Collective Investment and Financial Consultancy

COMPARISON OF COLLECTIVE INVESTMENT IN VISEGRAD GROUP COUNTRIES AND THE SELECTED EUROPEAN COUNTRIES[1]

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Abstract

The aim of the paper is to compare collective investment in the V4 countries – Czech Republic, Hungary, Poland and Slovakia – with the selected European countries. The authors compare and evaluate fund assets, structure of collective investment funds and the whole contemporary situation of the collective investment in the East European countries and those European countries where collective investment is most developed, zooming in on the most comparable countries.

Keywords: *collective investment in Europe, fund assets, types of funds, Visegrad Group*

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1. Introduction

In the course of the nineties, collective investment has become a significant investment instrument even in the former socialist countries. The purpose of the article is to compare collective investment practice in the Visegrad Group Four - Czech Republic, Hungary, Poland and Slovakia – and the selected European countries. In the selection of the European countries, account was taken of both the overall volume of the assets invested in the funds - in other words, those countries had been selected where the assets volume is the highest (namely France, Italy and Germany), and similarity of the selected countries with the Visegrad Four countries - the chosen criteria include the country's size and population number (market volume), and the country's economic advancement (Austria, Spain, Portugal, Greece, Belgium and Denmark). The authors make comparison of the assets volume in, and structure of, the funds and making use of such comparisons they endeavour to assess to what extent the collective investment in the V4 countries differs from the figures observed in the selected countries; finally they make preliminary conclusions concerning the prospects of collective investment.

2. Overall investment volume in the funds in the Visegrad Treaty countries and selected European countries

The base for comparison consists in investment in domestic so-called UCITS funds - i.e. funds which correspond to mutual funds under FEFSI directive (currently EFAMA[2]). These funds account for the majority of the fund investments in the V4 countries.

Table 1 Total net assets + total net assets per capita for selected European countries

Country/Number of Inhabitants (million)	*Total Net Assets (EUR million)*	*Total Net Assets per Capita (EUR million)*
Czech Republic/10	3 826	0,383
Hungary/10	4 627	0,463
Poland/38	9 551	0,251
Slovakia/5	1 595	0,319
France/62	1 053 700	16 995,161
Italy/58	374 840	6 462,759

[2] EFAMA –European Fund and Asset Management Association

Germany/83	230 665	2 779,096
Belgium/10	97 769	9 776,900
Denmark/5	50 432	10 086,400
Portugal/10	24 122	2 412,200
Austria/8	92 887	11 610,875
Greece/11	31 155	2 832,273
Spain/43	240 553	5 594,256

Source: EFAMA, own calculations

Should we compare overall investments into funds in the V4 countries, the majority of financial facilities is invested in Poland - amounting to EUR 9,551 million. The second place is occupied by Hungary (EUR 4,627 million), third is Czech Republic (EUR 3,826 million) and the last position is taken by Slovak Republic (EUR 1,595 million). If the population number is to be taken into consideration, Poland is on the contrary the country to fall on the tail of the chart since the number of inhabitants is markedly higher than in the other three countries. Comparisons however show that all the V4 countries fall considerably behind the selected European countries (see Table no.1) and the assets volume placed in the funds in the V4 countries account for less than a half a per cent point (0.46) in the overall investment volume of all EFAMA countries, which is rather a poor figure.

Table 2 Breakdown of chosen nationally domiciled funds (the UCITS market, % of total of EFAMA members)

Country	***%***
Czech Republic	0,09
Hungary	0,11
Poland	0,22
Slovakia	0,04
France	23,90
Italy	8,50
Germany	5,20
Belgium	2,20
Denmark	1,15
Portugal	0,55
Austria	2,10
Spain	5,50

Source: EFAMA

Considering the further mentioned countries, the absolute majority of assets is located in the funds in France (EUR 1,053,700), whereas France is also a country in which per capita assets in funds is the highest. Still regarding the overall assets volume in funds, France is followed by Italy (EUR 374,840 million) and Germany (EUR 230,665 million); considering the high number of inhabitants, the said countries nevertheless outrun countries with markedly lower population, such as Austria, Denmark and Belgium, when it comes to assets volume in the funds per number of inhabitants. It is exactly the similar market size why these countries had been selected for comparison purposes; Belgium has equal number of inhabitants to the Czech Republic or Hungary (10 million), Denmark's population equals to Slovakia's (5 million), Austria has comparable number of inhabitants and concurrently it is one of the most proximate neighbours of the V4 countries. A comparable country for Poland is Spain (43 million inhabitants), this country had been selected also due to its relatively limited economic advancement within the European Union; similarly, Portugal (10 million inhabitants) and Greece (11 million inhabitants) had been selected for comparison with the smaller countries since the Visegrad Treaty countries intend to economically approach the former two countries as soon as possible.

The table clearly demonstrates to what extent the Czech Republic, Hungary, Poland as well as Slovakia fall behind these countries in fund investing; hence, it may be implied that a massive development in collective investment in the V4 countries is to be observed exactly because of this considerable lag. Unless a substantial economic change on the financial markets and potential negative changes (both economic and political) are to be observed in the V4 countries, the future development of collective investment in these countries is supposed to be one of the dominant indicators which shall have impact on their financial markets.

3. Economic advancement of selected countries and volume of assets in the funds

Regarding the fact that development in the Visegrad Four had been substantially affected by their socialist history and hence they are still catching up with the West European countries, a part of this article is devoted to the relation of economic advancement of the country and their inhabitants and the overall volume of assets in the funds. Economic advancement is expressed by two indicators - gross domestic product per capita and average monthly salary, which is recalculated as per the purchasing power parity. The second indicator has been applied due to the fact that it better characterises possibilities of households to deposit free financial means to the funds.

As Table no.3 demonstrates, the indicators under review show a certain degree of correlation. If we first take the V4 countries into account, we can observe that the countries with the least assets in funds per capita Poland and Slovakia have the lowest GDP per capita as well as the lowest average monthly salary. The Czech Republic and Hungary show higher volume of assets in funds per capita and higher GDP as well as the average salary per capita than Poland and Slovakia, while it is apparent that Hungary's inhabitants tend to invest to collective investment funds slightly more than inhabitants of the Czech Republic in spite of the fact that GDP as well as the average salary per capita is a little lower in Hungary than in the Czech Republic.

Table 3 Total net assets per capita and economic advancement of the country expressed by average monthly salary per PPP and GDP per capita

Country	*Total Net Assets per capita (EUR million)*	*Average monthly salary per PPP (EUR)*	*GDP per capita (USD)*
Czech Republic	0,383	689	10 316
Hungary	0,463	650	9 900
Poland	0,251	579	6 337
Slovakia	0,319	522	7 624
France	16 995,161	1392	32 433
Italy	6 462,759	1347	29 047
Germany	2 779,096	1351	32 850
Belgium	9 776,900	1355	33 621
Denmark	10 086,400	1136	45 033
Portugal	2 412,200	926	16 125
Austria	11 610,875	1461	35 489
Greece	2 832,273	1037	18 366
Spain	5 594,256	1083	24 070

Source: EFAMA, World Bank, own calculations

Once we begin to compare the selected European countries, we find out that there exist three distinct groups of countries. France on its own forms the first group, whereas its volume of assets per capita markedly exceeds other countries, it has come on the second position in the average salary and regarding GDP it has fallen within the group of five countries whose GDP per capita exceeds USD 30 thousand. The second group includes Austria, Denmark, Belgium and Italy, where the high volume of assets in the funds per capita directly relates to the high GDP per capita in all the three countries (absolutely the highest figure from the countries under review achieved in Denmark) and high average salary in Austria, Belgium as well as Italy, while it is rather lower than the average salary in Denmark[3]. The third group of countries consists of Spain, Greece and Portugal, while the economically most advanced Spain has also the highest volume of assets in the funds per capita. Germany may be deemed an exception which regarding the GDP per capita and the average monthly salary has relatively limited amount of assets located in the funds. This is however caused by the fact that a lot of financial means in Germany is invested into other than mutual funds, too.

Taking a look into the future, the amount of investments into funds is supposed to grow in the Visegrad Group countries also hand in hand with the growing economic advancement.

4. Investments in the individual fund types

Table 4 UCITS assets by fund type in V4 and selected European countries (% of total, as of 31 March 2005)

Country/Fund Type	*Equity*	*Money Market*	*Bond*	*Balanced*
Czech Republic	4,68	57,34	19,76	17,00
Hungary	7,56	41,61	46,75	0,95
Poland	11,62	14,25	38,62	35,44
Slovakia	3,13	55,17	34,23	7,46
France	25,31	34,78	18,72	21,18
Italy	19,67	21,21	39,71	19,40
Germany	42,77	14,60	31,82	6,69
Belgium	56,20	2,31	9,20	22,60
Denmark	32,42	0	66,65	0,93
Portugal	7,55	36,54	42,33	7,73
Austria	14,99	11,02	52,79	6,64
Greece	16,26	46,19	32,06	5,49
Spain	33,80	22,14	28,77	15,29

Source: EFAMA, own calculations

It is evident that the structure of funds in all the countries under review is dissimilar and it seems to depend largely on the economic situation and historical development of the collective investment in the particular

[3] This fact is determined by the generally high price level in Denmark.

country. Investments in the individual funds reflect the investors' contemporary preferences which may further develop in time under changed conditions – we are however able to find interesting connections in this table. Concurrently, it is possible to compare this structure of funds with the structure of funds within the whole Europe (all EFAMA members) and the entire world[4] (see the Table no. 5 below).

