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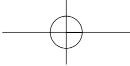
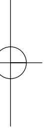
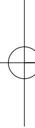
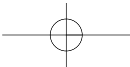
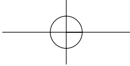
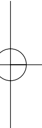
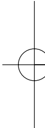
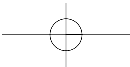


Part 1

Principles of Fund Management

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,

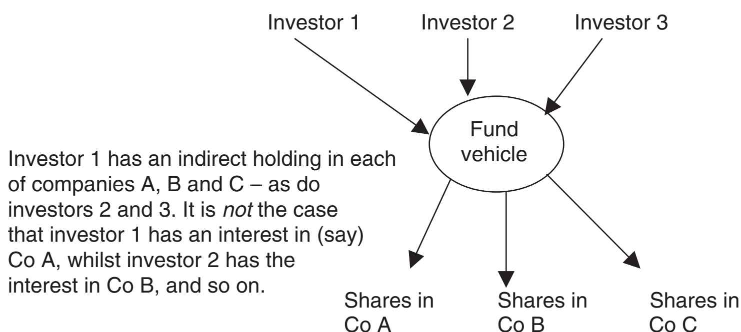


Figure 1.1 Schematic of a fund vehicle.

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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).

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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

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- 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

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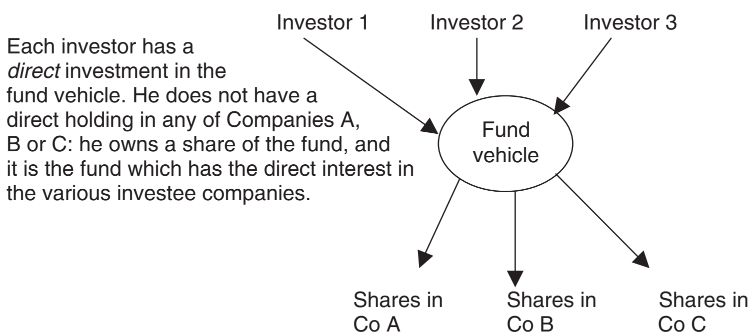

Figure 1.2 Each investor has a direct investment in the fund vehicle.

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

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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

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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.

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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;

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- 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

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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.

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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

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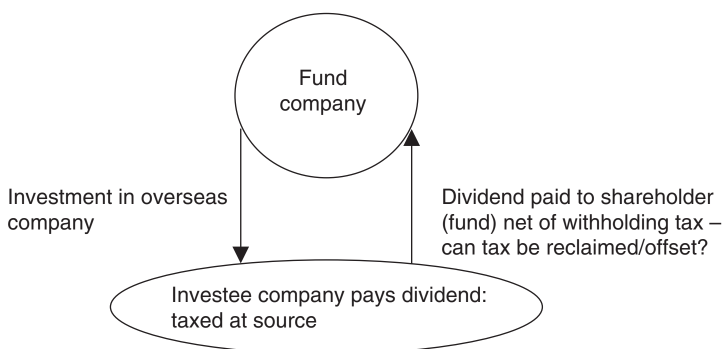

Figure 1.3 Tax inefficiencies.

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

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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

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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,

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for any or all of:

- A quick move to profitability, and a return on capital which will be crystallized by the fund manager's withdrawal of his capital.
- High levels of dividend payouts, preventing the investee company from reinvesting as much of its profits as it would like.
- Management decisions which favour the short-term interests of the shareholders at the expense of long-term growth.

The company on the other hand, whilst it is undoubtedly capital-hungry, may be hoping for the type of investor who provides:

- stability of capital;
- a long-term investment horizon and a level of patience which can only be offered by a private investor or one who does not labour under the obligation to demonstrate a good investment performance to his clients;
- potentially, management expertise which will benefit the investee company.

This mis-match between the requirements of investor (fund) and investee (business) can make for certain tensions. Further, the propensity of even specialist fund managers to adopt a herd mentality and to have similar aims and outlooks means that the effect of one manager withdrawing support for a business or sector can be amplified as his peers do likewise. Thus, from the perspective of an underlying investee company, product provider or even an economy, funds can in some circumstances be as great a force for evil as for good. This is particularly so for those funds which are lightly regulated, or completely unregulated, and which therefore have the flexibility to act quickly and decisively in moving money around.

Numerous studies have been carried out on the 'herding effect' of fund-based investments on share prices, with a view to establishing just how destabilizing the effect is. The subject is not an easy one to deal with, especially since the villains of the piece are usually seen as being unregulated or lightly regulated hedge funds, whose managers are notoriously coy about revealing their funds' positions. However, enough robust data appears to have been obtained to make certain deductions – in particular confirmation of what one might intuitively have suspected: that past investment returns tend to be greatest in those stocks bought by 'herding' funds – funds with a propensity to copy their peers, in a sort of 'follow-the-leader' approach, rather than choosing stocks on a truly independent or random basis. It was also lowest in those stocks sold by herding funds. This implies that the trading behaviour of funds can trap investee companies in a vicious (or virtual) cycle of disinvestments (or reinvestment); and further, there are indications that the effect is greatest amongst small-capitalization companies – that is, those most in need of stable investment.

The reasons for this type of behaviour on the part of fund managers are not entirely clear, especially given the proportion who cite their independence of view as being the chief propellant of their performance. Most of the possible answers seem to indicate that this independence of view is, in fact, less common than many managers

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would like to admit:

- In practice it appears that many, if not most, funds trade on the basis of a positive feedback strategy. That is, they tend to buy stocks with a good past performance. Given the finite investment universe, this means that many funds will buy many of the *same* past winners.
- Similarly managers display a tendency to sell stocks which have recently fallen in price (this tendency may be particularly exacerbated in managers whose strategies are momentum-driven).
- Many managers have a particular aversion to the shares of small companies, those with low liquidity or those with unfavourable volatility or risk/reward histories. If they do invest, they react in a more risk-averse way to any perceived sell-signals.
- Reputational fears appear to play a large part in decision-making, with managers in many cases apparently ignoring the results of their own in-house research to copy the trading activity of other managers. This indicates that they prefer the risk of 'getting it wrong' with the general herd than that of getting it wrong alone.
- It may also indicate that rather than copying the trades of the wider fund community, simply for reputational reasons, they are looking at the trades of other managers whom they regard as better-informed, inferring their rationales from the trades they have undertaken and copying them in certain cases – selective herding, but herding nonetheless.
- It may however also indicate that their in-house research is actually strongly correlated with the in-house research of their peers as a result of being based on the same indicators.
- Herding activity appears to be strongest amongst those managers with a growth-oriented style, as opposed to amongst value-style managers; and among specialist managers and focused funds, as opposed to generalists.

