***Financial Markets and Institutions, 7e* (Saunders)**

**Chapter 17 Investment Companies**

1) Funds that specialize in municipal bonds and certain types of real estate to minimize tax liabilities are called hybrid funds.

Answer: FALSE

Difficulty: 1 Easy

Topic: Size, Structure, and Composition of the Mutual Fund Industry

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 17-02 Distinguish between long-term mutual funds and money market mutual funds.

Accessibility: Keyboard Navigation

2) Hedge funds can short sell securities, whereas most mutual funds cannot.

Answer: TRUE

Difficulty: 2 Medium

Topic: Hedge Funds

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 17-08 Know what a hedge fund is.

Accessibility: Keyboard Navigation

3) A hedge fund that goes long in a convertible bond and short in the equity of the same firm is employing a market neutral arbitrage strategy.

Answer: TRUE

Difficulty: 2 Medium

Topic: Mutual Fund Returns and Costs

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 17-08 Know what a hedge fund is.

Accessibility: Keyboard Navigation

4) The shares of a closed-end fund with market value assets of $200 million and two million shares outstanding will always trade at a market value of $100 per share.

Answer: FALSE

Explanation: The fund's market value can be at premium or discount based on the demand for its shares.

Difficulty: 1 Easy

Topic: Mutual Fund Returns and Costs

Bloom's: Understand; Analyze; Evaluate

AACSB: Analytical Thinking

Learning Goal: 17-05 Calculate the net asset value of and the return on a mutual fund investment.

Accessibility: Keyboard Navigation

5) If you invest $10,000 in a mutual fund with a NAV of $50 per share and a 5.5 percent back-end load, you will receive less than 200 shares in the fund.

Answer: FALSE

Explanation: A back-end load is not paid until fund shares are sold.

Difficulty: 2 Medium

Topic: Mutual Fund Returns and Costs

Bloom's: Understand; Analyze; Evaluate

AACSB: Analytical Thinking

Learning Goal: 17-05 Calculate the net asset value of and the return on a mutual fund investment.

Accessibility: Keyboard Navigation

6) Because of their ability to hedge, the subprime mortgage crisis did not cause any significant losses to hedge funds.

Answer: FALSE

Difficulty: 2 Medium

Topic: Hedge Funds

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 17-08 Know what a hedge fund is.

Accessibility: Keyboard Navigation

7) Offshore hedge funds are not subject to taxation on fund distributions nor to U.S. estate taxes.

Answer: TRUE

Difficulty: 2 Medium

Topic: Hedge Funds

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 17-08 Know what a hedge fund is.

Accessibility: Keyboard Navigation

8) The market value of a fund's net assets divided by the number of mutual fund shares outstanding is called the NAV of the fund.

Answer: TRUE

Difficulty: 1 Easy

Topic: Mutual Fund Returns and Costs

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 17-05 Calculate the net asset value of and the return on a mutual fund investment.

Accessibility: Keyboard Navigation

9) Open-end fund shares often trade at a discount or premium relative to NAV.

Answer: FALSE

Difficulty: 1 Easy

Topic: Mutual Fund Returns and Costs

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 17-05 Calculate the net asset value of and the return on a mutual fund investment.

Accessibility: Keyboard Navigation

10) Load funds typically provide investors with higher rates of return and offer more services such as check writing, transfers between funds, and so forth, than no load funds.

Answer: FALSE

Difficulty: 1 Easy

Topic: Mutual Fund Returns and Costs

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 17-05 Calculate the net asset value of and the return on a mutual fund investment.

Accessibility: Keyboard Navigation

11) A 12b-1 fee is an implicit load charge.

Answer: TRUE

Difficulty: 2 Medium

Topic: Mutual Fund Returns and Costs

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 17-05 Calculate the net asset value of and the return on a mutual fund investment.

Accessibility: Keyboard Navigation

12) Households are the largest owner of money market mutual funds.

Answer: TRUE

Difficulty: 1 Easy

Topic: Size, Structure, and Composition of the Mutual Fund Industry

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 17-02 Distinguish between long-term mutual funds and money market mutual funds.

Accessibility: Keyboard Navigation

13) Hedge funds and REITS often employ significant amounts of leverage, but standard open-end mutual funds do not.

Answer: TRUE

Explanation: Mutual fund leverage is limited by regulation.

Difficulty: 2 Medium

Topic: Hedge Funds

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 17-08 Know what a hedge fund is.

Accessibility: Keyboard Navigation

14) The Federal Mutual Fund Commission (FMFC) is the primary regulator of the mutual fund industry.

