Online Study Guide

Mutual Funds

- Introduction
- Money Manager
- Custodian
- Underwriter
- Suitability
- Prospectus
- Act of 1940
- Trading
- Taxation
- REITs

Using this study guide.

This study guide is intended for use prior to attempting the accompanying exam. Read the complete study guide at your convenience before beginning the exam. You may cover the material in one session or break the material into several shorter sessions, whichever best fits your learning style. All answers to exam questions are covered in this document.

Before you begin, you may find it useful to click the thumbnails button to utilize thumbnails for navigating your way through this document. Thumbnails break the document into separate pages. Clicking the third thumbnail quickly advances the screen to the third page, clicking the sixth thumbnail quickly advances the screen to the sixth page, clicking the first thumbnail sends the screen back to page one, etc. Bookmarks operate similarly by advancing to different sections of the document. Simply use your mouse to click on the section of your choice.

Upstart Raising Copyright © 2004

Upstart Raising

Mutual Funds

Introduction

A mutual fund is a company which makes investments for individuals who share common financial goals. It continuously offers new shares to the public and will redeem those shares from any investor who wants to liquidate. The mutual fund company raises capital for the sole purpose of investing it for its shareholders; it has no other business than investing money. Mutual fund is a widely accepted synonym for an open-end investment company. There are various types of funds and each has its own investment objectives. A **growth** fund is used to provide long term growth of capital. An **income** fund is used to provide a higher than average current income stream. A **growth and income** fund is for investors who want a combination of both growth and income. A **specialized** fund is a fund which concentrates at least 25% of its investments in a specific industry or geographical area. A **balanced** fund's main objective is preservation of principal, not growth. It would be most suitable if an investor wants to preserve his principal and make some modest income gain. They are often referred to as "widows and orphans funds," and are considered one of the most conservative common stock funds. If a client is not looking for growth but wants his money invested in high quality short-term obligations, there are **money market** funds. **Money market** funds have no sales charge and generate daily dividends which are credited to the fund monthly. They provide yields that are normally more competitive than traditional bank checking and savings accounts. If an investor wants the safety of U.S. government bonds, the recommendation may be a **U.S. government bond** fund. If an investor needs tax-exempt income from a diversified portfolio of municipal securities, a **municipal bond** fund offering income free from state and/or federal taxation may be appropriate. Other kinds of mutual funds such as **GNMA** funds, **option income** funds, **foreign securities** funds, **precious metals** funds, and **asset allocation** funds are also popular. With an asset allocation, the fund manager has authority to invest in virtually anything.

A mutual fund company makes money from profits of selling securities in its portfolio, from dividends on stocks held in its portfolio, and from interest on debt securities held in its portfoliio.

Upstart Raising Copyright © 2004

The Money Manager

The money manger, also known as the management company or the investment adviser, makes investment decisions for the investment company on a daily basis. The money manager may be an officer of the fund, a committee of the board of directors, or a company under contract to the fund. The initial contract between the money manager and the fund is for two years and must be approved by both the board of directors of the fund and a majority of the shareholders. Afterwards, the contract is renewable every year and is approved by either the board of directors or shareholders. The main objective of a fund's money manager is to obtain enough diversification of the portfolio to meet the investment objectives of the fund and to identify the tax status of the fund's income and/or capital gains distributions.

The Custodian

Legally, all mutual funds must have a custodian. A contract between the mutual fund and the custodian (usually a bank) gives the custodian the responsibility to keep the fund's cash and securities safe. A custodian bank can act as a mutual fund's distributor of new shares, transfer agent, and registrar. The custodian bank is not involved in making investment decisions or managing the mutual fund, but primarily deals with bookkeeping, sending reports to shareholders, sending proxy voting forms, etc.

The Underwriter

An underwriter works under contract with the mutual fund to bring the fund's shares to the market and sell them to the public. A fund's principal underwriter is also referred to as the distributor or the sponsor. He may or may not solicit a dealer to sell and distribute the mutual fund shares. The underwriter's contract with the mutual fund is never over, but is subject to annual renewal and is subject to approval of the board of directors and shareholders of the fund. The fund's underwriter may enter into a selling agreement with dealers to sell and distribute shares to the public.

Mutual funds which sell directly to the public are no-load funds. They usually have a toll-free number and offer a prospectus to potential customers who respond to their ads in newspapers. These funds by-pass the need for an

Upstart Raising Copyright © 2004

underwriter and a dealer. Some funds sell to an underwriter who then sells to investors and others sell to an underwriter who sells to a dealer who in turn sells to the public.