Table 5 UCITS assets by fund type (world, Europe, % of total)

Fund Type	*Equity*	*Money Market*	*Bond*	*Balanced*
World	45 %	21 %	20 %	9 %
Europe	33 %	19 %	25 %	12 %

Source: EFAMA

Concerning the equity funds, the majority of financial means are in the Visegrad Treaty countries invested in Poland, followed by Hungary, Czech Republic and the last position is occupied by Slovakia. In total, all the V4 countries have rather limited amount of financial means located in the equity funds, especially making comparison of investments into these funds on the global scale as well as in Europe, where they are noticeably higher. Considering the countries under review, except for Portugal, investments into equity funds exceed 10% in all countries and over 30% in the four countries. The fact that investors in the V4 countries are so conservative is determined both by their limited experience with long-term investments (less experienced investors tend to prefer shorter-term and hence lower-risk investments) and concurrently by the situation on the world equity markets, which have not recovered yet from the three-year dramatic decline in years 2000-2002. Such a recession obviously affected the equity funds' proceeds and investors in the countries with short history in collective investment are yet to gradually regain the trust in them.

The relative "conservativeness" of investors in the V4 countries is clearly demonstrated with investments into funds on the money market, which take up majority in these three countries. Polish investors appear to be an exception, the share of funds on the money market in the total marked has shown a steady decline since year 2000, when these funds achieved 46% market share, presently only 14%share is observed. Out of the countries under review, the funds on the money market have a majority in Greece (46%) and relatively surprisingly in France (almost 35%).

[4] Source of information: EFAMA (www.efama.org) and Investment Company Institute (www.ici.org).

We may forecast that it is likely that if investments are to shift in the future between the individual funds, it is exactly the funds on the money market whose share in the market in the Czech Republic, Slovakia as well as in Hungary is to shrink.

In Poland, such transfers of investments may affect investors' preferences in their investments into balanced funds – Polish investors have in these funds the most financial means of all the investigated countries, the Poles are the only investors which have over 30% fund investments in these funds[5]. In total terms, the share of the balanced funds in the V4 countries is decreasing (e.g. such investments accounted for 63% of the whole market in the Czech Republic in year 2000, currently this figure amounts to 17%) and the individual funds shall profile as equity or bond funds. Limited interest is observed in balanced funds in Hungary, recently further fall in assets in these funds has been recorded, currently accounting for 1% of the market, while since year 2001 their share has been undulating between 1 and 2% of the market. These funds account for merely 1% also in Denmark. On the contrary, investment in balanced funds higher than the European average (12%) have, besides the mentioned Polish and Czech investors, also investors from the other four countries (Belgium, France, Italy and Spain).

The share of bond funds is considerably higher in Hungary, where it accounts for almost a half of the market, while the same investments accounted for even 74% in year 2001; a gradual fall of this share has been observed since that year. In Poland, the share of bond funds shows a dramatic fall as well, these funds showed the highest share in the market in year 2002 – amounting to 63%. The share of the bond funds amounts to approximately 35% in Slovakia and the bond funds have shown a permanent share of 20%[6] since year 2002 in the Czech Republic. As far as other countries under review are concerned, the bond funds are most popular in Denmark (66.65%) and Austria (52.79%), the same funds gain the least popularity in Belgium (9.2%, minimally 10% less than in other countries under review).

It goes without saying that investment in bond funds are more than in the case of other fund investments affected by the overall economic situation in the particular country, primarily by inflation, setting of interest rates and estimation of proceeds from bond funds in the future. Concurrently, the bond funds are considered as securing investments for investments in equity funds.

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[5] Polish investors tend to make use of balanced funds in the long-term horizon, primarily for pension savings.

[6] The Czech Republic also reports the lowest inflation rate and interest rates out of the four countries.

Taking this point of view, the European investors are more conservative in their investments than “the world” investors (see Table no.5).

5. Conclusion

The collective investment funds have begun to play a substantial role on the financial markets of the Visegrad Treaty countries, which is projected to gain even more significance in the future.

Unless a considerable change in the situation on the world financial markets is to be observed along with a negative event, which would affect the capital and money markets of the Czech Republic, Slovakia, Hungary and Poland, investors on these markets shall carry on investing into the collective investment funds. It may be presumed that the volume of investments into these funds shall continue to rise in the future since these investments are rather low compared to the selected European countries. Hence, there is a wide room for further growth, primarily in relation to their overall improvement of their economic advancement.

It is also likely that financial means shall be transferred between the individual fund types – investors shall pass from the funds on the money market to bond funds, especially to equity funds, as it is commonplace in the more advanced European countries and in the world.

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Electronic sources

[2] http://www.akatcr.cz
[3] http://www.efama.org
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[5] http://www.sec.cz

INSTITUTIONAL INVESTORS IN THE SLOVAK REPUBLIC[1]

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Abstract

The behavioural characteristics of institutional investors, therefore, will be an increasingly determinant of domestic and international financial market conditions, and the implications for financial market stability warrant serious consideration. The role of banks and institutional investors allowed us characterise phases of financial development: bank-oriented, market-oriented a securitized. Situation in Slovak Republic is closely to situation in rest of Europe (apart from Great Britain). Ageing of population required change of thinking both on-coming pensioners and governments. Saving for retirement increasingly taking place via insurance companies, mutual funds and newly opened pension funds in Slovak Republic.

Keywords: *institutional investor; financial intermediaries; mutual funds;*

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1. Introduction

Institutional investors are a permanent feature of the financial landscape, and their growth will continue at a similar, and perhaps faster pace. The behavioural characteristics of institutional investors, therefore, will be an increasingly determinant of domestic and international financial market conditions, and the implications for financial market stability warrant serious consideration. The role of banks and institutional investors allowed us characterize phases of financial development: bank-oriented, market-oriented a securitized.

2. Charakteristics of institutional investors

Institutional investors may be defined as specialized financial institutions that manage savings collectively on behalf of small investors toward a specific objective in terms of acceptable risk, return maximization, and maturity of claims. Videlicet entity with large amounts to invest, such as investment companies, mutual funds, brokerages, insurance companies, pension funds, investment banks and endowment funds. Institutional investors are covered by fewer protective regulations because it is assumed that they are more knowledgeable and better able to protect themselves. They account for a majority of overall volume. Institutional investors are part of non-bank financial intermediaries.

Non-bank financial intermediaries (NBFIs) comprise a mixed bag of institutions. They included all financial institutions that are not classified as commercial banks. But with the assimilation of building societies and other thrift deposit institutions with commercial banks as institutions that accept deposits and make loans, NBFIs mainly include venture capital companies, leasing and factoring and as well as various types of contractual savings and institutional investors. The common characteristic of these institutions is that they mobilize savings and facilitate the financing of different activities, but do not generally accept deposits from the public at large.

NBFIs play an important dual role in the financial system. They complement the role of commercial banks, filling gaps in their range of services, but they also compete with commercial banks and force them to be more efficient and responsive to the needs of their customers. Most NBFIs are also actively involved in the securities markets and in the mobilization and allocation of long-term financial resources. The state of development of NBFIs is usually a good indicator of the state of development of the financial system as a whole.

2.1 Contractual savings institutions

As already noted, contractual savings institutions are by far the most important NBFIs. They have the potential to accumulate vast amounts of long-term financial resources and to literally transform the structure and functioning of capital markets. Countries vary considerably in the relative importance of their contractual savings institutions. We can usefully distinguish three levels of development:

- countries where the assets of pension funds and insurance companies correspond to less than 10% of GDP;
- countries where they are over 10% but less than 50%; and
- countries where they exceed 50%, in some cases by a wide margin.

The first group covers most Latin American countries (with the exception of Brazil, Colombia and most notably Chile), all Francophone African countries, and all Eastern European and Asian countries (except the Asian countries listed below).

The second group covers Brazil and Colombia among Latin American countries, such Asian countries as India, Indonesia, Korea, the Philippines and Sri lanka, all MENA and Anglophone African countries, and all continental European countries (except Scandinavian countries as well as the Netherlands and Switzerland).

