BOMCOM-01/22

Fourteenth Meeting of the
IMF Committee on Balance of Payments Statistics
Tokyo, Japan, October 24-26, 2001

Mutual Funds and "Fund of Funds": Portfolio Investment or Direct Investment?

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International Monetary Fund

Mutual Fund and "Funds of Funds": Portfolio Investment or Direct Investment?

I. Introduction

1. Two queries have recently arisen about the classification in the balance of payments of mutual funds and "funds of funds".

(a) The first query affects mutual funds as a whole, and concerns the intended meaning of the text in paragraph 388 of Chapter XIX, "Portfolio Investment", of the fifth edition of the IMF's *Balance of Payments Manual (BPM5),* which states that "Mutual funds and investment trusts are also included" in the equities securities component of portfolio investment In particular:

- Whether the statement in paragraph 388 is intended to indicate that both the assets and the liabilities of mutual funds are to be treated as Portfolio Investment, equity securities.

- Assuming this to be correct, whether the classification as Portfolio Investment also applies to:

  - Mutual funds' assets that comprise 10 percent or more of the total equity of an enterprise—holdings that would be classified as Direct Investment if held by another investor, such as a pension fund.

  - Mutual funds' liabilities to an investor or group of related investors that represent 10 percent or more of the total equity of the mutual funds—again, a situation which would be treated as Direct Investment if the ownership involved an entity other than a mutual fund.

(b) The second query concerns the appropriate classification of "funds of funds" and was raised by a Coordinated Portfolio Investment Survey (CPIS) compiler in one of the small economies with an international financial center where many such entities are registered. The specific issue is whether a mutual fund in which a "fund of funds" owns 10 percent or more is a direct investment enterprise of the "fund of funds", and whether the assets and liabilities of the related mutual funds are therefore Direct Investment, rather than Portfolio Investment.

II. Definitions and Background

2. **Mutual Funds.** Mutual funds are collective investment schemes, operated by an investment company. The term "mutual funds" is commonly used in the United States to describe an entity that is similar to a *unit trust* in the United Kingdom (UK) and in other jurisdictions that are based on UK common law. In France, mutual funds are known as *fonds commun de placement*. Mutual funds can be broadly categorized into "public", "professional" and "private".

Public mutual funds: The key characteristics of public mutual funds include:

- As retail operations, they permit small private investors to invest in a diversified portfolio of shares, bonds and other securities, thereby spreading risk, without necessarily requiring specialized knowledge about particular markets or enterprises.
- Most mutual funds are "open-end" funds since there is no fixed amount of capital in the fund. If new investors wish to invest, the fund can issue new units and accept the investors' money into the pool. If the investors wish to turn their investment back into cash, the fund can cancel their units. The number of units in the fund, and the amount of money invested, fluctuates according to supply and demand. There are also "closed" mutual funds that do not accept new investors. Closed end funds have a limited number of units/shares on issue and an investor wishing to vacate the fund will sell them to another investor, in a manner similar to the sale of a share of a corporation.
- Shares in public mutual funds when sold are redeemed at their net asset value.
- Public mutual funds are managed by professional fund managers who invest in securities to achieve the funds' objectives such as capital growth, income, or a combination of both.
- It is usual for public mutual funds to be subject to some kind of regulation, in which the fund managers are required to report to the authorities certain information (such as net asset value, income, and possibly indicate that audited accounts are available for inspection if required) to indicate that the fund is being properly managed and remains within the terms of its prospectus.

Professional mutual funds: The structure is the same as a public mutual fund, in that it is a collective investment scheme, but professional mutual funds are established for the use by institutional investors. Other characteristics of professional mutual funds are:

- Usually they require a minimum investment of $1 million or more.
- As professional mutual funds are set up, for the most part, for sophisticated investors, supervisory requirements are often more limited than they are for public mutual funds.

Private mutual funds usually have only a limited number of investors, often with as few as fifteen share/unit holders. Other features are:

- The investment required is typically very large (at least on a par with professional mutual funds).

