



# *Mutual Funds*







## A Historic View on Mutual Funds:

The idea behind mutual funds goes back to the first quarter of the nineteenth century in Europe. It started in the Netherlands to be exact in 1822 then England in 1870. It went through a lot of developments and changes that occurred on the economical world until it reached the level it is now. The real beginning of mutual funds in its current concepts was in 1924 in the United States of America. The first fund was established in Boston by Harvard University professors and was named “ Massachusetts Investment Trust”. After that, it continued to expand in the United States and abroad especially after World War II. By 1966, it reached about 550 mutual funds with total net assets worth \$ 50 billion US Dollars.



Mutual funds continued its expansion until it reached 56,000 mutual funds around the world in 2005 where its total net assets

exceeded \$16.4 trillion US Dollars.

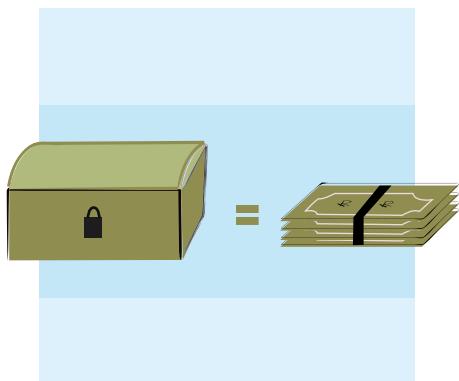
On the Arabian level, the Kingdom of Saudi Arabia was the first to enter this field. The National Commercial Bank (AlAhli) founded the first mutual fund under the name of “AlAhli Short Term Dollar Fund” in December 1979. The rules governing mutual funds in Saudi Arabia were issued 14 years after that date, i.e. by the beginning of 1993. As a result to this successful experiment, Saudi banks continued in issuing a lot of different mutual funds.

A list of the available mutual funds can be found on the website of the Saudi Stock Exchange (Tadawul) [www.tadawul.com.sa](http://www.tadawul.com.sa)

As for the other Arabian countries, they entered the same experience with varying degrees of success and popularity. Most of these experiments were characterized by the issuance of mutual

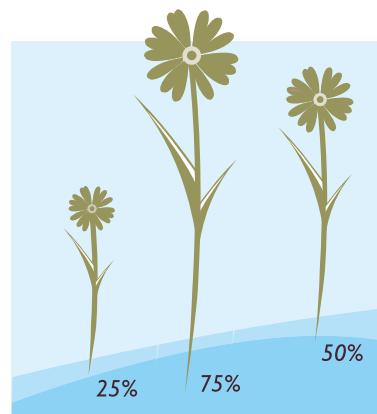


funds before the legislations governing it. Kuwait was the second Arabian country after KSA to have mutual funds. Its experimental trail started in 1985 then after nearly a decade some Arabian countries followed such as: Egypt, Bahrain and Oman in 1994, Morocco in 1995, Lebanon in 1996 and finally Jordan in 1997.



## The Definition of Mutual Funds

Mutual funds are known as investment pools that gather the capitals of a group of investors and manage them according to a specific strategy and investment goals which are set by the fund's manager to achieve investment benefits that cannot be achieved by an individual investor alone due to his limited resources. According to this, mutual funds contain a group of financial securities that are chosen according to a



specific criteria in order to achieve the benefit of diversity that leads to decreasing the total investment risk level.

Mutual funds' investments avoid the usual restrictions on individual investments. This would increase their ability to diversify and lower the costs of buying and selling shares. The profits of mutual funds usually consist of capital profits, profits resulting from an improvement or change in the prices of the invested securities in addition to the securities distribution if any. The fund can face losses in case the value of the securities, that make up the fund's assets, decreased.

## Features of Mutual Funds

*1- Specialized management:* a key feature of investing in funds is to benefit from the experience and knowledge of the fund's manager in making the best investment decisions. Direct investment



in securities requires analysis, study and knowledge of the determinants of profit and loss and the risks associated with these securities.

Only a small segment of investors have these skills. For that, mutual funds give the opportunity to benefit from the knowledge and professionalism of those specialized in investing and managing securities for investors who doesn't have financial analysis skills. The nature of the managers' work requires full time and moment by moment follow up on the market and economy as well as their skills in understanding the data and the consequences.

*2- Diversify investments and reduce risks:* investing in funds allow the individual investor to diversify his investments with a relatively lower cost from direct diversification and investment. This would give him a bigger opportunity to lower the risks of investment due to the diversity of the securities owned by the fund. Mutual funds provide investors with the possibility to diversify and

distribute investments in a systematic way across a wide range of assets, geographic regions and industries to reduce the risk of concentrated assets and take advantage of the differing returns.