Answer: FALSE

Difficulty: 1 Easy

Topic: Mutual Fund Regulation

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 17-06 Identify the main regulators of mutual funds.

Accessibility: Keyboard Navigation

15) Unit investment trusts (UITs) issue only a fixed number of shares redeemable at a specific termination date.

Answer: TRUE

Difficulty: 1 Easy

Topic: Other types of investment company funds

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 17-03 Distinguish between open-end mutual funds, closed-end funds, and unit investment funds.

Accessibility: Keyboard Navigation

16) Load funds charge one-time sales commissions that can be paid either upfront or at end of the investing period in the mutual fund.

Answer: TRUE

Difficulty: 2 Medium

Topic: Mutual Fund Returns and Costs

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 17-05 Calculate the net asset value of and the return on a mutual fund investment.

Accessibility: Keyboard Navigation

17) The price of an ETF is determined once a day when the market closes.

Answer: FALSE

Difficulty: 1 Easy

Topic: Mutual Fund Returns and Costs

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 17-04 Understand what is contained in a mutual fund prospectus.

Accessibility: Keyboard Navigation

18) ETFs are private investment pools, which are exempt from SEC regulations and with the ability to pursue diverse investment choices.

Answer: FALSE

Difficulty: 1 Easy

Topic: Mutual Fund Returns and Costs

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 17-04 Understand what is contained in a mutual fund prospectus.

Accessibility: Keyboard Navigation

19) Index funds have the highest cost among the different types of mutual funds.

Answer: FALSE

Difficulty: 1 Easy

Topic: Mutual Fund Returns and Costs

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 17-04 Understand what is contained in a mutual fund prospectus.

Accessibility: Keyboard Navigation

20) Money market mutual funds consist of a mixture of bonds and money market securities.

Answer: FALSE

Difficulty: 1 Easy

Topic: Size, Structure, and Composition of the Mutual Fund Industry

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 17-02 Distinguish between long-term mutual funds and money market mutual funds.

Accessibility: Keyboard Navigation

21) Open-end mutual funds guarantee

A) investors a minimum rate of return.

B) investors a minimum NAV.

C) to redeem investor's shares upon demand at current NAV.

D) to earn the rate promised in the prospectus.

E) None of these options are correct.

Answer: C

Difficulty: 2 Medium

Topic: Mutual Fund Returns and Costs

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 17-05 Calculate the net asset value of and the return on a mutual fund investment.

Accessibility: Keyboard Navigation

22) Hedge funds charge expense fees and performance fees. The average performance fee on hedge funds is \_\_\_\_\_\_\_\_.

A) 5 percent

B) 10 percent

C) 15 percent

D) 20 percent

E) 25 percent

Answer: D

Difficulty: 2 Medium

Topic: Hedge Funds

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 17-08 Know what a hedge fund is.

Accessibility: Keyboard Navigation

23) ETFs are a direct competitor to \_\_\_\_\_\_\_\_.

A) hedge funds

B) money market mutual funds

C) REITS

D) index funds

E) market neutral funds

Answer: D

Difficulty: 1 Easy

Topic: Size, Structure, and Composition of the Mutual Fund Industry

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 17-02 Distinguish between long-term mutual funds and money market mutual funds.

Accessibility: Keyboard Navigation

24) As the economy weakens, one would expect investment in \_\_\_\_\_\_\_\_ funds to increase and investment in \_\_\_\_\_\_\_\_ funds to decrease, ceteris paribus.

A) money market mutual; equity

B) equity; bond

C) municipal bond; money market mutual

D) corporate bond; municipal bond

E) long-term; short-term

Answer: A

Difficulty: 2 Medium

Topic: Size, Structure, and Composition of the Mutual Fund Industry

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 17-02 Distinguish between long-term mutual funds and money market mutual funds.

Accessibility: Keyboard Navigation

25) Hybrid mutual funds normally invest significant amounts in

A) common stock.

B) commercial paper.

C) long-term bonds.

D) treasury bills.

E) both common stock and long-term bonds.

Answer: E

Difficulty: 2 Medium

Topic: Size, Structure, and Composition of the Mutual Fund Industry

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 17-02 Distinguish between long-term mutual funds and money market mutual funds.

Accessibility: Keyboard Navigation

26) Money market mutual funds (MMMFs) have caused disintermediation at banks at times. This is because MMMFs

A) sometimes pay higher interest rates than bank deposits.

B) are less risky than bank deposits.

C) are now federally insured, like bank deposits.

D) offer guaranteed rates of return.

E) None of these options are correct.

