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Introduction

The purpose of this book is primarily to give those new to fund management an understanding of the operational issues with which they will need to be familiar – whether as potential fund sponsors, new entrants to the third-party administration industry, regulators, legal advisors or in any other capacity.

However, the book is also intended to serve as a more permanent reference manual for those engaged in fund management and administration issues, especially where they may be involved in a relatively specialized area such as fund accounting and would benefit from a broader overview of the issues. It seeks to give an overview of the practical issues to be taken into account for a broad range of aspects of fund management – from set-up and licensing to pricing, distribution, dealing and so on.

The first part of the text takes readers from the start-up phase – indeed, pre-start-up – through to the selection of an appropriate jurisdiction, fund structure and team of advisers and service providers. The second section deals with ongoing operational matters. It also deals with a range of problems which may arise, the risks that sponsors and operators may run, and what do to when things go wrong. The third and final section of the book takes a look at some relatively recent developments, and compares the advantages and disadvantages of certain jurisdictions.

The focus is intended to be on international funds, although reference is made to various domestic regulatory and tax regimes. The range of jurisdictions is of necessity not comprehensive, but aims to give readers a flavour of the material differences in how funds can be operated in various territories, and to provide a roadmap for making the right selection.

1 The concept of collective investment schemes

1.1 What is a FUND?

It is worth spending a few moments considering what we mean by the term 'fund', since the term is used by different people in different ways and can cause confusion. Defining our terms will allow a potential sponsor then to take the next step – where he determines whether a fund is in fact a suitable vehicle for his purposes, and if so what type is most appropriate.

A fund is simply a vehicle which permits the pooling of assets by a group of investors with a *common investment objective* (Figure 1.1). This objective will be to invest their money in (for example) securities or other assets, with the aim of generating a specific type of return – for example, capital growth, income, or some balance of the two. The pooling effect means that each investor participates – has a part share – in a large portfolio of securities or other assets, along with many other investors. No single asset in the underlying portfolio is attributable to any one investor – that is, we do not say 'the shares in ABC plc relate to Catherine Turner, whilst the shares in XYZ are Joe Singer's.'

The term 'fund' is often used interchangeably with the phrase 'collective investment scheme', and we will do the same in this text; 'c.i.s.' will also be used as an abbreviation for 'collective investment scheme'.

The above (fairly simple) definition is not where it ends, though. There are many vehicles which fall into it, and which most people would refer to colloquially as funds,

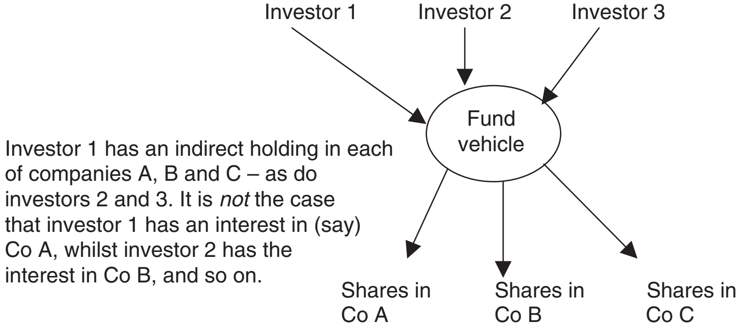

Figure 1.1 Schematic of a fund vehicle.

but which do not meet the *regulator's* definition of what constitutes a fund or c.i.s. – and where the arrangements consequently do not have to comply with any specific regulations applicable to either funds themselves, or to those who operate or promote and distribute them. For example, in many jurisdictions 'closed-ended' schemes are not regarded as funds for regulatory purposes, despite the fact that investors and sponsors alike see them as a means of satisfying their pooling requirements.

Further, definitions of what constitutes a fund for regulatory purposes are usually quite broad; a whole host of arrangements may technically meet the definition, whilst being of such a nature that it would be unnecessary and unreasonable to regulate them. For example, the definition of a pooling vehicle is usually drafted widely enough to capture almost any sort of arrangement where several people throw in their lot with one another, such as franchises and investment clubs, and where the income and profits or losses are shared *pro rata*. The definition therefore needs some fine-tuning if it is to exclude those arrangements which the regulator does not, or should not, want to capture. This can be done in one of two ways:

- by having a wide definition of what *is* a fund, and then defining some specific exclusions, or
- by having a narrow and specific definition of what a fund is, in which case no exclusions are necessary.

In practice, the former approach is more common, although examples of the latter still linger on in some countries. The former approach is, in essence, 'if it looks like a fund, it's a fund; but here are the exclusions' as opposed to the more unwieldy, 'if it meets this set of criteria it's a fund; but also if it meets this set, and this one, and this. . . .'