*Mutual Funds are usually divided into two kinds:*

When establishing any fund, the fund manager specifies the structure of the fund's capital i.e. the amount gathered and invested by the fund. **Open-end Funds** are flexible mutual funds in regard to the capital invested. It can increase or decrease according to the exported units that represent the percentage of the investors' contribution in the fund. An investor can get back the amount he invested whenever he wants. This type is the most common type in all financial markets and Saudi Arabia is one of them. On the other hand, **Closed-end Funds** are characterized that the investor's capital is fixed and the number of its units never changes. The outcome of the fund is not achieved by redemption but by selling the units to another investor or by the expiration of the fund's period.

Exchange Traded funds (ETFs) appeared for the first time by the end of the 80s, 1989 to be exact, with the rapid development of the financial innovations. ETFs combine between the flexibility of the open-end funds in regard to capital and high liquidity that is one of the closed –end funds characteristics.

These funds started in the Canadian financial markets then the American markets followed in 1993. Since then, ETFs started expanding and growing rapidly.

## Features of Exchange Traded Funds (ETFs):

- *Transparency*

Since ETFs track market indexes, it is easy to identify the investments of those funds in terms of content and investment rates. Exporters of these funds are committed to publish the information on full disclosure of the funds and the indexes it follows. Also, these funds are characterized with continuous assessment from the fund's manager during the trading period for the unit's value or what is known as the indicative Net Asset Value (iNAV) in addition to the end of the day evaluation or what is known as the Net Asset Value (NAV).

- *Flexibility*

ETFs units, due to their inclusion in the market, are easy to deal with. An investor can buy the units or sell them directly through the market just like buying stocks. Also the investor can buy from any of the ETFs regardless of the source. Unlike mutual funds, where investments should be handled through the fund's manager directly. In addition to that, there is no minimum to participate in ETFs.

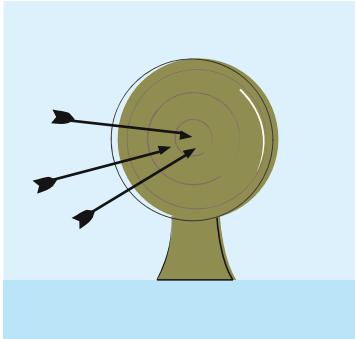
- *Cost*

Investing in ETFs is mainly characterized with low costs because the management fees are low. The reason for that is that the investment style, which is considered passive, is not required to make decisions in choosing stocks but it just follows a particular index. In addition, the investor shall bear the costs of trading the units of these funds which are the selling and buying commission compared to the subscription and redemption fees, if any, for other funds. The issuer of these is also committed to disclose those expenses in the memorandum of terms and provisions.

To facilitate trading the units of the ETFs, the fund's manager assigns a market maker for the fund. The market maker is an authorized person by the Capital Market Authority. His job is to provide liquidity in the ETFs market so there would be ongoing orders for buying and selling in order for the investor to buy or sell the units at any time.

## Mutual Funds Goals and Objectives

Mutual funds has a set of goals that meet the requirements of investors and commensurate with the acceptable risk levels. The fund's manager follows a specific policy and investment strategy to achieve these goals. That is why the securities that form the assets of these funds vary according to its goals and objectives. For example: when the achievement of a steady income is the goal of the fund's investment, the fund's manager sets the



policies and investment strategies that will determine the securities that will form the fund's assets to achieve these goals. Accordingly, the objectives of mutual funds can be generally classified as the following:

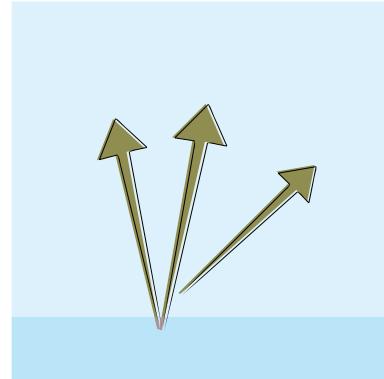
1. Invest to maintain capital.
2. Invest to achieve income.
3. Invest to achieve income and growth.
4. Invest to achieve growth.
5. Invest to achieve high growth.

### *Mutual Funds Classifications:*

Mutual funds can be classified according to the areas of investment it follows to achieve its goals as the following:

*1- Money Market Funds:* are funds that invest in the monetary market. They are characterized with high liquidity, short-term securities and low risk rates compared to other mutual funds. Although Money Market Funds are classified as low risk but

these funds are not risk free; the invested amount might decrease or fluctuate significantly due to several factors.



*2- Debt Instruments Funds with Fixed Income:* are funds that invest in a company's debt instruments such as bonds and others that are issued by companies, government and semi government entities or any other entity that is allowed to issue any kind of debt instruments. The prices of debt instruments are affected by several risk factors such as ,and not limited to: the interest rate, the bond's rating by rating companies and the risk of periodic payments disruption.

