2.1 Investment Company Securities

Three categories of investment companies are defined by the Investment Company Act of 1940:

1. Face-amount certificate companies
2. Unit investment trusts (UITs)
3. Management companies (which include both closed-end funds and open-end funds)

main objectives are to:

- ◆Protect investors from the activities of insiders
- ◆Prevent mismanagement of the investment company and unsound investment practices
- ◆Prevent misleading methods of computing asset value and earnings
- ◆Protect investor rights to disclosure, accuracy of information, and voting

Mutual Funds

Mutual funds pool money from investors to purchase securities such as stocks and bonds.	All mutual funds are required by law to have a board of directors. The board oversees the management and operations of the fund	The 1940 Act also requires that at least 40% of the directors be independent,
The board of directors hires an investment adviser; Responsibilities include, Investing the cash and securities held in the fund's portfolio & Managing day-to-day trading of the portfolio.	The investment adviser earns an annual management fee paid from the fund's net assets.	The custodian is an institution that acts as the caretaker of the fund's securities. Mutual funds contract a transfer agent to handle transactions with customers.

Mutual Funds (cont)

The fund contracts a sponsor, also called a distributor or an underwriter, to sell its shares.	A fund is classified as a **diversified investment company** if it follows the **75–5–10 rule**	◆75% of the total assets must be invested in securities issued by companies other than the investment company or its affiliates.◆Within the 75%, no more than 5% of the fund's total assets can be invested in the securities of any one issuer, and◆Within the 75%, the fund can own no more than 10% of the outstanding voting securities of any single issuer.
Mutual funds are required to disclose their investment policies and objectives to investors when shares are initially sold and, subsequently, on a regular basis through the annually updated prospectus.	The fund contracts a sponsor, also called a distri-butor or an underwriter, to sell its shares	Net asset value is simply the value of the fund's assets, minus all fund liabil-ities, divided by the number of shares.
There are two main types of mutual funds: actively managed funds and index funds	Index mutual funds are passively managed and operate with limited trading activity.	Fiduciary duty further requires portfolio managers to meet best execution responsibilities

Mutual funds are gener-ally **prohibited** from engaging in the following:
◆Selling securities short
◆Buying securities on margin
◆Participating in joint investment or trading accounts
◆Distributing their own securities, except through a sponsor
Mutual funds are also limited to issuing a single type of equity shares.
They can issue com-mon shares only, not senior securities such as preferred stock or bonds.

Permitted Activities for S6 Reps

- •UIT
- •Mutual fund shares
- •Variable life products (**ONLY IF INSURANCE-LICENSED**)
- •Municipal fund Securities
- •Variable annuity products (**ONLY IF INSURANCE-LICENSED**)
- •**NEW** issues of close-end company shares (**NOT IN SECONDARY MARKET**)

Prohibited Securities for S6 Rep

- • Stocks
- • Bonds
- • ETF
- • REITs
- • DPPs (including limited partnerships)
- • Options
- • Commodities (Ex agriculture, energy, and metals)

Rights

Rights, also called *"Pre-emptive rights"* or *"subscription rights"* . They are offered to existing shareholders by corporations that want to raise additional capital. Benefit of this is to give shareholders the first chance to buy new issued shares before sold to public ;can buy at a lower rate than current market price.

If exercised , the shareholder prevents dilution/ reduction of ownership interest.

Money Market Securities

Commercial Paper- (CP) Negotiable, unsecured debt instrument issued by a corporation to finance short-term expenses and working capital needs. Most issued in a form of a *promissory note* . Issued at a discount to their maturity value, discount representing interest that will be paid at maturity. To be exempt from SEC registration 33'ACT maturities may not exceed 270days.	Benefits; Safety, Liquidity, Minimal interest rate risk, Low inflation risk

Money Market Securities (cont)

Negotiable CDs - Deposit accounts or promissory notes with " fixed" maturities that are issued by banks. Pay interest through their maturity date, may have limited liquidity/withdrawal penalties if redeemed prior to maturity. (CD of $100,000 or more is called a *"Jumbo CD"*)	Risks; Low return,

Money Market Securities (cont)

Brokered CD - Offered to either individual or institutions by a 3rd party non bank provider, such as a brokerage firm. Offer longer maturities = higher yields than traditional negotiable CDs. Cant be redeemed early with the issuing bank(like Negotiable CDs, they can trade to other investors in Secondary Market)	Suitibility; investors with lower risk tolerance and an investment horizon of up to one year.

