4. MUTUAL FUNDS

PROFILE

A mutual fund is an entity, set up and operated by an investment management company, to raise capital for investing in financial instruments. A mutual fund allows investors to buy a portfolio of shares in small increments and to realize advantages over investing independently. These advantages include: (a) diversified investments across a large number of firms, (b) lower fees, (c) relatively lower risk than individual stock purchases, and (d) expert advice. For these advantages, mutual fund shareholders pay a fee. Mutual funds are invested in almost every traded financial instrument from common stocks and bonds to derivatives and money markets. Originally aimed at wealthy individuals seeking to diversify their portfolios, mutual funds have now become a typical investment vehicle for many consumer and some institutional investors. *Figure 4.1* summarizes four key characteristics of mutual funds of particular importance to the public interest community.

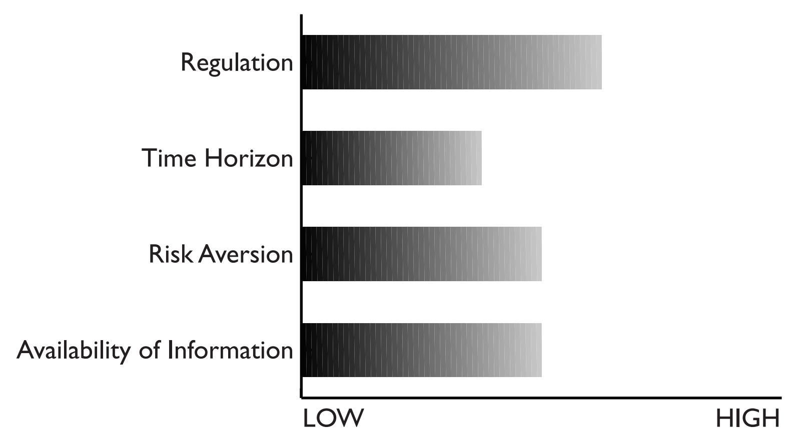
Size and Leaders

Known as investment trusts in most of Europe and Asia and unit trusts in the United Kingdom, mutual funds now represent the second largest pool of private capital in the world after the banking industry (1). In the United States, more than 6,500 mutual funds manage collective assets totaling more than US$4.49 trillion (2). Mutual funds range in size from a few million dollars to US$61 billion (represented by the world's largest fund, Fidelity's Magellan Fund). Other large mutual funds in the United States are managed by investment management companies such as Vanguard, Capital Research and Management, Dreyfus, and T. Rowe Price. Much of the mutual fund industry's growth in the United States can be attributed to increased inflows of capital from 401(k) and defined-contribution pension plans. Approximately 37 percent of U.S. households have assets in mutual funds. Although individual households account for most mutual fund investors, U.S. institutional investor (such as pension fund) assets in mutual funds have increased 400 percent since 1990 (3).

Key Features

A mutual fund is established by an investment management company with a specific investment strategy and objectives. Investment governance and guidelines dictate the fund's risk tolerance and the areas into which it can and cannot invest. Objectives might include short-term capital appreciation or long-term returns, as well as targets for specific sectors such as an energy fund or specific financial instrument, such as a bond fund. An analysis may be performed to decide acceptable parameters of composition and risk versus return. With wider parameters, there is increased opportunity for diversification, which reduces overall risk of the fund. Conversely, with narrow parameters such as a sector-specific fund, there is increased risk, as well as a greater potential for higher returns. Both time horizon and anticipated rate of return are

Figure 4.1 Key Characteristics of Mutual Funds



functions of the fund's investment strategy. Any change in investment strategy, such as introducing a social or environmental screen, requires a vote by shareholders of the mutual fund.

Investment management companies typically manage several, if not dozens, of mutual funds to attract a wide consumer base. These companies generate revenue from mutual funds by charging investors one of the following management fees: a purchase (front-end loaded) or redemption (back-end loaded) fee and/or a fixed management fee deducted from the fund's overall revenues (no load). Recently, there has been a shift from load to no-load funds, with the result that consumers' assets are more liquid, allowing easier movement and short-term investing. Another new development is the increase in the number of "index" funds designed to match the activity of an established index. An index fund has fixed targets for the types of firms it will buy and the percentage of each type to hold in its portfolio. Index funds carry very low fees and are managed passively compared to traditional mutual funds.

