Chapter 14: Investment Vehicles

Introduction

1. Investment Vehicles: assets offered by the investment industry to help investors move money from the present to the future, with the hope of increasing in value.

Direct and Indirect Investments

1. Introduction
    a. Direct Investment: buying securities issued by companies, governments, and real assets.
    b. Indirect Investment: buying securities of companies, trusts, and partnerships that make direct investments.
    c. Most indirect investment vehicles are pooled investments (collective investment schemes) in which investors pool their money together to gain the advantage of being part of a large group. The resulting economics of scale can significantly improve investment returns.
2. Comparison of Direct and Indirect Investments
    a. Advantages of Indirect Investment:
        i. Indirect investments are professionally managed.
        ii. Indirect investments allow small investors to use the services of professional managers who they could otherwise be unable to afford
        iii. Indirect investments allow investors to share in the purchase and ownership of large assets.
        iv. Indirect investments allow investors to own diversified pools of risks and thereby obtain more stable, although not necessarily better, investment returns.
        v. Indirect investments are often substantially less expensive to trade than the underlying asset. This cost advantage is significant for publicly traded investment vehicles that own highly illiquid assets.
    b. Advantages of Direct Investment
        i. Investors are able to exert more control over direct investments, whereas indirect investment requires that investors accept the decisions of managers.
        ii. Investors are able to choose when to buy or sell their direct investments to minimise their tax liabilities.
        iii. Investors can choose not to invest directly in certain securities.
        iv. Investors who are wealthy can obtain high-quality investment advice at a lower cost when investing directly.
3. Investment Control Problems
    a. Investment managers may not conduct sufficient research and due diligence while formulating investment decisions.
    b. Investment managers may receive commission from executing trades, and therefore have incentive to trade excessively. The practice of churning is selling and replacing an entire portfolio over the course of a year.
    c. Investment managers may favour themselves or preferred clients when allocating trades that are profitable.

d. Individual investors often have little control over the actions of managers, so it can be beneficial to invest in publicly traded pooled investments that have oversight from a board of directors. However, board members may be more loyal to managers. Luckily, these managers are typically paid by fees of AUM, and better performance attracts new investors.

Pooled Investments

1. Introduction
    a. Note that investors in pooled investments do not actually have legal ownership of the assets that the vehicle invests in. Rather, they have legal right to ownership of the ownership.
2. How Pooled Investment Vehicles Work
    a. Organizers of pooled investment vehicles are called sponsors. The ownership of these organizations can take the form of business trusts, limited partnerships, or LLCs. Depending on the form, shares are referred to as shares, units, or partnership interests.
    b. Pooled investments are overseen by a board of directors, board of trustees, general partner, or single trustee depending on the form of legal organization.
    c. The directors then appoint a professional investment management firm, which works on a contractual bases in exchange for management fees.
    d. Prospectus: a document provided by investment vehicles that discloses their investment policies, deposit and redemption procedures, fees and expenses, and past performance statistics. Additional information can be found in mandatory regulatory filings, websites, or marketing materials.
    e. Distinctions are made between types of pooled investment vehicles, including open-ended mutual funds, closed-ended mutual funds, and exchange-traded funds.
    f. Additionally, there are differences in the investment strategies of individual funds.
        i. Almost all closed-end funds use active investing, while open-ended funds may use either passive or active investing, and most exchange-traded funds use passive indexing strategies.
3. Open-End Mutual Funds
    a. The defining characteristic of open-end mutual funds is the ability to issue or redeem (repurchase) shares on demand. When investors invest in the funds, the fund will issue new shares and exchange them for the investor's deposit. When the investor wants to withdraw their investment, the fund buys the shares back.
    b. No-Load Funds do not require fees for deposit or redemption, and they said the price daily according to the Net Asset Value (NAV) of the fund, which is calculated as net value over the number of shares outstanding. These fees are typically 3% of price, but can be as high as 9%.
    c. Funds that do require fees can have front end and/or back end fees.
    d. Other funds change purchase and redemption fees. These fees help compensate existing shareholders for costs imposed on the fund from buying and selling additional shares.
    e. Money Market Funds: a class of open-ended mutual funds that investors view as uninsured interest-paying bank accounts. These are priced at a constant, typically $1, and the fund invests in instruments like fixed-income securities with high credit ratings, to

ensure that the NAV is actually close to its price. Money market funds are susceptible to runs if their value declines.