A major advantage of the former approach is that it makes it much easier for a regulator to adapt to the changing environment. Regulators are usually keen to limit the opportunity for people to wriggle through their 'regulatory net', by setting up new arrangements which escape regulation because they were simply never contemplated when the law was drafted. Where a definition is wide and turns on a set of broad characteristics, new schemes are unlikely to escape capture because of some technical nicety.

These matters may sound more theoretical than practical, but they can be important. Depending on a fund sponsor's intentions, it may suit him to set up his arrangements so as not to fall within a particular jurisdiction's definition – in which case a whole range of regulations may simply cease to apply. The sponsor should consider not only the definition which applies in the jurisdiction(s) where his fund is to be established and operated, but also that in any country into which he intends to promote it. This is because, again, one set of rules may apply to the promotion of a foreign fund into that country: and another – or none at all – to the promotion of non-fund investments. This is an issue we will revisit, once we have explored the 'definitions' theme further, by way of some specific examples.

First, we will take a look at the definition of a collective investment scheme as it is set out in Isle of Man legislation. This model is relatively common and derives from that which was established in the United Kingdom under the Financial Services Act 1986 (now superseded).

Section 30(1) of the Financial Supervision Act 1988 of the Isle of Man ('FSA88') defines a collective investment scheme as:

> '…any arrangements with respect to property of any description, including money, the purpose or effect of which is to enable persons taking part in the arrangements (whether by becoming owners of the property or any part of it or otherwise) to participate in or receive profits or income arising from the acquisition, holding, management or disposal of the property or sums paid out of such profits or income.'

So far, this is a very wide definition, potentially capturing all sorts of business arrangements and partnerships. Section 30(2) of FSA88 helps to clarify matters a little further: it states that to be a scheme, these arrangements:

> '…must be such that the persons who are to participate … do not have day to day control over the management of the property in question, whether or not they have the right to be consulted or to give directions…'

From this, it is now clear that if our vehicle is to be regarded as a fund (for regulatory purposes at least), its participants must be at one remove from the day-to-day management. This is helpful, as it rules out the kind of partnership arrangements where the parties operate their business between themselves: for our setup to be a collective investment scheme, someone else must be operating it.

Section 30(3) clarifies the definition even further. To be a scheme, the arrangement must have one or both of the following characteristics:

> (a) that the contributions of the participants and the profits or income out of which payments are to be made to them are pooled;
> (b) that the property in question is managed as a whole by or on behalf of the operator of the scheme.

Subsection (a) contains the pooling requirement which we have discussed earlier; and subsection (b) brings into the definition the concept of a scheme 'operator' – someone managing the assets and affairs of the vehicle, for its participants. This is the 'fund manager', whose role we will look at in detail in Chapter 4.

This is fine as far as it goes, but the definition we have so far is still very wide, and captures a number of arrangements which should not have to fall within the funds regulation regime. Therefore, and following the model of establishing a very wide definition and then carving out specific areas, subsections 30(5)–(7) of FSA88 then provide a number of specific *exclusions* from the scope of the definition – for example:

- Closed-ended companies
- Inter-group arrangements
- Employee share ownership schemes

- Franchise arrangements
- Clearing house arrangements.

The exclusion of closed-ended companies is important. If we establish our fund in the Isle of Man, or in any other jurisdiction with similar definitions, and if our scheme is closed-ended (i.e. has relative inflexibility in terms of the amount of share capital in issue) then it is not a collective investment scheme for regulatory purposes – and the c.i.s. regulations do not apply. That is not to say, of course, that other investment business or companies acts requirements do not apply – for example, the marketing of shares in the closed-ended company will still need to be carried out in compliance with applicable investment business regulations. Again, if our fund is quoted on a particular exchange, it will have to comply with any applicable listing requirements.

This limitation of the regulatory definition of a c.i.s. to open-ended vehicles is very common: for example, the definition of a mutual fund as defined under the Companies Act 1981 of Bermuda states that it is a company 'limited by shares and incorporated for the purposes of investing the moneys of its members for their mutual benefit and having the power to redeem or purchase for cancellation its shares without reducing its authorised share capital… .'

There are good reasons for having a much tighter regulatory regime for open-ended vehicles than for closed-ended ones, relating mainly to the need to provide investors with liquidity. We will look at these issues and the concept of open-endedness vs. closed-endedness in Chapter 2.

You might have noticed that under the Isle of Man definition we have been examining, we have not yet managed to completely exclude private arrangements – as, for example, where two people choose to pool their resources and have their money managed jointly by a third party, but have no reason to want their private arrangement to be regulated. In fact, the legislation in most jurisdictions does not *exclude* such arrangements from the scope of the definition – instead it *exempts* them from having to comply with the legislation and regulations, provided they are not promoted to the public and (often) provided they do not have more than a certain number of investors. So a private arrangement is still a scheme; it just does not have to be registered with a regulatory authority, or to labour under any regulatory constraints.