As we have noted, the actual measure of herding activity is difficult to assess, particularly among less regulated and less transparent vehicles, although there is cause to believe it exists to a greater extent in some types of fund than in others. This tendency has led on a number of occasions to funds – and in particular hedge funds – being castigated as the 'tools of economic chaos'; because they are a means by which sophisticated investors can move money quickly into and out of particular assets or markets, they are blamed – often correctly – for sharp swings in currency, commodity and share prices. Those on the receiving end of these swings (and those responsible for ensuring orderly markets and economies) often characterize this behaviour as profiteering: witness the comments of former Malaysian Prime Minister Dr Mahatir at the time of the Malaysian economic crisis in 1997/8 (Dr Mahatir placed the blame squarely at the door of hedge fund managers), or the press comment in 2001 which blamed a small number of hedge fund managers for the sharp decline in the value of the South African rand.

There is undoubtedly an element of truth in this view: the larger hedge funds (and indeed the mass of smaller funds, when exhibiting herding characteristics) exert real influence on markets and currencies as well as on individual stocks. Without doubt managers will apply – indeed, have a duty to apply – strategies which will benefit their funds, regardless (within reason) of whether these are at the expense of companies

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and economies. But any criticism of them should be balanced with their capital-raising and liquidity supplying role and the fact that in a free market they are often the clearest means of allowing investors to vote with their feet (or indeed their pockets).

Hedge funds – even where they invest primarily in derivative products as opposed to the underlying assets – perform a particularly important capital-raising function for the less-liquid markets. Where derivative products have been developed and are offered by a particular market, they exist to provide a risk management and capital-raising mechanism for various economic operators; and in buying and trading them, hedge funds provide essential components of the market's capital and liquidity in them, by acting as counterparties.

In addition, because they are not bound by the liquidity and other constraints of highly regulated funds, and typically have relatively long 'lock-in' or notice periods for redemptions, hedge funds are also major investors in (and therefore major providers of funding to) many new ventures in which there is little or no market at all. Their fleetness of foot in moving money around, as facilitated by their freedom from regulatory investment restrictions, is counterbalanced by the relative stability of their investors' commitments.

1.9 Listed funds

In addition to determining what degree of regulation his fund should be subject to, a prospective sponsor should also consider whether there are advantages to listing it. If so this should be borne in mind early on, so as to ensure that the structure of the fund does not preclude its being listed on the most appropriate exchange, or necessitate an unwieldy and expensive restructuring.

The advantages are mostly related to increased investor appeal:

- Many institutional investors are bound by law or regulation only to invest in listed investments.
- The 'visibility' of a fund's shares may be increased significantly.
- Shares can be traded at any time when the exchange on which they are listed is open – not just once a day, at the fund's dealing point.
- A fund which is listed may be attractive to investors who wish to employ a wider range of strategies – for example, placing stop-loss or limit orders.
- Listing may also allow investors to buy on margin or short-sell, so as to hedge the risk in his portfolio.
- Some listed funds such as Exchange Traded Funds (ETFs) now have options on their listed shares. Again, this can provide investors with a wide range of strategies which would otherwise not be open to them.
- Investors will pay reduced costs for their buy and sell transactions (i.e. there will be no initial charges or redemption fees for them to pay).
- Where an exchange provides for settlement through a central agency, such as Crest or Eurocelar's FundSettle, this can be particularly attractive to institutional investors.

There can also be benefits from the sponsor's perspective – for example, in terms of investment performance. Listed funds such as ETFs do not have to hold cash in

anticipation of investor redemptions (because the exchange is facilitating liquidity in the shares); this can reduce performance drag in times when market conditions favour a fully invested portfolio. Sponsors have also claimed that they regard the 'quality control' imposed upon them by virtue of a listing as being a useful internal discipline and means of promoting good governance.

There is no particular reason for a fund to be established in the same jurisdiction as that in which it is listed, although there may be economies in doing so. Managing listings across multiple jurisdictions, and the need to engage agents and legal advisers in other countries, can cause costs to escalate and increase the administrative and regulatory burden.

In order to obtain a listing, funds will generally be required to meet certain criteria. These differ from exchange to exchange, and may include minimum subscription levels, limits on the legal form which listed funds may take, and minimum disclosure requirements. A typical list of requirements is given in Table 1.1.

As well as entailing different requirements, listings on different exchanges will afford different benefits – some being regarded more favourably by investors of a specific type or in a particular location than others, and some being regarded as having a better reputation and general credibility than others. For this reason, it is important to have a clear idea of the needs and wants of your intended investor base at the outset, and to take advice on whether listing is likely to be of advantage – and if so, where.

For example, after taking advice a fund sponsor may decide that it would be advantageous to list a fund on one of the offshore exchanges, which may have less demanding criteria than onshore exchanges. At the same time, however, it may be advised that in order to meet the requirements of its target investor base, it should choose one which is recognized or designated by the US Securities and Exchange Commission or the United Kingdom's Financial Services Authority.

A comprehensive comparison of those offshore/international exchanges on which funds may be listed is beyond the scope of this text: however the following examples illustrate just a few of the considerations which a sponsor might bear in mind.

- *CISX*. An example of an exchange which can accommodate offshore/international funds in the offshore British Islands would be the Channel Islands Stock Exchange (CISX). The CISX has obtained recognition by the UK Inland Revenue under s841 of the Income and Corporation Taxes Act 1988 of the United Kingdom. This is a requirement for certain types of issuer and affects the UK tax treatment of securities listed on the CISX, including their ability to be held in certain UK 'tax wrappers' such as Individual Savings Accounts, Personal Equity Plans and Self-Invested Personal Pension Schemes; so, of course, a fund sponsor who saw the UK retail investment market as a primary target might see listing on such an exchange as attractive, because a fund which can be held in a tax-advantageous way will have a clear advantage over one which cannot. The CISX has also been accorded the status of a 'Designated Offshore Securities Market' by the US Securities and Exchange Commission, as provided for by rule 902(b), under 'Regulation S' of the Securities Act 1933. This regulation deals with sales of securities made outside the United States where there is no registration under the Securities Act 1933. The CISX will accommodate listings of funds set up as protected cell companies, and those established as limited partnerships.