Most institutional investors such as pension funds rely on advisors to identify investments, while individuals are relying increasingly on their own knowledge, using discount brokers, or buying directly from the fund. Some individual investors now get much of their information over the Internet and make purchases online, thus avoiding certain fees and trading costs. This trend is certain to escalate. These developments have resulted in a major movement away from mutual funds managed by full-service brokers, such as Paine Weber and Merrill Lynch, to discount brokerage and investment companies such as Charles Schwab and Fidelity. For investors still interested in receiving advice and guidance, commissioned financial planners, both independent and affiliated with fund organizations, have become increasingly important sources of information. Mutual fund investors also rely on tracking services such as Morningstar and Lipper Analytical that rate funds based on historical performance. According to *The Economist*, 80 percent of new mutual fund investments in 1996 poured into funds that had received a rating of four or five stars from Morningstar (4).

Regulation

The set up of a mutual fund is similiar to that of a corporation, except that they receive more favorable tax exclusions under the U.S. Internal Revenue Code of 1986. Pursuant to the Investment Company Act (ICA) of 1940, U.S. mutual funds are required to register with the Securities and Exchange Commission (SEC) and to price daily the net asset value (NAV) of their assests. The ICA also requires that a mutual fund investment be redeemable upon demand by an investor. Disclosure is regulated by the SEC, which mandates that investors be provided with a prospectus prior to investing and also receive periodic reports and an annual proxy ballot. Under the Investment Advisors Act of 1940, investment advisors of mutual funds are required to register with the SEC. Sales and marketing practices of mutual funds by the investment management company are regulated by the National Association of Securities Dealers (NASD).

Attention to Environmental Issues

Typically, environmental and social considerations do not figure prominently in the design or in the investment operations of mutual funds. However, an increasing number of socially responsible investment (SRI) funds have been established in recent years, including Domini Social Equity, Calvert Managed Growth, Hudson Investors Fund, and Pax World Fund. SRI funds usually apply a negative investment screen to avoid, for example, investments in the tobacco industry. Some funds that have invested in environmental services include Alliance Global Environmental Fund and the Fidelity Select Environmental Services Fund. As reported by Morningstar Research, SRI-screened mutual funds have more than US$4 billion in assets (5).

Significant research has been completed over the past several years, and many other studies are in progress examining the relationship between environmental investment screens and rates of return. Much of this information has been compiled by the Investor Responsibility Research Center, the Social Investment Forum, and the Innovest Group.

Another type of screen utilizes "best in class" or "eco-efficiency" investing. That is, the fund manager will invest in mainstream industries, identifying "best in class" companies within each industry that integrate voluntary performance standards such as environmental performance indicators (EPIs). Some prominent funds to utilize environmental measurements are the Storebrand-Scudder Environmental Value Fund, the Swiss Bank Corporation's Eco-Performance Portfolio, and the Dreyfus Third Century Fund. *(See Box 4.1.)*

Relevance to Developing and Transition Economies

In 1996, there were nearly 800 "international" and "global" funds. One of every eight dollars invested in mutual funds in the United States is invested overseas (6). Mutual funds have experienced the greatest increase of all equity investments in the emerging market economies. By 1996, emerging market funds had combined assets of US$132 billion (7). Mutual funds are also being established in developing and transition economies such as Chile and Thailand.

Examples of how a mutual fund links an individual investor in the United States to environmentally or socially sensitive investments in developing countries can be seen by examining the portfolios of funds such as the Fidelity Select Natural Resources Fund or the T. Rowe Price Emerging Markets Fund, which have holdings in timber, energy, and mining companies.

MUTUAL FUND DIAGRAM

Figure 4.2 illustrates the operation of a mutual fund. A mutual fund begins with an idea by an **investment management company** for a targeted fund or specific portfolio of investments that will meet the objectives of a group of investors. A **market niche** is identified by examining a variety of factors such as consumer trends, companies, industries, and emerging markets. The **investment management company (legal** and the **fund manager) establishes** the **mutual fund** and its **Board of Directors** and registers it with the **regulators** (SEC in the United States) for approval to proceed prior to soliciting buyers.