- Like professional mutual funds, the supervisory requirements for private mutual funds are limited, and sometimes there are no supervisory requirements at all. The authorities often take the view that as the investors are not retail, and are considered to be sufficiently informed about the risks of investing in these funds, they do not need the typical consumer/depositor protection. Moreover, because of the small number of investors, they are usually not deemed to pose a systemic risk.

- Private mutual funds may be much more highly leveraged than the typical mutual fund, and would include "hedge funds".

- The use by private mutual funds of financial derivatives, repurchase agreements and other borrowing devices is quite common.

3. The investment strategy of the professional mutual funds and the private mutual funds may be quite different from those of public mutual funds, although all three types may have speculative elements to them. However, as indicated above, because professional and private mutual funds are less regulated than public mutual funds, little information is available on them. Their importance in financial markets is, however, believed to be growing, and they are often registered in small economies with international financial centers.

4. **"Funds of funds"** or "umbrella funds" are unit trusts or mutual funds that invest in other mutual funds. The key characteristics of "funds of funds" are:

- A "fund of funds" may invest in mutual funds run by the same group or by an unrelated group or groups.

- The mutual funds in which the "fund of funds" invests may operate on a "wholesale" basis (i.e., only accepting investments from other funds) or on a "retail" basis (i.e., also accepting investments directly from individuals).

- The "fund of funds" may have access to wholesale rates of fees that reduce the cost to investors of doubling up on fund management fees.

- The structure permits delegation of management and diversification of the asset portfolio of the "fund of funds".

5. The situation of mutual funds investing in other mutual funds also arises with so-called "**feeder funds**", where subsidiaries in individual countries that meet the legal requirements of the economy in which the funds are raised, "feed" those funds into a single central fund pool under common management. (For example, a British multinational mutual fund manager's subsidiaries around the world could manage Japanese funds in their individual countries that "feed" money into a single Japanese fund managed in Japan.)

6. The classification of mutual funds does not appear to have been previously discussed at high-level balance of payments statistical meetings.

III. Statistical Treatment

7. **Mutual Funds**[1] The discussion of direct investment in the fifth edition of the Fund's *Balance of Payments Manual (BPM5)* and the *Balance of Payments Compilation Guide* is expressed in general terms and the issue of mutual funds is not mentioned. However, the principles set out in these two documents do not preclude mutual funds from being either direct investors or direct investment enterprises. Furthermore, the introductory section of the *BPM5* chapter on Portfolio Investment, after specifying the types of instruments included in the category, goes on to state that excluded from portfolio investment *are any of the aforementioned instruments included in the categories of direct investment* and reserve assets. (Paragraph 385.)

8. An argument could be made that although public mutual funds may hold 10 percent or more of the voting power of an enterprise (and therefore hold enough voting power to have an effective voice in management), the motivation of public mutual funds for holding shares is different from that of other institutional investors, such as pension funds or insurance companies, because public mutual fund managers do not usually have an intention to exercise a voice in management and some public mutual funds may have a policy against doing so. In other words, the objective of a public mutual fund is typically to pick good investments among existing businesses, rather than to become involved in running those businesses.

9. Similarly, it can be argued that an investor who owns 10 percent or more of a public mutual fund does not have an effective voice in the management of that mutual fund and therefore has a motivation different from the usual direct investor.

10. The view that the different objective of public mutual funds precludes them from being classified as direct investors or direct investment enterprises appears to be supported by the following statements in *BPM5* under the section on Direct Investment: Concepts and Characteristics:

- *As presented in this Manual, the primary distinguishing feature of direct investment is the significant influence that gives the investor an effective voice in management.* (Paragraph 360).

- *Direct investors are thereby in a position to derive benefits in addition to the investment income that may accrue on the capital that they invest…Such extra benefits are likely to be derived from the investors' associations with the enterprises over considerable periods of time.* (Paragraph 361).