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Basic Requirements for Listing	**Yes/No**
Fund itself must be locally approved, incorporated in a jurisdiction acceptable to the relevant exchange on which listing is sought, or be otherwise acceptable to the exchange	
Fund must have appointed an independent auditor	
Fund units/shares may have to be held through a named depository/ settlement agent	
Fund may be required to be of a prescribed minimum size (if already established) and there may be a requirement for a minimum tranche per affected class to be listed	
Fund must be able to provide timely calculation of its Net Asset Value (NAV) to the Exchange periodically	
Exchange will require that the fund's directors accept responsibility for contents of the listing documents	
Exchange will require that directors can demonstrate adequate knowledge, skill and experience in the management of funds – both in general and in the context of the type of fund which is to be listed	
Fund's Investment Manager (if one is appointed) must be able to demonstrate appropriate knowledge, skill and experience	
The various functionaries and service providers must disclose any conflicts of interests	
Shares/units in the fund must be freely transferable and capable of being traded on an equal footing (shares in the same class must rank *pari passu)*	
Annual accounts may be required to conform to International Accounting Standards, or to US or UK 'Generally Accepted Accounting Principles'	
Contents of Listing Documents	
General details	
All basic details – name, address, domicile, legal constitution of the fund which is applying to be listed	
Directors' 'Responsibility Statement'	
Declaration that an application has been made for listing	
Nature, amount, means of valuation and issue price of the tranche to be listed	
Arrangements for conversion between classes, if any	
Statement as to the potential for cross-class liabilities to arise, if any	
Auditors and other functionaries/service providers	
Disclosure of any pending legal proceedings	
Management	
Details of the fund manager, investment manager and any advisers	
Details of service and other material agreements, and remuneration	
Details of directors' remuneration	

Table 1.1

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Basic Requirements for Listing	Yes/No
Investment policy	
Statement as to the fund's investment objectives, policy and strategy	
Disclosure of material risks	
Specific disclosure requirements may be prescribed where a fund is able to make investments off-exchange/on an 'over the counter' basis, etc.	
Information regarding financial position	
Where a fund has been in existence for 12 months or more at the listing date, audited annual accounts	
Interim financial statement made up to a period of (say) no more than 3 months prior to the date of the listing document	
Where a fund has been in existence for less than 12 months prior to the listing date, an audited statement of its NAV as at a period of (say) no more than 3 months prior to the date of the listing document	
The makeup of the fund's investment portfolio as at a date no more than (say) 3 months prior to the date of the listing document	
If the fund is new and the above statements are not applicable, a declaration to that effect	
Any other material financial information	
Other information	
Information as to dividend/distribution policies	
Procedures for buying and selling	
Information as to costs of investment	
Ongoing Obligations	
Annual accounts (audited), and interims, to be sent to the exchange and to shareholders within a prescribed date (usually 6 months) from the close of the period to which they relate	
All NAV calculations to be notified to the exchange immediately on their finalization	
A file of all marketing material to be maintained, and provided to the exchange's officials on request	
All material changes, new developments or operational changes to be advised immediately to the exchange	
All price-sensitive information, material changes in performance or financial position to be notified immediately to the exchange	

Table 1.1 Continued

- *Europe*. Examples of exchanges with listing regimes for funds in the Eurozone include Dublin, Luxembourg and London; listing on these exchanges can be advantageous for funds with particular interest in being marketed into Europe. At the time of writing, one interesting trend was that of sponsors allegedly willing to pay the listing, legal and other fees necessary to get their fund listed on such exchanges, at least in part because of the 'due diligence' benefits this afforded them. That is, investee companies, banks and other counterparties which have to comply with detailed anti-money laundering requirements may, in many jurisdictions, be

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permitted to regard an entity listed on certain European exchanges as having been subject to sufficient 'due diligence' already. Consequently, they will not require full and up-to-date evidence of the identity and residential addresses of the fund's directors and key shareholders. The costs of listing may seem quite a high price to pay to remove what is essentially no more than an administrative burden, but for an investment company with numerous counterparties, and coupled with the other benefits we have already noted, it appears to be a realistic solution.

- *Other*. Other regional exchanges accommodating funds listings would include the Cayman Islands Stock Exchange (available at www.csx.com.ky) and the Bermudan Stock Exchange (available at www.bsx.com). As with several other exchanges accommodating funds, the Cayman Islands exchange now accommodates settlement of funds via Euroclear's 'FundSettle'.

1.10 Fund categorizations

There are a number of ways in which funds can be categorized; one is by target investor type, as we saw in Section 1.7. Another means of categorization is to group them according to their underlying investments.

In some cases, this type of fund categorization is prescribed by the regulatory authorities in the countries in which the fund is authorized; for example, in the United Kingdom the Financial Services Authority distinguishes between:

- Securities Funds – those funds investing in securities such as shares and debt instruments.
- Funds-of-Funds – those funds investing in the shares or units of other funds. We will look at funds-of-funds in greater detail in Chapter 2.
- Feeder Funds – those funds which invest solely in the units or shares of another fund, and whose NAV will therefore vary in approximately direct proportion to that of the underlying fund. Again, we will look at feeder funds in more detail in Chapter 2.
- Money Funds – those which invest in money market instruments such as certificates of deposit, commercial paper, bankers' acceptances, treasury bills, short-term government securities or quasi-government securities, repurchase agreements and the like. The precise definition of what is considered a 'money market security' differs from jurisdiction to jurisdiction, and so investors should ensure that they understand the true nature of the fund they are contemplating investing in (similarly, sponsors would be well-advised to articulate their investment policy clearly so as to obviate the potential for mismatched expectations).
- Futures and Options Funds; those which can invest in covered futures and options to a prescribed extent.
- Geared Futures and Options Funds; those which can employ uncovered futures and options to a prescribed extent.
- Property Funds; those funds which can invest in a mix of real property and shares in property companies: the maximum and minimum exposures to real property will be determined by regulations.

However, each of these categories is quite broad – its only purpose is to provide a framework on which the regulator can hang more specific regulations relating to

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investment restrictions. It would not necessarily help an investor compare funds with a particular industrial or thematic focus; for example, the UK regulatory grouping of 'Securities Funds' will include:

- a fund which invests solely in government stocks (gilts);
- a funds which tracks the UK main market index (the FTSE100);
- a fund which invests in a broad range of UK corporate bonds and shares with the aim of generating a balance of income and growth; and
- a highly focused fund which invests solely in (say) media stocks or start-up companies and which aims to generate high levels of capital growth with no income objective.