*3- Equity Funds:* are funds that invest mainly in companies' equity whether it was local, regional or international stocks. A lot of kinds fall within equity funds according to the fund's objectives as the following:



*3.1 Income funds:* it aims to achieve an income by investing mainly in the stocks of companies with a distinguished record of distribution returns.

*3.2 Growth Equity Funds:* seeks to develop its capital by investing in companies that are expected to have higher market value. The fund depends on achieving capital gains as its primary goal, with its distribution income not as a primary factor.

*3.3 Income and Growth Equity Funds:* it seeks to achieve profit by combining capital growth and achieving income.

*3.4 International Stock Funds:* seeks to invest in stocks of international companies and limit its work in the stock market of one specific country or more.

*3.5 Global Stock Funds:* it invests in the stock markets of several countries around the world.

*3.6 Sector Funds:* they invest in one area of indus-

try such as: agriculture, petrochemicals or other specified industries.

*4- Balanced Funds:* are mutual funds that combine between bonds and stocks. It sets aside a part of its investments to short-term financial instruments.

## *Methods of Managing Funds*

The Mutual funds industry has evolved until it has been managed by professional managers that have special skills in the selection of appropriate investment tools which are expected to have a unique performance. In this industry, there are two methods to manage the funds. One is known as the “Passive Management” method while the other is the “Active or Positive Management” method. You can differentiate between the two methods as the following:

### *1- “Passive Management” Method:*

The invested finances in the fund are distributed on a large number of stocks of one sector or it could expand to include the stocks of all the market’s sectors according to the index of that sector or the index of the whole market like investing in the stock of the industry index for example. This means that the manager of the fund invested in all the industry stocks so that the rates of the stocks in the portfolio are similar to the ratio of stocks in the index. Index funds are considered examples of the passive management funds ‘strategies.

In it, the fund's manager doesn't try to rebalance the fund to stimulate its performance to exceed the index's performance. For that, this method of management in general is characterized with lower costs of management fees which are cut off by the manager in regard to his work.



## 2- "Active or Positive Management" Method:

It is based on including the manager's skills to positively affect the fund's performance in gaining returns that are higher than the ones achieved by investing in the market indexes. Accordingly, managers always change their investment methods inside the fund.

Therefore, it is a necessity to restructure the stocks or the sectors or changing the proportions of property in it according to their readings of the future of the investment climate in the fund's market. This explains the relatively increase of the management fees in the funds that follow this method.

## Measuring the Mutual Funds' Performance

The Net Asset Value is the foundation of evaluating the performance of the mutual fund. The Net Asset Value consists of the fund's total assets minus its total liabilities. In detail: it is the market value of all the owned securities plus any receivable dues to the fund and any amount of cash after deducting any fund commitments. The unit price is calculated by dividing the net asset value on the number of the exported units.

$$\text{Net Asset Value} = \text{market value of securities} + \text{Fund's receivable dues} + \text{cash} - \text{fund's commitments \& expenses}$$

$$\text{Unit's price} = \text{Net Asset Value} / \text{number of exported units}$$

Return on Investment in the fund is measured by comparing between the prices of the mutual fund's units at the beginning and the end of the investment period as the following:

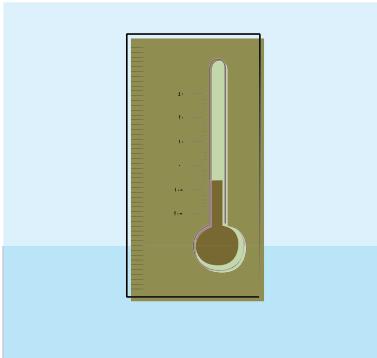
$$\frac{\text{Unit value by the end of the investment period} - \text{unit value by the start of the investment period}}{\text{Unit value by the start of investment period}} \times 100$$

If an investor bought a number of units in (x) fund with the value of 500 riyals per unit at the start of the investment period and sold those units in the value of 580 riyals per unit by the end of the

period, then the return on investment by the end of the investing period in the fund is :

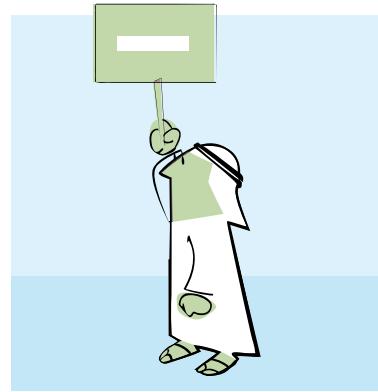
$$16\% = 100 \times \frac{500 - 580}{500}$$

The higher the investment fund's unit value, the higher return on investment in this fund. The performance of the mutual funds is affected, as other investment tools, by different factors according to the affected listed securities. This reflects on the fund's total performance and the value of its units. Managers and workers of these funds work hard to score the highest possible growth rates,



best performance by trying to know these factors and adapt their abilities and professionalism to improve the performance of these funds. The performance varies depending on the managers' ability in identifying these factors. Therefore, Mutual funds compete in attracting people with the most experience and professionalism in knowing these factors and managing it.

