

Relationship Among a Firm Issuing Securities, the Underwriters and the Public

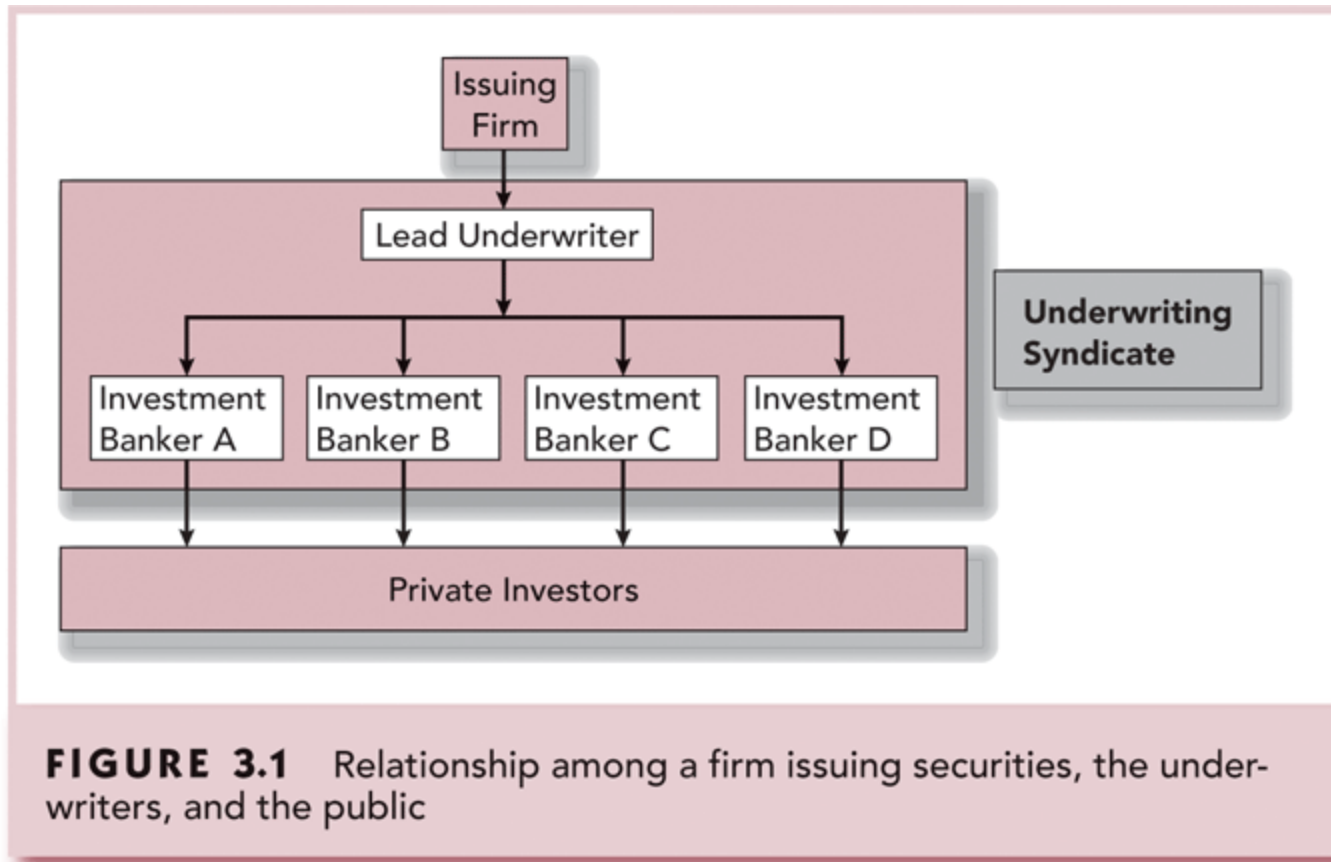
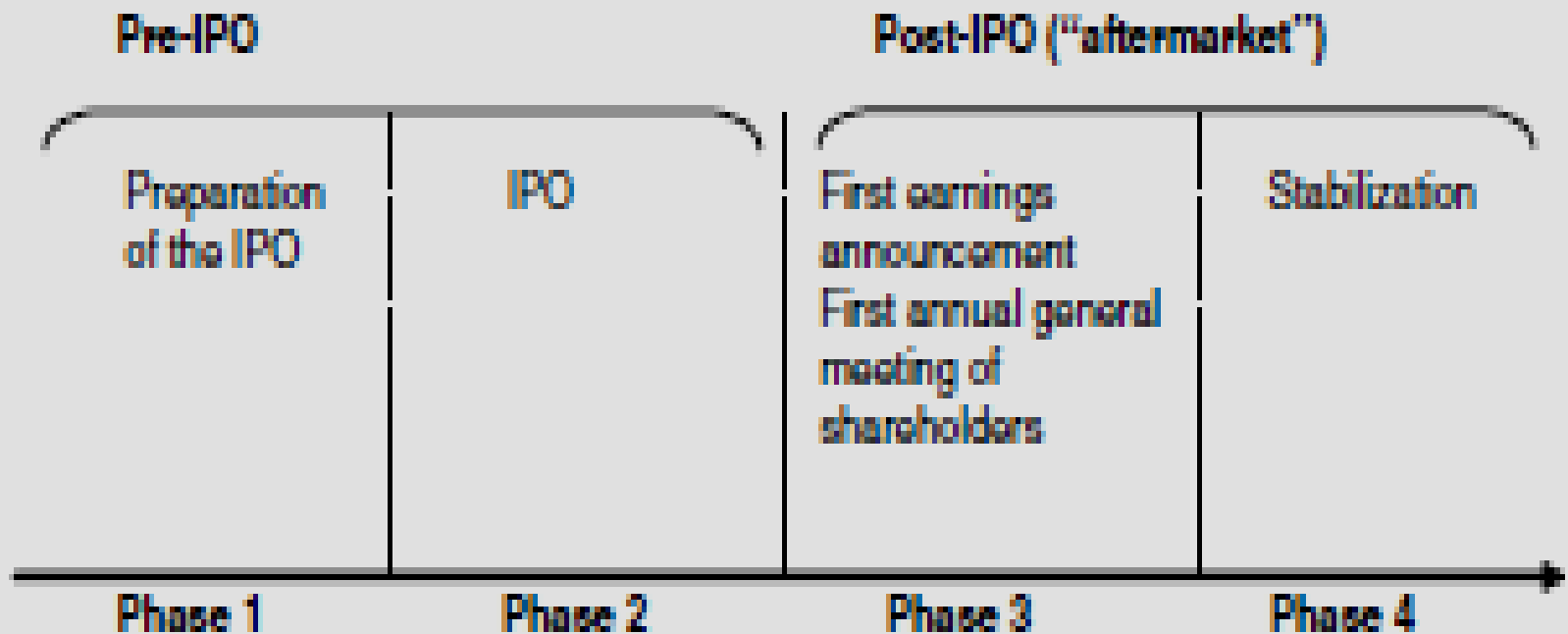