Because of this, other categorizations are laid down by industry bodies such as the UK's Investment Management Association (IMA). These are considerably more useful for the prospective investor, since they aim to make it easy for him to compare 'like with like' – either in terms of funds with a specific focus (e.g. UK Large Cap Equity Funds, or Emerging Markets Funds) or in terms of specific objectives (income funds, growth funds etc.). At the time of writing, the IMA maintained 31 main categories of fund, with a number of different methods of sub-categorization (see www.investmentuk.org).

1.11 Matching investors' objectives

How does a sponsor come to the decision to establish a fund? This is something of a chicken-and-egg question:

- In some cases, it is the fact that he has investment expertise which comes first. Having considered the options, he may decide he can best capitalize on this expertise if it is packaged as a fund, administered by a third party and marketed to investors.
- In others, the driver is the investor's need (and not the sponsor's requirement to find some way of commoditizing his skills). That is, a sponsor will see a captive investor base with unsatisfied investment needs, and will put together a product aimed at satisfying these needs. In this case, the sponsor may need to hire in the requisite investment skills by appointing an external investment manager or adviser.

Where it is investor need that is the driver, the prospective fund sponsor needs to take into account a variety of requirements – not just the basic requirement for an investment return, but features such as tax efficiency, income distribution capability, legal form and so on. Sometimes, a sponsor will need to structure a fund so as to accommodate different investor objectives, especially where the target market comprises different investor types (retail, institutional etc.) and investors in different jurisdictions. Such structuring can involve the use of different fund classes, or of feeder/hub-and-spoke arrangements so that offerings have the required features and charging structures and meet regulatory requirements for a number of different target investor bases.

We have already seen that – whatever the complexities of measuring the funds universe! – there is a vast array of fund-based offerings to choose from. This means that in theory the right choice is available to the investor, if only he knows where to look; but it also means that making the right selection can be a daunting prospect. The peer groupings and performance rankings which we noted above in Section 1.10 support comparisons of funds of similar types from the perspective of pure performance: but

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this stage is only of value once an investor has ascertained his own objectives, and then selected the group of funds from which he will ultimately choose an investment. The following headings set out some of the considerations which an investor will (or at least, should) consider when making a fund selection – and therefore the issues a sponsor should consider when investigating investor appetite for a proposed new fund launch.

Investment objective

One of the most basic questions will be '*what is our target investor base's investment objective, and what therefore must be the investment objective of a fund which will meet their needs?*' The question may sound so basic as to be facile, but fuzzy thinking at the outset, a failure on the part of management to articulate a fund's objectives and strategy clearly and thoroughly, and a tendency to allow strategy to drift rather than keeping these objectives in mind are between them perhaps the biggest causes of investor/manager tension in the fund industry.

The way in which a fund manager selects and uses the fund's underlying investments should be informed at all times by the fund's *investment objectives*; that is, the *type of return* which it aims to generate, and by its *risk profile*. It is important that the investor understands these, because his primary task is to select a fund with objectives and a risk profile which accord with his own.

The 'investment objective' of a fund refers to the type of returns it aims to generate for its investors. The types of return are, in the broadest terms:

- Capital growth – the fund will invest in order to increase the *capital value of its assets* without generating much, if any, income. Funds of this type often invest in low-yielding growth stocks.
- Income – the fund may invest in (for example) bonds and other fixed interest securities, or perhaps cash or high-yielding equities, to generate an *income for investors*; but without a substantial level of capital growth, and perhaps at the expense of some capital erosion.
- A combination of the two (a '*balanced*' fund) – a mix of equities and bonds may be used.

Of course, a variety of other assets may be used to achieve the objectives stated above and they are provided as examples only.

It may be worth considering what we mean by the words 'income' and 'capital'; although these are terms which most people take for granted they can be hard to define. Further, some fund product development and marketing departments (and the tax authorities) may take a different interpretation to that which you might intuitively assume.

Generally speaking, *income* is a form of return which is relatively regular: and which when taken does not result in the erosion of the capital base from which it is generated. *Capital* is more one-off in nature, and when it is taken reduces the value of the investment providing it, either in part or in total. Some relatively straight forward examples are given in Table 1.2 – and some of which are more complex, in Table 1.3.

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Nature of return taken	Income or capital?
Interest	Income: the cash deposit or bond is left intact and will continue to pay interest regularly until its maturity date
Dividends	Income: the company will continue to pay dividends regularly whilst profits and cashflow permit
Rent	Income: the value of the property is not diminished by taking rents, and rent will continue to be received whilst paying tenants are *in situ*
Partial realization of profits on a shareholding	Capital: the value of the shareholding is reduced by the amount of profit taken out

Table 1.2

In addition to the distinctions between different types of return, a fund services provider should determine the means by which such returns are to be measured. That is:

- Is the fund intended to provide positive returns compared to some other benchmark – for example, one synthesized from the performance of the markets in which it invests, or the performance of its peers? In this case, it will be described as targeting *relative returns* – returns which are positive relative to the performance of that benchmark. By this definition, a fund which rises 10 per cent over a period in which its benchmark rises 6 per cent will be described as having achieved a positive return of 4 per cent relative to the market. A fund which falls by 8 per cent over a period in which its benchmarks falls by 12 per cent will also be described as having achieved a positive return of 4 per cent relative to the market. An example of a fund targeting relative returns would be one whose stated investment objective is 'to outperform the MSCI World Index by at least X per cent per annum.'
- Is the fund intended to provide positive returns, regardless of the direction of the markets in which it is invested (or indeed of any other benchmark)? If so, it will be described as targeting *absolute returns*. An example would be a fund whose stated investment objective is to achieve 'an absolute return of in excess of 12 per cent per annum, regardless of market conditions and within a controlled risk framework.'

Fund policy: how will the fund's managers attempt to achieve its objective?

Every fund will have an investment policy – the strategy by which it attempts to attain its stated objective, and the geographic, sectoral or other investment focus that the portfolio will maintain. This policy will determine the types of asset in which the fund can invest, and helps potential investors determine whether the fund is appropriate to their situation.

Some examples of investment focus are given in Table 1.4.

Of course a given fund may have an investment policy and focus which combines several of the above elements – for example, one investing UK biotechnology stocks is specific in terms of geographic focus (the United Kingdom), asset class (equities) and sector (biotechnology).