The difference between an arrangement being *excluded* from the definition of a scheme, and its being a scheme but *exempted* from the need to comply with c.i.s. regulations, might seem largely immaterial but it can have important ramifications for those providing services to them, which we will consider in Chapter 3 (The Regulatory Environment).

So far we have seen that in many countries, the definition of a fund is quite specific, and for regulatory purposes at least, usually excludes closed-ended schemes. We have, however, also said that in common parlance closed-ended vehicles which are used for pooled investment purposes are also referred to as funds. For a layman's description of a fund we could do worse than something along the following lines:

Definition: A fund is a form of *collective investment vehicle*, which is managed on behalf of investors and which allows them to *pool their assets* with the aim of achieving a *common investment objective*.

The types of assets which might be included in a fund's portfolio are as varied as investors' imaginations (although regulated funds are subject to some limitations in

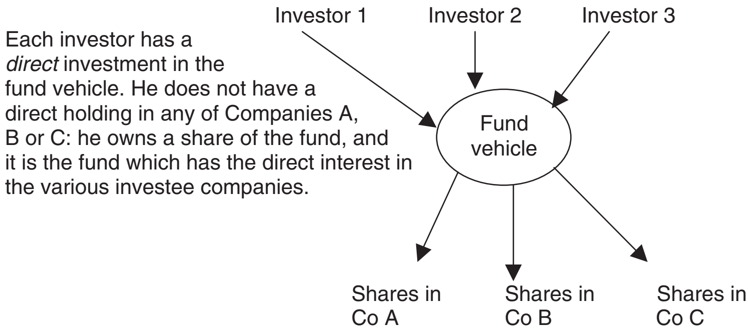

Figure 1.2 Each investor has a direct investment in the fund vehicle.

terms of what they can invest in; we will look at this in Chapter 3). The common underlying investments include:

- Equities
- Bonds
- Convertibles
- Derivatives
- Warrants
- Commodities
- Real property
- Deposits and near-cash assets in local and foreign currency
- Other funds.

More specialist or lightly regulated/unregulated funds may hold a much wider variety of assets, some of them relatively illiquid or difficult to value. For example, some – usually those aimed at sophisticated investors or those with specific interests in common – have been used to hold assets such as vintage cars, property ground rents, antiques etc.

Each investor has a direct investment in the fund vehicle, which holds the 'underlying' investments (Figure 1.2). He does *not*, however, usually have a direct investment in the underlying investments. It is the fund itself which has the direct interest in the underlying investment.

Investment via a fund is also therefore sometimes known as 'indirect investment'. The concept of indirect investment can be stretched somewhat where partnerships are used as fund vehicles, since with a partnership it is possible for tax authorities and others to look through to the individual partners and attribute interests such as tax liabilities/losses directly to them.

1.2 Capital structures

Funds may be 'closed-ended' or 'open-ended'. A company which is closed-ended will have a fixed authorized share capital – and a fixed amount of capital in issue at any point, with relatively little flexibility in terms of adjusting this (as, for example, with an ordinary company operating under traditional company law). An example would be the UK 'Investment Trust', a closed-ended company (and not a trust at all), established under the Companies Acts of the United Kingdom. Increasing or decreasing the number of shares in issue is a relatively laborious and potentially costly exercise and so the capital in issue is regarded as essentially fixed.

An open-ended vehicle, in contrast, has the ability to create new shares/units to meet demand from new subscribers, and to redeem and liquidate them when there is net disinvestment. Funds set up as unit trusts, partnerships, open-ended investment companies and purely contractual vehicles can be structured as open-ended vehicles.

Remember that, as we noted earlier, in many jurisdictions, the definition of a 'collective investment scheme' often excludes closed-ended vehicles: that is, the regulations which apply to regulated fund vehicles do not extend to closed-ended companies. Nevertheless, those businesses involved in establishing, managing and administering funds for third-party sponsors – known as 'third-party fund administrators' – usually have systems which can cater for both open-ended and closed-ended vehicles, and refer to both as funds or c.i.s.

We will look in more detail in Chapter 2 at the practical (as opposed to regulatory) implications of establishing a scheme as open-ended or closed-ended, and why a prospective fund sponsor might choose one option over the other.

1.3 Legal structures

When we discuss a fund's 'legal structure', as opposed to its capital structure, we mean the legal form it takes: that is, whether it is constituted as a company, a partnership, a trust or a purely contractual arrangement.

Depending on whether the fund is to be open-ended or closed-ended, some of these options may not be available: for example, a number of jurisdictions do not allow companies constituted under their laws to be open-ended, so only a unit trust structure can be used as an open-ended vehicle. Legislation facilitating open-ended investment companies is a relatively recent development in a number of countries.

