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You've Got to Speculate to Accumulate: Financial Markets and Portfolio Investments

Key Stage 5 Business
Resource 5

2019

Resource Five Overview

Topic	Institutional Investors: Smart vs Dumb Money
A-Level Modules	Decision making, strategies

Objectives

After completing this resource you should be able to understand:

- ✓ What institutional investors are and the different types
- ✓ The reasons for their growth and development.

Instructions

1. Read the data source
2. Complete the activities
3. Explore the further reading

Context

Retail and institutional investors invest in bonds, options, futures contracts and stocks. However, because of the nature of the securities and/or the manner in which transactions occur, some markets are primarily for institutional investors rather than retail investors.

Retail investors pay brokerage firm fees along with marketing and distribution costs for each trade. In contrast, institutional investors send trades through to exchanges independently or through intermediaries; they negotiate a fee for each transaction and avoid paying marketing and distribution costs.

Resource Five
Data Source

Section A

Institutional Investors

Trend over decades has been to greater institutional investing, and volume of trade on stock market now dominated by it. An epic shift of power in our society towards Wall Street.

An institutional investor is an organization that invests on behalf of its members. Institutional investors face fewer protective regulations because it is assumed they are more knowledgeable and better able to protect themselves.

Why are institutional investors important?

- institutions' growing dominance of the financial system and markets
- main players in securities investment
- illustrate all principles necessary for understanding securities investment
- careers in financial services are either in or dealing with institutional investors

Section B

The nature of institutional asset management

We must distinguish between asset management (service involving management of an investment portfolio on behalf of others) versus institutional investment (asset holder which may be distinct from the asset manager). So for example the Universities pension fund (institutional investor) may either manage its own funds (internal asset manager), or employ Merrill Lynch (external asset manager) to manage part or all of its portfolio.

Their size and growing importance justifies a focus on institutional investors. We shall see that institutions become more important as countries' financial systems become more sophisticated.

Resource Five
Data Source

There are also key cross country contrasts in financial structure – overall trends are common across countries but stylised differences remain. Notably, we see that financial sectors are larger and also institutional investors in the UK, US and Canada (Anglo Saxon countries) rather than in France, Germany, Italy and Japan (Europe and Japan).

The main types of institutional investors

- endowment funds
- commercial banks
- mutual funds
- hedge funds
- pension funds
- insurance companies

Section C

Mutual and hedge funds

Here we consider mutual and hedge funds, which are also known as dumb and smart money respectively. As we know, both mutual and hedge funds are managed portfolios, however they differ a lot in the way they manage those portfolios:

1. Hedge funds are managed in a much more aggressive fashion. Unlike mutual funds, hedge funds take speculative positions in derivatives, and they short sell stocks. With it comes increased risk, but also the chance to gain when the market is falling. Therefore, hedge funds are called smart, because they can take advantage of market conditions quickly and have some predictive ability.
2. Hedge funds are only available to accredited investors, who must meet a specific set of criteria to qualify. They are sophisticated investors with high net worth. Mutual funds are easy to purchase with minimal cash.

Resource Five Activities

Activities

1. What is a mutual fund? (Choose from below)

- A company that pools investors' money to create an investment portfolio
- Large insurance company with shareholders
- A low risk hedge fund

2. How is a typical mutual fund managed in order to insure the best return on investment? (Choose from below)

- Mutual funds are managed based on co-operative decisions made at quarterly shareholder meetings.
- A professional investment manager manages a mutual fund on behalf of the investors.
- A Certified Financial Planner is responsible to manage all aspects of any mutual fund.

3. Why hedge funds are called smart money?

4. The difference between hedge fund and mutual fund is? (Choose from below)

    a) A hedge fund is more regulated

    b) There is no difference, both are heavily regulated

    c) A mutual fund is more regulated

    d) There is no difference, both are not heavily regulated

Resource Five
Further Reading

Explore

1. Khan Academy online resource on mutual funds and ETFs: https://www.khanacademy.org/economics-finance-domain/core-finance/investment-vehicles-tutorial#mutual-funds
2. "Common sense on mutual funds" by John Bogle
3. "When genius failed" by Roger Lowenstein
4. "The Ultimate Hedge Fund Guide: How to Form and Manage a Successful Hedge Fund" by Frank Nagy

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