Mutual funds as a long-term financing source of the enterprise

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Mutual funds are nonbanking financial institutions that collect savings of individual investors in order to invest capital on financial market.
Capital market in Serbia is underdeveloped and shallow, characterised by a chronical shortage of quality long-term capital sources, and there are only few enterprises listed on the Stock Exchange A list attractive to mutual funds. The offer of quality shares, known as "blue chips", is rather poor, however great demand for them is.
In such circumstances companies are often faced with the problem of how to raise capital in case they do not have enough of their own. National companies still opt in favour of long-term loans (often under extremely unfavourable conditions), although the capital raising through IPO (initial public offer) and listing on the stock exchange would be a much more profitable solution in the long run. Banks and international monetary institutions are still the main creditors in Serbia.
The mutual funds make decisions on investing into a company on the basis of financial statements, plans and projections, rather than on the basis of the prospectus. Companies are advised to make efforts to atract mutual funds which are considered to be long-term capital sources and the best way to do that is doing business transparently and constantly improving business results.This would contribute to reducing costs of company financing, improving the current market position, as well as capturing new market segments, improving the quality of the products and services, and financing new development projects. It is important that there be a mutual interest shared by both the management of the fund and that of the company, and this is, above all, the profit.

1. Introduction

Mutual funds are non-banking financial institutions that collect savings of individual investors and invest the collected capital on financial market. On the basis of the funds invested, the investors become the co-owners of the investment fund portfolio. Mutual funds are a most appropriate form of capital mobilization. They appeared by far later compared to commercial (business) banks; however, as financial institutions, they contributed greatly to the in-depth growth of the capital market and its further development.

The facilities offered by mutual funds are numerous, such as:

1. Professional management, through experienced professionals who manage the portfolio in a way better than any individual investor would, even upon a detailed market analysis.
2. Diversification means that the mutual fund portfolio contains various issuers' securities, by which the risk is reduced in case some issuers' financial results prove to be unfavourable. This is so because the share of their securities in the entire portfolio is small, so they cannot induce any serious harm to the whole of the portfolio.
3. The simplicity of (re)investing, which means that there is no preconditioned minimum amout of investing, whereas there is a possibility of further purchase of additional shares, even in case when the investor is not in possession of any larger sum of financial assets. Mutual funds also offer a possibility of automatic reinvestment of dividends, as well as plans for financial assets withdrawal.

2. The mutual funds phenomenon

2.1 Mutual funds on developed countries financial markets and on those of former socialist countries of Europe

The mutual funds phenomenon is so widely spread that their net property worldwide at the end of 2007 amounted to $26.2 trillion, and the number of open mutual funds reached 66,350. Almost half of the total number of funds are funds containing shares, bonds and funds on the money market. The three types of funds we mentioned above are evenly spread, the rest are the balanced and other types of funds. According to the territorial spread, more than half of the total number of funds in the world come from the U.S.A., about one third of the number are from Europe, whereas the rest are of Asian origin. The U.S.A. also has a large number of the so-called *fund families*, where there is a large number of different types of funds under one umbrella. The developed countries of Europe follow the rising trend of popularity of funds that governs the American market.

During the 1990's, in almost all the former socialist countries od the Central and Eastern Europe, a model of mass voucher privatization (MVP) was implemented as a method of privatization of state or public-owned enterprises. The point of MVP is that the citizens are given free (or at a minimal comission) vouchers they could use to purchase the company shares, that is, exchange them for the stakes in the privatization-investment fund. The mass voucher privatization is the fastest and very popular privatization technique, aimed to ensure as just as possible a distribution of state or public property among all the citizens of a country who are of age. The MVP effects vary depending on the state, the economic and political situations in the period the MVP is conducted, as well as on the consistency of its implementation.