Answer: A

Difficulty: 2 Medium

Topic: Mutual Fund Balance Sheets and Recent Trends

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 17-05 Calculate the net asset value of and the return on a mutual fund investment.

Accessibility: Keyboard Navigation

27) Actively managed funds find it difficult to consistently earn higher risk-adjusted returns than a broad stock market index. The difference in return between actively managed funds and passively managed index funds can be explained by which of the following?

I. Lower expense ratios at index funds

II. Higher turnover ratios at index funds

III. Differences in returns in sectors of the market and the overall market return

A) II only

B) I and III only

C) I and II only

D) II and III only

E) I, II, and III

Answer: B

Difficulty: 3 Hard

Topic: Size, Structure, and Composition of the Mutual Fund Industry

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 17-02 Distinguish between long-term mutual funds and money market mutual funds.

Accessibility: Keyboard Navigation

28) By type of fund, there are more \_\_\_\_\_\_\_\_ funds than any other.

A) equity

B) bond

C) taxable money market

D) tax-exempt money market

E) hybrid

Answer: A

Difficulty: 1 Easy

Topic: Size, Structure, and Composition of the Mutual Fund Industry

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 17-02 Distinguish between long-term mutual funds and money market mutual funds.

Accessibility: Keyboard Navigation

29) The largest proportion of long-term mutual fund assets is held by \_\_\_\_\_\_\_\_.

A) bank trusts and estates

B) the household sector

C) nonfinancial corporate business

D) private pension funds

E) life insurance firms

Answer: B

Difficulty: 2 Medium

Topic: Size, Structure, and Composition of the Mutual Fund Industry

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 17-02 Distinguish between long-term mutual funds and money market mutual funds.

Accessibility: Keyboard Navigation

30) The market value of a mutual fund's assets divided by the number of fund shares outstanding is equal to the

A) load charge.

B) NAV.

C) expense ratio.

D) 12b-1 fee.

E) management fee.

Answer: B

Difficulty: 1 Easy

Topic: Mutual Fund Returns and Costs

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 17-04 Understand what is contained in a mutual fund prospectus.

Accessibility: Keyboard Navigation

31) Rank the following in asset size from largest to smallest in 2016.

I. Mutual funds

II. Insurance companies

III. Depository institutions

A) I, II, III

B) I, III, II

C) II, III, I

D) III, II, I

E) III, I, II

Answer: E

Difficulty: 3 Hard

Topic: Size, Structure, and Composition of the Mutual Fund Industry

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 17-01 Examine how and why the mutual fund industry has grown through time.

Accessibility: Keyboard Navigation

32) You have $10,000 to invest and you are considering investing in a fund. The fund charges a front-end load of 5.75 percent and an annual expense fee of 1.25 percent of the average asset value over the year. You believe the fund's gross rate of return will be 11 percent per year. If you make the investment, what should your investment be worth in one year?

A) $10,135.48

B) $10,337.46

C) $10,461.75

D) $10,556.23

E) $10,578.92

Answer: B

Explanation: Investment amount = $10,000 × (1 − 0.0575) = $9,425; FV1: $9,425 × 1.11 = $10,461.75;

Average assets = ($10,461.75 + $9,425)/2 = 9,943.375; $9,943.375 × 0.0125 = $124.29;

$10,461.75 − $124.29 = $10,337.46

Difficulty: 3 Hard

Topic: Mutual Fund Returns and Costs

Bloom's: Analyze; Evaluate

AACSB: Analytical Thinking

Learning Goal: 17-04 Understand what is contained in a mutual fund prospectus.

Accessibility: Keyboard Navigation

33) A fund has a NAV of $30 per share but the shares are currently selling for $32. This fund must be

A) an open-ended fund.

B) a closed-end fund.

C) a balanced fund.

D) an aggressive growth fund.

E) a money market mutual fund.

Answer: B

Difficulty: 2 Medium

Topic: Mutual Fund Returns and Costs

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 17-04 Understand what is contained in a mutual fund prospectus.

Accessibility: Keyboard Navigation

34) An open-end mutual fund owns 1,500 shares of Krispy Kreme priced at $12. The fund also owns 1,000 shares of Ben & Jerry's priced at $43, and 2,000 shares of Pepsi priced at $50. The fund itself has 3,500 of its own shares outstanding. What is the NAV of a fund's share?

A) $66

B) $56

C) $46

D) $36

E) $26

Answer: C

Explanation: [(1,500 × 12) + (1,000 × 43) + (2,000 × 50)]/3,500 fund shares = $46

Difficulty: 2 Medium

Topic: Mutual Fund Returns and Costs

Bloom's: Analyze; Evaluate

AACSB: Analytical Thinking

Learning Goal: 17-04 Understand what is contained in a mutual fund prospectus.