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Nature of return taken	Income or capital?
Dividend reinvestment schemes on fund holdings (see Chapter 9)	Many investors who have dividend reinvestment on their fund holdings mistakenly believe that they are benefiting from capital growth – they see the value of their fund holding increase by the value of the reinvested dividend each year and do not realize that this is the result of a dividend payment, the proceeds of which have been reinvested However the taxman's view in most jurisdictions is generally that the investor has received a dividend (income), which is taxable, and has simply chosen to spend it on buying more shares in the same fund
Returns on zero coupon or 'deep discount' bonds	Some bonds are issued in non-interest-bearing form, or pay very low levels of interest; instead, the investor receives his return by way of the difference between the discounted purchase price of the bond and its eventual redemption price. These are known as deep-discount or zero-coupon bonds Again, the tax authorities in most jurisdictions have long regarded such instruments as potential tax- avoidance vehicles, and in many cases have issued rulings or practice notes stating that a proportion of the return over the period will be deemed to be income. The holder will then be assessed to income tax on the increase in value, either in full at the redemption date or, in some cases, on a *pro rata* amount each year (despite the fact that the investor has received no cash flow from which to fund the tax)
Returns on rollup funds	Many funds which invest either directly or indirectly into income-yielding assets such as bank deposits, interest-bearing bonds and high-yielding stocks do not distribute the income they earn on these underlying investments by way of distributions or dividends. Instead, the income stays in the fund's bank account and is eventually invested in other assets. It 'rolls up', and boosts the NAV of the fund as a whole over time On the face of it, this allows an investor to gain exposure to stable, income-producing assets without actually receiving income in his hands. Instead, he receives the income accruals by way of what is, to all appearances, a capital gain on his holding in a fund. This may, for many investors, appear more tax efficient – for example, some live in jurisdictions which have income tax regimes but no capital taxes; others have capital gains tax allowances which can be offset against any liabilities In many jurisdictions, however, the local tax authorities have issued practice notes or rulings stating that they regard investments in income-producing assets via rollup funds as being potential avoidance techniques. They therefore assess resident investors in rollup schemes (whether domestic or overseas) on the proportion of the overall gain on redemption which is deemed to have arisen from income-producing assets. This may be taxed on eventual redemption, or annually, based on a notional return

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	An example of this is the United Kingdom's 'Distributor Status' regime for overseas funds. UK investors buying overseas funds which distribute substantially all of their income, and which comply with certain investment restrictions, will pay income tax each year on the dividends or distributions actually received. Those who invest in non-Distributor Status funds will be taxed on the entire capital gain upon redemption as if it were income tax, thereby losing the ability to offset 'true' capital gains against any capital gains tax exemptions or capital losses from other sources. At the time of writing, this regime was under review, but it provides a good example of the way in which a revenue authority can seek to prevent investors 'recharacterizing' income as capital growth and thereby mitigating their tax liabilities.
Definition of interest under the EU Savings Directive	The EU Savings Directive introduces a new regime for the tax of interest income earned by residents of the Union. It seeks to help national tax authorities collect tax due to them, where their residents have invested in products issues in another jurisdiction which is subject to the regime. It is intended that member countries, and certain 'third countries' will undertake to ensure that their local interest 'paying agents' identify those depositors or investors who are resident in the European Union. Depending on the local arrangements product providers will either withhold an amount of tax on certain 'interest' receipts, a proportion of which will be remitted to the tax authorities of the investing individuals; or alternatively, information relating to the interest income earned by an EU resident individual will be sent back to his local tax authority by the tax authorities in the interest paying agent's country. The wording of the directive is widely drafted; whilst it captures interest payments made to individuals, the wording defines 'interest payments' so as to capture distributions, and proceeds of redemption, from funds investing in debt instruments – whether directly or, in the case of a fund of funds, indirectly. This is another example of revenue authorities finding ways to drill down to the true source of an investment return, and characterize it according to its original source. Again, the detail of how the process will work in practice is yet to be finalized at the time of writing, as the details will need to be drafted at national level.
'High income' funds	Many funds promise a very high (sometimes guaranteed) level of 'income' to their investors. However, closer inspection of the offering documents may show that the promise is to make a set level of *payments* to the investor – whether or not the fund has earned sufficient income to support the level of payout. If the fund has not made capital gains to make up any income shortfall, then the value of the investor's holding will be eroded.

Table 1.3

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Example of potential fund focus	The fund will only invest in (e.g.). . . .
Single industry sector	Technology stocks Financial services
Single country	UK equities only US equities and bonds only
Capitalization	Large-cap, 'blue-chip stocks' Start-up ventures and smaller capitalization shares
Wider geographic area	Investments selected from the Pacific Basin Companies listed on the stockmarkets of Europe excluding the United Kingdom
Single asset class	International equities Bonds
Market type	Emerging markets
Other	Ethical funds

Table 1.5

Entry levels: how much will investors be able to place?

Many funds impose a minimum investment figure, for example, $10 000 or currency equivalent. In some cases, this is prescribed by regulation; for example, Isle of Man Professional Investor Funds must specify a minimum subscription of $100 000, whilst Isle of Man Experienced Investor Funds had, until recently, to impose a minimum of $15 000. (Both types of fund must also require that investors meet other criteria: see Chapter 12.) Managers of these types of funds are at liberty to impose higher minimum subscription levels if they so choose; but they cannot impose lower minima.

There is currently something of a trend away from the use of high minimum subscriptions, as a regulatory tool to screen out unsophisticated investors. This is in part because of an increasing acceptance that wealthy investors are not necessarily the most sophisticated (or vice versa). In addition, however, there has been a recognition that requiring a high minimum entry level to more complex, illiquid or risky funds may actually increase an investor's risk since if he is determined to invest, he has no option but to commit a large amount to the fund (whereas he may in fact have been content to subscribe much less if the option had been available).

Where funds are listed on a stock exchange, that exchange may also prescribe a minimum initial subscription: there are however a number of other exchanges which do not prescribe any minimum at all (e.g. the Channel Islands and Bermudan exchanges, excepting for certain types of fund). As noted in Section 1.9, this may be a factor in selecting an appropriate exchange on which to list.