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[1] As little is known at this time about the nature, behavior and objectives of professional mutual funds and private mutual funds, the discussion on the statistical treatment will deal only with public mutual funds.

- *In contrast, portfolio investors are primarily concerned about the safety of their capital, the likelihood of appreciation in value, and the return generated. Portfolio investors will evaluate, on a separate basis, the prospects of each independent unit in which they might invest and may often shift their capital with changes in these prospects, which may be affected by short-term developments in financial markets.* (Paragraph 361).

11. On the other hand, *BPM5* then goes on to indicate that:

- The definition of *a direct investment enterprise is an incorporated or unincorporated enterprise in which a direct investor, who is resident in another economy, owns 10 percent or more of the ordinary shares or voting power*. (Paragraph 362).

- *Direct investors may be …… associated groups of individuals or enterprises……*that own 10 percent or more of direct investment enterprises in economies other than those in which the direct investors reside. (Paragraph 367.)

- The use of two other definitions, one of which is the exclusion from Direct Investment of direct investment enterprises in which *the investor owns 10 percent or more but does not have an effective voice in management*, is not recommended. (Paragraph 363.)

12. If it is accepted that the specific definitions of Direct Investment stated in *BPM5* paragraphs 362, 363, and 367 take precedence over the general statements about the characteristics of Direct Investment stated in paragraphs 360 and 361, then the holdings of public mutual funds that represent 10 percent or more of the total equity of a specific enterprise should be classified as Direct Investment. Similarly, the holdings of individual investors in a public mutual fund that represent 10 percent of more of the total equity of that fund should be classified as Direct Investment.

13. If on the other hand the statements in paragraphs 360 and 361, combined with the statement in paragraph 388, are deemed to override the definitions in paragraphs 362, 363 and 367, then all the assets and liabilities of public mutual funds should be classified as Portfolio Investment, regardless of the percentage ownership.

14. **"Fund of Funds"** The "fund of funds" situation involves public mutual funds on both sides of the relationship. The entities involved in a "fund of funds" situation are:

(a) The fund managers of each of the funds—including the "investing" fund—who do not own the fund assets or income, but are paid a fee by the fund.

(b) The funds themselves, which are separate entities owned by the investors rather than by the managers.

(c) There may also be other parties involved, for example, a trustee responsible for holding the assets, separate from the managers, or separate entities to handle the administration and management of the funds.

15. There are a number of aspects of the "fund of funds" relationship that need to be clarified:

(a) *The classification of individual investors' interests in the public mutual funds*. Paragraph 388 of *BPM5* appears to indicate that the liabilities of the mutual funds to the individual investors are Portfolio Investment, classified under equity securities. Paragraph 385, on the other hand, would appear to imply that this treatment does not apply to the public mutual funds' liabilities to a related group of investors in the form of a "fund of funds".

(b) *The relationship between public mutual funds and their managers*. As public mutual funds are owned by the investors, an argument can be made that public mutual funds are separate units from their fund managers and therefore not subsidiaries of the fund manager. Although the fund manager effectively controls the decisions of the public mutual fund on a day-to-day basis, the fund manager is paid to provide that service to the fund and can be dismissed by the public mutual fund owners (although, in practice, investors find it easier to simply withdraw their money). It is appears to be clear, therefore, that the fund managers are "agents" of the public mutual funds and that there is no direct investment relationship between the public mutual funds and their managers.

(c) *The relationship between the "fund of funds" and the public mutual fund(s) in which it invests*. As indicated in paragraph 7 above, *BPM5* does not appear to explicitly exclude public mutual funds from being either a direct investor or a direct investment enterprise. One concern that has been raised in the case of the "fund of funds" situation is that if "feeder funds", such as those described in paragraph 5 above, are treated as Direct Investment, then an anomalous situation could arise in that the direct investors would be the feeder funds that have no effective voice in the management decisions of their "subsidiary", namely, the central fund that makes all investment decisions.