4. Closed-End Mutual Funds
    a. Closed-End Mutual Funds have a fixed number of shares; they do not issue or redeem shares on demand. They may issue additional shares in secondary offerings or through rights offerings, or they may repurchase shares. But, these events are uncommon, and the number of shares of closed-end mutual funds rarely changes.
    b. Listed closed-end mutual funds are traded on exchanges after they have IPOs. These funds use proceeds from IPOs to buy assets. Shares of these funds are traded on exchanges and are not priced at their NAV.
    c. These are typically actively managed.
5. Exchange-Traded Funds
    a. ETFs are pooled investment vehicles that are typically passively managed. However, an increasing number are actively managed. Fees and trading costs are generally low.
6. Comparison of Pooled Investment Vehicles
    a. Risks
        i. Variance in risk across pooled investment vehicles arises mostly from differences in how assets are managed, the main difference being passive versus active. Passively managed funds tend to have lower risk/variance, while actively managed funds have more.
        ii. Closed-end funds are also generally more risky than similar open-ended funds because of the discounts and occasional premiums at which closed-end funds trade relative to their NAVs vary over time. ETFs also have these features, but with smaller effects.
    b. Management Accountability
        i. The effect of management also varies across vehicle types. Managers of actively managed funds have greater influence over performance than those of passively managed funds.
        ii. Managers of closed end funds are largely insulated from their shareholders, as their AUM remain constant.
    c. Costs
        i. Costs incurred by the managers of pooled investment vehicles are deducted from returns, lowering investment performance. These costs are mainly associated with management, distribution, and account maintenance.
        ii. As with other characteristics, fees tend to vary across ways in which funds are organized. Passively managed funds tend to have lower management fees, while actively managed funds tend to have higher management fees.
        iii. For investors, there are also costs associated with trading. Buying and selling listed ETFs and Closed-End Funds is relatively easy, whereas buying and selling shares of open-end mutual funds can only be done at the end of the day.
    d. Tax Implications of Cash Distributions
        i. Pooled investment vehicles generally distribute income (mainly from interest and dividends) that they receive from holding securities as cash dividends to

investors. They also distribute short-term and long-term capital gains. Distributions are equivalent across shares. Some funds have DRIP.

Index Funds

1. Introduction
2. Security Market Indices
    a. Security Market Index: a group of securities representing a given security market, market segment, or asset class. These can be publicly published indices, or individually created and used indices.
    b. The Index Universe
        i. Broad Market Indices: cover an entire asset class, generally within a specific country or region.
        ii. Multi-Market Indices: cover an asset class across many countries or regions.
        iii. Industry Indices: cover single industries.
        iv. Sector Indices: cover broad economic sectors - sets of industries related by common products or customers.
        v. Fixed-Income Indices: cover debt securities and vary by characteristics of the underlying securities and issuers. Characteristics include sovereign, corporate, and distinguishment by type of instrument and length of yield.
        vi. Other Indices: track the performance of alternative investments.
    c. How to Compute the Value of Indices
        i. The two variables that determine the value of an index are the values of the securities included in the index and the weights assigned to each of them.
        ii. Index Reconstitution: the adding or removing of securities included in an index.
        iii. There are multiple approaches used to assign weights to the securities included in an index. They include:
            1. Price-Weighted Index: an index in which the weight assigned to each security is determined by dividing the price of the security by the sum of all prices of the securities.
            2. Capitalisation-Weighted Indices (cap weighted, market-weighted, value-weighted): an index in which the weight assigned to each security is determined by the security's market capitalisation.
            3. Equal-Weighted Indices: an index in which the weights assigned to each security are equal. Given that security prices change, regular index recomposition is necessary. Weight and price are inversely related.
        iv. Index Return: percentage change in the value of an index over a period of time.
3. Index Funds
    a. Index Fund: a portfolio of securities structured to track the returns of a specific index, referred to as the benchmark index. These require passive investment strategies.
    b. Index funds are quite popular, as they closely track market returns. Index funds are generally broadly diversified and highly transparent, with relatively low management and trading costs. They are also tax efficient, as they realize little capital gain. Many institutional investors invest in index funds, or create their own.

c. Full Replication: an investments strategy employed by some index fund managers in which they hold every security in an index benchmark.
d. Sampling Replication: an investment strategy employed by some index fund managers in which they hold a representative sample. This is beneficial when the costs associated with buying, holding, selling, and reweighing are sufficiently high.
e. Adjustments to weightings and recomposition of index portfolios are required consistently and whenever the companies within a benchmark change. The effect this has on index funds varies across the type of fund.
f. Index funds may also buy additional securities in times of increased cash flow, whether from investors, dividends, or interest payments. They may also sell securities if demands of cash flow are higher than inflow.