FIGURE 3.1 Relationship among a firm issuing securities, the underwriters, and the public

Four Phase of IPO



The objectives of the chapter are to provide an understanding of:

- The market for investment management.
- Mutual fund operations.
- The structure and strategies of hedge funds.
- The features and strategies of venture capital funds.
- The market for buyout funds.
- Opportunities in real estate investment trusts.

Market Overview

- Indirect investing
 - Investment management companies pool money from investors and invest in a portfolio of financial assets.
- Direct investing
 - Investors invest directly in individual securities.
- Indirect investing advantages
 - Managerial expertise
 - Diversification
 - Administrative costs
 - Convenience

Growth in Investment Management

- Increased popularity of defined contribution pension funds
- Concerns about Social Security and future financial obligations
- Desire for more aggressive investment growth
- Emergence of new investment distribution channels
- Effect of the Internet on investment knowledge and access

Investment Management Operations

- Unit investment trusts
- Closed-end investment companies
- Mutual funds
- Hedge funds
- Venture capital funds
- Buy out funds
- Real estate investment trusts

Types of Investment Companies

- Unit investment trust (UIT)
 - Purchases and holds a relatively fixed portfolio of securities.
 - Investors who buy units in the trust will receive a pro rata share of principal and interest or dividends.
 - UITs generally have a stated date for termination. After the dissolution of the trusts, the unit-holders receive all proceeds.

