts of assets: typically, 70% stocks and 30% bonds. They are riskier than fixed income funds but less risky than pure equities funds; however, there are more aggressive ones, which invest in more stocks and less in bonds, and those that are more conservative, which invest in less equities relative to bonds.

Fixed income/Debt fund

These funds invest in fixed-income instruments such as government bonds, investment-grade corporate bonds, and high-yield corporate bonds. They want to have money pouring into the fund on a regular basis, mostly from interest earned by the fund. In general, high-yield corporate bond funds are riskier than funds that invest in government and investment-grade bonds. Nevertheless, they offer a low-risk-low-return prospective and are suited for investors aiming to generate consistent income with a low-risk appetite.

Equity funds

These funds make equity investments. Because these products seek to develop quicker than money market or fixed income funds, they are more suitable for investors with a higher risk appetite. There are several types:

- Large-Cap Funds; the investment schemes investing 80% of the assets into shares/stocks of companies with large capital
- Small-Cap Funds; the funds investing 65% of the total assets into shares/stocks of companies which have a small capital and are listed at 251st or below according to market capitalization
- Mid-Cap Funds; funds with 65% assets allocated into mid-cap companies
- Multi Cap-Funds; the schemes investing in large-cap, small-cap and mid-cap funds in a wavering proportion

---

[3]: is a savings account with tax advantages that individuals can open to save and invest in the long term.
[4]: is a retirement savings plan offered by many American employers that has tax advantages to the saver

The investors can select among equity funds that specialize in different strategy, such as Thematic Funds, Focused Funds and Contra Equity Funds. Despite being classified as high risk, some strategies offer a significant return potential in the long run. They are perfect for investors in their peak earning stage who want to develop a portfolio that would provide them with exceptional long-term returns. Typically, an equity fund, also known as a diversified equity fund, invests across many industries to spread risk.

Exchange Trade Funds (ETF)

ETFs are a particular type of mutual fund or Sicav[5] whose key features are the possibility of trading them on the Stock Exchange as if they were a stock and their composition based on a reference index (benchmark[6]) through a passive management. An ETF synthesizes the typical characteristics of a fund and a share, allowing investors to take advantage of the strengths of both instruments, namely the ability to diversify and reduce risk typical of funds and the flexibility and transparency of information typical of shares traded in real time. The creation and redemption process requires authorized participants to buy and sell the securities that make up the benchmark index to create or redeem ETF shares/units. As a result, there is a liquidity match between the ETF and the reference market, so the spreads and order values displayed on the trading book have the same terms as those who directly buy or sell the index components.

However, in order to ensure maximum liquidity, it is necessary that for each ETF a specialist continuously exposes bid and ask orders for a minimum quantity and a maximum spread.

Structure

The organizational structure of a mutual fund outlines the rights and responsibilities of each of the key components of the fund's operations. The fund's operations include buying, selling, underwriting, and managing the fund's assets. The key components of a mutual fund's organizational structure are the sponsors, shareholders, board of directors, investment advisers, transfer agents, custodians and independent accountants.

Mutual fund creation

A sponsor, usually an investment or finance company, creates a mutual fund and organizes it as either as a business trust or corporation and registers it with the Securities and Exchange Commission (SEC). The company appoints a board of directors associated with the investment company and hires independent directors who are not associated with the company. The sponsor is the company typically puts up the start-up or seed capital to launch the fund. Once the company has at least $100,000 of seed capital, it can begin selling fund shares to the public.

Overall organizational structure

The organizational structure of a mutual fund is its chain of command. At the top of this chain are its shareholders (the people who buy shares in the mutual fund, the mutual fund itself and the board of directors). This means that those who work for and with the fund, such as the

---

[5]: abbreviation for Société d'Investissement à Capital Variable; they are joint-stock companies with variable capital that have as their exclusive object the investment of their assets, raised through the placement of their shares with the public.

[6]: a standard that serves as a basis for a comparison in each market (a 3-month federal T-bill is a benchmark for U.S. interest rates).

investment advisers, transfer agents, underwriters and custodians of the fund, are responsible for working in the best interests of the mutual fund, its shareholders and board of directors.