The third group covers mainly Anglo-American and Scandinavian countries (i.e. US, Canada, UK, Ireland, Australia, New Zealand, Denmark, Finland, Norway and Sweden) as well as Switzerland and the Netherlands among European countries, Hong Kong, Japan, Malaysia and Singapore among East Asian countries, South Africa and Chile. Contractual savings institutions experienced rapid growth in the 1980s in most countries of the third group. In four of these countries (the Netherlands, Switzerland, South Africa, and the United Kingdom), the total assets of pension funds and insurance companies exceeded 100% of GDP in the early 1990s, growing from less than 50% in 1970. Among East Asian countries, Singapore and Malaysia have long had sizable contractual savings sectors, with resources corresponding to between 50% and 70% of GDP, while in the 1980s, following the radical reform of its social security system, the total assets of contractual savings institutions in Chile expanded from less than 1% in 1980 to 30% in 1990 and 52% in 1993. The main factors explaining the high rate of growth in these countries were expansion of coverage and/or high investment returns, especially in the 1980s.

2.2 Contractual Savings Institutions and the Capital Markets

Contractual savings institutions can play a very important role in the development of a country's capital market. This depends on the allocation of their assets, which varies considerably from country to country, reflecting both historical traditions and differences in regulation. Real assets, and especially equities, are heavily represented in the portfolios of UK pension funds. This is generally attributed to the equity cult that UK fund managers have developed since the mid-1960s in response to the high rates of inflation experienced by the UK economy between 1960 and 1990. But this pattern is also explained by the absence of legally imposed minimum funding requirements and by the use of pension obligations that are quasi-indexed to inflation. Real assets represent a smaller proportion of pension fund assets in the United States and other Anglo-American countries and even smaller ones in continental European countries.

In continental Europe, pension funds (as well as life insurance companies) place the largest part of their assets in government, corporate and mortgage bonds and in long-term loans. This is partly the result of investment regulations and partly the result of a traditional emphasis on conservative investment policies. Although pension funds and insurance companies are subject to upper limits on their holdings of equities (as well as overseas securities) and although their managers are seeking either increases in these limits or their complete abolition, restricted investments are well below the specified limits. But a gradual shift of asset allocations of Dutch and Swiss pension funds in favour of equity investments is taking place and this has major implications for the size and liquidity of their respective national markets.

In most countries around the world, investments in foreign assets have been constrained by regulations, either foreign exchange controls or unnecessarily tight prudential controls. Following the removal of exchange controls and the relaxation of investment rules, pension funds in several countries have built up substantial holdings of foreign equities and bonds, reaching to well over 20% in Australia, New Zealand and the United Kingdom and around 60% in Hong Kong.

International diversification may increase portfolio returns, especially if pension funds become too big for the local markets, but a more general result is a reduction in investment risk, stemming from the less than perfect covariance of returns in different national markets. Contractual savings institutions in most countries tend to display a strong "home bias", which may be attributed to the nature of their liabilities, the absence of efficient hedging facilities, and their preference for investing in markets and securities they know better. Nevertheless, international diversification has been growing fast. Most countries, especially those with undiversified economies dominated by a few industries and a few family groups, should allow some foreign investments once a new pension system is well established.

2.3 Growth Factors of institutional investors

Growth of institutional investors can be described on two sides: supply and demand.

2.3.1 Supply sides factors

A, Institutional investors can offer the possibility of investing in large-denomination and indivisible assets.

B, Also professional management costs are shares among many investors and are marketly reduced.

C, The direct costs of acquiring the information and knowledge needed to invest is eliminated.

D, Ability to move money around among funds is in attraction so we call it customer services.

E, Institutional investors can also better control the companies than individual investors.

F, Specializing in certain types of asset can offer a wider range of options not only to households but also to other institutional investors.

G, They offer liquidity insurance to customers by allowing redemption of funds to cash without notice.

H, They also offer forms of insurance as a consequence of the pooling of risks.

I, Institutional investors can also decrease transaction and cost of diversification by large amount of trading.

2.3.2 Demand side factors

The key demand side factors underlying the growth of institutions are demographic developments and their link to saving patterns. The population is aging, owing to a decline in birth rate and rise in life expectancy, saving for retirement is increasingly taking place via institutional investors.

2.4 Impact on Capital Market Efficiency

The impact of contractual savings institutions on capital market efficiency depends on their size, their investment policies and their management practices. From a quantitative point of view, there is a certain correlation between the size of contractual savings and the development of equity markets, but the pattern is far from clear. The equity market is very large (in relation to GDP) in the United Kingdom and South Africa where pension funds invest heavily in equities, but it is also very large in Switzerland and Chile, where pension funds invest relatively little in equities. Also, in Malaysia and Singapore, the equity market is very large with high trading volumes even though direct investments by the respective provident funds in equities are either minuscule or nonexistent. Other investors, especially foreign institutional investors, probably account for the large capitalization of the equity markets, and the large volume of trading, in these two countries. Levine and Zervos emphasized the importance of the value of trading as an indicator of market efficiency, low transaction costs and market liquidity. They found that market liquidity is positively and robustly correlated with contemporaneous and future rates of economic growth, capital accumulation, and productivity growth. Recent years have witnessed very big increases in trading volumes in many stock markets around the world as well as growing equity markets, measured in terms of market capitalization in relation to GDP. In countries, such as Malaysia and Singapore, the growing internationalization of portfolio investing must clearly be a major factor in the veritable explosion of trading volumes on their equity markets. From 7% of GDP in 1985 (admittedly a recession year with depressed market prices and activity) trading volume exploded to 250% in Malaysia and 150% in Singapore in 1993 (though trading volumes suffered substantial falls in 1994). In contrast, in European countries, in addition to international investors, domestic institutional investors must also have contributed to the growth of trading volumes. This is especially in those countries where contractual savings institutions are in the process of redefining their investment policies in favour of equity holdings. Swiss trading volume was much higher than those of the US and UK markets in 1993, while the Dutch and Swedish markets reached in 1993 the level of the UK market in 1990.

Contractual savings institutions have the potential to act as catalysts for the modernization of securities markets, the development of efficient trading and settlement systems, the adoption of modern accounting and auditing standards, and the promotion of information disclosure. In the United States, the growing market power of pension funds and insurance companies has undermined the dominance of corporate bond markets by the traditional investment banks, that long after the passing of the Glass-Steagall Act in the 1930s continued to operate effectively as a cartel, with rigid hierarchical structures in syndicated issues. Institutional investors have been a major contributing factor to the advent of competitive bidding for corporate issues, the abolition of minimum commissions on equity trading and the restructuring of stock exchanges. The hedging needs of US corporate pension funds, operating under strict minimum funding requirements, have been instrumental in stimulating the development of immunization techniques and new products, such as zero-coupon bonds and collateralized mortgage obligations as well as index options and futures. More recently, institutional investors have become more actively involved in monitoring corporate performance and exerting direct and indirect pressure for better and more effective structures of corporate governance.

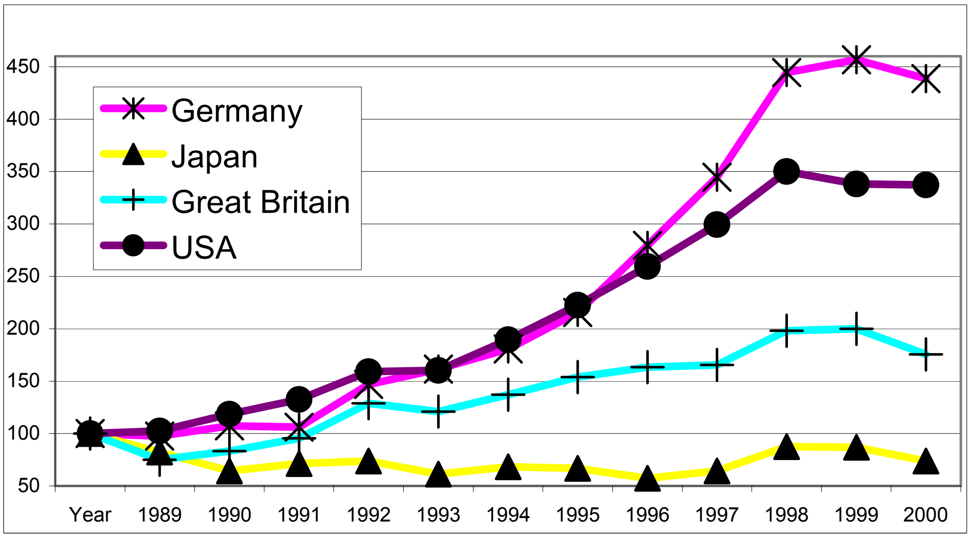
The role of pension funds and insurance companies in the capital markets has also come under criticism for allegedly causing greater market volatility, adopting a short-termist attitude on investments, and neglecting the financing needs of smaller firms. Because they trade more actively, institutional investors increase the liquidity of markets and lower volatility. However, their proneness to herding behaviour exposes markets to sudden changes of sentiment that may cause abrupt fluctuations in prices. The evidence on short-termism is also somewhat mixed and not particularly strong. Moreover, recent developments underscore the growing involvement of pension funds and insurance companies in corporate governance issues and suggest an increasing concern for the long-term performance of the corporate sector. Nevertheless, fund managers are themselves subject to short-term performance evaluations and are therefore forced to pay close attention to short-term prospects. With regard to financing smaller firms, contractual savings institutions need to rely on other specialist institutions such as banks as well as leasing, factoring and venture capital companies.