Types of Investment Companies (cont'd)

- Closed-end investment company
 - Issues a fixed number of shares listed on a stock exchange or traded over the counter.
 - ❖ **After the issuance of the shares, investors buying or selling these shares do not deal with the fund company, but instead, trade with other investors.**
 - Four main types of closed-end funds:
 - ❖ **International and global bond funds**
 - ❖ **International and global equity funds**
 - ❖ **Domestic bond funds**
 - ❖ **Domestic equity funds**

Types of Investment Companies (cont'd)

- Mutual fund
 - Pools money from a number of investors who share similar investment objectives, such as obtaining current income, maximizing long-term capital growth, or a combination of the two.
 - ❖ **A professional manager manages the fund to achieve its objective.**
 - ❖ **Each share represents a proportional ownership in all of the fund's invested assets.**
 - ❖ **The net asset value (NAV) of a mutual fund determines its share prices. NAV is the value of the fund's assets, less its liabilities, divided by the number of outstanding shares.**

Types of Investment Companies (cont'd)

- Hedge fund
 - An unregistered, private investment pool bound by the investment agreement investors have signed with the sponsors of the fund.
- Venture capital (VC) funds
 - Make equity investments in entrepreneurial companies.
 - ❖ **The financiers recoup their investments when the company they have invested in (called the portfolio company) either goes public or sells out to another corporation.**

Types of Investment Companies (cont'd)

- Real estate investment trust (REIT)
 - Pools capital from investors to acquire or to provide financing for real estate.
 - Like a closed-end fund for real estate in that retail investors can trade shares on a stock exchange.
 - Investing in REITs gives an investor a practical and efficient way to include professionally managed real estate in an investment portfolio.

Mutual Fund

- An investment company that makes investments in a portfolio of securities on behalf of fund shareholders who share common investment objectives.
 - The value of a mutual fund portfolio fluctuates as investors invest in or redeem shares and as the value of the securities held by the fund rises or falls.
 - Each investor owns an undivided interest in the portfolio and shares mutually with other investors in gains and distributions derived from the fund's investments.

Advantages of Mutual Funds

- Diversification of investment reduces risk
 - Buying mutual fund shares creates an ownership interest in all of the securities the fund owns.
- Professional money management
 - Provides a way for the individual investor to obtain the same professional money management available to large institutions and wealthy investors.
- Variety of mutual funds
 - A wide variety of funds are available to meet individual investor's investment objectives

Advantages of Mutual Funds (cont'd)

- **Ease of investment**
 - It is easy to invest in mutual funds.
- **Issuance of both full and fractional shares.**
 - Investors can purchase shares based on an even dollar investment.
 - Each full or fractional share represents ownership of the fund's overall portfolio and not a specific interest in any one investment in a portfolio.
- **Mutual funds are liquid.**
 - Investors can redeem shares any business day without penalty.

Types of Mutual Funds

- **Equity Funds**

- Aggressive growth
- Growth Sector
- Growth and income
- Income equity
- Emerging markets
- Global equity
- International equity
- Regional equity

- **Hybrid Funds**

- Asset allocation
- Balanced
- Flexible portfolio
- Income-mixed

- **Taxable Bond Funds**

- Corporate bond
- High yield Global bond
- Government bond
- Mortgage-backed
- Strategic income

Types of Mutual Funds (cont'd)

- **Tax-free Bond Funds**
 - State municipal bond
 - National municipal bond
- **Money Market Funds**
 - Taxable money market
 - Tax-exempt money market-national
 - Tax-exempt money market-state

Mutual Fund Share Pricing and Performance

- Mutual funds determine the price of their shares each business day.
 - A fund's **net asset value (NAV)** is the value of all the fund's assets, minus liabilities, divided by the total number of shares outstanding.
 - A fund's **offering price** is its NAV plus (if any) the applicable sales charge.
 - The **redemption price** is its NAV minus (if any) the applicable redemption fee, or back-end load.