Accessibility: Keyboard Navigation

35) You have $16,000 to invest in a mutual fund with a NAV = $45. You choose a fund with a 4 percent front load, a 1 percent management fee, and a 0.25 percent 12b-1 fee. Assume that the management and 12b-1 fees are charged on year-end assets. The gross annual return on the fund's shares was 9 percent. What was your net annual rate of return to the nearest basis point?

A) 3.33 percent

B) 7.64 percent

C) 6.25 percent

D) 4.52 percent

E) 4.64 percent

Answer: A

Explanation: {{[$16,000 × (1 − 0.04) × 1.09] × (1 − 0.0125)}/$16,000} − 1 = 3.33%

Difficulty: 3 Hard

Topic: Mutual Fund Returns and Costs

Bloom's: Analyze; Evaluate

AACSB: Analytical Thinking

Learning Goal: 17-04 Understand what is contained in a mutual fund prospectus.

Accessibility: Keyboard Navigation

36) Investors pay load charges to receive

A) higher returns on their investments.

B) additional services from funds.

C) voting shares of stock.

D) advice on which fund to buy.

E) 12b-1 remunerations.

Answer: D

Difficulty: 2 Medium

Topic: Mutual Fund Returns and Costs

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 17-04 Understand what is contained in a mutual fund prospectus.

Accessibility: Keyboard Navigation

37) A money market mutual fund's total assets increase from $100 to $105 when the fund has 100 shares outstanding. Which of the following will happen?

A) The fund's NAV will rise from $100 to $105.

B) The fund's NAV per share will rise from $1 to $1.05.

C) The fund will issue a total of five new shares.

D) The fund's NAV will fall 5 percent.

E) The fund will close to new investors.

Answer: C

Difficulty: 3 Hard

Topic: Mutual Fund Returns and Costs

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 17-04 Understand what is contained in a mutual fund prospectus.

Accessibility: Keyboard Navigation

38) The primary regulator of mutual funds is the

A) NASD.

B) CFTC.

C) NYSE.

D) SEC.

E) NSMIA.

Answer: D

Difficulty: 1 Easy

Topic: Mutual Fund Regulation

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 17-06 Identify the main regulators of mutual funds.

Accessibility: Keyboard Navigation

39) You have $12,500 to invest and you are considering investing in Fund X. The fund charges a front-end load of 3 percent and an annual expense fee of 2.25 percent of the ending asset value over the year. You believe the fund's gross rate of return will be 8 percent per year. If you make the investment, what should your investment be worth in one year?

A) $12,125.20

B) $13,095.00

C) $12,654.80

D) $12,800.36

E) $13,162.50

Answer: D

Explanation: Investment amount = $12,500 × (1 − 0.03) = $12,125; FV1: $12,125 × 1.08 = $13,095.00; After expenses: $13,095.00 × (1 − 0.0225) = $12,800.36

Difficulty: 3 Hard

Topic: Mutual Fund Returns and Costs

Bloom's: Analyze; Evaluate

AACSB: Analytical Thinking

Learning Goal: 17-04 Understand what is contained in a mutual fund prospectus.

Accessibility: Keyboard Navigation

40) You have $15,000 to invest in a mutual fund. You choose a fund with a 3.5 percent front load, a 1.75 percent management fee, and a 0.5 percent 12b-1 fee. Assume, for simplicity, that the management and 12b-1 fees are charged on year-end assets. The gross annual return on the fund's shares was 12.50 percent. What was your net annual rate of return to the nearest basis point?

A) 9.97 percent

B) 6.12 percent

C) 9.25 percent

D) 5.42 percent

E) 8.56 percent

Answer: B

Explanation: {{[$15,000 × (1 − 0.035) × 1.125] × (1 − 0.0225)}/$15,000} − 1 = 6.12%

Difficulty: 3 Hard

Topic: Mutual Fund Returns and Costs

Bloom's: Analyze; Evaluate

AACSB: Analytical Thinking

Learning Goal: 17-04 Understand what is contained in a mutual fund prospectus.

Accessibility: Keyboard Navigation

41) Which one of the following fund types is likely to have the lowest annual expense ratio?

A) Index funds

B) Equity funds

C) Bond funds

D) Balanced funds

E) Hybrid funds

Answer: A

Explanation: Unmanaged funds have lower expense ratios.

Difficulty: 1 Easy

Topic: Size, Structure, and Composition of the Mutual Fund Industry

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 17-02 Distinguish between long-term mutual funds and money market mutual funds.