2.5 Mutual funds companies

Mutual funds investing in equities or bonds have been developed over time as means for offering to small individual investors the benefits of professional fund management and efficient risk diversification. Their number has proliferated in recent years, especially in the financial systems of high income countries. There are now mutual funds specializing by sector or by country or region as well as mutual funds following active investment management policies or passive ones using published indices of various types of securities. The proliferation of specialized mutual funds has allowed their use by pension funds and other institutional investors for their asset allocation, provided a reduced management fee can be negotiated.

Pension funds and other institutional investors clearly lack the specialist skills needed to invest in particular economic sectors or in particular regions or countries. Using well established and successful mutual funds is an economically viable and efficient alternative. Mutual funds, in the form of venture capital funds, are also established by successful venture capitalists. Such funds have also become an important outlet for the financial resources controlled by pension funds and other institutional investors. Institutional investors often lack the skills for dealing with small firms and new ventures, both in selecting promising projects and in monitoring their performance. Participating in venture capital funds, that may also be listed on the stock exchange and may thus be easy to dispose, is an effective alternative that is gaining popularity around the world. Such funds or investment trusts may also be used for financing infrastructure projects, real estate development, and other forms of private equity. The latter usually offers higher returns than publicly listed and traded equity and is also gaining in popularity among institutional investors in America, Europe and Asia.

Figure 1 Financial assets of investment corporations as a % of GDP



Source: Author's calculation

3. Situation in Slovak Republic

3.1 Banking sector

Banks is still dominated in Slovak Republic at the volume of deposits. Their assets reached volume 1 162 935 mld. Sk at the end of 2004. Development of bank's assets in past few years is shown in the next table.

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Table 1 Bank´s assets as a % of GDP

In mil. Sk	1997	1998	2000	2001	2002	2003	2004
Assets	796256	769764	846954	928808	1014014	985445	1162935
As % of GDP	119	113	123	130	135	126	141

Source: NBS

On the other side development of bank's assets were slowly than increase assets of the others Slovak institutional investors. Last five years banks assets contribution gradually descent on total financial sector assets as marketly shown in the next table.

Table 2 Bank's assets contribution on total financial sector assets as a %

	1997	1998	1999	2000	2001
Commercial banks	90,0	89,9	89,6	89,2	87,7
Insurance companies	4,9	5,4	5,9	5,7	6,3
Voucher privatization funds	0,7	0,5	0,6	0,0	0,0
Investment companies	0,3	0,3	0,4	0,6	0,8
Voluntary pension funds	0,0	0,1	0,2	0,3	0,5
Leasing companies	4,1	3,7	3,4	4,1	4,7

Source: IMF

We can see the most enlarge insurance companies reducing bank's fraction.

3.2 Mutual funds

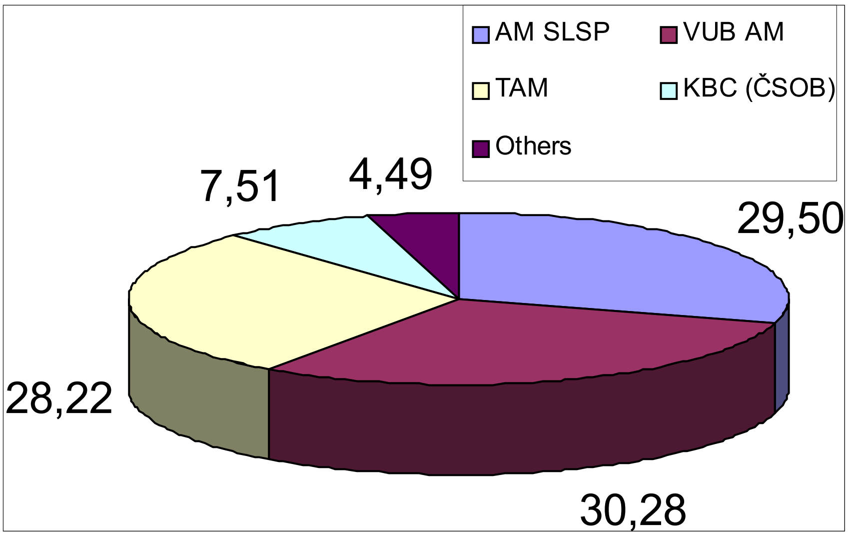
Mutual funds are significant institutional investors in Slovak Republic. Growth of net cash flow was nobody assuming. Mutual funds became important institutions transferring cash from primary investors to ultimate creditors in that manner. Slovak mutual funds get record in 2003 of net cash flows EFAMA[2] countries. Net cash flow reach amount 138 % on annual basis. Next year was very successful again with 39 % growth. At the end of 2004 was in mutual funds over 30 mld. Sk but begging of 2005 was very amazing. First February week net cash flows attack 2 mld. Sk limit.

Structure of cash invested to fund follow Europe investment sentiment. Investors mainly prefer not risky type of funds like money-market and bond.

[2] Formerly FEFSI

In spite of constantly enlarging supply of new funds administering mainly foreign asset companies this market is relatively little competitive. Market is dominated by four companies established by substantial banks operating in Slovakia. Their market shares are exhibit in the chart.

Figure 2 Market shares of mutual funds companies in Slovak republic at the end of 2004



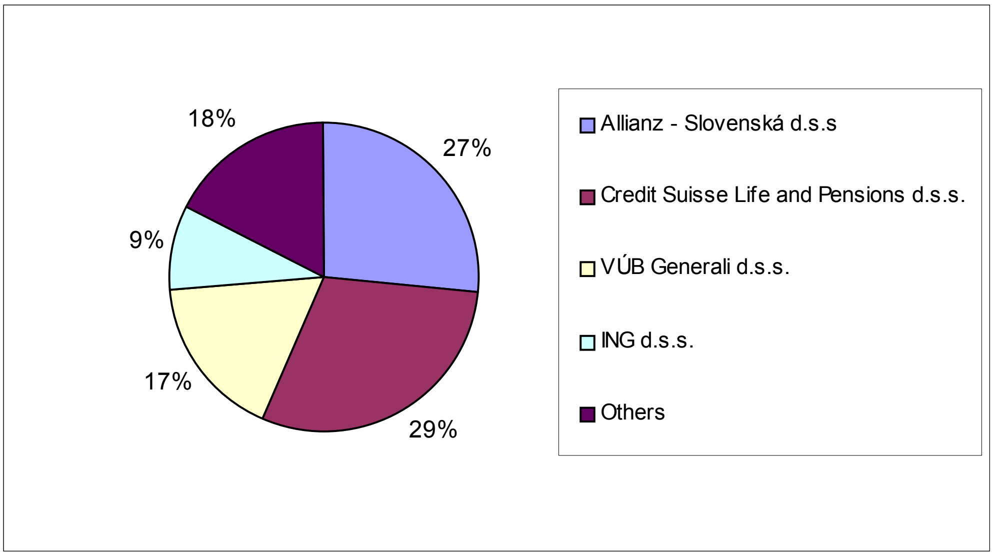
Source: ASS

The three biggest Slovak banks: Všeobecná úverová banka, Slovenská Sporiteľňa a Tatra Banka control near 90 % of all deposits to mutual fund industry. At this point of view we can say that individual investors move the cash from bank time deposits to their mutual fund companies.

3.3 Pension funds

At the begging of the year 2005 enters into force pension reform enabling to save for working people on retirement in pension funds. Much more people rebound favour about this pension reform than initially expected and now is registered over 1 million people in pension funds. Financial market authority approval eight companies due this reform in which was near 5 mld. Sk at the end of September 2005.

Figure 3 Market shares of mutual fund companies in Slovak republic at the end of September 2005



Source: ADSS

As like mutual fund biggest banks or insurance companies operating in Slovakia dominated to the market, exemption Credit Suisse relatively new company, focusing particularly for retired payment. Four companies managed till 80 % of invested capital.

4. Conclusion

Situation in Slovak Republic is closely to situation in rest of Europe (apart from Great Britain). Ageing of population required change of thinking both on-coming pensioners and governments. Saving for retirement increasingly taking place via insurance companies, mutual funds and newly opened pension funds in Slovak Republic. New act prefer to this by lowering tax. But we can analyze it after few years, but growth of mutual funds can confirm this.

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INVESTMENT INTO THE UNIT TRUSTS IN THE EUROPEAN UNION AND IN THE SLOVAK REPUBLIC

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Abstract

For beginning of a new stage in the development of collective investment in Slovakia it´s possible to regard the acceptation of legislature valid from 2000, which has in an imported measure converged to the state usual in the high developed countries. The law made it possible to transform and form new home subjects – trustee companies which manage unit trusts but also entree of foreign subjects of collective investment into the slovak market. The slovak investors have got the possibility to deposit their savings into the standard funds, which activities are high transparent and active regulated. At the beginning of the year 2000, the volume of the assets in the funds of Slovakia doesn´t reached a fraction of the assets in banks. The growing of the consciousness in the community about the collective investment and the overall view of subjects activ on the market and decline of the interest for the bank deposits have speeded up the interest for the collective investment through funds.