Reporting to shareholders and directors

Those who service the mutual fund share in its organizational structure. Fund servicers include investment advisers who manage the fund's portfolio; underwriters sell fund shares to the public; transfer agents who carry out and keep records of shareholder's transactions; and administrators who perform the clerical duties for those that service the fund. It also includes the people who maintain internal controls over fund servicers to ensure they are complying with federal and state securities regulations. All the servicers of the fund work together in the best interests of the mutual fund itself, shareholders and the board of directors.

Mutual fund shareholders

Because shareholders of mutual funds own part of the fund company, they have certain voting rights that offer quite a bit of latitude to shape the parameters of a fund. Shareholders elect the fund's board of directors. And with a majority vote, they can also keep the fund's management fee from increasing and disallow the fund's objective or policies from changing. The collective rights of shareholders allow them to work closely with the fund's investment adviser in somewhat of a check-and-balance relationship that holds the fund company.

The Board of directors

The primary role of a fund's board is to oversee the fund, without having a hand in the day-to-day management of the fund. A mutual fund's board includes directors, 75 percent of whom must be independent directors as mandated by Congress through the Investment Company Act of 1940. "Independent" means separate from the management of the fund company by not having any substantial business dealings with the fund adviser or underwriter. When the fund's adviser drafts contracts, the board is tasked with reviewing and approving them. Directors also oversee a fund's compliance with federal laws and review the fund's performance.

The Investment adviser

The investment adviser handles the fund's business affairs and directs its investments. An investment adviser also has a team of employees, some of whom represent the interests of the shareholders. The adviser manages the fund's portfolio by deciding which securities to buy and sell that align with the fund's objectives and conform to the fund's policies.
An investment adviser is often the fund's first shareholder who creates the fund by providing seed money. Advisers and their employees are held to strict standards of compliance, which include guidelines that prevent them from allowing transactions that present a conflict of interest.

The principal underwriter

If an investor purchases shares of a mutual fund through a broker-dealer, that broker-dealer must be authorized to sell shares through a sales agreement with the fund. The principal underwriter of a fund acts as the agent who executes these sales agreements and ensures compliance of broker-dealers. And even though the underwriters are not acting as broker-dealers, and they typically do not offer or sell shares to investors, they are still required to register as broker-dealers because of the Securities Exchange Act of 1934.

The Board's Administration

A mutual fund's board may hire numerous administrators, which may be individuals or organizations. Administrators handle the details of office operations by providing office space and clerical services such as accounting, bookkeeping, data processing and auditing. The fund's board oversees administrators to make sure they adhere to compliance procedures and maintain internal controls.

The Transfer Agent

A transfer agent provides one of the services that mutual fund shareholders enjoy the most: distributing the dividends to them. However, transfer agents perform other tasks such as preparing the dividend statements and calculating the tax information; they also track the trading activities of the fund. Additionally, some transfer agents may oversee customer service departments to handle shareholder questions.

Because a mutual fund typically does not issue tangible certificates (for example, as a stock fund does), the responsibility of transfer agents is crucial. The transfer agent must correctly record the ownership of shares in the fund's extensive computer recordkeeping database, and agents must be certified with the SEC.

The Mutual Fund's Custodian

The custodian of a mutual fund maintains "custody" of the fund, which typically means that a bank keeps the funds (if the fund holds foreign securities, an international foreign bank or securities depository acts as the custodian). Strict custody rules mandated by the Investment Company Act require that the fund's securities must be kept separately from the investment adviser's securities. Custodial duties include receiving dividends and interest for safekeeping, paying the fund's expenses, tracking loaned securities and reporting all cash transactions.

The bank custodian also maintains a detailed fund custody agreement that includes reconciliation of fund assets to help safeguard against fraud and theft. An additional safeguard against fraud and theft is the requirement that the fund must have a fidelity bond to protect shareholders against the possibility of employee embezzlement or larceny.

The Independent Public Accountant

Reporting to a fund's audit committee, which is part of the board, the independent public accountant is responsible for conducting audits on the fund's financial statements. A comprehensive audit includes a review of how the fund controls its reporting and how it implements measures to keep the fund's securities safe.