Accessibility: Keyboard Navigation

42) A(n) \_\_\_\_\_\_\_\_ fund must hold substantial cash reserves in order to meet fund redemptions from shareholders.

A) closed-end

B) REIT

C) open-end mutual

D) ETF

E) unit trusts

Answer: C

Difficulty: 1 Easy

Topic: Mutual Fund Returns and Costs

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 17-04 Understand what is contained in a mutual fund prospectus.

Accessibility: Keyboard Navigation

43) You wish to invest $17,445 in a mutual fund with a NAV of $26.03. The fund charges a front-end load of 4.50 percent. How many fund shares will you receive?

A) 595

B) 640

C) 616

D) 668

E) 628

Answer: B

Explanation: ((1 − 0.045) × 17,445)/26.03

Difficulty: 2 Medium

Topic: Mutual Fund Returns and Costs

Bloom's: Analyze; Evaluate

AACSB: Analytical Thinking

Learning Goal: 17-04 Understand what is contained in a mutual fund prospectus.

Accessibility: Keyboard Navigation

44) A fund that has a fixed number of shares outstanding and is traded on an exchange is called a(n)

A) open-end mutual fund.

B) hybrid fund.

C) market timing fund.

D) index fund.

E) closed-end fund.

Answer: E

Difficulty: 1 Easy

Topic: Mutual Fund Returns and Costs

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 17-04 Understand what is contained in a mutual fund prospectus.

Accessibility: Keyboard Navigation

45) ETFs have several advantages over index funds, including the ability to

I. trade throughout the day at continuously updated prices.

II. purchase ETF shares on margin.

III. sell ETF shares short.

IV. sell the shares back to the fund.

A) I, II, and III only

B) I, III, and IV only

C) II, III, and IV only

D) II and III only

E) I, II, III, and IV

Answer: A

Difficulty: 2 Medium

Topic: Size, Structure, and Composition of the Mutual Fund Industry

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 17-02 Distinguish between long-term mutual funds and money market mutual funds.

Accessibility: Keyboard Navigation

46) You are considering purchasing shares in a typical mutual fund that has three classes of shares outstanding: Class A, Class B, and Class C. If you purchase Class A shares, you will pay

A) a back-end load and no 12b-1 fees.

B) a front-end load and a small 12b-1 fee.

C) no front-end load but a back-end load.

D) a back-end load and full 12b-1 fees.

E) a front-end load and full 2b-1 fees.

Answer: B

Difficulty: 3 Hard

Topic: Mutual Fund Returns and Costs

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 17-04 Understand what is contained in a mutual fund prospectus.

Accessibility: Keyboard Navigation

47) You are considering purchasing shares in a typical mutual fund that has three classes of shares outstanding: Class A, Class B, and Class C. If you purchase Class C shares, you will pay

A) a back-end load and no 12b-1 fees.

B) a front-end load and a small 12b-1 fee, but eventually your shares will be converted to Class A shares.

C) no front-end load but a back-end load.

D) a back-end load and full 12b-1 fees.

E) a front-end load and full 12b-1 fees.

Answer: D

Difficulty: 3 Hard

Topic: Mutual Fund Returns and Costs

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 17-04 Understand what is contained in a mutual fund prospectus.

Accessibility: Keyboard Navigation

48) One of the recent trading abuses in the mutual fund industry was allowing selected investors to rapidly trade in and out of a mutual fund in order to profit on stale prices. This practice is called

A) diluted brokerage.

B) front running.

C) directed order flow.

D) soft dollar commissions.

E) market timing.

Answer: E

Difficulty: 1 Easy

Topic: Mutual Fund Regulation

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 17-06 Identify the main regulators of mutual funds.

Accessibility: Keyboard Navigation

49) Which of the following is not considered an abusive activity in mutual funds investing?

A) Market timing

B) Late trading

C) Directed brokerage

D) Indexing

E) Improper assessment of fees

Answer: D

Difficulty: 2 Medium

Topic: Mutual Fund Regulation

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 17-06 Identify the main regulators of mutual funds.

Accessibility: Keyboard Navigation

50) Which of the following is not an advantage of a mutual fund?

A) Cheaper transactions costs

B) Diversification

C) Monitoring activities at lower costs

D) No default risk

E) All of these choices are correct.

Answer: D

Difficulty: 2 Medium

Topic: Mutual Funds and Hedge Funds: Chapter Overview

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 17-01 Examine how and why the mutual fund industry has grown through time.

Accessibility: Keyboard Navigation

51) Why are mutual funds popular with individual investors?