Once the mutual fund is established, an ongoing symbiotic relationship exists between the **mutual fund** and the **investment management company**. The employees of the **investment management company** operate the **mutual fund**, which serves as the vehicle through which the assets are **invested** and **liquidated**. Management of the **mutual fund** is driven by the **fund manager**. The **marketing** program is then launched by **marketing staff** and **analysts**, with or without a **public relations** effort, to attract **individual** and **institutional investors**. A **prospectus** (or **offering circular**) is distributed that details the investment guidelines of the fund. The **prospectus** discloses legally required information as well as marketing information, such as investment objectives of the fund, minimum individual investment, dividend policy, fees, and risk characteristics. This marketing and distribution of the **prospectus** is done through the **investment management company** and **financial planners/advisors/brokers**. **Investors** are likely to consider the **rating** of a fund as assessed by a tracking service such as Morningstar.

The structure of a **mutual fund** provides shareholders with **proxy power**. Every year, investors receive proxy ballots to elect members of the **Board of Directors** for the fund. Further, any changes in a fund's investment strategy or governance must be approved by a shareholder proxy vote. The key to the success of a fund will rest on its ability to meet investors' expectations (rate of return and others) while investing according to its **investment guidelines**.

The investment capital that flows into the fund from **individual and institutional investors** is used to make **investments** in securities in a manner consistent with the corporate governance of the fund. Key individuals in this process are the **research analysts** who are responsible for interfacing with the various companies. These analysts are the key link between the fund and companies for gathering information, evaluating information, and potentially influencing the industries where **investments** may be made. Although the responsibility for these activities is under the auspices of each **fund manager**, many of the **investment management company** employees, such as **research analysts**, may be working on multiple funds; thus, it is the **fund manager** that ultimately will have control over a specific fund.