Industry outlook

The main theme in early 2022 was depicted in a reduction in global growth (however not less than trend) compared to the post-lockdown surge of 2021. However, the Russian invasion of Ukraine totally changed the context creating short-term risks for markets and, subsequently, a revision of the long-term outlook. Indeed, now the immediate threat is caused by high energy prices, rising food prices and disrupted supply chains, which, consequently, lead to lower global growth and higher inflation (especially in Europe); conversely, the longer-term problems are a potential new cold war between Russia and the West of the world, increased military spending and a further blow to globalization.

In addition, a further substantial acceleration in inflation that does not subside over the remainder of the year should make central banks more aggressive in tightening monetary policy, thereby sacrificing economic growth in future years and potentially disrupting markets once again. Therefore, they will need to address very carefully the long-term inflationary implications of commodity price increases during the remainder of the year to anchor long-term inflation expectations, but, also, proceed cautiously with interest rate increases due to the potential impact on growth.

What will be the behavior of investors?

In these early months of 2022, market assets have retraced significantly, with fixed income securities now offer higher total returns from higher rates and wider credit spreads.

According to J.P. Morgan, a combination of corporate credit, both investment grade and high yield, seems like the best choice. In addition, another financial instrument it has decided to focus on at this time is short-term securitized credit because of its low sensitivity to interest rates, shock-absorbing structure, strengthening credit, and consumers with strong balance sheets in a tighter labor market.

Differently, per Forbes, investors who are tired of stock market volatility are looking to the bond market. The first quarter of the year saw record amounts of money flow into some bond exchange-traded funds (ETFs). This shift in preferences is curious, as for years, the bond market has been overlooked in favor of exaggerated returns from the high-speed stock market. But with yields on the rise, bonds can increasingly compete with dividend-paying stocks, particularly among investors seeking steady returns. This attitude, because of the high volatility present in the stock market and the rush to safe-haven assets like bonds, reflects the high uncertainty among market participants right now.

However, the coming months will likely bring clarity that the worst of the sell-off is over. As a result, many investors will be looking to find out if there is a buying opportunity for tech stocks that have been "left for dead" or if there is more of a wait-and-see dynamic.

As for the rest of the year, investors may find comfort in the second quarter of 2022, which is likely to be a period of stronger economic growth than the first; in the meantime, to combat inflation, insiders recommend focusing on building a diversified portfolio, more specifically consisting of short duration[7] bonds and value-type stocks[8] (Closely correlated to inflationary expectations), rather than growth-type stocks[9] (Generally driven by changes in real yields).

---

[7]: is a measure of the sensitivity of the price of a bond or other debt instrument to a change in interest rates.

[8]: are all those shares of companies active in stable sectors characterized by a very low profit growth rate. By their very nature, value stocks have low balance sheet multiples and unexceptional Price/Earnings and Price/Book Value ratios.

[9]: are all those shares whose price is decidedly and visibly higher than the profits produced. Growth stocks have high Price/Earnings and Price/Book Value ratios.

Sources

Introduction

- https://www.sec.gov/edgar/searchedgar/mutualsearch.html
- https://www.investor.gov/introduction-investing/investing-basics/investment-products/mutual-funds-and-exchange-traded-1
- https://www.fidelity.com/learning-center/investment-products/mutual-funds/what-are-mutual-funds
- https://investor.vanguard.com/investment-products/mutual-funds
- https://www.finra.org/investors/learn-to-invest/types-investments/investment-funds/mutual-funds
- https://www.franklintempleton.com/investments/options/mutual-funds

Types of hedge funds

- https://www.investopedia.com/terms/i/indexfund.asp
- https://www.investopedia.com/terms/b/balancedfund.asp
- https://www.paisabazaar.com/mutual-funds/equity-funds/
- https://www.borsaitaliana.it/etf/formazione/cosaeunetf/coseunetf.en.htm

Structure

- https://finance.zacks.com/organizational-structure-mutual-funds-10269.html

What to expect in the future

- https://russellinvestments.com/us/global-market-outlook#ColorBoxesRoot_b8fda17e-a2a8-4716-be82-0e57bee24097
- https://am.jpmorgan.com/it/it/asset-management/adv/insights/portfolio-insights/fixed-income-views/
- https://www.forbes.com/advisor/investing/stock-market-outlook-and-forecast/