Outstanding results have also been achieved in former socialist countries in which the funds achieved the value of tens of billions euros in a very short time, with a large number of citizens inveszing in mutual funds. In Croatia, for example, 11 years upon their appearance, such funds control the net property of about €4 billion, with 95 open funds being active. In Slovenia, about €3 billion was invested into mutual funds, with about one hundred different types of funds actively working.

2.2 Mutual funds on the Serbian financial market

Serbia is the only country in these parts in which the privatization is not carried out using the MVP model. The question is: why did we use other methods of privatization and would the implementation of the MVP model result in fairer effects of privatization, as a majority of citizens would be included. Throughout the privatization period there was no obligation to verify the origin of capital with which a large number of enterprizes were privatized in Serbia. Until a couple years ago Serbia was one of the few countries in Europe where enterprises with a significant development and profit potential could be bought at low investment, and this was the main reasom the *venture* funds emerged.

The investment logics of *venture* funds says that during a number of years of presence in the company, these funds invest rather substantial sums of capital and supply the necessary management knowledge, in order to raise the market value of the company they took over. Then, the shares of the "cured" company are sold at the stock exchange at a price several times higher than the innitial, purchase price, and the *venture* funds withdraw from the ownership in the company, taking their share in the income in proportion to the funds invested (about 80% of profit belongs to the investors, the rest goes to the professional management). The expected revenues are high and range from 15% to 20% annually, over a 5 to 7 year period, however, these investments are highly risky and amounts of less than $200 million are rarely invested. In the former socialist countries, in which the financial market has come to life in the last 10 to 15 years, there was a real "battle" going on between multinational corporations and *venture* funds concerning the takeover of the companies that could, with a substantial „financial injection" and professional management, be successfully restructured and sold in a later period, at a prospectively high profit for the investors.

After a decade of Serbia's lagging behind the countries in the region, the Investment Funds Act was passed and enforced towards the end of 2006. Given the obvious fact that such funds achieved outstanding results on the capital markets of neighbouring countries, it would have been much better if this Act had been enforced at an earlier time, and especially before the first *venture* funds invested their capital.

The Law in this country provides that three types of funds are allowed to operate: the open funds (which are organized), closed funds (which are founded) and private funds. The minimum amount of equity capital for open and closed funds is €200,000, whereas for the private funds it amounts to €50,000 (in dinar equivalent value on the day of subscription). A wide range of financial instruments into which the fund property may be invested is stated. The Law also defined the upper limits of investments in certain types of securities of one issuer, the costs and incomes the fund achieves in the course of its operations, the method of fund management, the obligation of giong public with the prospectus and the minimum of its information contents, as well as any other issues included into the legislative of this relatively new field. The following types of funds are mentioned to operate in the future: a) funds for raising the value of property; b) balanced funds and c) funds for retaining the value of property.

The first mutual fund in Serbia was founded in February 2007. It was a balanced fund, and all the rest were the funds for raising the value of property. The value of property of these funds on 25th June, 2008 amounted to 3.5 billion dinars or approximately €45 million. During the early months of operating, the investment units of the majority of funds reached the price by 30% to 40% higher compared to their innitial price. Following these, two closed mutual funds started their operations, and in the second half of the year a new close fund will start, investing into real estate.

Closed funds raise capital by public sale of shares, they invest long-term and are generally more profitable compared to open funds, however, the innitial investments into closed funds are much higher (shares are significantly more expensive) and investors should be informed beforehand on the investment logics of these funds. With the rise of the number of closed funds, the Belgrade Stock Exchange plans to organize a separate segment of quotation. It is a fact that open funds are much more available to a greater number of small investors in possession of smaller amounts of capital to invest through the mutual fund. In case of both open and closed funds the investors are advised to invest over a period of a minimum 3 to 5 years, since the advantages of investing into mutual funds can be felt and the stock exchange oscillations reflected on the fund performances can be annulled only over a longer period of time. A growing number of mutual funds is an indicator of a positive trend on the domicile financial market, which is mirrored in the growing diversity of investment possibilities, where every owner of capital will be in a position to find a mutual fund according to his investment objectives and the risk tolerance. A number of funds from Croatia and Slovenia are also licenced on the Serbian financial market, and an increased interest of mutual funds from the more advanced countries in this reagion to invest in the domicile financial market is expected.