Again, we will look at the practical implications in more detail in Chapter 2; at this stage, we will focus on acquainting ourselves with the general concepts.

1.4 The size of the funds universe

The variety of different legal and capital structures, and consequent definitions of a fund, means that industry estimates of the number of funds available worldwide vary wildly; at the time of writing, they ranged from under 40 000 to over 80 000 – depending on how a given commentator defined his fund 'universe'.

The picture is complicated in part because some agencies only capture open-ended funds in their statistics, whilst others include all vehicles intended to provide pooling benefits – that is, including closed ended vehicles. It can be further confused in terms of whether the agency includes only regulated funds, or both regulated and unregulated; and whether it registers an umbrella fund (a concept which we shall look at in Chapter 2) as a single fund or whether it counts all the umbrella's sub-classes as separate funds.

One of the other difficulties of assessing the size of the funds universe is the number of 'private' schemes which are established nowadays. Many funds are set up for the purposes of accommodating a handful of private individuals, or a specific institutional investor. They may not apply to, or need to, be regulated. Where this is the case there is often no easy way for the statistical agencies or regulators to capture them in their estimates. Further (and especially in the case of unregulated schemes), whilst the process of adding newly established funds to the statistics may be relatively straightforward, and is helped by the fact that sponsors may be willing to volunteer this information so as to attract investors, the process of removing closed funds can be a little more hit-and-miss. If a fund is unregulated and there is no legal reason for its removal to be flagged to the regulator, and if its managers are not inclined to provide performance data to any of the agencies measuring such data, it can linger on in the headcount statistics for some time after it has, in fact, ceased trading.

The different methods of defining the funds universe have also distorted the perceived success of different jurisdictions in attracting new funds business – some choosing to cite the headline numbers in terms of the widest possible definition, so as to improve perceptions of their success. Others are more rigid in their interpretations. When looking at cross-jurisdictional comparisons, therefore, it is important to delve deep enough to ensure you are comparing like with like!

Nonetheless, it is possible to emass meaningful statistics. At the end of the year, the size of the worldwide mutual fund market (that is, open ended schemes only) was estimated at just under $14 000 000 000 000 – some 23% upon the previous year. This estimate excludes funds-of-funds.

1.5 Origins: the first collective investment vehicles and the emergence of a funds industry

The fund industry is often said to have begun in the United Kingdom in the mid-1800s, when the Foreign and Colonial Government Trust was formed. However its roots in fact go back much further. The concept of collectivization of 'investment' interests can be traced as far back as 200 BC, by way of contracts which we would probably describe nowadays as life annuities. A European variation on this theme, the 'tontine', became a relatively common means of raising finance from the public in the Middle Ages; many of the principles then developed still inform today's fund industry, although it was not until the 18th century that true funds began to emerge.

Two developments in the capital markets also assisted in the development of a fund industry: these were:

- The development in the 18th century of securitization, which allowed private loan instruments (typically plantation loans to the West Indies) to be transformed into publicly traded securities;
- Stock substitution – that is, the repackaging of one security in the form of another with different characteristics which were more palatable to a particular investor market. The end product was essentially an early form of depository receipt.

Both of these developments led to new markets in instruments which had potential investor appeal – but which, in order to attract private capital from a risk-averse investor base, needed something more. This 'something' was provided in 1774, in Holland, where in that year the first '*Negotiatie*' of its type was formed by a local merchant named van Ketwich.

Van Ketwich solicited subscriptions for a new vehicle, which promised even smaller investors diversification at a low cost. This benefit – risk spreading, at accessible entry levels – is still a key selling point for collective investment vehicles the world over. The fund was called *Eendragt Maakt Magt* (literally, 'Unity Makes Strength' – an apt motto for the industry even today) and it invested in a range of bonds issued in countries such as Spain, Russia, and central and south America.

The fund was what we would today term a closed-ended fund, an equivalent to the UK investment trust: the concept of open-endedness had not yet arrived. At launch, some 2000 shares were issued at a par value of 500 guilders each, giving it an initial capital of some 1 m guilders. The fund was listed on the Amsterdam exchange, and a number of key investor protection concepts, surprisingly modern in their approach to corporate governance and the avoidance of conflicts of interests, were inbuilt:

- Van Ketwich himself was not involved in any investment selection. His involvement was limited to managing the fund's administrative affairs, and he was committed to providing an annual statement of account to the vehicle's 'commissioners'.
- The day-to-day investment management was delegated to two of the fund's directors, who were required to operate within a defined mandate.
- The company's prospectus restricted investment selections to 10 classes or groupings of bonds, and required that the investment managers spread the portfolio across these groupings so as to achieve the promised level of diversification.