In some cases, where listing requires that investors meet a minimum subscription, this can be addressed through the establishment of a feeder fund investing directly in the listed underlying vehicle. This allows those investors (perhaps institutions required to limit their holdings to listed vehicles) who can meet the minimum subscription level to invest directly in the listed fund. Smaller investors, provided they are not constrained by a requirement to invest only in listed vehicles, can subscribe their

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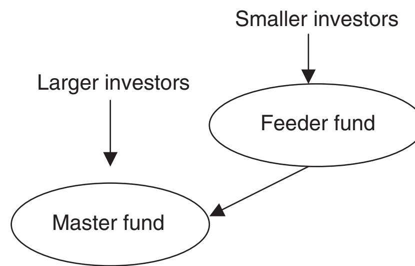

Figure 1.4 Feeder fund as a vehicle to accomodate smaller investors.

smaller sums via the feeder fund (Figure 1.4). The feeder therefore serves two purposes:

- Provided it meets the minimum subscription level itself, it acts as a vehicle to 'box up' those smaller investors and provides them with an entry route into the underlying fund.
- It may also provide a mechanism for differential pricing, with the direct institutional investors only suffering the charges levied within the listed fund and the smaller investors potentially being charged an additional layer of fees at feeder fund level.

Regulatory and listing requirements aside, a fund manager will in any event wish to impose some minimum initial subscription level; he should also impose minimum additional subscriptions, and minimum residual holdings to be maintained subsequent to any partial redemptions. This is necessary to screen out investments which are uneconomic in size; that is, those on which the management fees, adjusted for the costs of administration, will not turn a meaningful profit.

The level at which these minima should be set will depend upon the size and 'shape' of the fees charged by various functionaries. One factor which is increasingly affecting this process is the growing burden of 'due diligence'. We will look at this issue in more detail in later chapters; for now it is sufficient to note that many third-party fund administrators have discovered, on analysis, that where their agreement with the sponsor is such that the third-party administrator's staff collect identity verification documentation from the client fund's investors, so as to comply with anti-money laundering legislation, the regulations have changed to such an extent that they now need to reprice their services. An alternative is for the administrator to agree that it will carry out a certain amount of work in requesting investor due diligence, but that after that and if it fails to receive the appropriate documentation, it will be entitled to decline the subscription or (if the subscription has been processed), forcibly redeem the holding. This is clearly unattractive for the fund sponsor and in some cases, especially where the sponsor is itself involved with the distribution process and/or the fund is essentially aimed at a private, known investor base, the sponsor is now taking the collation of due diligence on itself.

Lump sum or regular contribution

Most funds accept only lump sum investments. However some, typically retail funds, offer a regular investment option which can make them accessible to investors who

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Date	Amount invested	Price per share	Shares purchased
January	100	50	2
February	100	40	2 ½
March	100	30	3 ⅓
April	100	30	3 ⅓
May	100	40	2 ½
June	100	50	2
July	100	60	1 ⅔

Over seven months, the fund's average price per share was £42.86. However, an investor employing pound cost averaging would have paid only an average of £40.39 per share.

Table 1.5

have not yet amassed the minimum lump sum, or who are seeking the self-imposed financial discipline of a regular payment. The inclusion, or otherwise, of a regular payment option will, of course, have cost implications as the administrator is required to deal with a large number of relatively small subscriptions. Many third-party administrators simply do not have the capacity to deal with regular contribution funds; those which do generally rely on highly developed and efficient systems and relationships with their banks. A sponsor who wishes to add regular payment options at a later stage should enquire of his proposed administrator at the outset, since changing administrators so as to accommodate this could be unwieldy and expensive.

One benefit which is often 'sold' to retail investors is pound-cost (or dollar-, or euro-cost) averaging; this relies on the fact that an investor who is subscribing the same amount each month will receive more shares/units when the fund's NAV is depressed, and fewer when it is high. The effect is that the investor pays a lower portfolio average cost per unit/share purchased, than the average unit/share price in the fund over the period. It can be illustrated as shown in Table 1.5 – our investor will subscribe £100 per month in the same fund.

The average unit cost to a monthly investor can therefore be shown to be lower than the average fund price over same the period.

What is the investor's time horizon?

In most cases, both sponsor and investor alike should take the view that the longer the term, the better. From the sponsor's perspective, the longer an investor's funds are tied up, the greater the management fees and the less administration involved in terms of applying newly subscribed, or liquidating newly redeemed moneys. A sponsor will therefore prefer to target an investor base whose money, once invested, is relatively inert – rather than one which may be high volume but high-turnover.

As regards investor needs, the conventional wisdom is that a 5-year time horizon is the minimum to which the investor should be able to commit, before buying an equity-based fund. Three years is the minimum often cited for bond funds, and as little as one year for cash funds. Sponsors should bear in mind, however, that whilst the above time frames are commonly quoted, they are also nowadays probably too simplistic.

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For example, fund managers establishing cash and near-cash funds for certain types of institutional client may find that their target audience's time horizons and liquidity needs merit a much closer analysis than the indicative timeframes set out above. Captive insurance managers, in particular, will usually have a detailed understanding of the likely incidence and scale of any potential claims their client captives are likely to suffer (potentially necessitating redemptions from any cash fund in which they are invested). A fund manager who ensures that he has a clear picture of both the maturity and risk profile of his clients' portfolio from an investment/claims matching perspective may find that he is able to make use of longer-term instruments – and thereby potentially achieve a significant performance uplift – than would otherwise be the case. The same will be the case for any fund aimed at meeting the needs of an asset/liability matching client – pensions, insurance or otherwise.

Under the heading of time horizons, a sponsor should also consider the frequency at which the proposed fund will deal, and any required notice periods which investors must give prior to redemptions. Considerations to be borne in mind include:

- *Regulatory requirements:* Highly regulated and retail funds are generally daily dealers: and indeed in some jurisdictions this is a requirement. Funds subject to lighter, or no, regulation may be able to operate with more infrequent dealing periods.
- *The nature of the underlying assets*, and how easy they are to liquidate to meet redemptions. For example, a fund which invests in other, infrequently dealing funds (e.g. a fund-of-hedge-funds investing in hedge funds which are mostly monthly dealers) is unlikely to be able to offer a dealing period of less than one month, and may need to prescribe a one-month notice period as well so as to enable redemption money to be raised. Many funds dealing in illiquid assets such as property have very lengthy inter-dealing and notice periods.
- *Investor expectations*, and whether the fund will be less appealing to investors if they perceive it as offering restricted access to their funds. In practice, investors in relatively retail offerings often see no material difference between a daily dealing fund and a weekly dealer. Investors in specialist funds, with illiquid underlying holdings, are (if the fund has been properly distributed) normally sufficiently sophisticated to understand the limitations on their investment's liquidity.
- *Cost*. The process of calculating an NAV on a daily basis (and if necessary, of publishing this) can push costs up considerably, and weekly dealing may enable the administrator and manager to levy a significantly lower annual management charge.
- *Impact on investment portfolio*. Where a fund manager can collate a weeks' worth of investor transactions and process all those received prior to the cut-off date on one weekly dealing day, instead of placing many small deals on a daily basis, life can be considerably easier for the investment manager and the portfolio may be subject to much less disruption. For one thing, the investment manager should receive better advance notification of significant net inflows or outflows, and can consider how best the portfolio should be positioned. For another, the reduced dealing frequency reduces the amount of tinkering which has to be done to raise or absorb liquidity on a daily basis, which may keep underlying dealing costs down; and the netting-off of a week's subscriptions and redemptions can mean that the number of underlying portfolio transactions which are necessitated purely for liquidity purposes may be reduced or eradicated all together.