Hedge Funds

1. Characteristics
    a. Definition: Hedge Funds are private investment pools that investment managers organise and manage. As a group, they pursue diversified strategies. The term 'hedge' originally referred to taking positions with specific correlative features in order to reduce risk.
    b. Availability
        i. Hedge funds are typically available only to those investors who meet wealth, income, and investment knowledge criteria that are established by regulators. Most investment in hedge funds comes from large institutional investors and high net worth individuals.
    c. Lock-Up Agreements
        i. Hedge funds typically feature lock-up agreements which lock up investors' capital for established periods of time, typically the length of time in which the managers expect they will be able to implement and succeed in their investment strategy. HFT funds tend to have short lock-up periods than funds that have strategies with longer time horizons.
    d. Compensation
        i. Hedge fund managers receive compensation through the 2 and 20 structure, meaning that they receive 2% fees for all AUM and 20% of profits in excess of a hurdle rate.
        ii. Managers usually earn performance fees only if the fund is above its high-water mark, which reflects the highest value, net of fees, that the fund has reach at any time in its past. This ensures that investors pay managers only for net returns calculated from the initial investment and not for returns that recoup previous losses. This is also known as the loss-carryback provision.
            1. Some managers will terminate their funds if they have losses sufficient to where they think they can no longer achieve their high-water mark. However, this does not solve their problems, as they will likely face difficulty raising new funds.

2. Risks
    a. Although many hedge funds are not particularly risky, the high performance fees might encourage fund managers to take substantial risk. This can be increased by the use of leverage and derivatives.
    b. Hedge fund managers are also typically investors in the funds they manage. Their co-investment helps assure investors that the managers' interests are well aligned with theirs.
    c. Most hedge funds are open-end investments and allow new investors to buy in and existing investors to leave at the NAV. However, this can only be done after the lock-up agreement obligations have been fulfilled.
3. Legal Structure and Taxes
    a. Legal structure and domicile, and therefore tax structure, is largely dependent on the situations of the management and investors. Different structures and different countries have different tax regulations.

Funds of Funds

1. Funds of Funds: investment vehicles that invest in other funds. They can be actively or passively managed.
2. There are two main strategies employed by funds of funds. The first is the selection of managers that the fund thinks will perform well, followed by investment into their funds. The second is the selection of strategies that the fund thinks will perform well, followed by investment into funds that employ those strategies. The portfolios held by these companies are diversified.
3. Investing in funds of funds typically involves high management fees because they are paying for two levels of fees.

Managed Accounts

1. Investors contract investment professionals to manage their investments by implementing specific strategies in addition to advisory and commission fees.
2. Wrap Account: an account through which a retail investor can acquire the services of investment professionals. The cost of these accounts is typically fee based and ranges from 1-3% of AUM, typically paid either annually or quarterly.
3. Commingled Account: an account in which the capital or two or more institutional investors is/are pooled together and jointly managed.

Tax-Advantaged Accounts and Managing Tax Liabilities

1. Tax-Advantaged Accounts
    a. Tax-advantaged accounts allow investors to avoid paying taxes on investment income and capital gains as they earn them. Contributions to these accounts may also have tax benefits. However, there are restrictions on when these funds can be withdrawn.
    b. There are a variety of factors that are involved in determining the taxes that must be paid in these accounts. Some require taxation at the time of investment, followed by taxation on the accumulated returns, while others require no taxation until the point of withdrawal. Additionally, different purposes (such as education and healthcare versus regular consumption) are taxes differently.

2. Managing Tax Liabilities
    a. Capital gains taxes are taxes imposed on investors for the increase in value of the investments they make. These are only made at the time of realization, at which time the rate is determined by holding period. Gains can be offset by losses, reducing taxable amount.
    b. Investment income can be reinvested and then taxed at capital gains rates if realized at later times.
    c. Determination of tax strategy should also involve the consideration of current versus future tax rates.