Keywords: *collective investment, trustee companies, unit trusts, finance investments, yield*

1. Introduction

The most usual way to valorize the finances in Slovakia is still their bearing interest on the current bank deposits. Bank products as current accounts, forward deposits and checkbooks offer a high level of security of the deposited funds, but the yield for such deposits is very low. Nevertheless is this method the most current and that for two reasons: It´s alltogether the first possibility, which was for the slovak investors at disposal and also the misstrust to other meaner of investing. The reason was the crash of many non bank subjects. Nevertheless straight dealing with securities offers a high yield, however it bears also the risk of loosing. Somewhere between the two a.m. ways of valorizing the finances is the collective investment. Also the open unit trusts offer a very interesting combination of three ground parameters which have to be judged by each investment how the yield, risk and liquidity. The advantage of the unit trusts is, that despite the inspect paradox, that according to the law the trusts can´t guarantee a fixed yield. And therefore the client can get higher yields as by current bank productes. The motive of collective investment can be, that the client have to play in the bank that he doesn´t loose and the investor in unit trusts play with the goal to win.

The activators of the collective investment in Slovakia have been from the year 2000 mainly consulting firms. Banks also startet their activity and moved the savings of the clients in the trusts. Today we can say, that the move of the savings from the current bank products into the vehicles of collective investment is in Slovakia a trend matter.

The main reason is, that the current bank products reached a negative net yield so the real value of the bank savings is going down. For many years was the reality, that the majority of population has deposited the savings in banks, today each 10th saved crown is invested in unit trusts. That´s the proof, that collective investing in unit trusts combine a non risk deposit of money with reaching an overaverage profit.

2. Collective investment in Europe

Collective investment is developing in Europe already over 40 years, but the biggest boom has stated in last six years. The value of the assets rose almost triple. This big increase was connected with an inflating bubble of the prices on the security markets. After the valuations of the security funds multiple exceeded the average valuations nobody want to stay outside. Interesting is the fact, that the crash of this investment bubble has not damaged the assets of the trusts. According to the statements from the European association of national units for trustee companies (FEFSI) the whole value of assets reached in 20 european countries (EU + Switzerland and Norway) the sum of 4.761 Bi. EUR. The most important segment on the market of collective investment are the open-end unit trusts (UCITS) which bear assets about 3.511 Bi. EUR. In the countries united in FEFSI exist approximately 28.000 unit trusts UCITS, what in literal translation means „enterprises of collective investment into transferable securities“.

European legislature knows also real estate trusts, commodity trusts, hedging trusts which up to now in Slovakia not exist.Even if the unit trusts are developing in each country, on the european market of collective investment are dominant four countries. The most assets of the world fortune in unit trusts are invested in France (8,05 %), Luxembourg (7,61 %), Great Britain (2,67 %) and Germany (1,93 %).

The importance of collective investment grew in the last years significantly. For example if the value of the investment assets in unit trusts in 1995 reached 23 % of the european GDP (15 EU member countries + Poland, Czech Republic, Hungary, Norway and Switzerland), in 2002 the part reached already 52 %. In the USA the part is even 70 %. That reflects the increase of the value of assets shared for one inhabitant from 4.000,- EUR to the present 11.000,- EUR.

The period after 1995 is covering with the stage of investment bubble, when the prices of shares strong increased. The part of shares in portfolio of european UCITS increased from 25 % to 45 % whereas the part of obligations droped from 36 % to 24 %. In the years 2001 till 2003 the situation has changed and investors began to buy more less-risk instruments of the capital market. The part of shares in UCITS so droped to 31 %. That was the proof, that the investors are overall in the world the same. As the share bubble was influted and the share titles were expensive, european investors bought them. Inverse, after bursting of the bubble, when it´s possible to buy shares of good quality cheaper, the part of investments in shares droped.

Interesting is the difference of the investor-preferences. Whereas the north countries of the EU (Sweden, Belgium, Denmark, Finland) have had a part of shares more as 50 % (Great Britain even 70 %), investors in south and middle Europe have been more carefully with shares. In south Europe was the part of the shares in portfolio 30 – 40 %, in Poland and Austria even only 10 – 15 %.

The average european trust has today assets under administration about 140 Mio. EUR whereas five years ago it was only 90 Mio. EUR. Despite the strong increase the european trusts remain relatively small in comparison with the US trusts. The average size of a US trust has a level about 875 Mio. EUR. An average trust in USA has a volume of assets like all unit trusts together in Slovakia. Even happened cases when a open unit trust closed for new investments, only to protect the existent investors.

One of leading european countries is Luxembourg, where we can observe a concentration of collective investment despite a small number of population. We can say, that the fund industry, built in this country, was exclusive construed for finance institutions, which distribute funds in the whole world. The first trust was founded in 1959 and today the number of trusts excceds 1.500. The reasons, why Luxembourg had become the finance center in the area of trust industrie are as follows:
- *taxation:* the luxemburgian trusts are not subject of profit-taxes, taxes from capital yields, there is no taxation of dividend payments and by chance deducted tax. Luxembourg has signed an agreement about avoiding of double taxation with some countries inclusive Slovak republic,
- *favourable legislature area*: The luxembourg law is an ideal area for trusts since 1983. Luxembourg was alltogether the first country, which has implemented the regulations of the EU in 1988. Practical it means, that trusts, which are subject of luxemburgian law have a „passport“ and can be distributed in the entire EU,
- *perfect finance infrastructure*: high qualified staff of luxemburgian firms is the guarantee that international investors are interested to register and to provide administration of trusts in Luxembourg.

3. Collective investment in Slovakia

In 2000 passed the legislation the law No.385/1999 about collective investment, which replaced the law No. 248/1992 about investment trusts and companies, which already not corresponded to the changed conditions on the slovak capital market. The law solved complex the problems of collective investment with stress to appropriate regulation and supervision about the subjects of collective investment. At the same time the law solved the problems of investment trusts founded for the first wave of coupon privatisation. According to this law the investment companies, investment trusts and depositories have to be adated to the new legislature till 30.06.2000 and to order a new licence. Already in the first quarter there were first signs that the interest in the population to invest is reviving particularly through the opened unit trusts. The home-trustee companies have reinforced and have got a new profile and there was interest from international trustee companies.

The market for open participate letters in Slovakia exceeded the double in 2000. To it paticipated also relatively a significant decrease of interest rates in banks.

At the beginning of the year 2001 through the collective investment there was collected almost 7 Bi. SKK and in 2002 the trustee companies had under administration together 14,7 Bi. SKK. It´s all the strangely that in the given period, ruled on the markets an unfavourable development for the yields of trusts. Regarding the yields in the given period under unfavourable conditions the best results have reached conservative investments: loan trusts and monetary trusts. This situation emerged as consequence of decreasing the interest rates through the central banks meaned that the prices of loans soared.

Disastrous development reached the stock unit trusts, because it follows a correction of overvalued stock prices in the technological area and except of that hapened a whole recession of global economy. That caused a 30 % decrease of the fortune-value belonging to the trusts activ in the technological sector. Moreover trusts with investments on the US market have registered a dropp of their value as a consequence of decreasing the stock prices in the USA as consequence of the terrorist attacks, the consequence was the move of funds from stock markets to the loan trusts with a lower risk and a stable yield.

Regulation of collective investment has been amended from the 01.01.2002 through the law No.566/2001 concerning the securities and investment services. The law liberalized the admittance of international trustee companies to the slovak market with the objective to distribute their trusts through security dealers with the permission to grant investment services.

The entire sum allocated in unit trusts amounted to 14,7 Bi. SKK on the market were activ 39 home and 93 international open trusts and 53 closed unit trusts. In 2002 growed the market in dollar expression over 179 %, on the other side the amount invested in unit trusts have been only 5 % of the deposits of the population in banks. The best sell performance reached the currency market trusts because their performance was doubble higher as by deposits on the current accounts, into the stock trusts has been invested only 1,5 Bi. SKK.

Already in the first six months of 2003 the volume of the administrated fortune was over 50 % higher than in 2002. In the given period has Slovakia in the growth dynamic overtaken all middle european countries because in 2003 the volume of funds administrated through the trustee companies grew about 140 %. By the end of the year the unit trusts registered nearly 37,3 Bi. SKK. To an important measure that was caused also through the decrease of interest rates through the NBS in 2002 with which the term deposits in banks lost the interest by investors. In the category of money and loan funds the best performance reached the funds, orientated to the slovak crown. The performance of the crown funds was at the level 3-4 % which was caused through a slow down dropp of the crown interest rates. The stock funds have reached a performance about 10 and more percent and the mixed funds 5 -10 %.

The volume of funds invested in unit trusts has increased in 2004 about 30 Bi. SKK. Similar as in 2003 the slovak market of unit trusts reached one of the highest rises in the european countries. Under 17 countries in the european federation which units the national associations of trustees, the Slovakia register the highest percentage increases of funds, invested in unit trusts. The reason is the delayed entrance of that kind of investment in comparison with other members, which have already passed the first boom. Despite this dynamic development Slovakia is still the member country with the with the lowest volume of assets in unit trusts, by conversion to one citizen the Slovakia is on the 15th range. The entire volume of funds invested in unit trusts mounted to the end of the year 2004 already round 70 Bi. SKK.