The fund aimed to distribute a prescribed dividend of 4 per cent per annum. It was innovative in design: as well as its implicit benefits of diversification, van Ketwich built in a type of draw or lottery, such that each year a number of shares would be redeemed at slightly over par. Both of the shares which came immediately before and after a retired share in the register would receive a dividend in excess of the standard 4 per cent. This lottery concept was a not uncommon feature in the Dutch market of the time, but introduced an element of complexity which might be regarded as excessive in today's markets.

The fund was wound up in 1824, following difficult market conditions which took some of the shine off its initial success; nevertheless its early healthy returns and popularity had by then spawned a number of imitators, including others sponsored or administered by van Ketwich himself.

The concept of the investment trust took some time to travel abroad: it was not until 1868 that the first such fund was established outside the Netherlands. This was the Foreign and Colonial Government Trust. Established in London, it promised 'the investor of modest means the same advantages as the large capitalist, in diminishing the risk of investing in Foreign and Colonial Government Stocks, by spreading the investment over a number of different stocks.' The fund was again closed-ended – it was the first UK investment trust – and was closely modelled on its Dutch predecessors (including provisions such that shares would be retired from income during its defined life of 24 years).

As had been the case in Holland, once the concept was introduced the London market took to it with enthusiasm, and in the next decade a number of other trusts were established. It took until the 1890s for the idea to cross the Atlantic and for the first US investment trusts to be set up.

Despite its late arrival on the fund scene, credit for establishing the first open-ended is usually accorded to the United States. In 1924, three Boston-based businessmen pooled their cash to establish the Massachusetts Investors Trust, a mutual fund launched with assets of $50 000 (invested in about 45 stocks). It was so popular that after a year it had grown in size to nearly $400 000 and had about 200 participants. Many imitators followed and whilst the stockmarket crash of 1929 slowed growth, confidence was bolstered in the 1930s and 40s as Congress passed laws formalizing certain investor protections. The Securities Act of 1933 and Stock Exchange Act of 1934 required that mutual funds be registered with the Securities and Exchange Commission and that they provide a prospectus for prospective investors. The Investment Company Act of 1940 then introduced a regulatory framework for mutual funds, which still provides the basis for US fund regulation today.

Following these developments, the US mutual fund market grew rapidly in popularity over the 1940s and 50s. In 1940 there were fewer than 80 funds on the market, with total assets of some $50 million; by 1960 this had grown to 160 funds with around $17 billion and by the end of the 60s, some 270 funds and $48 billion of assets.

Subsequent landmarks have been the development of new categories of fund. In 1972 the United States' first money market mutual fund was formed, by way of the Reserve Fund, inc. and invested in money market instruments (i.e. cash and near-cash investments such as treasury bills, certificates of deposit and commercial paper) as opposed to longer-term securities. It offered investors an alternative to cash in the bank, with competitive returns and diversification across a number of deposit-takers. It began life with assets of some $300 000 and by 1975 had grown to around $390 million. From these beginnings the US money market fund industry exploded to some $80 billion by 1981.

In 1976, John Bogle was credited with the launch of the first retail fund to track a market index – the precursor of today's tracker funds. Now known as the Vanguard 500 Index Fund, Bogle's fund hit the $100 billion mark in November 2000 to become the then-largest mutual fund in existence.

Other developments and innovations have further fuelled the growth of the fund industry. Whilst space does not allow for a more detailed examination of the past, we will look at the emerging trends and likely future developments in Part 3 of this book.

1.6 Purposes, advantages and disadvantages of collective investment schemes

Why would an asset manager decide to offer his services packaged as a fund, rather than by way of direct investment portfolios? There are advantages and disadvantages to be considered, both from the perspective of the potential investor, and from that of the sponsor himself.

First, as we have noted, funds allow a group of investors to combine their resources with a view to achieving certain objectives. For retail investors, they can provide a useful alternative to direct investment, where the investor lacks any or all of the following:

- enough money to achieve a reasonable degree of diversification in his own right;
- sufficient investable assets to interest a professional fund manager running segregated client portfolios;

- the expertise to make the appropriate investment decisions;
- the time and inclination to do so.

The *advantages* to a retail investor of investing via a fund may include:

- *Economies of scale*. The combined weight of assets in a fund should mean that its manager can negotiate favourable commission and other charges, thus (in theory, at least) reducing the costs of investment to the individual investor. In addition a money market fund should, by pooling its investors' assets, be able to command the institutional rates of interest on the CDs, treasury bills etc. in which it invests, that any other substantial investor could obtain – but which would be inaccessible to the retail investor. At the least, it is arguable that these economies should partially offset the costs of running the fund itself.
- *Diversification (spread of risk)*. Diversification is the process of spreading investments across a number of different holdings, and potentially across different asset classes or markets. It has the effect of mitigating investment risk: if an investor has only a single investment holding, he will suffer considerably if that holding falls in value. On the other hand, if his portfolio contains several investments, the effect of any one of those investments falling in value is reduced. (Of course, the price to be paid for this risk reduction is that the positive effect of outperformance by any one of those holdings will also impact less on the performance of the portfolio as a whole.) A fund manager who seeks to deliver returns which do not diverge very far from the market norm is likely to have a well-diversified portfolio – that is, a large number of holdings in the underlying portfolio. One who is aggressive and confident in his stock selection skills, and whose fund is aimed at investors who can tolerate more risk will tend to a more focused approach: his portfolio will not be so well diversified, but if his selections are correct the impact of each one will have a correspondingly greater impact on the overall fund performance.