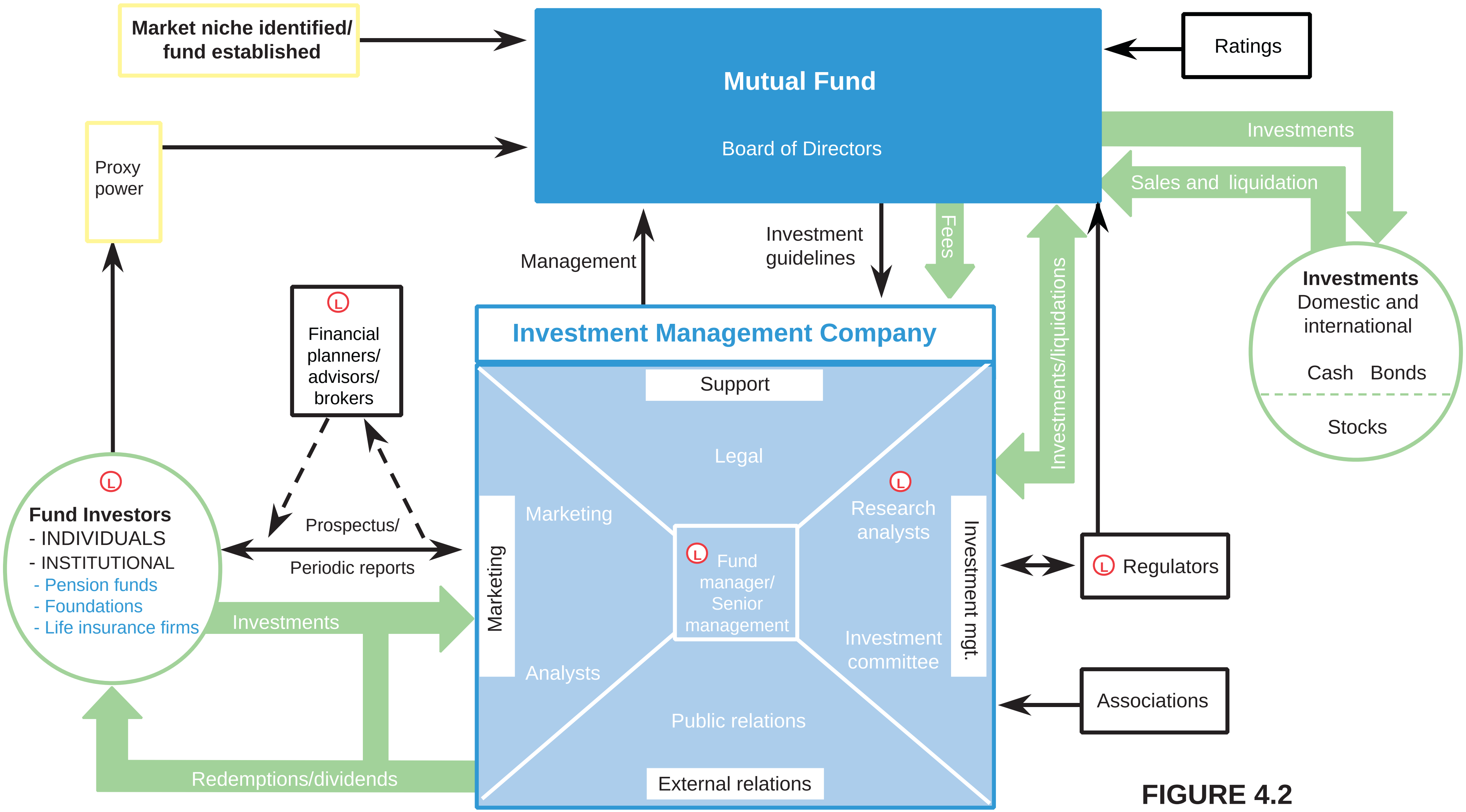


FIGURE 4.2

MUTUAL FUND

In deciding to invest in specific companies, the **research analyst** and **investment committee** will ask the following questions:

- Does a potential investment fit within the **investment guidelines** of the fund's governance? How does the investment fit with the current exposure to risk?
- Will the fund become a minority/majority owner by investing in the company?
- Will the investment make the press? Does it have positive marketing value for the fund?
- Will the investment attract long-term investors to the fund, thus stabilizing the investment pool of capital?
- What are the potential market conditions and government regulations that will impact the financial performance of a company? What are the economic forecasts for the region in which the company operates?
- How is the company going to perform compared to its competitors?

Investment management companies receive information and education from **associations** such as the National Association of Securities Dealers (NASD) and the Investment Company Institute (ICI) in the United States.

As the fund becomes more mature, the investment management company will begin to distribute **periodic reports** and handle **redemption** requests by investors. Investors may also receive **dividends** that may be reinvested.

LEVERAGE POINTS

Research Analysts—*Bottom-line leverage*. Research analysts drive the investment decisionmaking of a mutual fund within the fund's defined parameters by providing information and recommendations to the fund manager. In a typical fund, the analyst is interested in environmental or social considerations only to the extent that he or she is convinced that they are significant factors influencing performance. In an SRI fund, analysts are interested in information regarding environmental or social characteristics of particular industries, countries, or companies. Because they are in frequent contact with companies seeking investment, analysts can request specific data and alert those companies to environmental and social issues that concern investors.

Fund Manager—*Bottom-line leverage*. Managers of typical funds are interested in environmental or social considerations for one of two reasons: (a) if he or she is convinced that those considerations are significant factors influencing financial performance; or (b) if he or she is convinced that application of environmental or social investment criteria will increase the number of investors or the amount of capital under management.

Government Regulation (SEC or equivalent)—*Policy leverage*. Regulators could facilitate the disclosure of information regarding the environmental or social character of a fund's investments by requiring that such information be included in a fund's prospectus and periodic management reports.

Individual Investors—*Values-based leverage*. As the mutual fund industry increasingly markets itself as a mainstream retail product, it will react to consumer demands. Individual investors have the power to select from a wide array of funds, and can indicate a preference for environmentally and socially responsible investing by choosing funds with those characteristics and by requesting information on the environmental and social character of mutual funds. If the mutual fund industry perceives that consumers want environmental information, the industry will react by including some environmental data within a fund's prospectus. Public interest groups can educate their members, employees, and the general public about the availability of screened funds and how they can evaluate their portfolios, including retirement and 401(k) investments.