16. There are two options for classifying the transactions of the "fund of funds".

Option A: Apply the 10 percent criterion to "funds of funds" and treat those that hold 10 percent or more of a public mutual fund as being in a direct investment relationship with those mutual funds.

Rationale:

- *BPM5* does not make any specific exception for the case of the "fund of funds" situation.
- Exceptions to the 10 percent ownership rule should be avoided.
- The "funds of funds" have a potentially effective voice in the management of the funds in which they invest, even if this is not exercised.

Option B: Create an exception to the 10 percent criterion for the “fund of funds” situation.

Rationale:

- The relationship is usually not about a lasting relationship, but about short-term asset management—the percentage ownership can vary over short periods of time with purchases and withdrawals—both those of the “funds of funds” and those of the public mutual funds in which they invest.

- The relationship is usually not about control—the fact that the inherent objective of “funds of funds” is to delegate the function of management, points to a lack of intention to influence decisions by the public mutual funds in which they invest. (If the fund intended otherwise, it would presumably invest directly, rather than through other funds.)

- An argument could be made that *BPM5* paragraph 363 anticipates that there can be variations from the 10 percent criterion in national data in order to reflect the actual control situation. (However, *BPM5* clearly states that data for international reporting should be based on the 10 percent criterion rather than on actual control).

- A somewhat analogous case is that of repayable (that is, non-permanent) debt securities held by financial intermediaries, which are treated as Portfolio Investment even when the holder and issuer are in a direct investment relationship. (*BPM5* paragraph 372). The rationale for this exception appears to be that the movements in debt securities in such cases are motivated by liquidity concerns, rather than by issues of influence, and that they are therefore similar to portfolio investment in nature. (Note, however, that in 1999 the BOP Committee judged that insurance companies and pension funds, which, like public mutual funds, are collective investment schemes, are specifically excluded from the paragraph 372 exception.)

- While an exception for public mutual funds makes the definition of Direct Investment more complex, but is likely to be easier to implement in practice because all public mutual funds would be classified as portfolio investors and investigations into the percentage ownership of their investors and investments would be unnecessary. (On the asset side, many “funds of funds” may not know their percentage ownership of the public mutual funds in which they are invested, given that the total “equity” of those funds varies from day to day.)

IV. Topics for Discussion

17. Professional Mutual Funds and Private Mutual Funds

- *What do Committee members know about the nature, behavior, and objectives of professional mutual funds and private mutual funds? Are members aware of any research that has been done on these issues?*

- *Do members agree that research should be undertaken on professional and private mutual funds to determine whether the investment strategies of these types of funds may have a bearing on how their activities should be classified in the balance of payments statistics?*

18. Public Mutual Funds

In order to clarify the apparent inconsistency in the text of BPM5 about the treatment of mutual funds, the views of the Committee members would be appreciated on the following questions:

- *Have these issues arisen in other countries? If so, how have they been dealt with?*

- *In practice, do public mutual funds exercise influence on:*

    - *Enterprises in which they invest?*
    - *Mutual funds in which they invest?*

- *Can the apparent inconsistency between the text in paragraph 388 of BPM5, which appears to indicate that public mutual funds are to be included under Portfolio Investment, and the text in paragraphs 362-367 on Direct Investment, be reconciled by the fact that paragraph 388 is preceded by the statement in paragraph 385 of BPM5 that any of the equity and debt securities normally included in Portfolio Investment are excluded if they meet the definitions for Direct Investment or Reserve Assets?*

- *If the intended meaning of paragraph 388 is that both the assets and liabilities of public mutual funds are to be treated as Portfolio Investment regardless of the percentage ownership of the total equity of entities in which the assets are invested, how should this be clarified to compilers? As an amendment to the BPM5, or as an item for clarification in BPM6?*

- *If an exception to the 10 percent rule is not to be made for all public mutual funds, should such an exception be made for "funds of funds"? If so, how should this be clarified to compilers? As an amendment to BPM5, or as an item to be addressed in BPM6?*