Money Market Securities (cont)

Banker's Acceptance - (BA) Short-term negotiable debt instrument issued by a borrower and a guaranteed by a commercial bank. Technically a time draft, that promises future payment. Maturities between 30-180 days

Treasury bills , which are the MOST liquid US treasury security, are money market instruments B/C they mature in 1 year or less.

Treasury Notes that are within 1 year of their maturity date are also classified as Money Market.

Hedge Funds

A **hedge fund** is simply an investment partnership set up by a money manager. Its legal form is typically a limited liability company, a limited partnership, or an offshore corporation. if the company goes bankrupt, the creditors cannot go after the investors for more money than they've invested into the hedge fund.

Hedge Funds (cont)

Hedge funds pool money from investors and invest in securities or other types of invest-ments with the goal of earning positive returns.
Hedge funds may operate as blind pools.
inappropriate for retail investors
hedge funds often require investors to commit to periods of illiquidity, called lock-up periods
They are exempt from the Investment Company Act of 1940 & Securities Act of 1933
Sold only through private placements to institutions and accredited investors

Hedge Funds (cont)

hedge funds are **not appropriate** for an investor needing short-term liquidity, for example, an individual trying to purchase a home. Their lack of liquidity, high-risk investments, and aggressive management make them most appropriate for sophisticated investors with a high net worth.

Soft Dollars

Soft dollar payments that fall within the safe harbor include those for:
◆Research services provided by the broker-dealer
◆Educational or research seminars and meetings **(excluding travel, hotel, meal, and entertainment expenses associated with the meeting)**

Soft Dollars (cont)

Federal securities laws require maintaining adequate books and records concerning soft dollar allocations, along with disclosure of soft dollar compen-sation to investors.

Shareholder Rights

Limited liability -Shareholders cannot lose more than their original investment

Voting Rights- Each share has 1 vote. Shareholders elect the BOD and vote on significant policy matters

Financial Reports/ Company Info - Shareholders have the right to access certain Financial Reports. (filed with SEC) and audited reports

Claim to company Assets/Ea-rnings- In event of Liquidation (aka Bankruptcy) Common Shareholders have rights to company assets. Last to be paid - if any

Dividends- (If declared by BOD) common shareholders have the right to receive dividend. Typically paid quarterly.

Shareholder Rights (cont)

Transferability - (liquidity) Shareholders have the right to sell their stock; liquidate their positions.

As an owner of the company's common stock, A shareholder is entitled to certain legal rights of ownership.

Warrants

Warrant entitles the holder to buy the issuer's stock at a specified price for a period of time. A warrant is a long-term instrument (5 years or more). The exercise price of the warrant is higher than stock price at the time of issue. Warrants only work if stock appreciates over time.

Warrants are frequently attached to bonds or Preferred stock as a **sweetener**. Like rights, They can trade separately on the open market.

U.S Gov Securities

U.S Gov Securities - Default risk is almost non-existent, as payment of principal and interest on these issues is guaranteed by the *Full faith and credit* of the U.S Gov. Interest paid is taxable at the Federal level, but exempt from state and local level.	**Benefits**: Safest investments; Steady stream of income. Highest safety of principle and interest. Liquidity. Inflation risk protection (TIPS ONLY) . Fixed maturity date
T-Bills - Shortest term of 1 year or less. Like Zero-coupon bonds, they do not pay interest prior to maturity; sold at a discount and mature at par value.	**Risks**; Inflationary risk, Purchasing power risk (except TIPS). Interest rate risk

U.S Gov Securities (cont)

T-Notes - Pay interset every 6 months, and issued with maturities of 2,3,5,7 or 10 years, in denominations from $100 to $1,000,000.	**Suitibility**; Income with capital appreciation

Treasury-Bond - aka T-Bond, have the longest maturity of government securities. Pay interest every 6 months, currently issued with a maturity of 30years. (Highly liquid in secondary market)

The longer the maturity the greater the investment risk, T-bonds are most affected because of their long maturity

(REIT)

A real estate investment trust (REIT) owns and operates income-producing real estate or real-estate-related assets.