Answer: They provide opportunities for small investors to obtain low-cost diversification; professional fund management according to specific objectives; economies of scale in investing (lower commissions and research costs); higher rates of return than available on bank deposits; and convenience services such as switching funds, low-cost reinvestment, and sometimes even check-writing capabilities.

Difficulty: 2 Medium

Topic: Mutual Funds and Hedge Funds: Chapter Overview

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 17-01 Examine how and why the mutual fund industry has grown through time.

Accessibility: Keyboard Navigation

52) What is the purpose of index funds? How does this differ from other equity mutual funds? Why are index funds growing in popularity?

Answer: The purpose of index funds is to mimic the performance of the underlying index such as the S&P500. Their purpose is to provide investors with a rate of return similar to the stock market as a whole. Other equity mutual funds are actively managed; that is, funds conduct research and pick individual stocks they believe will perform better than the market as a whole. Index funds now comprise about 25 percent of long-term funds. They are increasingly popular because they have very low expense ratios and because the performance of managed funds (after expenses) has not been sufficiently better than index funds to warrant incurring the higher fees. Also, more widespread education about market efficiency has probably encouraged more investors to choose indexing.

Difficulty: 2 Medium

Topic: Size, Structure, and Composition of the Mutual Fund Industry

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 17-02 Distinguish between long-term mutual funds and money market mutual funds.

Accessibility: Keyboard Navigation

53) How are money market mutual funds similar to and different from bank deposits?

Answer: Both are safe and earn fairly low rates of return. However, bank deposits are insured by the FDIC, and money market mutual funds are not. That is the biggest difference, but money market mutual funds almost never experience financial difficulty. Because banks may have to meet reserve requirements to back their deposits and pay deposit insurance premiums, bank deposits typically pay a lower rate of return than money market funds. Money funds also typically require higher minimum balances.

Difficulty: 1 Easy

Topic: Mutual Fund Balance Sheets and Recent Trends

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 17-05 Calculate the net asset value of and the return on a mutual fund investment.

Accessibility: Keyboard Navigation

54) How do closed-end investment companies differ from open-end mutual funds?

Answer: Open-end funds create new fund shares when investors buy more fund shares; the fund also redeems the shares upon demand, so liquidity is provided by the fund. The number of fund shares fluctuates daily, but fund shares trade at the net asset value. Closed-end funds trade over the counter or on an exchange. The fund has a fixed supply of shares outstanding, and an investor wishing to purchase shares must find someone willing to sell their shares. Imbalances in supply and demand of the shares of the closed-end fund can cause the shares to trade at prices different from the fund's net asset value. Discounts from net asset value are common. Because a closed-end fund does not have to redeem shares from investors, it does not have to hold as large cash reserves as an open-end mutual fund.

Difficulty: 3 Hard

Topic: Mutual Fund Returns and Costs

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 17-04 Understand what is contained in a mutual fund prospectus.

Accessibility: Keyboard Navigation

55) What are the four main categories of mutual fund trading abuses mentioned in the text? Explain the problem with each.

Answer:

1. Market timing: Allowing selected traders to conduct in and out trading of a mutual fund that is holding overseas securities in order to exploit price changes in the overseas accounts.

2. Late trading: Similar to timing, allowing selected traders to place or cancel orders after the NAV is posted for the day because of new information coming out after close. Both of these practices allow certain investors to profit at the expense of longer-term fund investors.

3. Directed brokerage arrangements: Mutual fund managers use certain brokers to execute the fund's buy/sell orders and, in exchange, the brokers advise their clients to buy that fund. This is a conflict of interest that may result in funds paying higher brokerage costs and investors not getting objective advice about which fund to invest in.

4. Improper fee assessments: Some brokers have not disclosed load charges on funds and/or not given the appropriate discounts to qualified customers, thus overcharging (cheating) the customer.

Difficulty: 3 Hard

Topic: Mutual Fund Regulation

Bloom's: Remember; Understand

AACSB: Reflective Thinking

Learning Goal: 17-06 Identify the main regulators of mutual funds.

Accessibility: Keyboard Navigation

56) On Monday an equity mutual fund has cash of $150 and stocks worth $900. The fund has 100 shares outstanding. On Tuesday the stocks fall in value to $800 and 10 shares are then redeemed by the fund. Assuming that the fund uses its cash first to cover redemptions, what is the one-day rate of return to the remaining fund shareholders, and how much cash and stock does the fund now have?