Mutual Fund Share Pricing and Performance

- Determining the price of a fund's shares
 - A fund's net asset value (NAV) is the value of all the fund's assets, minus liabilities, divided by the total number of shares outstanding.
 - A fund's offering price is its NAV plus (if any) the applicable sales charge.
 - The redemption price is its NAV minus (if any) the applicable redemption fee, or back-end load.

Mutual Fund Share Pricing Example

- A mutual fund owns a portfolio of stocks worth \$10 million at the end of the business day; its liabilities are \$1 million; and it has 800,000 shares of the fund outstanding. Net asset value (NAV) for the fund is calculated as follows:

$$NAV = \frac{\$10,000,000 - \$1,000,000}{800,000} = \$11.25$$

Types of Mutual Funds

- Exchange-Traded Funds (ETF)
 - An index fund or trust listed on an exchange and traded like a listed stock during trading hours.
 - Investors can trade shares in ETFs as a single security.
 - ETFs cover a wide variety of broad stock market, industry sector, international stock, and U.S. bond indexes.

Technology and Mutual Funds

- Benefits of technological advances
 - Enabled better customer service and introduced a broad array of new products at a reasonable cost.
 - Made it possible for mutual fund companies to manage the records of their shareholders.
 - Allowed the use of 800 numbers and routing of incoming calls to provide information and take orders over the phone
 - Internet access helps investors gain access to Wall Street research and real-time data from investment companies' web sites.

Factors Causing Growth in Mutual Fund Assets Worldwide

- Favorable economic conditions in developed countries in recent years
- Popularity of mutual fund investing for retirement and an improved living standard
- Private savings as a substitute/supplement for government retirement programs
- Growth of the middle class worldwide

Mutual Fund Selection: Fund Strategies

- **Capital preservation strategy**
 - Appropriate for investors who want income, a fair amount of stability, and some increase in the value of the investment.
- **Moderate growth strategy**
 - Suitable for investors who primarily want a balance of moderate growth and moderate income with a fair amount of stability.

Mutual Fund Selection: Fund Strategies

- **Wealth-building strategy**
 - Suitable for investors who want the potential for growth and capital appreciation, but also want some protection from stock market volatility.
- **Aggressive growth**
 - For investors who want the potential for substantial growth and capital appreciation.

Mutual Fund Investment Strategy Matrix

Tolerance for Risk	Investment Horizon of 0 to 3 Years	Investment Horizon of 4 to 6 Years	Investment Horizon of 7+ Years
High	Moderate growth	Wealth-building	Aggressive growth
Moderate	Moderate growth	Moderate growth	Wealth-building
Low	Capital preservation	Capital preservation	Moderate growth