Institutional Investors—*Values-based leverage*. NGOs, foundations, universities, and many other institutional investors are often willing to

Box 4.1 Environmental Investing: From Values to Bottom Line

Background: Individual investors have always had the option of exercising social responsibility by eschewing "sin stocks." Institutionalized socially responsible investment (SRI), however, is a relatively recent phenomenon. The movement was spurred in the 1970s by two high-profile social issues—arms manufacture in the aftermath of the Vietnam War, and divestment from South Africa in the apartheid era. Consequently, the early focus of SRI was on avoidance and screening out ethically unacceptable activities. In the late 1980s, environmental criteria were added as an investment screen, fueled by a surge in green consciousness. Whether social or environmental criteria were used, until the mid-1990s, the financial performance of SRI was poor and the movement relied heavily on values-based leverage to attract investors.

Action: In the past few years, environmentally oriented investing has been supported by a new message: "green business is good business." Recent studies suggest that firms attentive to environmental value—both in terms of risk avoidance and opportunity identification—reap financial value. Moreover, some analysts argue that developments in international policy and regulation are creating growing financial opportunities for firms that are environmental leaders. Perhaps most importantly, this message is buttressed by quantitative evidence from U.S. markets that financial performance is positively correlated with environmental performance (1).

Outcome: A change in the message has brought about a change in investment criteria. From application of a "negative screen," some investment managers have begun to apply a "positive screen" to affect the environmental profile of investment portfolios. "Eco-efficiency" now serves as an investment criterion. A company's efficient use of natural resources, suggest proponents of this approach, is an indicator of good management overall. Swiss Bank Corporation's "Eco-Performance" portfolio, for example, identifies "eco-leaders"—sector-specific leaders in environmental performance—and "eco-innovators"—leaders in emerging resource-efficient sectors—as a complement to financial analysis in selecting stocks.

Analysis: With the transition from negative screens to positive "eco-efficiency," the target audience for environmentally oriented investing may shift from values-based to bottom-line investors. For values-based investors, the new approach raises questions about how to determine the environmental credibility of a "green fund." Because the vast majority of investors are bottom-line investors, however, there is little doubt that the new approach may enormously increase the appeal of environmental investing, and is a step toward mainstreaming environmental concerns into global investment portfolios.

NOTES

1. For a compilation of studies correlating financial performance with environmental performance, see http://www.innovestgroup.com/library.htm

Sources: Tennant, Tessa. "The Growth In Environmentally Responsible Investment." In Taylor, Bernard, Colin Hutchinson, Susan Pollack, and Richard Tapper, eds. *The Environmental Management Handbook.* London: Pitman Publishing. 1996; Deutsch, Claudia H. "Investing It: For Wall Street, Increasing Evidence that Green Begets Green." *New York Times*. July 21, 1998; and Swiss Bank Corporation. *Eco-Performance Portfolio—World Equities Prospectus.*

consider criteria other than short-term rates of return for investing their endowments. They can create demand for environmentally and socially responsible mutual funds and for further information dissemination.

Financial Advisors—*Bottom-line leverage.* Financial advisors are extremely influential in directing their clients' investments because they are seen as impartial experts who help their clients identify investment goals and objectives. As a group, financial advisors could play an important role in educating individual and institutional investors on the environmental and social implications of investments.

NOTES

1. "Mutual Fund Assets Second." *Pensions & Investments*, September 16, 1996, p. 26.
2. "Survey: Fund Management." *The Economist.* October 25, 1997.

3. Investment Company Institute website, http://www.ici.org.
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5. Philippe Mao. "Socially Responsible Investing." *Sky.* June 1997.
6. Ted Fishman. "The Joys of Global Investment." *Harpers.* February 1997.
7. The World Bank. *Private Capital Flows to Developing Countries: The Road to Financial Integration.* Oxford, U.K.: Oxford University Press. 1997. p. 16.

AVAILABLE INFORMATION

Investment Company Institute: http://www.ici.org

Mutual Funds advisory newsletters, 1-800-442-9000

Association of Investment Management and Research: http://www.aimr.com

Rating reports: http://www.morningstar.net and http://www.lipperweb.com

U.S. Stock Exchange: http://www.nasdaq.com

U.S. Securities and Exchange Commission: http://www.sec.gov

Online guides to socially responsible investments: http://www.greenmoney.com and http://www.goodmoney.com

U.S. Social Investment Forum, Washington, DC: http://www.socialinvest.org

U.K. Social Investment Forum, (44-171) 377-5907

Calvert Group's "Know what you own" website: http://www.calvertgroup.com/kwyo/index.htm

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