In comparison with other FEFSI countries in Slovakia are dominant money market funds. In this funds investors placed in 2004 74,6 % of funds, which have benn directed to unit trusts. For comparison in the association reached this part 12 %.

According to statistics of Slovak assciation about trustee companies nearly 75 % of all invested funds have been invested in money funds. Because of multiple decrease of interest rates through the NBS reached these funds an overaveraged value on the level 4-5 %.

Till 17 % of all new investments have been directed to the loan money funds. The drop of key interest rates supported the profits of loan money funds, which reached a valuation in average of 6,4 %. The key factor of this valuation was the decrease of the interest rates through the central bank, because by decrease of interest rates the value of purchased loans is growing and that caused the growth of the unit value.

A good valuation on the level about gross 10 % reached the loan trusts which invested their funds in government loans in middle Europe. Investments in stock trusts reached a part only about 2,6 % which is only 50 % against 2003.

The present valid law No.594/2003 about collective investment has increased the protection of the investors with the obligation of the trustee companies to fulfill the criterions of the capital appropriation in dependence to the fortune under administration of the unit trusts.By the sale of unit trusts is an important factor the width and quality of the distribution net. That confirms the development of sales for two last years bacause the sale of unit shares through the branches of strong banks is the biggest competition adventage.

Table 1 Net sales OPF in Slovakia (in SKK, 01.05.2004 – 12.31.2004)

	2004	2003
Asset Management SLSP	9 771 179 249	6 423 478 550
VÚB Asset Management	8 422 032 603	6 593 548 318
Tatra Asset Mangement	7 308 617 755	6 145 815 313
KBC (ČSOB)	2 410 845 588	1 634 509 040
Pioneer Investments	946 251 889	380 505 673
Istro Asset Mangement	552 243 405	753 713 542
AMSLICO AIG Funds	489 216 088	261 314 787
WIOF (SFM Group)	271 316 159	177 598 978
Dexia	192 302 919	–
ING Bank	134 401 821	–
Capital Invest, Invesco (HVB Slovakia)	126 470 915	463 533 942
ABN AMRO	3 816 402	–
Volksbanken (Ľudová banka)	3 524 256	78 612 207
Investičná a Dôchodková správ. spol.	-17 609 951	54 900 794
PRVÁ PENZIJNÁ	- 351 332 945	- 359 392 392
J&T Asset Management	–	- 833 435 003
	30 263 278 158	21 774 703 748

Source: www.ass.sk

The prove is also the reality, that between the three biggest net sellers are the trustee companies of the three biggest banks: Slovak saving bank (AM SLSP), Tatrabank (TAM) and VUB - General saving bank (VUB AM). This three leading companies share one below the other 80 % of the market. The mentioned banks are using a wide net of branches and cross-selling when the bank employees recommending the depositors, who are not satisfied with the traditional deposit products, the diversion of the money into the trusts.

The more demanding the administration of the trust is, the more employees and analyses are required. Because of frequent changes in portfolio the trust manager has to pay higher transaction costs and with it the fee in the trust is higher. The lowest fee have the money funds and the highest fee have the stock funds.

The managers of the trusts ordinary share entrance fees with the distributors, come out fee is a motivations factor, that the share holder doesn´t leave the fund. Some trustee companies indicate this fee, but often they remit it, if the share holder persist in the fund a sufficient long time.

The growth dynamics of sales of participation letters has had a big speed also at the beginning of the year 2005. The net sales of open unit trusts in Slovakia have in February reached a value about 1,8 Bi. SKK.That was the second best result in the history. The entire net sales in the present year already exceeded the limit of 10 Bi. SKK. In comparison with the same period in 2004 the sales have increased quadruple and exceeded already one third of net sales of the whole last year.

Probably in the current year it will not be possible that the crown loan funds can repeat the success from the last year, the expected yielding is at the level 3,5-4 %. Money crown funds may reach a valuation between 2,5 and 3 %.

Measures of the NBS against a strong increase of the crown caused a decrease of interest for government securities and the consequence is a reduction of the yields for crown loan funds.

According to the some analytics, in the current year we can expect a more favourable development by the international stocks and by international loans, mainly by multinational european and japanese firms which have to be able to overcome the expected low growth of the oconomics in this areas. On the other side is to take into the consideration the move of the slovak crown rate aginst international currencies.

In this year it´s assumed a partial increase of the part of investments to the mixed and stock funds how far will continue the growth on the global stock markets.Higher valuation is expected in case of european firms because they state a higher measure of undervaluation.

Slovakia belongs also in the fund branch to developing countries with a big potential. The collective investment started in the last period a trend of a steep developing segment of capital market. This trend will continue and that´s obvious from the increase of the volume of administrated fortune in trusts of collective investment. The volume of administrated fortune by the end of the first six months of the year 2003 was 1,55 times bigger then to the end of the year 2002 and 2,1 times bigger in comparison with the same period in 2002. In 2002 the assets in unit trusts in Slovakia increased round 179 % which was in the given year the biggest increase in the world. Even if we are according the volume only a grain in the sea of sand, in the dynamik-coefficient of growth we clear also henceforth overtake other middle european countries. In 2003 no one of these countries had an increase of fortune about 98 % under administration of the trustee companies. The sector of collective investment again confirmed, that it is already some years the most dynamic part of the home finance market. In 2004 the averaged entire deposits to the open unit trusts were weekly in average 500 Mio. SKK.

Table 2 Structure of net sales OPF in SR (in Mio. SKK, 02.18.2005)

	2004	**2005**
Money Funds	22 588,5	6 601,1
Funds of Bond	5 136,5	3 629,0
Funds of Share	780,6	189,0
Mixed Funds	1 652,7	193,3
Funds of Funds	104,1	0,3
	30 262,4	**10 612,7**

Source: www.ass.sk

Net sales of funds in Slovakia had in the first quarter 2005 the following structure: 38,2 % loan funds, 3,1 % stock funds, 2,4 % mixed funds and 56,3 % money market funds. The average investment shows the differencies of the slovak investors to the relevant averages in Europe, America or the world. Slovaks are extremly careful and conservative, when they over 50 % of their investments entrusted to money market funds. The stock funds in Slovakia extremly lag behind. If we look at the dates from the end of 2003 in Europe, America or in the whole world, the importance of money maket funds sank eventual stagnated. Against that in Slovakia growed the importance already about 7 %.

On all sophisticated markets of finance investments are valid the same basic rules. The first is about risk and yield. Simplified it can be interpreted: The bigger the yield, the bigger the risk.The money market funds are the most conservative manner of investing, follow the loan funds and to the most risky investments are belonging the stock funds. The second basic rule is the longer investment horizon is at disposal, the higher risk the investor can allow to undergo. This rule can´t be generalised because exist investors who don´t wont, can´t or don´t accept whichever fall of value of their fortune also when only temporary. The last rule is, that the historic yields are not a guarantee and not a determination factor for yields in the future.

4. Conclusion

The slovak capital market has a specific character and also the slovak investor has an other position in connection to this rules. He is influenced through a lot of specific factors from which probably sourced his extremly conservativity and difference opposite the more sophisticated markets. The market with slovak stocks is weak and investor in Slovakia who will take more risky investments is forced to take international investments in stocks and automatically undertakes also the currency risk. Except the moves of share prices which can influence his yield, the move of the exchange rate of the slovak crown aginst EURO, USD or against other currencies can also influence his yield. The strengthening of the crown drops the profits, which can the investors gain from the stock funds. Maybe therefore the slovak investors avoid the stock markets.

The next of the factors which can influence the investors in Slovakia are historically interesting yields of crown money market funds and loan funds caused through high starting point intrest rates and their gradual decreasing. Thanks to that the conservative funds also reached above the average yields. By high yields in the past the investors didn´t like to undertake an additional risk in connection for instance with stock funds. In Slovakia high yields definitely not exist and in this direction the market get a standard quality. The interest rates are low and if we deduct the administration fees, the yields by loan or stock funds are more attractive as yields, which we can suspect from the money market funds.The mentioned fact may lead to more popularity of more risky funds and to a progressing approximation the structure of slovak investments to sophisticated markets.

The structure of the slovak investments was influenced through demanding of separate kinds of investments. The easest, at least complicated and most secure is the investment in the money market fund. But that doesn´t mean, that this is for the investor most suitable and most advantageous. But that´s a certain tax for the inexperience.

The structure of the trust market in Slovakia has changed in the last two months radical. Market in the year meantime comparison grows, but the investors move their money from the low yielded money market funds into other types of assets. In the last year into the money funds have been directed 75 % of investments, from August of the present year there appear withdrawals from this funds.

At present the biggest increase of investments is recorded by loan funds, but a surprising big share represent investments in stock- and roof funds. In September of the present year 1/4 of entire investments have been directed into stock funds and into the roof funds even 1/3 of entire investments. Last year investors placed into the roof funds ca. 100 Mio. SKK during the last three months of this year almost 2,4 Bi. SKK.