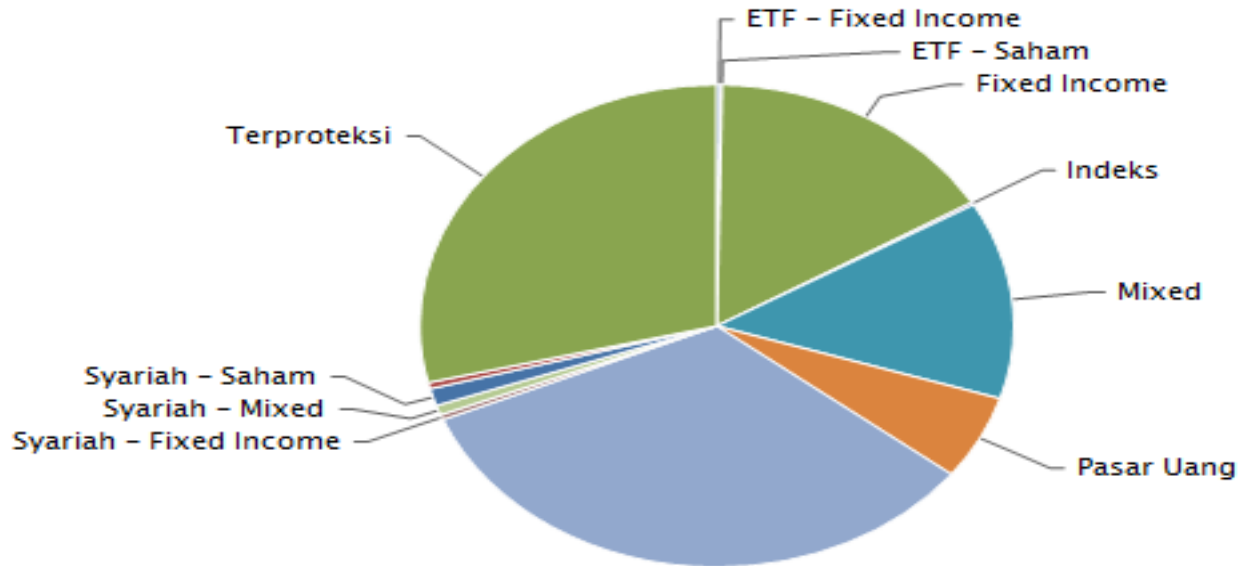
Mutual Fund Selection: Asset Allocation

- **Asset allocation**
 - The process of strategically diversifying investments between stock, bond, and cash in order to achieve a return consistent with the investor's financial goals, investment horizon, and risk tolerance.
- **Developing an asset allocation program**
 - Determine financial goals and investment horizon.
 - Evaluate level of risk tolerance
 - Develop a detailed asset allocation strategy using assets that complement each other
 - Implement the strategy

Asset Allocation Strategies

- Strategic asset allocation
 - Is a value-oriented technique that seeks to increase exposure to the market when recent market performance is poor, and to reduce exposure when recent market performance is good.
- Dynamic asset allocation strategy
 - Seeks to ensure that the value of the portfolio does not fall below a certain level (portfolio insurance) to avoid large losses and secure any favorable market move.

Composition of Mutual Funds in Indonesia



ETF - Fixed Income	(363,788,430,185.00)
ETF - Saham	(24,503,462,699.43)
Fixed Income	(22,466,956,927,576.93)
Indeks	(255,750,854,255.40)
Mixed	(18,423,986,886,887.59)
Pasar Uang	(7,875,082,086,062.28)
Saham	(46,113,551,028,050.05)
Syariah - Fixed Income	(472,936,429,550.16)
Syariah - Mixed	(899,776,406,508.93)
Syariah - Saham	(1,612,178,026,785.03)
Syariah - Terproteksi	(601,184,318,503.13)
Terproteksi	(40,007,526,694,461.98)

Source: Bapepam-LK

Hedge Fund Investment Styles

Style	Holding Period	Expected Volatility
Emerging markets	Short/medium term	Very high
Short only	Medium	Very high
Macro	Medium	Very high
Sector play	Medium	High
Distressed	Medium/long	Moderate
Growth	Medium/long	Moderate
Risk arbitrage	Medium	Moderate
Convertible arbitrage	Medium	Low
High yield	Medium	Moderate
Event driven	Medium	Moderate
Value	Long	Low/moderate
Opportunistic	Short	Low/moderate
Market neutral	Short/medium	Low
Convergence	Short/medium	Low

Sources: *All About Hedge Funds*, Van Hedge Fund Advisors, 2001.

TABLE 5.5

Venture Capital (VC) Funds

- VC firm
 - Operates several VC funds; pools funds from investors and invests in entrepreneurial companies.
- Unique features of VC
 - Are actively involved in searching for candidates, negotiating, and structuring the transaction, and monitoring the organization.
 - Investments tend to last for several years, typically three to seven
 - Securities purchased by VC funds are usually privately held.

Venture Capital (VC) Funds

- A VC fund passes through four stages in its life:
 - **Fundraising:** obtaining capital commitments.
 - **Actual investment:** the company that becomes a portfolio company of the fund.
 - **Portfolio growth:** the fund makes and manages the investment until the closing of the fund
 - **Closing:** the VC fund liquidates its portfolio of companies using one of three forms: an initial public offering (IPO), a sale of the company, or bankruptcy.

Venture Capital Terms

- Venture funds
 - Provide such first-round financing for risky investments are often called VC angels.
- Restricted securities,
 - Securities acquired directly or indirectly in a transaction not involving any public offering.
 - Restricted securities can be sold via a subsequent private sale or a public offering registered with the SEC.