(REIT) (cont)

REITs provide a way for individual investors to receive **diversification** and a share of income produced from commercial real estate ownership without buying and holding properties. they receive a proportion-ate share of distributions from the pool of assets based on the amount of their ownership.
minimum requirements on the investment of REIT assets and the pass-through of the income they generate:
At least 75% of a REIT’s total assets must be invested in real estate.
◆At least 75% of a REIT’s gross income must be derived from rents or mortgage interest.
◆95% of a REIT’s income must be derived from dividends, interest, and property income.

(REIT) (cont)

◆On an annual basis, REITs must distribute at least 90% of their taxable income to shareholders in the form of **dividends** REITs cannot pass through losses.

publicly traded REITs may be listed on exchanges. Their price is related to their net asset value (NAV)

Publicly traded REITs trade on major exchanges and offer investors the liquidity and transparency advantages of publicly traded stock.

Non-traded REITs are distributed through broker-dealers. While potential returns may be very attractive, these are often illiquid and fees can be high.

(REIT) (cont)

Private REITs, or private-placement REITs, are generally exempt from Securities Act registration. They can be sold only to accredited investors and institutional clients, and do not trade on exchanges.

3types of REITs

1. Equity -quity REITs—they generate income for shareholders by purchasing and operating income-producing commercial real estate.
2. Mortgage -invest in mortgages or mortgage-backed securities that are tied to commercial and residential properties.

3.Hydrid- combine the investment strategies of equity REITs and mortgage REITs by investing in both real properties and debt instruments secured by mortgages on real estate.

Fund Share Class (A,B,C)

Class A shares normally have front-end sales charge.**lower 12b-1 fee** than other share classes. (**Offer breakpoints**, which are discounts off the sales charge based on the dollar amount invested). Front-end loads may be beneficial for investors who intend to hold their shares for more than several years, as well as those making large purchases who want to benefit from breakpoints.

Fund Share Class (A,B,C) (cont)

Class B shares have a back-end or a **contingent deferred sales charge** (CDSC) that is paid when investors redeem their shares within a specified number of years. HIGH 12b-1 fees. Class B shares **do not offer breakpoints**. These shares may be appropriate for investors with little investment cash and a long investment horizon

Class C shares - no upfront sales charge. They charge **high 12b-1 fees**; highest annual expense charges of the share classes. (The high expense charge is often called a *level load*) They **do not offer breakpoints.** designed for people who want to make short-term mutual fund investments

Fund Share Class (A,B,C) (cont)

No-load funds are mutual funds that are sold at their NAV, without any sales charge added. In other words, the NAV and the POP are the same.

Sector Funds

sector funds or specialty funds concentrate their assets in a single industry, such as technology or healthcare. present more risk than funds with greater sector diversification. They are most appropriate for investors who are interested in a particular industry like ECO-FRIENDLY companies

Common Stock Categories

Blue Chip Stock- Large stable companies, steady earnings and dividends. Moderate growth potential

Income Stock-Stocks that produce income- In the form of consistent dividends for investors, ex) Utility stocks

Common Stock Categories (cont)

Cyclical Stock- *Mirrors the economy*,strengthening when economy is growing - or declining in value when economy is weakens. ex) restaurants, hotel chains, airlines,and automobile manufacturers

Defensive Stock- These stocks *perform steadily* regardless of economic cycles. (*the ups and downs*) Satisfy basic consumer needs. ex) Utilities, food, gas, toilet paper

Growth Stocks- *HIGH* potential for appreciation, grow faster in value in a strong market or decline faster in a poor market than others. ex) Tech stocks, Pharmaceuticals, new companies .