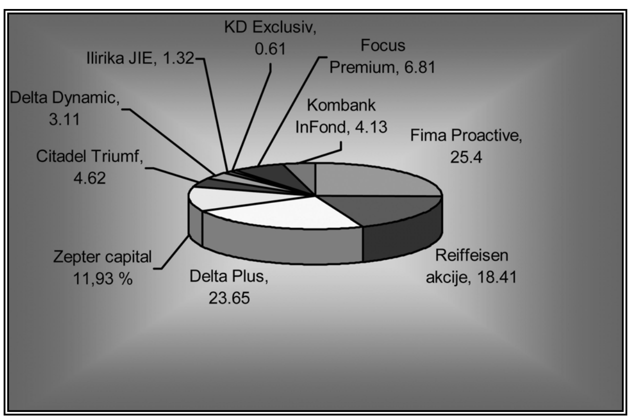

Figure 1: *Participation of certain mutual funds on the Serbian financial market on 25th June, 2008*

Figure 1 shows that out of the total of invested capital into mutual funds, ¼ belongs to each of the funds that were the first to be founded and start operations on the financial market of this country, and these are one balanced fund ("Delta Plus") and one for raising the value of property ("Fima Proactive"). All the other funds were founded somewhat later, therefore their market share is smaller. As well as in other countries in this region, it is banks who lead in founding the funds, which is a proof of banks'growing interests in investment banking and their response to an ever fiercer competition coming from the part of institutionalized investors. It is also evident that the citizens are becoming increasingly interested to direct their savings towards mutual funds and other institutionalized investors due to higher revenues compared to classic fixed-term deposits with the banks (average revenues of mutual funds range from 8 to 15%).

2.3 Mutual funds as long-term financing source of domicile enterprises

The problem with our capital market is that it is rather "shallow"; that is, there is no adequate offer of financial instruments into which mutual funds, but also other institutionalized investors would invest. The listing of public corporations in the fields of telecommunications, electric power supply, oil industry, on the Stock Exchange would greatly improve the quality of offer of securities, since their shares are considered to be of high quality, and are known as "blue chips". There is a shortage of firms interesting to the mutual funds on capital market at the moment and, unless the situation develops in that direction, a possible scenario may be that the investment funds raise capital on the domicile market and place it on the foreign capital markets. Such an outcome would be very unfavourable for the development of national economy, since mutual funds can be a very prolific long-term financing source of the enterprise.

The interest rates paid to bank loans in Serbia are significantly higher compared to the average interest rates in the countries in this region. One of the reasons is a high risk of the country and a low credit rating, due to which the domicile banks borrow capital on the world markets under rather unfavourable conditions. Another reason is a restrictive monetary politics conducted by the Central Bank, aiming to control inflation and reduce credit expansion by ways of increasing the effective interest rate, the rate of statutary reserve on foreign currency deposits and other instruments. To these should be added the bank margins, all of which together result a high price of borrowing and a heavy burden for the firms. With the growing competirion among banks and a more significant role of institutionalized investors (investment, pension and insurance funds) on the financial market of Serbia it can be expected that the price of borrowing will fall. All this, however, should be observed in the context of movements on the global market and the presence of macroeconomic (in)stability in Serbia. For example, the mortgage crisis has for months been present on the U.S. market, the recession is possible, and these conditions have greatly diminished the offer of capital.