  An investor with a relatively small sum to invest, investing directly into shares or bonds, is unlikely to be able to achieve a meaningful level of diversification. That is, firstly he will probably not have sufficient money to invest in more than a handful of stocks; and secondly, if he does try to spread his money across a number of holdings, the costs of commission, stamp duty (if applicable), bank charges and so forth on each transaction will be disproportionately high and will reduce his net investment performance. By investing via a fund, the investor is gaining an indirect interest in a much wider spread of holdings.

  Many larger funds have far in excess of 100 underlying investment holdings – even the most focused funds rarely have fewer than 20 holdings (unless they are 'funds-of-funds' – see Chapter 2), and regulations usually require that retail funds observe minimum diversification requirements. We will look at the form these often take in Chapter 3.

  The degree of diversification achieved will depend not only on the number of holdings in a fund's portfolio, but also on the likely correlation between their individual returns. For example, a fund which focuses solely on the shares in US retailers may be diversified in terms of holdings in that sector, but it will be completely focused on a single industrial sector; if that sector suffers, the investor's fortunes will also suffer accordingly. We can therefore say that funds may offer diversification across not only individual companies, but also across a range of sectors, asset classes, countries and even investment styles.

- *Specialist investment expertise*. Normally, professional portfolio managers are only interested in providing services to those investors with substantial sums to invest. Investing via a fund allows many small investors to pool their resources, so as to collectively amass sufficient to be of interest to a professional manager. Thus funds provide access to specialist professional investment skills which would otherwise only be accessible to the very wealthy.
- *Eliminate administrative burden*. Even those investors who have sufficient funds to invest directly may not wish to take on the administration of a well-spread portfolio, with all that this entails. Investing via a fund means that it is the fund's manager/administrator, and its custodian, who will deal with issues such as the administration of investment transactions, settlement, dividend and interest collections, corporate actions and so on – and the record-keeping for all these activities.
- *Regulated status*. Not all funds are regulated, but many are – indeed many actively seek regulated status, because this can be a considerable comfort to investors. Investors may be encouraged to commit money to a fund because they know that it and its operators have been subject to scrutiny (by way of a licensing process) and that they are supervised on an ongoing basis and have to observe certain investment restrictions.
- *Access to foreign markets*. Certain of the world's stockmarkets are not open to private investors from abroad (although the number of markets where this is the case has fallen in recent years, as many countries have opened up to foreign investment). Others are theoretically open to private foreign investors, but the complexities and costs of dealing on them are such that most people would not want to incur them. Whereas a private individual may not be able to deal on a specific market, a fund manager may, on behalf of its fund (which is an institutional investor), be able to do so. Thus funds may offer individuals exposure to areas of the world which are difficult or impossible for them to invest in directly.
- *Access to products*. Some products are not available to retail investors, either for regulatory reasons or because of the product provider's policies. An example might be a hedge fund with high minimum entry levels, or one which has closed to new business but whose managers are willing to provide access to certain favoured institutional counterparties. Other examples might include sophisticated investment products employing derivatives, with the aim of achieving a specific risk profile. Individuals investing in a fund which itself uses such products or strategies can thus gain access to a portfolio with specific risk characteristics, which would otherwise not be available. Examples might include the many funds structured to offer capital protection coupled with an element of exposure to the stockmarket's upside.
- *Tax efficiencies*. Where an investor is resident in a jurisdiction which has capital gains taxes (CGT) or the equivalent, a fund can achieve significant tax deferral or mitigation: indeed many private funds are established to protect a family's wealth, for exactly this reason.

  An investor resident in a country with CGT, and who holds a portfolio of direct investments, will (subject to any CGT allowances) be liable for tax on the gains he realises when trading that portfolio. Even if he has other losses against which these gains can be offset, the administrative burden of doing so can be reasonably substantial.

However, if his investments are held indirectly – that is, through the medium of a fund – then it is the fund which realises the gains. Many types of fund incur no, or low, tax liabilities on gains realised on their underlying portfolio.

This means that a fund can act as a tax 'shelter' for gains on underlying transactions; the investor pays no capital gains tax until he realizes his holding in the fund itself. He may thus obtain significant cash-flow advantages through the deferral of CGT; indeed, he may be able to permanently avoid the tax in part or in full, by realizing his fund holding at a time when his overall CGT liability is low – for example, when he has other losses against which to offset it.

