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# THE FUND INDUSTRY

How Your Money Is Managed



ROBERT POZEN

THERESA HAMACHER

Foreword by DON PHILLIPS  
Morningstar, Inc.



+ WEBSITE

The companion website features fund details,  
quantitative examples, and additional charts and graphs

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*How Your Money Is Managed*

ROBERT E. POZEN AND  
THERESA HAMACHER



*Foreword by*  
Don Phillips



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## Foreword

**S**cores of books tell investors how to choose a mutual fund. Dozens more feature famous fund managers recounting their investment glories. A handful of texts even offer thoughts on how to reform and improve the fund industry. But there's no other book that gives readers such a thorough overview of how the fund industry operates, its evolution, its regulation, and what makes it tick. If you want to truly understand today's mutual fund industry, there's no finer text than the one in your hands.

Mutual funds have become the investment vehicle of choice for investors around the world, and with good reason. No other investment offers the same level of convenience and diversification at such an affordable price. Funds revolutionized and democratized the investment landscape. Yet the industry itself goes largely unexamined. Small investment partnerships and family businesses have morphed into global financial powerhouses seemingly overnight, dramatically altering the investment landscape, yet few fully understand the fund industry's structure, its distribution methods, and its back-office workings.

If you are one of the millions of fund investors and you want to know how your money is processed and managed, not just which funds had the highest return, this book is for you. Similarly, if you work for a fund company, are involved in fund distribution, or work perhaps as an independent director for a fund, this text has much to offer. If you are an auditor, lawyer, or custodian or work for one of the many data services companies involved with the fund industry, this text will be invaluable. Moreover, journalists, policymakers, and professors following the industry and its transformational role in capital markets will find this text an indispensable reference.

Of course, all that I've said here applies to the earlier editions of this text as well. What makes this third edition special? For one, it features much more coverage of funds outside the United States and much more material on other types of pooled investments, such as hedge funds, exchange-traded funds, and separate accounts. But I'd argue that the most significant upgrade is the involvement of Theresa Hamacher, one of the sharpest and classiest people I know in the industry. Terry perfectly complements Bob Pozen's

considerable expertise to form a dream duo to guide readers through the world of funds.

I first met Terry when she ran a top-performing convertible-bond fund back in the 1980s. Convertibles are an odd niche of the financial world that demands expertise in both equity and fixed-income management. Terry brought not only formidable intelligence but great creativity to the task, and her fund delivered fine results to shareholders. Her hands-on expertise in portfolio management shines through in the investment-management sections of the text. Terry went on to even greater successes, first in managing other investment professionals, and more recently in heading NICSA, the National Investment Company Service Association, which is the organization of service providers to the fund industry, where she's fought for ever-higher professional standards. No one knows portfolio management and back-office operations like Terry. As importantly, Terry brings an educator's touch that translates arcane information into easily understood and readily assimilated insights. She's an ace.

Bob Pozen is similarly impressive. My defining memory of Bob came from the late 1990s when Bob headed up Fidelity's asset management arm. The scene was an industry conference devoted to how the Internet would change everything. The conference was abuzz with New Economy fever, and rival fund executives boasted of money pouring into their recently launched Internet-themed investment funds. Against this background, Bob was asked when Fidelity would launch its Internet fund; after all, Fidelity was a leader in sector funds and already had funds investing in such specialties as air transportation and property and casualty insurance. Bob's answer shocked the audience. He said Fidelity wouldn't be launching an Internet fund at that time because he didn't want to take the calls in five years from investors who had bought the fund in the midst of the current euphoria. To me, Bob's sentiment embodied the notion of stewardship over salesmanship. While many of his peers were eager to push what was then easy to sell, Bob recognized that the most valuable asset of any fund manager is its reputation and that short-term gains that come at the cost of long-term reputational damage aren't worth taking.

Coupled with his deep-seated commitment to stewardship, Bob's expertise in the legal aspects of fund management and his passion for public policy fully round out this book's impressive parentage. Like Terry, Bob has continued to flourish in the industry, moving on from Fidelity to guide the venerable MFS organization back to its historic position of industry leadership. He stands today as one of the industry's most revered statesmen. His insights help shape financial regulation, and he's a thought leader in the debate surrounding retirement-planning issues. With this text, he generously gives back to the industry in which he's enjoyed such success, sharing a

lifetime of accumulated wisdom with future industry leaders. Just as veteran stock fund managers prize their tattered copies of Ben Graham and David Dodd's *Security Analysis*, coming generations of fund industry leaders will cling to this essential text. It's that good and that important a book.

DON PHILLIPS  
*Managing Director,  
Morningstar, Inc.*

# Preface

**M**utual funds play an integral role in daily life. In 2009, more than 87 million Americans invested their money through mutual funds, using them as vehicles to save for such important life goals as the purchase of a home, a child's college education or a comfortable retirement.<sup>1</sup> Many businesses rely on money market mutual funds for help in managing their cash balances. And mutual funds are an increasingly popular savings vehicle in Europe, Asia, and other regions of the world.

In the United States alone, more than 157,000 individuals worked directly for fund management companies—among them call center representatives and credit analysts, wholesalers, and portfolio managers. Firms providing critical support to funds—including audit, custody, legal, and technology services—employed hundreds of thousands more. Yet these jobs in the United States represent only a fraction of worldwide employment in the fund industry.