Enterprises are still reluctant and not knowledgeable enough as regards the execution of the initial public offer of shares (IPO), although that could be a most inexpensive and a very efficient way of financing the growth of the enterprise. The Security Commission is ready to face the initial public offers of shares, however, our firms do not show enough interest in it. The initial public offer is the first appearance of shares on the financial market, the primary one, that is. In this way the firm offers its shares to a wide range of prospective investors and raises capital necessary in financing the development of business operations. If the domicile firms opted for the initial public offer more often, the range of investors would equally often include large institutionalized investors too, e.g., mutual funds, which would in this way place the capital raised by the sale of the fund's investment units.

Mutual funds, similarly to other institutionalized investors, can influence the development of small and medium companies (SME) by participating in the long-term sources of financing the company, either as majority or minority proprietors, and over a limited or an unlimited period of time. That would enhance the efficiency of a firm, the strenghtening of the existing market position, as well as capturing new market segments, improving the quality of products and services and financing new development initiatives. It is important that there is a mutual interest shared by the management of the fund and the management of the company, and this is, first and foremost, the profit. An additional motive can be a sector or regional economic development. The funds make decisions on participating in the SME capital primarily on the basis of financial statements, plans and projects, on the basis of prospecti, while the companies should try to attract mutual funds as reliable long-term financing sources by their transparent business and a continual improvement of performance. An additional motive for the mutual funds to invest into companies will also be the termination of the privatisation process, when a clearly defined ownership structure, profit guided business, business objectives and growth orientation of the company will become the factors on the basis of which the mutual funds will decide on investing into concrete companies. All these should be viewed in the context of the growing indebtedness of Serbian companies; namely, only in the first quarter of this year the liabilities (debt) of national companies increased by 10% and amounted to €8.5 billion, whereas the net indebtedness in the same period also increased in comparison with the previous years and amounted to €525 million. Due to an increasingly more difficult debt servicing both from the point of view of the state and that of the companies, decisions should be made more in favour of the alternative sources of capital instead of classic bank loans.

Recently, the SEAF fund (Small Enterprise Assistance Fund) came to Serbia. This is a fund providing aid to small enterprises. The SEAF provides the capital and operational support to the companies that have no access to traditional sources of capital, and operate on the developing markets. The SEAF also helps the chosen company to make contacts on a global level and improve its credibility, which makse the development and profitability of the company faster. Although by investing into a chosen company the SEAF becomes a co-owner of it, the advantage the company gains is that there are no high costs of borrowing (as in traditional bank loans) and threats to liquidity. After a number of years the fund sells its share and withdraws from the ownership structure, achieving higher revenue rates, in accordance with the risk taken. A greater number of such funds could be very useful for small or newly established firms with a solid growth potential, a genuine product or service, but lack in capital, managing experience and contacts to facilitate their appearance on the foreign market.

2.4 Conditions for a more important role of mutual funds on the Serbian financial market

In order that the capital market develop and the quantity and quality of the offer and demand of financial instruments be improved, it is necessary that the corporative management be raised to a higher level. Transparency in business doing does not mean only reporting the financial statements in mass media or on the Internet. It means a continuous communicating all the events relevant to the company performance and its results to all the present and prospective shareholders (co-owners) of the company. Medium and large companies (in this country) are also obliged to review their financial statements. A majority of activities that are understood as corporative management make at the same time the conditions for including a company into the A listing of the Belgrade Stock Exchange. The companies listed on the Stock Exchange only following legal regulations, most often fearing the competition, still fail to reveal their reports. With no reports on the performance of such companies, investment funds will hesitate to invest in them. Out of the total number of newly incorporated shares, only a small number of market active securities is expected. In some large, successful corporations that were privatized earlier (breweries, dairies, cement works, etc.) the majority ownership ranges up to 90% of the total capital, which diminishes the possibility that these so-called "blue chips" will soon become an issue of secondary trading. Such conditions also affect the operations and structure of the mutual funds portfolios, which, although interested in investing into quality securities, will not face an adequate offer. The fact is that a lack of quality market material still remains a crucial problem and a limiting factor of the domicile capital market growth. Apparently, inclusion of new companies into an off- market trading will improve quantity, rather than quality of the market offer, which may hinder the development pace of the domicile mutual funds.