- *The administrator's capability*. Many third-party fund administrators (particularly those in the offshore environment) do not have the systems and staffing to accommodate daily dealing funds and will either decline to take them on, or will quote terms which effectively price daily dealing out as an option. Sponsors who intend to launch a fund on a weekly-dealing basis on cost grounds, with an eye to moving to daily-dealing when critical mass permits, should check whether their administrator will be able to cope.

Where a manager is forced, for operational reasons (e.g. the illiquidity of the underlying assets) to impose an infrequent dealing cycle there may be other ways in which investors with particular liquidity needs can be accommodated.

These can include the interposition of a 'manager's box' or 'marketmaker' facility with the ability to undertake transactions in between formal dealing dates. In such cases, care must be taken to ensure that both investor and manager understand the basis on which the interposed marketmaker will price the asset, and where the risk lies between the marketmaker's dealing date and the fund's next dealing date.

In many cases, listing a fund is a means of providing such liquidity but for fund managers who cannot or do not wish to meet the requirements for listing on an exchange, a proprietary marketmaker can often provide this facility – depending on local regulatory requirements. The marketmaker may be the management company itself; alternative structures include establishing a separate vehicle which may may hold out as willing to deal in the shares of one or more funds. The marketmaker itself may be subject to some form of regulation.

In some cases, a marketmaker vehicle which is itself a subsidiary of the fund in which it provides intra-dealing day liquidity can be advantageous, in that it can assist in managing the fund sponsor/manager's position risk; where the sponsor/manager owns the marketmaker itself, it will either need to assume the risk of price changes in the fund between dealing dates, or to draft the sale agreements between marketmaker and investor in such a way as to remove this risk – an arrangement which some would regard as artificial. However, where the marketmaker is established as a subsidiary of the fund, care must be taken in terms of:

- the marketmaker's own regulatory status;
- the avoidance of conflicts of interest;
- the nature of the disclosures made to investors (both in connection with sales through the marketmaker, and in connection with the status of the marketmaker as an asset of the fund); and
- any regulations relating to self-investment.

Charging structure: investor expectations and transparency

The issue of an investor's time horizon leads us on to consider the use of charging structures as a potential tool for encouraging investor commitment. So, for example, sponsors should consider whether exit fees are a viable alternative to initial fees. This has implications in terms of cash flow (especially where the sponsor or manager has to fund intermediary commissions up-front and there is no initial fee to provide the cash for this). Further, not every third-party administrator has the systems capability to accommodate exit fees – especially where these are to be levied on a staggered basis

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(i.e. 5 per cent on any redemption in the first year after investment; 4 per cent in the second year, and so on). This is because the administrator has to be able to identify the agedness of a given holding on redemption and apply the appropriate exit charge. Where they are able to do this, administrators may nevertheless charge a higher fee for the extra administration burden. This will need to be borne either by the fund or individual existing investor, impacting on performance, or by the manager, impacting on profitability.

The inclusion of a performance fee element is now commonplace for certain types of fund (typically hedge funds). There are conflicting views on their merits: many investors are happy to see a manager incentivized to perform well on their behalf. Others feel that it encourages the manager to take risks which he otherwise might not – particularly if the performance fee is supplemented by a relatively high 'basic' annual management fee. We will look at some of the issues arising in the calculation of performance-based fees in a later chapter.

It is worth noting that investors are, nowadays, considerably more fee-savvy than they used to be. In part this is a result of better investor education, and in part because of greater regulatory demands for transparency on the part of product providers. As we have noted above, TERs are now published by professional agencies and it is relatively simple for a prospective investor to determine how competitive a fund is in terms of its charging structure.

Fund management group

Before selecting a fund on the basis of its individual merits, an investor will usually also consider whether the management group to whom he is entrusting his funds meets various criteria. In some cases, there will be little the sponsor can do to address any concerns arising from these considerations, but in others there may be some options:

- *Track record:* Some fund management groups have better records than others, and an unknown fund sponsor may find that he benefits more from an alliance with an established fund group than from going it alone.
- *Ownership:* The fund management industry has been subject to much merger and takeover activity. Investors and advisers will usually be concerned that the management team within a recently merged group may be suffering from a lack of focus, or that there will be changes within the investment team as economies are sought.
- *Investment style:* By investment style we mean the investment manager's approach to selecting investments. The differences in various styles merit a text in themselves, and are beyond the scope of this book. However, at different times and in different market conditions, those managers who favour a 'value'-oriented style will perform better than those pursuing a 'growth' style. In addition, investors and their advisers will also have their own views as to which style is preferable. For a description of the value style of investing, we could do worse than to look back to van Ketwich, introduced in Section 1.5. After the success of his first investment trust, van Ketwich introduced a second in 1779 (named *Concordia Res Parvae Crescunt*: 'Little things grow by consent'). Instead of specifying the groups of securities in which this fund could invest, this time his prospectus simply specified that the fund would invest in 'solid securities and those which, as a result of a decline in their prices, merit speculation and may be bought at below their intrinsic value ... which it

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would appear reasonable will result in benefit.' Put very simply, value investors buy securities which appear undervalued when they are assessed on the company's fundamentals – its cash flow, NAV, dividend cover and so forth. Growth investors are less interested in fundamentals and more in the momentum of a given stock or sector.