Buyout Funds

- Buyout funds defined
 - Investment firms that invest in leveraged buyouts (LBOs) using borrowed money for the purchase price of the buyout company.
 - ❖ **The assets and future cash flows of the selling company typically are used to secure the debt.**
- Characteristics of LBO firms
 - Use other people's money to acquire companies
 - Seek out distressed companies in out-of-fashion industries to avoid paying top dollar.

Buyout Funds (cont'd)

- Management buyout (LBO)
 - An LBO in which the purchasers are the management of the company.
 - Management usually invests in the equity of an LBO company together with an LBO fund, a corporate investor, or a group of institutional investors.
 - The seller and subordinated lenders sometimes receive equity in the new company.

Buyout Financing Structure

- Senior loan
 - Collateralized by a first lien on the assets of the company and includes:
 - ❖ **Revolving line of credit: a line of credit on which the company pays a commitment fee and can take and repay a loan at will.**
- Senior term loan
 - Loan based on a percentage of the fair market value of the land and buildings, as well as the liquidation value of the machinery and equipment.

Buyout Financing Structure (cont'd)

- Subordinated financing
 - Funds raised from insurance companies or subordinated debt funds
 - A public offering of high-yield or non-investment-grade bonds to insurance companies, pension funds, and other institutional investors provides the financing.
 - Equity financing that makes up the difference between the financing required and the financing available in the form of debt.

Real Estate Investment Trusts (REIT)

- An investment company that pools funds from investors to invest in income-producing residential and commercial properties.
 - REITs differ from stocks only in that they are engaged exclusively in the real estate business.
 - They pay dividends and may be listed on an exchange.
 - As large blocks of real estate become equitized, investment opportunities in REITs will expand.

Types of REITS

- **Equity REIT**
 - A corporation that purchases, owns, and manages real estate properties and draws its revenues come from rent.
- **Mortgage REIT**
 - A corporation that purchases, owns, and manages real estate loans and draws its revenues from interest from the mortgage loans.
- **Hybrid REITs**
 - Combine the investment strategies of both equity REITs and mortgage REITs.

Brokerage & Clearing Companies



The objectives of the chapter are to provide an understanding of:

- The various types of brokerage services securities firms offer.
- Interdealer brokers' functions for non-exchange-traded securities.
- The trading mechanism in electronic communications networks.
- The importance of clearing and settlement.
- The services provided by various clearing firms.

Types of Brokers

- **Full-service brokers**
 - Provide a complete menu of financial services, including trade execution, research reports, financial advice, and financial planning.
- **Discount brokers**
 - Execute trades for customers for lower commissions but do not provide research or advice.
- **Electronic brokers**
 - Only offer their services online.

Types of Accounts

- Cash account
 - The customer pays the brokerage house the full transaction value for any securities and does not borrow funds from the brokerage firm.
- Margin account
 - Customers to borrow money from the brokerage firm to purchase securities.
 - ❖ **Margin account restrictions**
 - Initial margin: a deposit of cash or eligible securities equal to 50% of trade values.
 - Maintenance margin: customer equity equal to 25% of the market value of securities held in the account.

Types of Accounts (cont'd)

- Asset management accounts
 - Require a minimum balance to open and they charge an annual fee.
 - Offer automatic reinvestment of the account's cash balances in money market funds.
 - Offer loans based on the marginable securities in the account.
- Wrapped accounts
 - The customer pays the brokerage firm a flat annual fee to cover all services and trading commissions.

Types of Orders

- Market order
 - Instructs the broker to buy or sell the securities immediately at the best price available at that time.
 - Ensures that the transaction will be completed, but the price of the trade is unknown until executed.
- Limit orders
 - Specifies a particular price for a trade (buy or sell).
 - **Buy order:** customer specifies the maximum price that he is willing to pay for a security.
 - **Sell order:** the customer specifies a minimum price that he is willing to accept to sell the security.

Types of Limit Orders

- Effective for one day or good until canceled
- All or none: fill the whole order or nothing
- Immediate or cancel: fill any part of the order immediately or cancel the order
- Fill or kill: fill the entire order or kill (cancel) the entire order

Types of Orders (cont'd)

- Stop orders
 - Used to purchase or sell a security after its price reaches a certain level.
 - **Buy stop order** is placed above the current market price to stop buying once a higher price level is reached.
 - **Sell stop order** is placed below the current market price to stop selling once a lower price level is reached.
 - A stop limit order becomes a limit order once the limit price is reached.