The *disadvantages* to the investor of investing via a fund may include:

- *Costs*. The costs of operating a fund offset some of the economies of scale. They include management and administration charges, custody costs, stock brokerage, legal and audit fees, printing and publishing costs and the like. The costs involved for some funds can be extremely high, and may outweigh any anticipated benefits. Investors are well advised to investigate the Total Expense Ratios (TERs) of funds they are considering buying. TERs are published by many funds directly; in other cases they can be obtained by referring to surveys published by agencies which specialize in calculating them. An example would be Fitzrovia (available at www.Fitzrovia.com). We will look at the various costs incurred in operating a fund, and how these are borne, in Chapter 4.
- *Lack of control*. Some investors like to be highly involved with their investments, and do not appreciate the fact that they cannot instruct the fund's manager as to what holdings to buy and sell – in fact in the case of a retail fund they are unlikely to have much, if any, contact with their fund manager at all. Certain managers whose funds are aimed at, and tailored to the needs of, very wealthy or sophisticated investors are happy to engage in discussion with their clients – but the communication is likely to be one-way; whilst an investor may be kept informed, he is unlikely to be able to influence investment decisions unless the fund is one which has been established specifically for himself and his family/close associates.
- *No guarantees*. Specialist investment expertise does not guarantee good performance, as many investors can attest; so an investor may end up paying substantial costs, but still suffer from an investment performance well below that of the market as a whole.

  Of course, certain funds *do* come with 'guarantees' attached; but these sometimes need close examination. Certain regulators exercise controls over the use of the word 'guarantee' in product descriptions; but where funds are established in countries where this is not the case, the 'guarantee' could be close to useless. In some cases they are limited to the guarantees attached to the underlying bonds or other investments in which the fund invests; in others, they are issued by a subsidiary of the fund sponsor group which has little or no substance.
- *Tax inefficiencies*. Whilst funds can provide a useful shelter for income and gains realized on their underlying holdings, they can also be inefficient in some circumstances. This is particularly the case where they are established in jurisdictions which do not have double taxation treaties with the countries in which they invest. This is quite often the case with 'offshore' jurisdictions, which – because of their tax regimes – may have difficulty in negotiating treaties with onshore authorities. Such

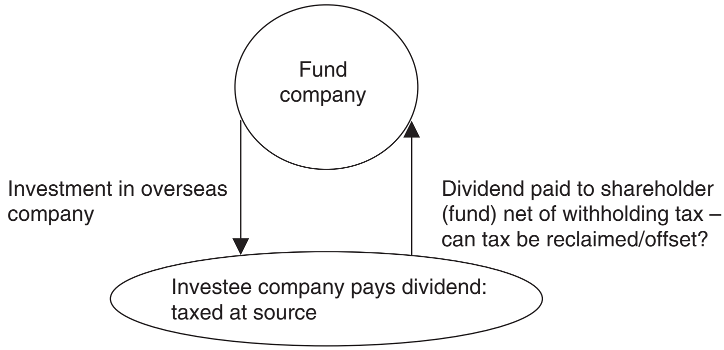

Figure 1.3 Tax inefficiencies.

funds may find it impossible to reclaim withholding taxes deducted on dividend or interest income on their underlying investments (Figure 1.3).

- *Lack of depositor protection*. Whilst many regulated funds, including those in certain offshore jurisdictions (e.g. Authorized Schemes in the Isle of Man) benefit from investor protection schemes of one form or another, this is not the case with every jurisdiction or class of fund. In some locations investors will benefit from more effective or comprehensive depositor protection under a bank deposit protection scheme, than they will when investing in a mutual fund operated in or from that jurisdiction. For example, investors in a US Mutual Fund are essentially uninsured against loss, whereas an individual with his money in a savings account would have the benefit of the Federal Deposit Insurance Corporation protection scheme, to the tune of up to $100 000 per account.

For the fund sponsor, the advantages of offering his services by way of a packaged product (a fund) are:

- *Ease of administration*. The sponsor can (for a cost) outsource the administration of many aspects of the investment function – including portfolio valuations, the maintenance of individual investor accounts, dividend/distribution calculation and so on. This means that the sponsor can concentrate on its core competencies, whether these be investment selection, macro-management or marketing and distribution.
- *Homogenization*. The sponsor does not have to cater to the differing requirements of a number of investors – all of his customers have accepted standardized terms and conditions, both in terms of an investment mandate and in terms of administrative functions such as reporting, etc., by way of the fund's offering documents.
- *Distribution*. Depending on the regulatory status of the fund, it may be possible for it to be distributed widely by tied sales agents, independent financial advisers, fund supermarkets and as fund-links to life products. Increasingly, the use of Contracts for Differences ("CFDs") is also being used as a way for investors to gain exposure to certain funds.