The most importend reason of this trend is a weaker performance of crown money funds, but it´s also the fact, that the clients are better informed and have got some experiences from the money funds.

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EXCHANGE TRADED FUNDS IN CAPITAL MARKETS

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Abstract

Paging through professional financial publications or regular press nowadays we see analysts split over their opinions and recommendations regarding investments in different types of funds marked by varying degrees of risk and return. However, both analyses and experience from collective investments overseas, especially in the U.S., give evidence that, in the long run, index funds replicating the market portfolio yield approximately the same return as the best-performing and most profitable risk equity funds or hedge funds, which often focus on a specific market segment. Latest trends in the fund industry around the world show an increasing number of investors turning their attention to index funds, which limit the risk to investors by diversification.

Keywords: *Index funds, market portfolio, exchange traded funds, innovation ETF*

1. Introduction

Index funds are based on Markowitz's market portfolio theory, which says that a market portfolio represents a risk weighted average return of the entire market assuming the existence of a risk-free asset. This important conclusion has led to the construction of index funds in the early 1970s, initially open to institutional investors only. The first index portfolio was set up in 1971 by the bank Wells Fargo, followed in 1976 by the introduction of the first public index fund by the investment company Vanguard and its renowned manager J. C. Boglem. This facilitated access to capital market investments to the lay public as well.

Index funds are a special type of equity mutual funds whose portfolio contains all shares included in a relevant market index, both in terms of structure and value. In other words, an index fund is a perfect copy of its benchmark index. This sort of funds combine the best virtues of open-end mutual funds (UCITS) and investment funds (Open End Investment Companies – OEICs, or investment trusts). Dividends earned on individual constituent equities are reinvested into portfolio equities, while respecting their share based on weights in the index. This ensures that the fund and the benchmark index perform along the same lines.

An index fund may sometimes fall short of the returns posted by the index it mirrors. It is due to a so-called tracking error, which gauges the deviation from the index performance. Where does the deviation come from? It is mostly from various broker fees and the funds' operating expenses or other technical factors.

1.1 What are the advantages of index funds?

- The biggest asset of index funds is their passive management and, consequently, low operating costs. The only operations carried out by fund managers are those required to preserve the appropriate portfolio structure. This means they only purchase securities which are added to the index, or sell those which drop out.
- Index funds have small staff, and since there is no need to analyse securities, there are no analyst bills.
- Empirical and statistical data shows that index funds actually outperform a number of actively managed funds.
- Since their costs are low, customers pay minimum or no fees (e.g. the Vanguard 500 index funds charges a mere 0.18%).

Index funds are distinguished by the type of index they track. Many target or copy a broad market – market-wide indices (Wilshire 5000 Index, S & P 500, and the like). Some funds mirror the dynamics of a particular sector, industry (DJ U.S. Financial Sector Index), or international indices (MSCI Europe Index).

2. Exchange traded funds

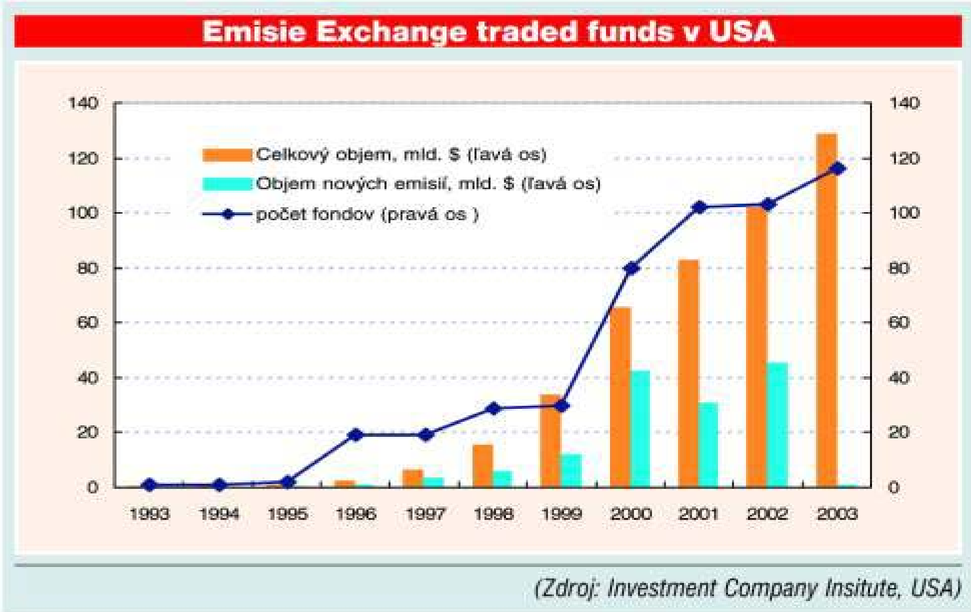
This form of investments, known to investors as exchange traded funds (ETF), experienced a boom in the 1990s. Their securities became tradable in secondary markets as well. The first exchange traded funds appeared and received their name in 1993 on the AMEX market (American Stock Exchange). It was mainly in the 1990s that they attracted growing interest from investors, yet the trend has continued after 2000. Investments in ETFs totalled USD 87 billion in 2002, but exceeded the USD 187 billion mark by 2004.

Exchange traded funds are open-ended. They have general meetings, a board of directors, executive officers (unlike classic mutual funds) and an obligation to audit their assets every year. Apart from that, there is another essential difference between classic open-end mutual funds and ETFs. Since open-end mutual funds have their asset management costs to cover, their buy and sell rates are different. The spread (premium) pays for management and trading fees. An ETF issues no unit certificates, but rather regular shares which an investor is free to buy or sell at any time.

ETFs are valued much in the way shares are rated at a stock exchange on a trading day. Their price is derived from the value of the benchmark index, or its components. Gaps, if any, between the index value and the fund price resulting from the interaction of supply and demand are offset by arbitration. The value of individual ETFs does not precisely reflect that of the benchmark index. It is determined as a percentage of the benchmark index value. For a fund replicating, for instance, the NASDAQ 100, whose value is set to ¼ of index, if the index scores 1,200 points, the ETF will be worth USD 30 per share.

An investor may thus take long or short positions, or buy on margin from a broker. Daytrading allows institutional investors in particular to conduct arbitration operations. The very composition of ETF makes it possible. Investors take advantage of the difference between the price of ETF securities and their net asset value (NAV). Stock brokers handling arbitration transactions seek out and buy cheaper ETF shares and trade them for more expensive securities included in ETF portfolios. As the demand for ETF securities rises, their price begins to grow and near the NAV. As soon as the price of ETF securities exceeds the NAV, the arbitrators carry out a counter operation. However, these operations are only affordable to institutional investors, as they require a large number of securities. That is the reason why the greatest interest in exchange traded funds also comes from hedge funds, which among other things deal in arbitration and other speculative trade. The development of ETFs is illustrated in the chart below.

Figure 1 Issues of exchange trade funds in the U.S.



Total volume in USD billion (left axis)
New issues in USD billion (left axis)
Number of funds (right axis)
Source: Investment Company Institute, U.S.

ETFs offer investors a wide variety of investment opportunities. As with index funds, investors can invest in the whole market, a single sector, in bonds, international equities, etc.

Among the first ETFs emerging in 1992 were SPDRs (Standard & Poor's Depositary Receipts) which tracked the S&P 500 index. Traded on AMEX since 1993, they still rank among the most popular exchange traded funds today. SPDR issue deposit certificates the value of which mirrors that of equities pooled in the S&P 500 index. Investors are paid a regular quarterly dividend. Unlike early index funds, SPDRs have a lifespan till 31 December 2099. SPDRs currently copy sector indices as well, allowing investors to diversify their portfolios in certain economic sectors. They also played a special role in the technological sector investment spree in the late 1990s.

Also enjoying great popularity among investors are EFTs based on the Dow Jones Industrial Average and NASDAQ 100 family. Known as DIAMONDS and QQQs, they entered AMEX in the late 1990s. AMEX is considered the "cradle" of exchange traded funds today. In mid-2004 it listed 139 ETFs (out of 159 registered in the U.S. at that time).

The table below gives an overview of the biggest exchange traded funds and their basic characteristics.

Table 1 Exchange traded funds

Title	**S&P Depositary Receipts Trust Series 1**	**DIAMONDS Trust Series 1**	**NASDAQ 100 Index Tracking Stock**
Acronym	SPY	DIA	QQQ
Slang name	Spiders	Diamonds	Cubes
Index	S&P 500	DJIA	NASDAQ 100
Price/index ratio	1/10	1/100	1/40
Trading launch	29/1/1993	20/1/1998	10/3/1999
Assets (as at 26/7/2004)	USD 41.07 billion	USD 7.55 billion	USD 23.08 billion
Daily trading volume*	USD 43 million	USD 6.7 million	USD 106 million

* 3-month average as at 26/7/2004.

The market is still dominated by Spiders and Cubes, which make up 80% of total trading volume in exchange traded funds.