After calculating the return on investment to the fund, this return can be evaluated from different aspects. It can be absolute by evaluating the return achieved by the fund in a specific period without comparing it with other financial instruments' returns or the general index or the sectors index. In addition to evaluating the return through relative comparison OR evaluate it after keeping in mind the level of inherent risk.



## *How to Choose between Mutual Funds*

To choose the right mutual fund, the investor should review the quantitative criteria related to the fund's fees, performance and risks in addition to the return on risk standards. Furthermore, quality standards should be reviewed because of their importance in achieving the best quantitative standards. One of the most important quality standards but not limited to: the management

team, the investment strategy, the size of the fund, and members of the Fund's Board of Directors.



## How to Sell or Buy Mutual Funds' Units

*Typical Mutual Funds:* Mutual funds are not that different from other investment tools in selling and buying their units. First, the investor determines the investment's objectives. Then, he chooses one of the mutual funds that apply to his goals. After that, he opens an investment account at the issuing financial company and fill the applications related including the number of the units wanted for selling or buying. If you want to participate in mutual funds, you are advised to follow the following aspects:

- Each investment fund has specific evaluation days and also specific days to enter or withdraw.
- Buying a unit in the fund is based on the unit's price that comes directly after placing the buying order.

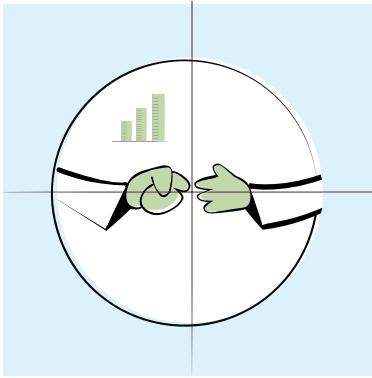
- The fund has subscription fees that differ between funds and it also may vary according to the invested money.
- There are minimum limits to enrolling, withdrawing or adding that differ from one investment fund to the other.
- The settlement period differs between funds.

*Exchange Traded Funds (ETFs):* ETFs are subjected to the same trading rules as the Exchange in regard to trading periods and types of orders. Units are bought and sold by buying and selling offers during the trading periods. The minimum to buy units through the capital market is one unit. ETFs are not subjected to specific ownership limits like in stocks. The buyer bears the responsibility of the commission of buying and selling the units in the ETFs market.

## Read the Memorandum of the Terms and Provisions of the Fund

The fund manager is committed to provide the memorandum of the terms and provisions of each fund. It should contain detailed information to help investors make the right decision in selecting and investing in the fund that achieves his investment objectives. The memorandum includes:

1. Planned objectives and policies to be followed by the fund manager in investing the subscribers' funds.
2. Potential risks that the fund's investments can be exposed to.



## Information about Mutual funds

Different information are available on mutual funds and they differ according to their nature. The funds' manager is keen to highlight the overall picture of the fund through various publications containing comprehensive information that usually contain:

- General information about the fund such as: the date it was established, currency of the fund, unit price at its establishment, current share price, management fees, subscription commission and dates, minimum withdrawal or addition, repayment period when withdrawing and so on.
- Information about the fund's manager, its nature and goal, historical performance record, asset distribution, statistics on its revenues and dangers as well as other information that differ between funds according to its nature and what an investor should know about it.

Information on the units' prices in funds which can be pursued through a number of sources such as:

- 1- "Tadawul" website or brochures ([www.tadawul.com.sa](http://www.tadawul.com.sa)).
- 2- The company's website (the authorized person by CMA), the fund's manager or its brochures.
- 3- Newspapers, magazines and economic publications.

3. Approved fees and expenses.
4. The fund's Board of Directors.
5. Approved auditor by the Board of the fund.
6. Names of the members of the Islamic law committee and the fees of their consultation in case the fund operates according to the Islamic Law principles.
7. The conditions of the subscription and redemption that define the allowed period to subscribe and redeem and the minimum amount to that.
8. Evaluation days of the fund's assets and the days to buy the units or redeem them.
9. The index: the fund's manager should compare the fund's performance to a particular index that is set when the fund is established. The manager chooses the index based on the type of the fund's investments in terms of geography or the type of financial instruments in which it invests in.





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