Types of Brokerages

- Full-service brokerages
 - Offer a full range of investment products, including stocks, bonds, mutual funds, certificates of deposits, insurance, and annuities.
 - Offer services such as financial advice on retirement planning, asset allocation, portfolio management, college funding, estate planning, and trust services.

Types of Brokerages (cont'd)

- Discount brokerages
 - Resulted from deregulation of the brokerage industry in 1975 when negotiated commissions became available to individual investors.
 - Offer fast access and lower commissions for executing transactions for independent investors who telephone or use a computer online to request a trade.
 - Do not offer investment advice to their clients, and they provide only limited services.

Types of Brokerages (cont'd)

- Electronic brokerage
 - Developed when discount brokerages allowed their existing customers to trade online.
 - Focused on first-time, self-directed individual investors.
 - Offer one-stop shopping where investors can trade, research, and track stocks, and customize their online portfolio accounts for a low commission cost.
 - Have expanded beyond stock brokering and now help to distribute shares of initial public offerings to retail customers.

Types of Brokerages (cont'd)

- Interdealer brokerage
 - Display bids and offers of other dealers anonymously
 - Enhance liquidity by providing a central mechanism to display the bids and offers of multiple dealers
 - Allow dealers and investors to trade large volumes of securities anonymously and efficiently based on these bids and offers.
 - Compile the anonymous bids and offers of other government securities dealers and traders and display the quotations on screens located in the dealers' offices.

Types of Brokerages (cont'd)

- Electronic communications networks (ECNs)
 - Computerized trading systems that match buyers and sellers of securities.
 - Let buyers and sellers of stock meet without the use of intermediaries such as market makers and specialists.

Electronic Communications Networks

- **Advantages**

- Extended trading hours
- Lower costs
- Fewer errors
- Faster trades reduce ***slippage***
- Reduced opportunity for ***front running***

- **Disadvantages**

- Lack of liquidity during extended trading hours
- Not widely available
- Maintaining necessary trading volume

Clearing And Settlement

- Settlement
 - The transfer of money and securities by a clearing bank between the parties to complete a transaction to receive and deliver money and securities.
 - **Clearing account:** a firm's money and securities accounts at its clearing bank.
- Clearing and settlement process:
 - Completing the trade ticket and conveying its details to the back office.
 - Matching the terms and configuration.
 - Settlement and booking.

Mortgage-Backed Securities (MBS)

- Mortgage Backed Securities Clearing Corporation (MBSCC)
 - Provides automated trade comparison/confirmation and net settlement services.
 - Offers a real-time Electronic Pool Notification (EPN) system to transmit pool information quickly, efficiently, and reliably to reduce *fail* costs
- MBSCC settlement systems
 - Trade-for-Trade
 - Settlement Balance Order (SBO)

International Transactions

- Euroclear
 - Is the largest clearance and settlement system for internationally traded securities.
 - Is a delivery-versus-payment system with settlement in book-entry form.
 - Offers a Securities Lending and Borrowing Program, which enables participants to avoid costly fails by borrowing securities automatically during the settlement process.

International Transactions (cont'd)

- Clearstream

- Is a major clearing and settlement system for international securities transactions that uses delivery-versus-payment to minimize risk..
- Offers settlement services for internationally traded securities:
 - ❖ **Automatic securities lending, flexible financing, custody, and cash management.**
 - ❖ **New Issues Acceptance service to lead managers, issuing and paying agents, and their advisers to facilitate new issues of securities in the international markets.**

International Transactions (cont'd)

- Emerging Market Clearing Corporation
 - Engages in clearance, multilateral netting, and risk management of transactions involving emerging-market debt instruments.
 - Employs a designated trade-matching system that :
 - ❖ **Compares emerging-market debt trades executed by major securities firms and transmits them to the EMCC.**
 - ❖ **Evaluates trades to guarantee accepted transactions and reports to members on an accepted trade report.**
 - ❖ **Calculates margin requirements daily, issues margin calls, and manages the resulting collateral.**
 - ❖ **Transmits settlement instructions to Euroclear or Clearstream on behalf of EMCC member firms.**