In 2002 practically all indices were already occupied by ETFs. Many analysts were sceptical about the future of these funds, in particular those linked to equity indices.[1] In response to that, new ETFs emerged, this time referring to indices of fixed-income securities. Branded as bond exchange traded funds, they were rolled out in the U.S. market on 26 July 2002 by Barclay's Global Investor. Their indices follow price trends in corporate and government bonds. They are traded similarly as ETFs tied to equity indices. Trademarked iShares[2], the Barclay's Global Investor ETF brought larger trading opportunities for those seeking short-term profits. The new iShares allowed investors to focus on the yield curve, taking both long and short

[1] Jim Shirley (a well-known Lipper analyst) says that "the emergence of too many new exchange traded funds investing in equities may have a negative impact."

[2] The company uses the same trademark for its equity ETFs.

positions in bonds with different returns and maturities responding to interest rate movements.

Bonds index funds are a risk-hedging tool appealing to conservative investors above all. There are only 10 bond index funds in the U.S. at present. To some extent, this appears to be related to the tightening of the Fed's monetary policy. The most popular bond fund among investors is Lehman 20+ Year Treasury (TLT).

Since 2000 ETFs have gone through some innovation in equity indexed funds. The index fund pioneer Vanguard introduced what it called VIPER ETFs – Vanguard Index Participation Equity Receipts. VIPERs can be traded like any other stock. But rather than a stand-alone ETF, they are a distinct class of shares in Vanguard index funds. The company did not stop there and went on to launch Extended Market VIPERs, later followed by Total Stock Market VIPERs. In January 2004, it unveiled a VIPER fund based on sector indices and indices clustering large-capitalisation firms. In doing so, the company broke away from traditional indices such as S&P, Russell and Barra, and switched to Morgan Stanley Capital International (MSCI) indices. ETFs based on MSCI indices emerging since 1996 cover a larger number of world regions and sectors.

Barclay's followed suit with its new iShares MSCI EAFE Index ETF which replicates an international equity index. Another application is the iShares MSCI Japan Index ETF.

Holding company depositary receipts (HOLDS) are a specific ETF category. Introduced in 1998 by Merrill Lynch, they are known for the Semiconductor HOLDRs Trust securities. Each portfolio is a package of 20 equities, their number decreasing whenever a merger or acquisition happens. The structure of depositary receipts implies that the holder owns all shares included in the package. Bank of New York acts as the holder's agent and can be approached by investors to trade HOLDRs for shares featured in the portfolio (in lots of hundreds). Investors may also choose to sell unprofitable shares and keep the most profitable ones.

ETF took some time before arriving in Europe in April 2000, when they started trading on the London and Frankfurt stock exchanges. In London, ETFs are set up mostly by Barclay's and investment banks Merrill Lynch and Bloomberg. The London Stock Exchange created a special trading platform for ETFs called extraMARK.

The major indices currently tracked by exchange traded funds are listed in the following table:

Table 2 Market indices and ETF

Market-wide indices	Dow Jones U.S. Total Market, Russell 3000
Large-capitalisation (Large-Cap) indices	Dow Jones Industrial Average, Russell 1000, S&P 500
Medium-capitalisation (Mid-Cap) indices	Russell Mid-Cap, S&P Mid-Cap 400
Low-capitalisation (Small-Cap) indices	Russell 2000, S&P Small-Cap 600
Sector indices (technological, internet, Multi-Cap)	Nasdaq 100, Nasdaq Composite
Fixed-income instrument indices	Lohman Aggregate Bond, Goldman Sachs $ Inves Top Corporate Bond
International indices	MSCI EAFE, S&P Europe 350
Emerging market indices	MSCI Emerging Markets
Specialised indices	Intellidex Indexes, S&P 500 Equal Weighted Index

Large-Cap ETFs track indices pooling companies with high market capitalisation (over USD 4 billion) such as General Electric, Microsoft, IBM, Johnson and Johnson, 3M Co, Boeing Co, Procter and Gamble and the like. These ETFs are marked by relatively lower volatility compared to others and have also paid higher returns in recent years.

Mid-CAP ETFs cover the market segment comprising firms with market capitalisation of USD 1-4 billion. They are typical for seeking value growth. They already fall into the higher-risk category, and their portfolios feature corporations such as Washington Post, Coach Inc, XTO Energy Inc, Tyson Foods, or JeBlue Airways Corp.

Small-CAP ETFs monitor the performance of firms with market value of up to USD 1 billion. Since they primarily seek rising equity value, they entail higher volatility. Notwithstanding that, in the past few years we have seen these funds perform better than those mentioned above. They list companies such as IDEX Corp, First Midwest Bancorp Inc, Valeant Pharmaceuticals, Human Genome Sciences Inc, etc.

3. Innovation in the ETF market

In the past five years, the number of exchange traded funds shot up and, apart from bond ETFs and many other innovations, ETFs have been looking for ways to other segments as well. Specialised ETFs are set up, with assets linked to commodity prices.

In 2003 the first gold-backed securities had their market debut, introduced by the Gold Bullion Securities fund under the label GOLD. The Gold Bullion Securities shares represent 1/10 of troy ounce of gold. Their issue was supported by the World Gold Council and the Australia-based Gold Bullion Ltd. In December 2003 they entered the London Stock Exchange under the acronym GBS. In the same year, the World Gold Council asked the SEC for permission to trade them on the U.S. market as GLD. The first license for a "gold fund" was granted to Barclay's Global Investors, whose iShares COMEX Gold Trust trade on AMEX as IAU. One indisputable quality of this sort of funds in the high credibility enjoyed by their financial intermediaries (e.g. Barclay's is regarded the top player in index trading).

The successful takeoff of gold ETFs set the example for other funds in other countries. Today they relate not only to gold, but to oil as well.

The interest in stock exchange operations in the U.S. has been largely fuelled by the regulation policy. The SEC discarded restrictions to the volume of investments in ETFs imposed by the Investment Company Act, whereby a fund was not allowed to invest more than 5% of its assets in a single firm.

Another change in the world of ETFs is a move to actively managed ETFs which, rather than tracking an index, would modify their portfolios depending on market situation. Such funds, however, require active management and would therefore lose their competitive edge in the form of low fees. ETFs using leverage can borrow funds.

In 2002 the European Central Bank allowed mutual funds to invest a part of their assets in exchange traded funds. Certain limitations remain in Europe, as EU legislation does not allow mutual funds to borrow in the market.

Forecasts envision the assets managed by ETFs to swell to one billion dollars by 2007, posing serious competition to mutual funds. As a result, mutual funds will likely be forced to cut their management fees.

3.1 Advantages of ETFs

In a nutshell, the advantages of exchange traded funds can be described as follows:

1. The prices of securities in capital markets develop according to the "random walk" theory, meaning that an investor cannot earn returns above market average in the long run. This implies that at a given point his return can be higher or lower than the market average. ETFs always pay the long-term market average.
2. Unlike other mutual funds, they let investors trade throughout the stock exchange trading day, using short selling, margin trading as

well derivatives. It is this high flexibility that has contributed to ETFs being used not only for long-term investments, but for daytrading as well.

3. ETFs cost less. So from the investor's perspective, they are also attractive for low fees. There is no initial fee. The only fee charged is for asset management, withheld from dividend payouts, which usually does not exceed 0.5% of assets annually. As opposed to ETFs, non-index funds often charge investors not only higher initial fees, but also management fees and exit fees. Since these fees are included in reported returns, the investor's actual net (real) gain may be much lower. ETFs usually ask no initial or exit fees.
4. Unlike non-index funds, index funds hardly trade, only if they need to realign their portfolios. An ETF buys or sells securities only if a new security is added or one removed from the benchmark index to reflect the new index composition. This results in low portfolio turnover as a ratio of total transactions to total assets held by the fund. ETFs can thus avoid the high costs involved in trading, such as all kinds of broker fees, analyses, etc.
5. The low portfolio turnover also implies tax savings. While high turnover rates in non-index funds often generate considerable capital gains, which is subject to taxation, ETF can save on taxes with their lower turnover.

3.2 Disadvantages of ETFs

1. Each purchase and sale involves broker fees which reduce return. This is in particular true for daytrading, where the investor needs to trade a large bulk of securities to cover fees when price movements and gains are small. That is why daytrading involves the application of margin systems, where the investor pays down only a margin (a fraction of the original price) and takes advantage of the leverage effect to earn higher gains.
2. Disadvantages can also be seen for investors using the dollar cost averaging technique, investing certain sums at regular intervals to eliminate and average rate fluctuations. The broker fees incurred naturally reduce the bottom line.
3. As normal index funds, ETFs also encounter tracking errors, meaning that they not always mirror the net value of assets held. In case of a more substantial tracking error, arbitrators intervene by purchase or sale, as necessary.
4. Professionals start to appreciate ETFs in particular for the flexibility they offer in portfolio diversification. As a consequence of ongoing

globalisation and rapid technological progress in financial market trading, risk diversification is becoming increasingly problematic.

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