Penny Stocks- *Unlisted* Securities (do not trade on national exchange) trade less than $5. Investors seek penny stocks for goal of capital appreciation. (Risky, lack of liquidity)

ADRs

American Depository Receipts (ADRs) represent ownership in shares of *non-US companies* that trade in the US. Made available thanks to the major commercial banks who buy a bulk of shares from foreign companies. They bundle the shares in groups and re-issue them to US exchange or OTC,

RISKS: Political risk, currency exchange risk.

U.S Gov Agency Securities

Government Sponsored Enterprises - (GSEs) Are authorized to raise money through issuing debt securities	Benefits; Steady stream of income, very safe, higher coupon payments than treasury securities.
Gennie Mae - (GNMA) The only Agency fully backed by the US GOV.	Risks; Inflationary risk, Interest Rate risk, Pre-payment (for mbs)

Freddie Mac - (FHLMC) Sponsored by the U.S Gov

Fannie Mae - (FNMA) Sponsored by the U.S Gov

Stock Fund

stock fund or an equity fund is a mutual fund that invests in stocks of companies that align with its investment objective.

UIT

Unit investment trusts (UITs) are another type of investment company regulated under the **Investment Company Act of 1940**. One of the main characteristics that distinguishes UITs from open-end and closed-end funds is that UITs are not actively managed.

UIT (cont)

The creation of a UIT involves the drafting of an organization document, the **trust indenture**, by the **fund's sponsor**, which initiates the formation of the trust. In the indenture, the sponsor names a **trustee**, which handles the administrative duties.
UITs do not have a board of directors; they have a sponsor.
termination date established at the inception of the trust.
Because the portfolio is fixed, a buy-and-hold strategy is followed, and the securities are not actively traded. UITs are often substantially cheaper than mutual fund shares because there is **no fee for active management**

UIT (cont)

An advantage of a **fixed portfolio** is that it allows investors to know what securities are held within a UIT through the lifetime of the trust. The UIT is **dissolved** and is no longer active when it reaches its termination date.
payment includes either;
◆Receive proceeds in cash—The trust will liquidate, and unit holders will receive a cash distribution of the trust's proceeds based on their ownership interest.
◆Rollover at a reduced sales charge- trust sponsor may offer a new series of the same trust, or may have new UITs available for investment
Has units, not shares.

Generally speaking, unit investment trusts may not be appropriate for investors seeking capital preservation. The portfolios take on the risk of the underlying securities. There is no assurance that an individual UIT portfolio will meet its objective.

Types of Stock Funds

◆**Growth stock funds**, also called growth stocks, invest in stocks of companies that are expected to grow at a rate faster than the market average. Mid-cap and small-cap stocks often represent strong growth potential and are held within the portfolios of growth stock funds.
◆**Aggressive growth funds** seek long-term growth by investing in stocks of small to midsized companies. Stocks of these companies tend to have greater upside potential than the overall market trend, but also greater risk and volatility. Stocks of these companies rarely pay dividends. Instead, corporate earnings are reinvested for further research and development.

Types of Stock Funds (cont)

◆**Value stock funds** invest in value stocks, which are the stocks of companies that investors or mutual fund managers believe are selling at a price lower than their market value. They are considered “cheap” Value stocks commonly pay dividends to investors.
◆**Blended stock funds** attempt to achieve cost-effective returns and appreciation potential for investors by investing in both growth and value stocks
.◆**Income stock funds** invest in dividend-paying companies, stressing steady income over appreciation. These funds might include preferred stocks, blue chip stocks, and utility stocks.

Types of Stock Funds (cont)

◆**Growth and income funds**, also known as combination funds, include some stocks for growth and others that pay high dividends

Preferred Stock

Preferred Stock - Another type of equity security issued by corporations. Acts like both stock and bond. (sensitive to interest rates changing)

Has **no** voting rights

Liquidation priority is higher than common stock, but lower than debt securities/ general creditors

Dividend payments - while **not guaranteed**, paid regularly on a quarterly basis. *Fixed*; Based on the par value of the stock.

Even though it represents equity in a corporation, it trades on the market more like a debt security.

Options

Portfolio managers buy puts to protect their portfolios & Sell covered calls to generate income.