It's a highly complex industry, offering more than 7,600 funds with different investment objectives and approaches to consumers through multiple distribution channels—through intermediaries, direct sales, and retirement plans. It's governed by detailed laws and regulations that are continually evolving.

*The Fund Industry* explains how this industry works in practice. We examine how mutual funds are structured and discuss the key laws and regulations governing their operations. We go behind the scenes at fund management companies to explain how they select investments for fund portfolios, sell fund shares around the globe, and provide service to fund shareholders.

We wrote this book for anyone who's unfamiliar with the mutual fund industry but would like to know more. All we ask is that readers understand key economic and tax terms such as interest rates and capital gains; knowledge of basic investment concepts—such as the difference between stocks and bonds—is helpful, but not required. We explain the jargon and try to assemble the various components of the fund industry into a coherent whole. Callout boxes highlight key definitions and recent controversy or give you a feel for what it's like to work for a fund management company.

This book doesn't just update the second edition of Bob Pozen's *The Mutual Fund Business*—it adds much new material to address the tremendous changes in the industry in the eight years since that book was published. Among the enhancements are:

- A revised first section explaining how investors can research and evaluate funds to find the ones that fit with their preferred asset allocation
- A separate chapter on money market funds, a category that has received much more attention as a result of the credit crisis of 2008
- A completely revised chapter on securities trading, reviewing the tremendous growth in virtual exchanges and automated trading
- A chapter on exchange-traded funds and hedge funds, investment vehicles that have soared in popularity recently
- Two additional chapters on the global fund industry, summarizing trends in asset gathering outside the United States

Despite these additions, this book has fewer pages than its predecessor because we've established a companion web site for the book at [www.wiley.com/go/fundindustry](http://www.wiley.com/go/fundindustry). Rather than including supplementary materials in an appendix to each chapter, we've posted them online; you'll see references to these materials throughout the text. There's a special section of this web site for teachers; it contains review and discussion questions and suggestions for readings and case studies.

One area that we wished we could have covered in greater detail was derivatives, but space was simply too short to do justice to this complex topic. Instead, we've just made brief mention of their impact on mutual funds, especially during the credit crisis of 2008. The web site provides a list of reference materials if you'd like some background reading. Another omission: a glossary—in this case without regrets—since it's now so easy to look up definitions online. One of our favorite sources for basic financial information is Investopedia.

This book is divided into five sections:

1. *Section I: An Investor's Guide to Mutual Funds* looks at funds from an investor's perspective. We review the advantages and disadvantages of mutual funds, explain how they operate, and discuss how investors can gather information about potential fund investments. We also explore the different categories of mutual funds and review how investors might choose funds within each.
2. *Section II: Mutual Fund Portfolio Management* examines how funds manage their investments. We discuss portfolio management in stock, bond, and money market funds and then examine how funds implement



investment decisions through trading. We conclude with an overview of how mutual funds exercise their responsibilities as substantial stock investors.

3. *Section III: Selling Investment Funds* reviews how mutual funds are distributed to investors in the United States. We discuss sales through intermediaries, directly by funds and through retirement plans, examining issues within each channel as well as those affecting all channels. The final chapter in this section reviews the inner workings of two other investment vehicles that have become increasingly important: exchange-traded funds and hedge funds.
4. *Section IV: Operations and Finance* explains how the fund industry provides customer service and keeps portfolio records. We also review the financial dynamics of mutual fund management companies, examining factors that drive their profitability, and trends in mergers and acquisitions.
5. *Section V: The Internationalization of Mutual Funds* looks at cross-border investing and asset gathering. We take a look at the investment and operational issues faced by U.S. mutual funds investing outside the United States. We examine the special challenges involved in distributing funds across the world and discuss how the European Union has increased cross-border distribution. We end with a survey of the asset management industry in Asia and in the Americas outside of the United States, with a focus on China and Chile.

Supplementary materials mentioned throughout the text—plus a guide for teachers—are available online at [www.wiley.com/go/fundindustry](http://www.wiley.com/go/fundindustry).

# Acknowledgments

**W**e would not—and could not—have undertaken a project of this scope without the help of experts in the disciplines that this text covers. We want to thank the many volunteers who made this book possible.

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But our biggest thanks go to our spouses. Without their love and patience, this book would have been completely impossible.

ROBERT POZEN  
THERESA HAMACHER  
*November 2010*

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# An Investor's Guide to Mutual Funds

**M**utual funds are designed to make life easier for investors. Funds give savers of even modest means access to top-quality investment management combined with a high level of convenience and service, all at a reasonable price.

Since the mission of funds is to serve investors, we start this book by taking a look at mutual funds from an investor's perspective. We give an overview of mutual funds by focusing on four critical questions:

1. Why invest through mutual funds?
2. How do mutual funds work?
3. How do investors research a potential mutual fund purchase?
4. How do investors choose a mutual fund that's right for them?

This section has four chapters:

Chapter 1 provides an introduction to investing through mutual funds. It reviews their advantages and disadvantages, summarizes their history, and discusses how they are used by investors today. It concludes by providing an overview of the entities that work to ensure that funds meet their obligations to investors: the government regulators and the industry associations.

Chapter 2 describes the basic structure and operations of a mutual fund. It begins with a discussion of two key fund features: daily liquidity at