Suitability

In choosing an appropriate mutual fund to recommend to a client, it is very important to compare the non-statistical features as well as the statistical performance of different funds. These statistics are readily available to show the growth and income over the past several years. Two of the most important statistical comparisons are performance of the investment company and expense ratio. The expense ratio is calculated by dividing the annual operating expenses (including management fees) by the average annual net assets. The normal range for an expense ratio is one to three per cent. Three non-statistical factors to use when comparing one mutual fund to another are withdrawal plans, reinvestment programs and conversion privileges. A withdrawal plan allows the investor to receive monthly or quarterly payments from the mutual fund. A reinvestment program gives the investor the right to automatically reinvest his dividends and/or capital gains. A conversion privilege allows the investor the right to convert from one fund to another within the family at no cost or at a reduced sales charge. The statistical and non-statistical features most valued by a client should be carefully reviewed before making a recommendation.

The Prospectus

Since mutual funds are always a new issue, providing a prospectus to potential customers is a requirement, not an option. The client is to be given the prospectus prior to the sales solicitation. The prospectus of an open-end investment company includes the investment objectives and investment policies of the fund, its breakpoints, and a description of the management and advisory contract. Additionally, the prospectus will include the maximum sales charge, a brief summary of what the fund is, how it operates, a summary of the most recent 10 years' operating results, how to purchase shares of the fund, information on the redemption of shares, tax status, financial statements, etc. Most firms use sales literature provided by and paid for by the underwriter. The SEC does not approve or disapprove of securities including mutual funds. A disclaimer known as the SEC no-approval clause is included in each prospectus.

Upstart Raising Copyright © 2004

The Investment Company Act of 1940

The Investment Company Act of 1940, which was designed to protect the interest of investors, established the definition for an investment company. A management company and a unit investment trust both meet the qualifications for an investment company, but a holding company's main focus is buying up and running other companies. Holding companies do not exclusively manage portfolios for their shareholders and therefore, are not investment companies. Closed-end funds are investment companies, but not mutual fund companies. In contrast to an open-end investment company, a closed-end investment company makes a one time offering of shares to the public which are nonredeemable by the company but trade like stock in the open market. Although closed-end funds may change in value if interest rates rise or fall their market value is driven by the law of supply and demand.

The 1940 Act stipulates that shareholder approval is needed to make any proposed changes in the investment policy of the company, sets forth the rules concerning breakpoints, rights of accumulation, and the use of letters of intent, dictates that no more than 60% of the board of directors of an investment company may be insiders or those affiliated with the company, and mandates that a mutual fund pay on redeemed shares within seven days. It is unlawful for any affiliated person or principal underwriter of a registered investment company to borrow money or other property from the fund. Another stipulation of the '40 Act is that at least 40% of the board must be made up of people who have no other position or affiliation with the fund, its underwriter, its investment adviser, or any group related in any way to any of these groups. All investment companies are required to send reports which include a balance sheet, an income statement, a listing of the amounts and values of securities, and a statement of purchases and sales to each shareholder at least semi-annually.

To meet the restrictions of a "diversified company" under the Investment Act, a company must invest 75% or more of total fund assets so that not more than 5% of the total fund assets are invested in any one corporation and not more than 10% of the voting securities of any corporation is held by the company. The other 25% of the company's total assets does not have to be diversified in this way. In truth, though, most diversified funds invest a larger percentage of their assets than the minimum 75% like way.

Upstart Raising Copyright © 2004

Trading

Mutual funds have professional portfolio managers to assist in the management of the fund's portfolio and to buy and sell securities for the fund if the directors approve. The fee the investment company pays for this service is usually determined by the net assets of the fund. The general management fee is usually ½ of 1% of the average annual net assets. The lower the assets, the lower the fee and the higher the assets, the higher the fee, but the cost to the shareholder is only $5 per year on each $1,000 in the fund.

Shares for an open-end investment company are not sold in the same way as stock for other corporations. A major difference is that investors buy and redeem mutual funds at net asset value. Fund shares may be bought at the public offering price through brokers/dealers who have contracts with the Principal Underwriters for the fund. The public offering price is the same as ask price and is the net asset value per share plus the sales charge. The net asset value (NAV) is decided as of the close of the NYSE on business days the exchange is open. NAV per share is calculated by dividing the value of all the fund's assets (with liabilities subtracted) by the number of shares outstanding. The last sale price of the day is used for portfolio securities. Another name for NAV is bid price. The public offering price is calculated once per day (at the close of trading) on each day the NYSE is open.