- *Geographic resources:* Some fund houses have a real presence in the countries in which they invest, and understandably will cite this on-the-ground ability to stay in touch with the market as a reason to expect them to outperform. Others rely on a desk-based analysis of third-party research and other data, and may believe that technology and the speed of modern communications renders an *in situ* presence an unnecessary expense. Again, investors and advisers will have their own views as to which approach is better.
- *Internal management style:* Many investment houses have individual managers with strong reputations, and have used these individuals' track records to attract business. However, people are prone to moving from one job to another, and reliance on the reputation of a single individual can leave the investment house vulnerable if that individual is poached by another house and investors switch holdings in order to follow him. Many houses nowadays avoid the culture of the 'star manager' and prefer to promote their team approach and overall investment philosophy.
- *Regulated status:* Investors may take comfort from the fact that a fund management group is regulated; however this is only really meaningful if the regulator itself meets certain standards. This generally means its having statutory status (as opposed to its being an industry-sponsored body of which membership is voluntary, or which has little in the way of sanctions); and that it is a member of, or adheres to the standards of, an internationally recognized body such as the International Organization for Securities Commissions (IOSCO). Where a fund manager is regulated by such a body, its investors have the comfort of knowing that it has been subject to a vetting process at the outset, and that it should also be supervised on an ongoing basis. In a few jurisdictions, the element of ongoing supervision is non-existent or cursory; some regulators place most of their reliance on financial reporting and on notifications from the business' auditors; in a number of others it is largely focused on anti-money laundering practices, with low levels of supervision in terms of investor protection. In addition, the existence of a statutory compensation scheme, and/or an industry ombudsman, can be a valuable investor protection benefit and thereby a meaningful marketing tool, despite the additional costs associated with them. Whilst many investors will not appreciate such niceties, awareness is increasing rapidly, partly aided by the efforts of the international financial press and of those jurisdictions which do impose such requirements.

Taxation

Sponsors should consider the tax status of their target market, and any requirements which may arise out of this. Specialist advice should be taken, in connection with:

- The tax treatment of income distributions and redemption proceeds in the investor's hands. A number of offshore jurisdictions are currently reviewing the likely impact of the EU Savings Directive on their funds industries since it is clear

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that both distributions and redemptions on certain types of funds will be affected. These include all of those jurisdictions which are a part of the European Union (such as Ireland), but also those which are not member states but whose status has some dependency on another member state (such as the Isle of Man, the Channel Islands, and the Cayman Islands).

- Tax treatment of the fund itself. In many jurisdictions, international funds (i.e. those not targeting local residents) are not subject to local direct (income, capital or corporation) taxes or indirect taxes such as value added tax (VAT); in others, tax is levied, albeit at a relatively low level.
- Tax treatment of the underlying investments; where the fund is to invest in foreign instruments on which withholding taxes are levied, are double taxation agreements in place which will allow for the reclamation of those taxes? As we have seen, this may not be so if the fund is established in an offshore jurisdiction since these locations often have difficulty in negotiating treaties with their onshore neighbours.

Taxation matters will be important in selecting not only the correct jurisdiction in which to establish and/or operate a fund, but also its legal form: for example, funds established as partnership vehicles may be more attractive from a tax perspective where applicable legislation allows income, gains and/or losses to be attributed on a *pro rata* basis to the relevant investors. A number of jurisdictions, including the United Kingdom, United States, Isle of Man and Channel Islands have enacted legislation permitting partnerships viable as fund vehicles.

Past performance

Whilst it has become a commonplace to say that past performance is no guarantee or indicator of future performance, it is a rare investor or adviser who will not take account of a fund manager's track record in deciding whether to place funds with him. In recent years, regulators in a number of jurisdiction have become increasingly concerned about investors' reliance on past performance, on the grounds that:

- Certain surveys appear to have confirmed the lack of correlation between past and future performance; and
- The investment teams within a given fund management house can, and do, change, taking with them the skills and experience which have stood the house in good stead.

In some cases, regulators have sought simply to impose regulations which standardize statements of performance (so that investors can compare like with like), and which place increasing focus on transparency in terms of charging structures and on full disclosure of material risks. In others, there are indications that they are keen to go further, seeking to prevent managers from advertising on the basis of track record at all.

Whilst there may be merit in their arguments, and it is true that investors should not assume that a fund which has performed in the top quartile for the past year will continue to do so, it is unlikely that past performance will cease to be a material factor in decision-making. It may be fair to say that a fund which has consistently been a top performer will not necessarily continue to be so: however, it is also likely that most

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investors and advisers would prefer to avoid a fund which has been a consistently poor performer – unless there are very persuasive reasons for doing otherwise!

Fund managers can do nothing to change history: however what they can do is ensure that any performance measurements of their funds position them fairly, against relevant benchmarks and/or peer groups and that the NAVs and distributions represented are accurate. A sample of prices quoted in independent fund pricing/performance measurement agencies can reveal a frighteningly high number of inaccuracies. There may not be a great deal that the manager can do to obtain redress, other than ensuring that those price feeds over which it does have control (e.g. because it pays for their publishing) are accurate.

Risk profile

Just as every investor should have a clear picture of his investment objective, so as to be able to identify a fund which has similar objectives, so he should have a clear idea of his risk tolerance so as to be able to select a fund which has a similar profile. Whilst many institutional investors can articulate their risk tolerance accurately, unfortunately many private investors have a much hazier idea of their own tolerance: time and again advisers struggle to explain that the potential for reward will almost invariably be correlated to the level of risk incurred.

Many managers, and indeed some third-party distributors such as fund supermarkets and life companies offering third-party fund links now offer 'risk ratings' to try and assist investors in choosing appropriate investments for their needs. These may use models along the lines of a scale, from 0 to 5, where:

0 = the fund is regarded as virtually zero-risk (its capital is protected by a third-party guarantee given by an institution with a strong credit rating);
5 = the fund is regarded as highly risky and whilst its objective is to obtain high levels of capital or income, there is a significant possibility that the investor may lose some or all of his capital.

It is important that where a fund manager provides his own risk profiler, this is as accurate as is possible; and that where he becomes aware that his funds are included in another business' risk profiling he raises any concerns as to the accuracy of the rating with that business promptly:

- An inappropriately high risk rating could deter investors for whom the fund is, in fact, appropriate.
- More seriously, an inappropriately low rating could result in investors taking on a level of risk they had not intended to. In the event of losses this could, conceivably, lead to claims for compensation on the grounds that the fund's riskiness was misrepresented.

Certain regulators have considered, or are considering, introducing their own risk rating models but progress in this regard is not brisk: in part because of difficulties in agreeing risk rating methodologies and in part because of concerns over liability to investors in connection with any inaccurate ratings.