Types of Bonds + Main Objective

Treasuries - Safety of principle (backed by U.S GOV)

Muni bonds- Tax free interest income (Federally tax free, may be state/local tax free *#tripletaxfree*)

Zero coupon Bond - Long-term savings

MBS - Mortgage backed securities - Monthly fluctuating income; diversification

Money Market -Liquidity; safety of principle

Corporate Bonds- Income (pay higher interest)

Convertible Bond - Equity opportunity to issuer (not income)

Suitability of Stock Funds

Stock funds are **most appropriate** for investors seeking long-term growth through capital appreciation, although dividends and capital gains may also supply income for investors that have an income objective.

International Stock funds

International funds and global stock funds invest in stocks issued by companies located throughout the world. Global stock funds can also include stocks in the U.S.
Stock funds can also invest in only a specific geo-graphic region, such as Europe or the Pacific rim.

Suitability of Stock Funds

Stock funds are **most appropriate** for investors seeking long-term growth through capital appreciation, although dividends and capital gains may also supply income for investors that have an income objective.

Sales charge

mutual funds may charge a maximum sales charge of 8.5%. To qualify for this maximum sales charge, mutual funds must offer three features

1. Breakpoints
2. Rights of accumulation
3. Automatic reinvestment of dividends at NAV (no sales charge added)

Funds that do not offer these three features can charge a maximum sales charge of 6.25%

Calculating the POP

Public Offering Price=Net Asset Value/(100% − Sales Charge)

Risks of Equity Closed-End Funds

Each equity fund has its own unique risks. Some major risks associated with equity funds include:
◆Market risk, which is the risk that downturns in the marketplace will negatively impact a specific investment
◆Business risk, which is the concern that the management of a specific company will not be able to meet operating expectations
Equity funds that include foreign securities also might incur:
◆Political risk, which is the risk that investments in a foreign security will be impacted adversely by unfavorable political developments

Risks of Equity Closed-End Funds (cont)

◆Currency risk, which is the risk that investments denominated in foreign currencies will lose value as exchange rates fluctuate

Exchange-traded funds (ETFs)

ETFs are designed to closely track the performance of a specific sector, market benchmark, or index.
It is important to note that ETFs, like UITs, are **passive investment vehicles**; they are not actively managed to outperform the current market. One advantage of this passive strategy is that ETFs are typically a lower-cost option for investors because there are no management fees.

Exchange-traded funds (ETFs) (cont)

Investors who want exposure to indices in a tax-efficient manner and without incurring management fees or high trading costs should consider ETFs
ETFs, like closed-end funds, are exchange-traded.
investors must still **pay commissions** when purchasing these shares
The fact that the shares are extremely liquid might lead investors to overtrade their positions, creating **timing risk** and increased commission charges.

Variable Insurance Products and Regulation

nsurance companies offer products that include a unique feature unavailable through other investments: a guarantee. Life insurance products guarantee a payment to survivors in the event of the death of the insured. The annuity products insurance companies offer can guarantee income that cannot be outlived.	he purchasers of the coverage are called policy owners or contract owners

Variable Insurance Products and Regulation (cont)

Life insurance helps protect against the risk of dying too soon. It promises to pay a death benefit to named benefi-ciaries when the insured dies, provided premiums have been paid to cover the cost of coverage as agreed to in the contract	Persons that purchase life insurance products are usually subject to medical underw-riting
The two major categories of life insurance products are fixed and variable	Fixed life insurance products promise a specified death benefit in return for payment of the agreed premiums.

Variable Insurance Products and Regulation (cont)

Premium payments for fixed products are invested in the insurance company's general account	Moody's, and Fitch actively monitor insurance company per-fo-rmance and ability to meet contra-ctual obligations. Another rating organization is A.M. Best.

nsurance companies are primarily subject to state regula-tion.

variable products they offer are classified as securities, and become subject to the same regulations that apply to other security products, including :◆The Securities Act of 1933
◆The Securities Exchange Act of 1934
◆The Investment Company Act of 1940
◆The Investment Advisers Act of 1940

2.2 Management Investment Companies

Two types of management companies, closed-end and open-end. Open-end investment company securities are more commonly called mutual funds