The potential disadvantages are:

- *Inability to personalize services*. The sponsor's offering to all of its investors will be relatively homogeneous; there will be no opportunity to tweak portfolios, or

administrative features, to appeal to the needs of specific potential clients. This constraint is mitigated to a degree, if the sponsor's client base and fund range is big enough that he can offer:
  - different share classes with different features (such as feeder funds with a currency hedging overlay, or classes with different fee structures); or
  - a sufficiently large range of sub-funds from which investors can construct a tailored portfolio of funds, so as to meet a specific investment objective.
- *Cost*. The various costs of administering a fund, both in terms of paying its service providers and in meeting any regulatory costs, must be borne – either by the provider, or by the fund itself. If the provider meets the costs, its profit margin will be reduced; if the fund meets them, its net returns will be reduced, its investors will be less satisfied and it will find it more difficult to market itself on the basis of performance.
- *Regulatory and product constraints*. Depending on the regulatory status of the fund, there may be considerable constraints in terms of:
  - Obligation to diversify;
  - Limits as to the size of influential holdings in investee companies;
  - Limits on holdings in illiquid or unquoted investments;
  - Restrictions to certain 'eligible markets';
  - Inability to borrow or hedge, and controls on the ways in which hedging instruments may be used.

1.7 The market for funds – institutional, retail, specialist

Funds are typically grouped by the category of underlying asset in which they invest, or by the nature of the returns they are intended to generate. However, they can also be broken down into groupings according to the type of investor they are aimed at.

Retail investor funds are aimed at the general public; they typically have relatively low entry levels, and are subject to the most stringent regulatory controls in terms of their investment policies and how they are managed, administered and promoted. Individual investors may make their own decisions about which funds to buy, or they may be guided by a financial advisor.

Managed clients are often medium-to-high-net worth individuals, with sufficient investable funds to have their money professionally managed – albeit not in a portfolio of directly held shares. Their wealth may be managed by a specialist investment house, or a stockbroker or bank offering wealth management services. Portfolios will comprise a number of different funds. Managers targeting this category of investor may structure their funds so as to appeal to investment houses which will hold their clients' assets in the name of a single nominee, sub-segregating individual client portfolios on their own in-house systems. They tend to operate on a non-certificated basis, and may have a relatively high minimum entry level, which relates to the aggregate holding of the investment house as opposed to the positions of its underlying investment clients.

Wholesale investors include institutions such as life insurance companies, pension funds and so forth – organizations with large pools of surplus wholesale cash, on which they need to generate a return. The institutional market has grown significantly in recent years, in part because of developing pensions and trust legislation which has allowed greater freedom of investment to pension fund managers and trustees. Whilst trustees are now able to invest assets in a wider range of instruments than was once the case, they have also generally been burdened with an increasingly explicit duty of care – in terms of matters such as how they invest money, when they should take external advice or engage external managers, and what degree of diversification they should employ. Products such as funds have grown in their appeal as the providers of packaged solutions to many of these issues.

1.8 The role of funds as a node between the investing public and the capital markets

We have already noted the advantages that funds can offer investors, in providing access to areas of economic opportunity which might not be available to them (or at least, not on attractive terms) as direct investors.

The concomitant benefit of this is that funds play a role of huge importance in fuelling a developed economy. They do this by collecting investable capital from private and other investors, converting its form through the vehicle in which it is packaged, and then bringing it to those businesses and markets which need it, but which cannot easily accommodate direct investments.

Many products and markets are – for regulatory reasons, or for reasons of economies of scale – only accessible to substantial or professional investors. This would exclude most private individuals, but might well include the majority of funds. Further, whether they can access those markets or not, retail investors might well stay away from them simply because they do not have the knowledge, experience or access to information to engage with them, or because they do not have the ability to employ the strategies which will optimize the risk/reward characteristics of their exposure to them. By pooling together the individual sums of many individual investors, and channelling this into equity, debt and other offerings, fund managers provide much-needed funding to the capital markets.

Examples include:

- Venture capital funds, many of which benefit from tax favourable treatment – a means for governments to encourage private investment into startup businesses or businesses operating in economically disadvantaged areas.
- Pension funds investing via specially established fund vehicles (which may well not be available direct to the investing public).
- The various forms of partnership vehicle which are used in some jurisdictions to facilitate investment in film financing, a type of activity which might be unpalatable to many if it were not ‘packaged’ in this way.

Of course, fund managers have a particular agenda in mind: and that is to achieve sufficiently good performance to keep attracting new money, either for their existing funds or for new ones. The demands of this agenda are not always consistent with the needs of the investee companies. A fund manager investing in startup vehicles may be supplying it with much-needed capital: but it may be looking, in return,