The offering (ask) price of a fund's shares is determined by dividing the NAV by 100% minus the sales charge. If a fund has a sales charge of 6% and a net asset value of $8, the ask price is determined as follows: $8.00 divided by (100% - 6%) or $8/.94 = $8.51. The offering or ask price is $8.51. The public offering price for a mutual fund with a NAV of $7.50 and a 5% sales is computed as follows: NAV divided by (100% - Sales Charge %) or $7.50 divided by (100% - 5%) 95% = $7.89.

Redemption price is the amount the investor will receive at the time of redemption. Mutual funds must be redeemed within seven days of receipt of an investor's request for redemption. The redemption price of a mutual fund is the net asset value (NAV) per share next determined after the certificates are delivered along with the written request for redemption. Some mutual fund companies charge a redemption fee which is simply subtracted from the NAV at the time of redemption. Redemption fee is a percentage charge to the

Upstart Raising Copyright © 2004

investor at the time he redeems his shares and is also known as deferred sales load. If a no-load fund has a NAV of $15 and the prospectus called for a 1.5% redemption fee, an investor would receive $15 - ($15 X 1.5%) or $14.77 per share at the time of redemption.

When a public investor buys mutual fund shares, there is a retail charge called the sales charge. The particulars of the sales charge are written in the prospectus for clients to read. If the NAV and offer price are known, the percentage of sales charge can be calculated as follows: offer price less NAV divided by offer price. For example, if the NAV is $6.50 and the offer price is $7.00, the sales charge is $7.00 - $6.50 or $.50 divided by $7.00 = 7%. The maximum sales charge for an open-end fund is 8.5%. No-load companies redeem at NAV and add no sales charges. If NAV and public offering price are equal, the company is adding no sales charge and is most likely a no-load mutual fund company.

Some investors choose to invest in programs known as level charge plans which charge the same, level, 8.5% sales charge each time an additional investment is made. One level charge plan is a fixed dollar amount per interval and another is a fixed number of shares per interval. The main advantage of a fixed dollar amount per interval is dollar cost averaging which gives the investor the lowest cost per share over a given period of time. That is, when the public offering price of the fund is high, fewer shares are bought and when the public offering price is low, more shares are bought, resulting is greater profits to the investor.

A letter of intent gives an investor 13 months to reach a breakpoint level while having the benefit of reduced sales charges on current purchases. An investor may backdate a letter of intent no more than 90 days. The total time frame for a letter of intent is 13 months and the period begins to run on the date of the letter. If the amount actually bought over the 13 month period is more or less than indicated in the letter of intent, adjustments in the sales charges will be made.

Upstart Raising Copyright © 2004

Taxation

Investors make money from mutual funds in three basic ways and must pay taxes on all three of those ways: reinvesting dividends, capital gains taken as new shares, and dividends taken in cash. Reinvestment of dividends and /or capital gains does not defer or alter the taxation of those items in any way. The advantage of reinvesting distributions is the compounding effect of leaving the shareholder's money in the fund and the savings of sales charges on the purchases of new shares. The fund will inform shareholders of the tax status of its various distributions by providing a yearly statement. The statement will designate which distributions are considered short term and which are considered long term as well as how much of the distribution is dividend income.

Mutual funds companies may be given special tax treatment if they comply with specific regulations set forth in Sub-chapter M of the Internal Revenue Code. The main condition requires that the fund distribute at least 90% of its net investment income to investors as a dividend. The company will avoid corporate taxation on the 90% it distributes and will pay corporate taxes only on the other 10%. These dividend pay-outs to the shareholder are considered long-term capital gains to the investor and would be subject to taxation. Since this is a distribution of capital gains from the fund, and not a sale of shares by the investor, the investor has no control and must accept the distribution and pay taxes on it.

Real Estate Investment Trusts

Real Estate Investment Trusts (REITs) are trusts that invest in diversified portfolios of real estate holdings. They purchase real estate, make short-term loans for construction, long-term mortgage loans, and are highly leveraged. Publicly registered REITs trade over-the-counter and on the exchanges. The rules for Regulated Investment Companies set the minimum payout of net investment income at 90% and the minimum payout of net capital gains income at 90%**.** In order to qualify for no federal income tax, a REIT must be established under a trust indenture, receive 75% of its income from mortgage income and rents, invest at least 75% of its assets in real estate or real estate mortgages, and distribute at least 95% of its earnings to its shareholders. Additionally, in order to pay no federal tax, the REIT must be managed during

the entire year by one or more trustees who hold legal title to the property and have control over the management of the trust and the REIT must have at least 100 beneficial owners as evidenced by transferable shares or transferable certificates of beneficial interest.

Now that you have completed reading this course, you may proceed to the accompanying exam to earn a verifiable certificate of completion.