Answer: The fund pays the selling shareholders the NAV of ($800 + $150)/100 = $9.50 per share or $9.50 × 10 = $95. This reduces the fund's cash balance. The fund is then left with $800 in stocks and $150 − $95 = $55 in cash. The ending NAV is still ($800 + $55)/90 shares = $9.50. Because the initial NAV was $10.50 and after the price drop the NAV is $9.50, the one day return is thus ($9.50 − $10.50)/$10.50 = −9.52%.

Difficulty: 3 Hard

Topic: Mutual Fund Returns and Costs

Bloom's: Analyze; Evaluate

AACSB: Analytical Thinking

Learning Goal: 17-04 Understand what is contained in a mutual fund prospectus.

Accessibility: Keyboard Navigation

57) An investor is considering two mutual funds. Fund A has a 5.75 percent front-end load and a 1.25 percent expense ratio. Fund B is no-load, but has a 2.25 percent expense ratio. If the investor plans on being in either fund for six years, which should they choose given that they have $16,000 to invest and both funds have gross returns of 12 percent per year? Fees are applied at each year-end to year-end asset values, but the load is taken out up front only once.

Answer:

Fund A:

$16,000 × (1 − 0.0575) = $15,080 initial investment

$15,080 × 1.12 = $16,889.60 in year 1, subtract expenses of 1.25% × 16,889.60 = $211.12 = $16,678.48

Net annual return for each year will be ($16,678.48/$15,080.00) − 1 = 10.60%

FV in six years: $15,080.00 × 1.10606= $27,601.46

Fund B:

$16,000 × 1.12 = $17,920.00 in year 1, subtract expenses of 2.25% × $17,920 = $403.20 = $17,516.80

Net annual return for each year will be ($17,516.80/$16,000) − 1 = 9.480%

FV in six years: $16,000 × 1.09486 = $27,550.45

The future value of Fund B is less than the future value of Fund A, so choose Fund A.

Difficulty: 3 Hard

Topic: Mutual Fund Returns and Costs

Bloom's: Analyze; Evaluate

AACSB: Analytical Thinking

Learning Goal: 17-04 Understand what is contained in a mutual fund prospectus.

Accessibility: Keyboard Navigation

58) Why do many mutual funds now offer three different classes of shares? What are the differences and what should you consider in choosing the classes?

Answer: Class A shares pay a front-end load and usually incur a small 12b-1 fee. Class B shares typically have no front load, but incur a back-end load and a larger 12b-1 fee; after a set period of time, such as six to eight years, the Class B shares convert to Class A and thus incur the smaller 12b-1 fee. Class C shares have no front load, and a back-end load is incurred only if shares are sold within a set number of years. These shares do not normally convert to Class A and thus carry the full 12b-1 fee for the entire holding period. Although an investor must consider the specific cases, as a general rule, investors should probably avoid Class A shares because the up-front deduction of funds implies that less money is invested and compounded through time. Class B shares may be preferable to Class C shares if the shares will be held for a sufficiently long time. This is because Class C shares face the higher annual 12b-1 fee forever.

Difficulty: 3 Hard

Topic: Mutual Fund Returns and Costs

Bloom's: Remember; Understand

AACSB: Reflective Thinking

Learning Goal: 17-04 Understand what is contained in a mutual fund prospectus.

Accessibility: Keyboard Navigation

59) Why is it important to regulate the mutual fund industry?

Answer: All financial firms must be regulated to prevent fraud, embezzlement, and various abuses. Mutual funds need to be regulated to ensure that investors have enough valid information to evaluate the fund, and to ensure that the fund does what it promises the investor it will do. For example, the fund could claim to invest in low-risk assets, but instead buy higher-risk assets and keep the additional return for themselves if it were not regulated.

Difficulty: 2 Medium

Topic: Mutual Fund Regulation

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 17-06 Identify the main regulators of mutual funds.

Accessibility: Keyboard Navigation

60) In what ways are hedge funds different from mutual funds?

Answer: The primary differences are as follows:

1. Hedge fund investors must be institutions or accredited investors. To qualify, an individual investor must have a net worth of at least $1,000,000 or have an annual income of at least $200,000 ($300,000 if married). Hedge funds may only be sold via private placements.

2. Hedge funds are not nearly as regulated as mutual funds and generally take on considerable risk, including a high amount of leverage. Disclosure requirements are also quite a bit lower than for mutual funds. All hedge fund performance disclosures are voluntary. In fact, it is probably correct to say that no one is monitoring the normal activities of hedge funds.

3. Fees on hedge funds are higher than on mutual funds. Fees include standard management fees and a quite large performance fee if the fund performs well.