In order that a company's shares be included into the A listing of the Belgrade Exchange, it is necessary that the company operate for a period of at least three years, that its minimum amount of capital be €10 million, the review of financial statements be performed in accordance with the Ministry of Work of Serbia and judged as positive without reserve, that the minimum of 25% of totally issued shares be engaged in "free" trade, and that the dividends are paid to the owners of preference shares. By May 2008 only three national companies were incorporated into the A listing of the Stock Exchange or in the BELEX BEST index. Viewed from the standpoint of the capital market, the society and the national economy, the more conditions for inclusion into the exchange listing the company meets, the safer, more reliable and the more attractive the market will be for national and foreign investors. The exchange index BELEX15 is made up of the shares of 15 most liquid national companies and banks whose shares were traded most.

However, due to unstable political conditions and to uncertainty as regards further development of Serbia, foreign investors hesitate to invest into national securities. The participation of foreign investors in the overall trade and in share transactions in the past year was around 40%, it was only in April that it rose to around 80%, to plumet to around 35% in May. For a substantial period the exchange indices kept falling, which directly influenced the fall in the value of funds' investment units. In such circumstances, following excellent initial results in the work of the funds and the capital owners' increasing interest in investing through new financial intermediators on the financial market of Serbia, it is very hard to motivate prospective investors to invest into funds. From the moment the parlamentary elections in Serbia were announced, the exchange indices were falling constantly, and the values of the investment units of all funds fell under their initial nominal value. Investors are advised to invest into funds over a longer period (a couple of years) to neutralize the losses and achieve revenues above the fixed-term deposit revenues with the banks, for example. Evidently, the inhabitants of Serbia enjoy a financial suficit, since DM8 billion were converted into a new currency, euro (€) in the course of 2002. Similarly, new foreign currency savings of our citizens amounts to over €3 billion, which means that there is a free, dispersed capital that ought to be employed through investment funds.

In order that the quantity and quality of offer on the capital market be improved, it would be useful if the cities, municipalities or the state issued low-risk hipotecary securities, worldwide known as municipal bonds ("*munis*"), by which they would make themselves less dependents on the classic financial sources (the budget or bank loans). This is especially recommended having in mind a constant budgetary deficit and still very expensive long-term bank loans.

3. CONCLUSION

Funds will best justify their presence on the financial market and accept the trust they are granted if they enable the owners of the investment units to achieve the revenue rate above the fixed-term deposit interest rates with the banks. An opportunity to earn more, with a relatively acceptable risk is a safe instrument to attract new investors and larger amounts of capital into funds. It should be pointed out that on financial markets in the region, where investment funds have been around for a number of years, the revenue rate amounts between 20% and 30% on an annual level, which is several times more compared to the average annual interest rate on fixed-term deposits with commercial banks.

A larger number of investment funds on the domicile financial market and a larger amount of raised capital will ensure that investment funds, according to their investment objectives, invest into various sectors, activities, enterprises that have already shown high productivity or that are still to develop. Thus the investment funds, as large institutionalized investors become co-owners of enterprises, however, they simultaneously grant an easier and less expensive access to long-term sources of capital, which are often scarce. Due to fiercer competition and their taking over a classic function of loans from the banks, mutual funds contribute to improving the quality and reducing the price of financial services and capital. All this mentioned, it is important that companies, with their profitability and transparent activities, growth potential and quotation on the Exchange, become attractive to investment funds, since this is certainly an easier way to raise the necessary capital. It is also necessary that the companies be adequately informed about the advantages of the initial public offer of shares (IPO), as an inexpensive and efficient way of raising the necessary capital and financing the company's development. In addition to all mentioned above, also important is the political stability in the country and in the region and a comittment to European integrations as one of the preconditions for a normal functioning of financial market and all its participants and the realization of their roles on this market.

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