4. Hedge funds take on a broader scope of risks than the typical mutual fund and do not invest according to a publicized strategy. Fund gains and losses can be substantially greater than with typical mutual funds. Many employ mathematical models to predict relationships between prices or interest rates in different markets and make levered bets to profit on aberrations from normal prices. Many are not fully diversified on purpose. A well-managed hedge fund may be able to generate better returns in poor market conditions than mutual funds. (Note: In fact, an investor may be best served by having a hedge fund investment during poorer market conditions when mutual funds are constrained by their investment objectives and must remain invested in struggling markets.)

Difficulty: 2 Medium

Topic: Size, Structure, and Composition of the Mutual Fund Industry; Hedge Funds

Bloom's: Understand

AACSB: Reflective Thinking

Learning Goal: 17-02 Distinguish between long-term mutual funds and money market mutual funds.; 17-08 Know what a hedge fund is.

Accessibility: Keyboard Navigation

61) What new rules have resulted from the mutual fund trading abuses?

Answer:

New rules include those requiring:

\*Improved governance

\*Greater confidentiality: Keep client trades and holding confidential.

\*Greater disclosures:

              Disclose rules on fair value pricing.

             \*Brokers are required to disclose to customers any tie in arrangements with specific funds.

             \*Funds must have a chief compliance officer (CCO) that answers to the board.

             \*Shareholder reports must disclose all fees shareholders paid as well as management's discussion of fund performance over the period.

\*Note: PROPOSED by SEC, but not approved: "Hard closing" on buy/sell order processing as of 4:00 PM EST daily.

Difficulty: 3 Hard

Topic: Mutual Fund Regulation

Bloom's: Remember

AACSB: Reflective Thinking

Learning Goal: 17-06 Identify the main regulators of mutual funds.

Accessibility: Keyboard Navigation

62) What are the primary differences between index funds and ETFs? What are two examples of ETFs?

Answer: ETFs are exchange-traded versions of index funds. Advantages of ETFs include the ability to be traded throughout the day at continuously updated prices, and they can be purchased on margin and sold short, unlike index funds. ETFs have no capital gains distributions to add to tax liability in a given year. Examples include SPDRs on the AMEX and Vanguard's Large-Cap VIPERS funds.

Difficulty: 2 Medium

Topic: Size, Structure, and Composition of the Mutual Fund Industry

Bloom's: Remember; Understand

AACSB: Reflective Thinking

Learning Goal: 17-02 Distinguish between long-term mutual funds and money market mutual funds.

Accessibility: Keyboard Navigation

63) Hedge funds may be classified into three types based on their investment strategies and risk level. What are the three types and their broad risk levels? Many different strategies exist in each type. List one example strategy in each type.

Answer: The three main types are as follows:

* Market directional funds that seek high returns using leverage by using risk arbitrage strategies such as taking positions on how the prices will move. Market timers and funds that invest heavily in certain sectors of the economy would fit into this category. These funds take on high risk.
* Market neutral or value-oriented funds limit their exposure to market risk and may engage in a combination of risky and less risky investment strategies. Examples in this category would include fund of funds and funds that specialize in distressed securities (e.g., vulture funds). Capital preservation is often a major priority of these type funds.
* Market neutral or risk-avoidance funds seek moderate and stable returns. These funds are more likely to engage in lower-risk arbitrage strategies and classic hedging. They still use leverage but focus on reducing correlations in the portfolio and exploiting temporary mispricings. They often look for out-of-favor stocks and small differences in spreads on bonds that appear to be misaligned.

Difficulty: 3 Hard

Topic: Hedge Funds

Bloom's: Remember; Understand

AACSB: Reflective Thinking

Learning Goal: 17-08 Know what a hedge fund is.

Accessibility: Keyboard Navigation

64) How are hedge fund expenses different from mutual fund expenses? What are hurdle rates and high water marks at a hedge fund? Why are these used?

Answer: Hedge funds charge the normal annual management expenses similar to mutual funds, but hedge funds also charge performance fees. Performance fees give the fund managers a percentage of any positive returns on the fund. These fees average 20 percent and have been as high as 50 percent! Because these fees are so large and because having them might tempt managers to seek exorbitant risk levels, fund investors require a hurdle rate, which is a minimum rate of return the fund must earn before the performance fee can be assessed. Likewise, many funds have a requirement that the hedge fund NAV must be at an all-time high (high water mark) before the performance fee can be assessed.

Difficulty: 2 Medium

Topic: Hedge Funds; Mutual Fund Returns and Costs

Bloom's: Remember; Understand

AACSB: Reflective Thinking

Learning Goal: 17-08 Know what a hedge fund is.; 17-05 Calculate the net asset value of and the return on a mutual fund investment.

Accessibility: Keyboard Navigation